



## Hobby Loss Audits

Tree farming constitutes a significant segment of the economy. Many tree growers are small businesses, and others are giant companies. For many, having your own woodland is a source of pleasure and joy. The sounds of nature, animal activity, and interesting vegetation are everywhere.

### The IRS's Take on Tree Farming

The IRS analyzes tree farming, along with other types of farming, under the hobby loss rule, and there are many Tax Court cases on the subject. Often the IRS will say that the taxpayer's main motive for cultivating a tree farm is the pleasure derived from the beauty and serenity of the farm setting, rather than to engage in a profit-making venture.

If the IRS decides that your venture is not operated in a businesslike manner, it could disallow your tax deductions.

### One Man's story

If the taxpayer has a history of losses, it is important to be able to withstand IRS scrutiny. For example, in *Clark v. Commissioner*, T.C. Memo 1969-241, Harold Clark of Annapolis, Maryland, was a bricklayer and mason by trade. While working in Northern California, he saw a specimen of Oregon myrtle — a tree that is native to the West — and often used as an ornamental tree. Its leaves, known as California bay laurel leaves, are sold commercially as a spice. Mr. Clark became fascinated by the qualities of the tree and its possibilities.

After an injury, he was unable to work full time. He decided to raise Oregon myrtles as a side business and sell the seedlings as well as the bay leaves. He gathered a large quantity of seeds in the woods in Northern California and took them back to Maryland. He sought advice from various experts about cultivating these seeds.

Mr. Clark planted about 6,000 seeds on his land. Three hundred of them came up, and he transplanted those into cans. He hoped to sell them to nurseries as ornamental trees. He left seeds at various arboretums with the hope that he could stimulate their interest in the trees.

However, his first crop soon withered due to a drought. The next year, another crop of new trees died because he put too much fertilizer on them.

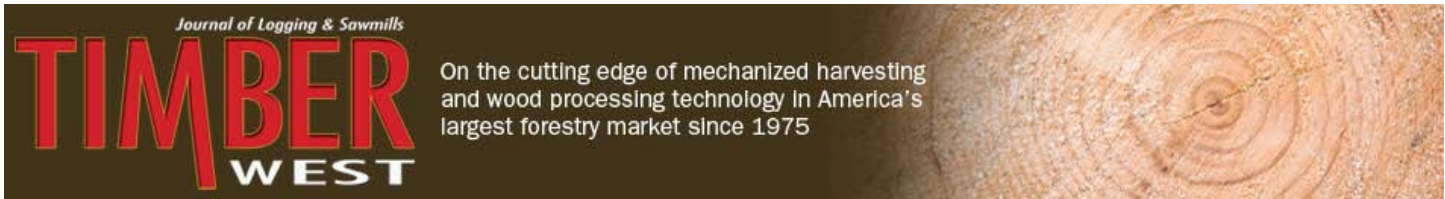
He planted a third crop with 15,000 new seeds he purchased from a vendor who gathered them in California, but that crop also failed. He soon discovered that his land was contaminated by oil and gas from a nearby filling station.

The IRS denied his tax deductions because it said there was no established market for the seedlings, and there was a significant risk associated with growing these trees in Maryland.

The Tax Court reversed, saying this was a commercially feasible activity, "albeit fraught with difficulties and limitations." The court said Mr. Clark was in the startup phase of the venture, and during that time, Mr. Clark discovered the difficulties and limitations and dealt with them. Also, the court noted that since Mr. Clark was able to work as a bricklayer only part time due to his injury, his main activity was the growing of Oregon myrtles.

The court said that Mr. Clark "assiduously investigated the botanical possibilities and problems involved in growing Oregon myrtle but, because his efforts at propagation were unsuccessful, made little effort to sell the production."

The court said that there is no requirement that an immediate profit be realized, "nor does the expectation of profit need to be



reasonable, although the prospect of an eventual profit has a bearing on the taxpayer's state of mind.”

The court said that Mr. Clark was believable as a witness, and that he had an honest expectation of eventually making a profit.

### **The Moral to the Story**

A key point of this case is that people are engaged in a business, rather than a hobby, so long as they have an honest intention of carrying on the activity as a business. People may choose a highly speculative venture, as in the above case. It is not necessary that your expectation of profit be reasonable. A business is judged not on the reasonableness of the activity, but on the sincere intentions of the taxpayer to make a profit.

Another point is that, prior to starting a tree venture, it is important to investigate the commercial aspects of the particular species, whether there is a market for the trees, and how to grow them.

In the above case, the taxpayer won partly because he was in the early startup phase and, according to the court, it could take a significant period of time until a profit would be realized. Also, the taxpayer had researched the industry prior to starting the venture, and the court was able to conclude that he had an honest expectation that his tree farm would become profitable in the long run.

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