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# AMERICAN HORSE COUNCIL'S TAX BULLETIN



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## **Congress Passes and President Signs Bill Extending Expired Tax Provisions Through 2014**

Just before closing down for the year, Congress passed and the President signed into law a bill which extends several tax provisions favorable to horse owners, breeders, and equine businesses which had expired or were reduced at the end of 2013. The bill, often referred to as the “extenders bill,” extends these provisions retroactively for eligible equine assets, including horses, placed in service **at any time** during 2014. The extensions are effective only through December 31, 2014. On January 1, 2015 they again expire or revert to prior levels. These provisions that were extended are discussed below.

***Depreciation of Race Horses*** - From 2009 through 2013 all race horses were depreciated over three years, regardless of their age when they were placed in service. This provision was passed in 2008 through the efforts of Mitch McConnell (R-KY), the new Majority Leader in the next Congress.

This change, which eliminated the 7-year depreciation period for race horses, expired at the end of 2013. This resulted in requiring race horses not over 24 months old when placed in service to be depreciated over 7 years.

The extenders bill extends the three-year depreciation period for all race horses placed in service during 2014, regardless of age.

***Section 179 Expense Deduction*** - For the last few years, the so-called Section 179 business expense deduction was set at \$500,000. This meant that anyone in the horse business could immediately expense up to \$500,000 of the cost of any investment in business assets placed in service during the year, including horses. The deduction was phased out dollar-for-dollar as investment in all of the owner’s business activities exceeded \$2 million.

The expense deduction had reverted to \$25,000, with a phase-out starting at \$250,000, for property placed in service after 2013.

The extenders bill extends the expense deduction at \$500,000, with a phase-out starting at \$2 million, for property, including horses, purchased and placed in service during 2014.

***Bonus Depreciation*** - An individual or company in the horse business could depreciate up to 50% of the cost of new property purchased and placed in service in 2013, including some horses and other equipment. This was known as “bonus depreciation.” It was restricted to new assets, which

meant that the first use of the horse or other property had to begin with the taxpayer.

Bonus depreciation had expired for purchases after 2013.

The extenders bill extends bonus depreciation at 50% for the cost of new assets purchased and placed in service during 2014.

***Conservation Easements*** - Favorable rules for contributions by farmers and ranchers of capital gain real property for conservation easements, allowing a deduction of up to 100% of the donor's contribution base, expired for donations after 2013, resulting in a smaller deduction in 2014 and thereafter.

The extenders bill extends through 2014 the enhanced deduction for contributions of conservation easements.



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## **IRS Implements Its Appeals Judicial Approach and Culture (“AJAC”) Project**

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IRS Examinations (audits) will grow longer and more expensive under the new Appeals Judicial Approach and Culture Project (“AJAC”) which became effective September 2, 2014. Under AJAC, IRS Administrative Appeals will be more difficult to access.

Background

### **Background**

The Appeals Division of the IRS has long been one of the most efficient and effective branches of the federal government. The IRS Appeals Division will review decisions made by the IRS Examination Division. The Exam division does make errors, as can be expected, given its size, number of audits conducted and the complex nature of our federal tax system. Although the Appeals Division is part of the IRS, they provide Appeals Officers who take a fresh and independent look at audit results from the IRS Examination Division, correct mistakes and resolve cases without trial – most of the time. Resolution of tax disputes through the IRS Appeals Division is accomplished more quickly and inexpensively than by legal actions in the U.S. Tax Court or U.S. District Courts.

Bypassing the Examination Division

### **Bypassing the Examination Division**

A problem arose over the years, with some practitioners wanting to bypass full participation in an IRS examination, and then going to the Appeals Division, where the practitioner would present the evidence and conclude the case. The reason that the IRS Examination Division is bypassed is that practitioners think the Appeals Officers are more experienced and more intelligent than the examination Division personnel, including IRS Tax Auditors and Revenue Agents. Plus, Appeals Officers have broader power to settle cases than Examiners.

Appeals Officers are usually more experienced, better trained and more capable than the examiners. They are also in a higher pay grade. Many Appeal Officers are either certified public accountants or attorneys. Overall, they do an excellent job of resolving tax disputes.

The practice by some practitioners of essentially bypassing the Examination Division to present the evidence in a case first to the Appeals Officers has resulted in the new AJAC policy, which is

designed, in substantial part, to stop people from bypassing the Examination Division. However, as discussed below, implementation of the AJAC policy will raise costs for taxpayers and slow down the resolution of tax disputes.

### **The AJAC Project**

The new policies in the AJAC Project are set forth in memoranda to the IRS Examination Division and the IRS Appeals Division include sections that will:

**(1) Frequently require a case to be sent back to the Examination Division from the Appeals Division if the taxpayer attempts to give new evidence to the Appeals Officer that was not previously shown to the Examination Division; and**

**(2) Deny access to the Appeals Division in the event that a taxpayer has not provided all of the data that an Examiner has demanded.**

There are other aspects to AJAC, but the foregoing two are going to have immediate impact. For full details see Memorandum for Appeals Employees dated July 2, 2014 from John V. Cardone, Control No. AP-08-0714-0004 and Memorandum for SBSE [Small Business-Self Employed] Examination Executives dated August 28, 2014 from Shelley M. Foster, Control No. SBSE-04-0814-0064.  
Problems with AJAC

### **Problems with AJAC**

The requirement that a case be sent back to the Examination Division from Appeals will inevitably cause delays. First, to transfer the files back to the Examination Division will take time. Then time for consideration of the new evidence must be worked into the schedule of the prior Examiner (Tax Auditor or Revenue Agent). Particularly now when the IRS is being asked to administrate the Affordable Care Act, without expansion of its budget, IRS resources are stretched thin. Integrating the returned case into their workload for a “second go-round” with the Examiner will likely take even more time.

As a practical matter, one can question whether new evidence presented to an examiner who has already taken a position on an issue in a written report is likely to be favorably received. Human nature makes examiners likely to defend the correctness of their prior decisions. Additional evidence presented to an examiner who has already made an adverse decision, and who is being compelled to take time to reconsider the case in light of that new evidence might not be considered in an unbiased fashion.

For most horse owners, audits are handled by a CPA, EA or other accountant. In many cases, the taxpayer’s accountant does not have expertise in the horse industry. An equine tax law specialist is commonly not consulted until there has been an adverse determination in the audit on an issue such as whether the losses incurred can be offset against other income based on Internal Revenue Code (“IRC”) Section 183 “hobby loss” rules. In the face of an adverse determination, an equine law expert would typically prepare a Protest Letter to be sent to the Appeals Division, which describes the adverse determination by the IRS Examination Division and frequently is accompanied by evidence that was not presented at the audit. The additional evidence is often the key to getting an erroneous determination

by the Examination Division overturned in the Appeals Division.

However the new IRS AJAC policy will force the Appeals Officer to send the new evidence, and the case, back to the Examination Division for the new evidence to be considered by the Examination Division. This procedure will cause substantial additional time to be consumed and increase the cost of resolving a tax dispute.

The new AJAC policy will block the abuse of the system by practitioners who try to ignore and bypass the Examination Division, but it will do so only at the cost of increased expenses to taxpayers and practitioners being forced to duplicate time and effort in the Examination Division, and expenditure of additional time and effort by the Examination Division employees as well.

Another aspect of AJAC is that the IRS Examiner will have authority to deny taxpayers an administrative appeal at all. Under AJAC, if a taxpayer does not comply with all of the examiner's demands for documents or other things, the examiner can deny that taxpayer a direct Administrative Appeal. This provision puts tremendous additional power in the hands of the IRS Examination Division. Most Tax Auditors and Revenue Agents are reasonable in the amounts of data and documents which they put in their Information Document Requests ("IDRs"). But if an examiner were unreasonable, and such situations do exist, the taxpayers could be blocked from an administrative appeal without filing a petition in Tax Court first.

The taxpayer would still have the right to seek redress of a mistaken audit conclusion by filing a petition with the United States Tax Court. The Tax Court will send cases to the Appeals Division for review if they have not already been through Appeals. Such Appeals are referred to as "docketed" Appeal. The term "docketed appeal" arose from the fact that a case that has already been filed in Tax Court has a Tax Court "docket number". But docketed appeals do not permit as much time to resolve a dispute as an undocketed appeal, and therefore are less desirable for resolving a dispute. It is preferable that a taxpayer have his or her choice in deciding whether to file an Appeal before or after filing an action in Tax Court.

Response to AJAC

A reasonable response to the new IRS AJAC policy might be to approach all IRS audits as if they will be going to Appeals, hire the equine tax expert at the audit stage, and present all evidence that might be desirable to present at an Appeal to the IRS Examination Division the first time around, and thereby avoid having to go back to the IRS Examination Division a second time if one does need to go to the Appeals Division to obtain a just result.

Conclusion

This new AJAC policy seems certain to add to the cost of resolving disputes with the IRS, and also to create massive amounts of new work for the IRS Examination Division. It may prove to be another situation in which the "cure" is worse than the problem that it was designed to fix. Compare IRC Section 469, the "Passive Activity Loss" rules, enacted in the 1986 Tax Act to combat "tax shelters", which did reduce certain "tax shelters", but spawned many thousands of tax controversies and caused untold millions in expense to taxpayers.

The bottom line for horse owners facing audits under the AJAC policy is that preparation for an audit should be more comprehensive and include introduction of all evidence that may be needed in an Appeal.

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