AMERICAN HORSE COUNCIL'S
TAX BULLETIN
1616 H Street, NW, 7th Floor, Washington, DC 20006 (202) 296-4031 / www.horsecouncil.org

© 2015 AHC 2015-6
Tax Bulletin No. 377

By Thomas A. Davis, Esq., Davis & Harman LLP, Washington, DC

Expired Tax Provisions under Consideration as Congress Approaches Year End

Over 50 tax provisions which expired at the end of 2014 are being discussed by the House and Senate tax writing committees in an effort to reach an agreement on extending some or all of the provisions before Congress adjourns for the year. The target is to finish all necessary business by December 11th, 2015, including funding the government through fiscal 2016.

Several of the expired provisions are very beneficial for horse owners and breeders. They are:

1) ***3-year depreciation for all race horses.*** Without this tax provision, some younger horses have to be depreciated over 7 years.
2) ***50% Bonus first year depreciation for all new property, including eligible race horses.*** There is no bonus depreciation now.
3) ***Section 179 expensing up to $500,000, with a dollar- for-dollar phase-out starting at purchases over $2 million.*** The limit is now $25,000, with a phase-out starting at $200,000.
4) ***Donation of Conservation Easements*** – The temporary rules related to the contribution of capital gain real property for conservation purposes, including special rules for contributions by farmers and ranchers allowing a deduction of up to 100% of the donor's contribution base, expired for contributions made after 2014.

The discussions between the tax writing committees have centered around whether to make some of the provisions permanent, e.g. bonus depreciation, to extend some extenders retroactively, but not all, or to extend all extenders retroactively for one or two years. Senator Grassley (R-Iowa), a former Chairman of the Senate Finance Committee, predicted this week that a two-year extension of the measures will likely prevail since "Nobody can narrow down exactly what they want to do."

© 2015 AHC 2015-5
Tax Bulletin No. 376

The Return of Reason in Treatment of "Past Losses" in Section 183 "Hobby Loss" Cases

By B. Paul Husband, Husband Law Group, Universal City, CA

In Metz v. Commissioner, a decision handed down in early 2015, the Tax Court announced an important return to reason from a pernicious and illogical doctrine that was often applied to the detriment of horsemen. The Metz opinion set forth a rational approach to "past losses".

In Section 183 "Hobby Loss" cases, the issue is one of subjective intent. If the taxpayer's primary (not necessarily exclusive) motive in engaging in the activity is to make a profit, then the horse owner is allowed to offset horse business losses against other income . The law is clear that in determining the subjective intent of the taxpayer, that objective factors are to be considered, and the non-exclusive nine factors set forth in Treasury Regulation 1.183-2(b) will be used in this evaluation.[2]

One problem repeatedly encountered by some horsemen as they seek to defend the tax treatment of their horse businesses is the assertion by the Internal Revenus Service (IRS) of a doctrine which can essentially be stated as follows:

> "Unless the horseman can recoup all past losses, he/she/it
> ***cannot*** have a profit motive."

This doctrine is not contained in the Internal Revenue Code, or the Treasury Regulations. Rather, it was a statement, unsupported by authority from a 1965 Tax Court case called Bessenyey v. Commissioner.[3] In Bessenyey, the Tax Court stated that a horse owner who had lost money over the years could not have a profit motive unless she could expect to recoup all prior losses.

Specifically, the Bessenyey Court stated:

> "….the presence of losses in the formative years of a business, particularly one involving the breeding of horses, is not inconsistent with an intention to achieve a later profitable level of operation, **bearing in mind, however, that the goal must be to realize a profit on the entire operation, which presupposes not only future net earnings but also sufficient net earnings to recoup the losses which have meanwhile been sustained in the intervening years**. [emphasis added]

It is the boldfaced language quoted above that has been cited by courts to the detriment of horsemen, time and again, over the past 50 years.

The boldfaced statement above did not cite as its source, the Internal Revenue Code, or the Treasury Regulations, or prior case law. In addition, it is not logical.

Suppose that 70 year old Henrietta Horsebreeder experienced losses in her horsebreeding business that totaled $10 million over a twenty year period, but she finally managed to achieve an annual profit of $250,000 per year, starting in year 21 of her operation. Her goal in year 21 and going forward is to make a $250,000 profit each year. It cannot be fairly said that a $250,000 annual profit is not a profit. Even if Henrietta is not likely to recoup $10 million in prior losses at the rate of $250,000 per year – it would take 40 years to recoup all past losses – likely beyond the lifespan of a 70 year old – yet, in reality, she can still have a profit motive on a year to year basis.

Yet in numerous cases, the IRS cites Bessenyey for the proposition that if the horse owner's losses are too large for expected total recoupment, the horse business owner **must** be considered **not** to be in business for profit and therefore cannot offset horse business losses against other income.

The *"Bessenyey Doctrine"* was much like the Emperor's New Clothes, and for decades, no one stood up and declared that it made no sense logically nor was it based on authority, until Tax Court Judge David Gustafson in Helmick v. Commissioner[4] in 2009 made the following common sense observations:

> An overall profit is present if net earnings and appreciation are sufficient to recoup the losses sustained in the "intervening years" between a given tax year and the time at which future profits were expected. See *Bessenyey v. Commissioner* [citation omitted]. Respondent correctly notes that the Helmicks' horse activity sustained losses from no later than 1985 through at least 2002, **but respondent seems to assume that the requisite profit motive as of any given year must involve an expectation that even all past losses will be recouped, so that the activity will have generated a net profit over its entire course. This position distorts the notion of profit motive for purposes of section 183.**
>
> If a natural disaster caused the death of 90 percent of a rancher's herd and resulted in a catastrophic loss that could never be recouped, but the rancher thereafter expected to generate an overall prospective profit by breeding and selling the remaining 10 percent of his herd on a foregoing basis, then he could not be said to lack a profit objective after the disaster merely because he would never recoup the prior loss. Likewise, even assuming arguendo that the Helmicks could never recoup their losses from years prior to 1997, if they expected to generate an overall profit from 1997 onward, then they cannot be said to lack a profit objective with respect to those later years merely because they would never recoup their losses from years prior to 1997. Rather, the Helmicks meet their burden as to any year for which they show that they expected eventually to recoup losses sustained in the "intervening years" (to use the phrase from Bessenyey) between the current year and the hoped-for profitable future. Thus, we must determine, as of each of the relevant years, whether the Helmicks expected their horse activity to generate an overall profit between that year and the time at which future profits were expected.

The reasoning of Judge Gustafson is sound. It reflects common sense.

But, Helmick was not immediately followed in other Tax Court decisions. For example, in the 2011 case of Weller v. Commissioner[5] the Tax Court stated:

> "….bearing in mind, however, that the objective must be to realize a profit on the entire operation—future net earnings and also enough earnings to recoup losses that have been incurred in intervening years. *Bessenyey v. Commissioner*"

In 2012, in the case of Foster v. Commissioner [6] the Tax Court stated:

> An activity's cumulative losses should not be of such a magnitude that an overall profit on the entire operation, including recoupment of past losses, could not possibly be achieved. *Bessenyey v. Commissioner,* 45 T.C. at 274

In 2013, the *exact words* quoted above in Foster were quoted by the Tax Court in the case of Dodds v. Commissioner.[7]

Riding to the rescue of reason was Tax Court Judge Mark V. Holmes in the 2015 case of Metz v. Commissioner.[8] When the IRS made a *Bessenyey Doctrine* argument in Metz, Judge Holmes responded with an insightful call for a return to reason, as follows:

> The Commissioner, however, makes one argument we must confront—what is the "profit" in the "profit motive" whose existence we're searching for? The Commissioner argues that "petitioners' activity can only be considered to be a for-profit activity if petitioners have a bona fide expectation that the amount of the future profit will more than offset the $20 million of losses incurred from inception to date." **We disagree—this argument "distorts the notion of profit motive for purposes of section 183." Helmick v. Commissioner, 2009 WL** 3012725, at *10 (the goal must be to realize a profit on the entire operation, which presupposes not only future net earnings but also sufficient net earnings to recoup the losses which have meanwhile been sustained in the intervening years (citing and discussing *Bessenyey v. Commissioner* [Dec. 27,660], 45 T.C. 261, 274 (1965), *aff'd*, 379 F.2d 253 (2d Cir. 1967))). **We continue to agree with our interpretation of Bessenyey in Helmick and hold that the Metzes "meet their burden as to any year for which they show that they expected eventually to recoup losses sustained in the 'intervening years' * * * between the current year and the hope-for profitable future." Id. This is to say that if a taxpayer can expect to generate an overall profit from the current year onward, then it can't be said that he lacks a profit objective simply because he will never generate an overall profit over the lifetime of the activity. [emphasis added]**

The foregoing analysis is logical. It does make sense.

In any challenge of an older horse business by the IRS, if the outmoded, illogical *Bessenyey Doctrine* is asserted as it has been in years past, the horse business owner should counter it with a citation to the better reasoned Helmick and Metz decisions.

Reason has been returned to the treatment of past losses in Section 183 "Hobby Loss" cases. Horse business owners should tip our collective hat to Tax Court Judges Gustafson and Holmes for their insight, integrity and willingness to reinterpret the *Bessenyey Doctrine* in a logical and sensible manner.

---

[1] The horseman also has to deal with the passive activity loss rules in Internal Revenue Code Section 469 and substantiating the deductions, but the hobby loss rules of Section 183 are the first choice of the taxing authorities as a basis for denying a horse owner's deductions.

[2] **(b) Relevant factors**.— In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) Manner in which the taxpayer carries on the activity.— **
(2) The expertise of the taxpayer or his advisors.— **
(3) The time and effort expended by the taxpayer in carrying on the activity.— **
(4) Expectation that assets used in activity may appreciate in value.— **
(5) The success of the taxpayer in carrying on other similar or dissimilar activities.— **
(6) The taxpayer's history of income or losses with respect to the activity.— **
(7) The amount of occasional profits, if any, which are earned.— **
(8) The financial status of the taxpayer.— **
(9) Elements of personal pleasure or recreation **.**

[3] 45 T.C.261 (1965); affirmed 379 F.2d 252, although the Second Circuit did not cite the dictum which has caused mischief, discussed in this note.
[4] T.C. Memo 2009-220
[5] T.C Memo 2011-224
[6] T.C. Memo 2012-207
[7] T.C. Memo 2013-76
[8] T.C. Memo 2015-34

Copyright 2015. All rights to this AHC Tax Bulletin No. 377 are retained by the American Horse Council. No reproduction or distribution of this Tax Bulletin is permitted without prior written consent of the American Horse Council.

The AHC Tax Bulletin is a digest of current tax developments affecting the horse industry. The AHC Tax Bulletin is for informational purposes only and not intended to take the place of professional tax counsel.

Editor-in-Chief
Thomas A. Davis, Esq
Davis and Harman, Washington, DC

AHC Tax Bulletin Advisory Board

Robert B. Dale, III, CPA
Yount, Hyde & Barbour, PC
Middleburg, VA
www.yhbcpa.com

Doug Dean
Dean Dorton Allen Ford, PLLC
Lexington, KY
www.ddafcpa.com

Paul Husband, Esq
Husband Law Group
Universal City, CA
www.husbandlaw.com

John Kropp, Esq
Graydon, Head & Ritchey
Cincinnati, OH
www.graydonhead.com

Bruce Oberfest, Esq, CPA
Bruce D. Oberfest & Associates
Chappaqua, NY

Douglas Romaine, Esq
Stoll Keenon Ogden, PLLC
Lexington, KY
www.skofirm.com

Joel B. Turner, Esq
Frost Brown Todd
Louisville, KY