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Tax Court Finds Riding Arena Repairs Not Deductible

The taxpayers, husband and wife, purchased in 2006 a 10 acre parcel of land in Santa Ynez, California, on which they built their residence and various other structures. These structures include three barns and a horse riding arena used in a horse boarding and sales business operated by Santa Ynez Valley View Farm, LLC, a California limited liability company the taxpayers formed and at all times wholly-owned.

Construction of the riding arena was completed in early 2007 at a cost of $150,000. As it turned out, defects in the construction of the riding arena required taxpayers to expend more than $100,000 in 2007 and 2008 in order to remedy the defects. They sued the original contractor for defective construction and in 2009 settled the lawsuit for a payment of $50,000. The taxpayers reported on their 2009 tax return an itemized deduction of $69,100 as a casualty loss deduction resulting from the repairs to the riding arena.

The IRS disallowed the casualty loss deduction taken by the taxpayers on their 2009 return on the grounds that it was not a "casualty" as that term is used in the tax code. The taxpayers did not agree and took the disagreement to the U.S. Tax Court. The husband represented himself and his wife at trial.

The Court noted that to be deductible a casualty must be from "unusual and unexpected events *** caused by sudden or destructive force." Accordingly, the court found that expenses paid or incurred to correct damage caused by faulty construction methods are not deductible as a casualty loss.

The taxpayers also argued that if it was not a casualty loss, it was a property loss incurred in a trade or business. The court responded by noting that a property loss must be evidenced by closed and completed transactions, fixed by identifiable events and actually sustained during the taxable year. The court pointed out that a loss deduction is not permitted where there is mere shrinkage in value and the owner continues to use the depreciable property in their business. To be deductible, the court noted that the property must be sold, exchanged, retired, or abandoned. Accordingly, the court found that the taxpayers were not entitled to a business loss deduction for the cost of the faulty construction. ***[Richard Wideman, et ux. v. Commissioner of IRS, T.C. Summary Opinion 2015-61]***

Editorial Comment: While the taxpayers were not allowed a current deduction for the cost to repair the faulty construction as a casualty loss or business property loss, the amount can be added to the tax basis of the property and recovered through depreciation deductions of the riding arena. The depreciation schedule listed the initial cost of the riding stable at $150,000.

Court Finds Taxpayer's Dressage Activity Not Engaged in as a Business – Again

The taxpayer is an international dressage rider and trainer. Dressage is a competitive equestrian sport design to showcase a horse's physique and training where horse and rider are expected to perform a series of predetermined movements or tests. During the 2008-2009 period she owned no horses. From at least 1999 through 2009 she did not compete in any horse shows.

From 2004 through 2009 the taxpayer did not report any net income from the equine activity, and the only receipts reported from the activity were $588 in 2004. The taxpayer reported net losses from the equine activity over the 2004-2009 period of $154,656. The IRS had disallowed the taxpayer's equine activity expense deductions for tax years 2007 and 2008 because she failed to show that the activity was engaged in for profit. The Tax Court sustained the IRS disallowance of the resulting deficiencies on the ground that, for those years, taxpayer's equine activity was not engaged in for profit. [**McMillan v. Commissioner, T.C. Memo. 2013-40,** appeal filed (9th Cir. Sept. 9, 2013)]

The IRS audited the taxpayer's 2009 tax return and determined a tax deficiency which included denying a deduction for a loss of $7,486 that the taxpayer claimed resulted from an activity she described as "horse breeding and showing." The IRS also denied a deduction of $26,312 for legal expenses that the taxpayer claimed were in connection with her IT business activity that she described as information technology and database management. The taxpayer disagreed with the IRS determination and took the matter to the U.S. Tax Court. Judge Halpern wrote the opinion for the Tax Court.

At trial, the IRS argued that the deductions relating to the taxpayer's equine activities should be disallowed for two reasons. First, the IRS argued that the equine activity was not a going concern and the taxpayer was therefore not carrying on a trade or business because (1) she did not own or lease horses in 2009, (2) did not in that year train any horses, (3) did not, from at least 1999 through 2012, compete in any horse shows, and (4) during that same period did not breed any horses. The court rejected the IRS position. The court pointed out that the taxpayer testified that in 2009 she did train horses, although the documenting records had been lost by the moving company. The court found that the IRS had failed to prove that, in 2009, the taxpayer's equine activity had not actually commenced or the taxpayer was not regularly and actively involved in the activity.

The Judge next turned to the question of whether or not the taxpayer engaged in the equine activity as a business for profit. He applied the nine factors set forth in the regulations to be considered when ascertaining a taxpayer's profit intent. Based on the taxpayer's history of substantial losses from 2004 through 2009, the court found that during 2009 she did not carry on the equine activity to make a profit.

The court did allow, however, one deduction of $5,690 for interest expense on the 2009 tax return which relates to indebtedness the taxpayer incurred in 2007 to transport a horse, Goldrush, to Australia. The court found that the IRS failed to prove that the equine activity was not a trade or business in 2007 or that, even if it was, it was not an activity engaged in for profit. Therefore the court concluded that the IRS failed to prove the debt-financed expenditure to transport the horse in 2007 was not a trade or business expenditure and an activity engaged in for profit.

The court also dismissed the accuracy-related penalty assessed by the IRS because the IRS had the burden of showing the absence of reasonable cause or lack of good faith and failed to do so. ***[McMillan v. Comm., T.C. Memo, 2015-109.]***