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Tax Bulletin No. 379

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Circuit Court Affirms Lower Court Finding Horse Activity Not a Business for Profit

The taxpayers, wife and late husband, bred Tennessee walking horses on their farm in Tennessee. They incorporated the horse-breeding operation as LSA, Inc. and claimed substantial losses as deductions from LSA on their personal tax returns. (The husband died in a fire at their residence in January of 2003.) The IRS determined that the horse-breeding operation was not an activity engaged in for profit and therefore assessed taxes and penalties against taxpayers. After paying up the assessment, taxpayers went to the District Court for Central Illinois and sued the government for refund of taxes they paid. In 2014, the district court found that LSA was not run as a for-profit business. Therefore, LSA losses were not deductible as business expenses. ***[Estate of Stuller v. United States, 2014 WL 3734328 (C.D. Ill. 7/22/2014)]***. The lower court case was summarized in AHC Tax Bulletin #370.

The taxpayers appealed the decision of the district court to the U.S. Court of Appeals for the Seventh Circuit. On appeal, the taxpayers argued that the district court erred in determining that the taxpayers' expert witness, a long-time trainer of Tennessee Walking Horses, lacked the requisite expertise and methodology to testify as an expert witness. The Seventh Circuit noted given the witness' failure to consider the financial records of LSA and his unfamiliarity with the relevant factors outlined in the IRS regulations, the District Court was well within its discretion to exclude the witness' testimony as unreliable. The witness had no specialized experience or reliable method to draw upon when opining on the intent of the taxpayers to turn a profit.

Taxpayers also challenged the district court's finding that LSA is not engaged in an activity for profit. The Seventh Circuit noted that the district court applied each factor set forth in the regulations to the facts - so made no legal error ¬- and drew inferences and conclusions that were grounded in the evidence. Its conclusion that only one factor, the expectation of asset appreciation, weighed in the taxpayers' favor, while most every other consideration pointed to the horse-breeding as a hobby or personal pleasure for the taxpayers was not implausible, illogical, or internally inconsistent. The circuit court went on to note that the taxpayers never came close to turning a meaningful profit through LSA and the best objective indicator that horse-breeding was a hobby, not a business, was their high tolerance for loss. LSA reported losses every year from 1994 to 2002 except for a $1,500 profit in 1997. Considering, in particular, LSA's poor record-keeping, lack of business practices directed at making a profit, substantial annual losses, and significant tax benefits to taxpayers, there is no clear error in the district court's finding that the totality of facts and circumstances show that LSA was not run as an activity with the intent to profit.

The surviving wife also appealed the district court's finding that she lacked "reasonable cause" for the failure to timely file the 2003 income tax return. The circuit court found that the district court did not clearly err in finding that she lacked reasonable cause for her untimely filing. **[*Estate of Stuller v. United States;* 7th Cir. Court of Appeals, Jan. 26, 2016]**

Tax Court Finds Horse Training Activity Not Engaged in for Profit

During the taxable years in issue, 2010 and 2011, the taxpayer, Linda Kaiser, operated a financial consulting and insurance business from her home called "Kaiser Consulting/Insurance Sales." The taxpayer also conducted a horse training activity known as "The Forty Carrot Wisdom Co." Previously, she had operated a small business, worked in real estate and insurance, and was a sales manager at a multinational financial services company.

In addition to being a competent dressage rider, the taxpayer has owned between one and four horses since 1998. In 2009, the taxpayer purchased a couple of carriage horses to train in the hopes that she could "make good money" by selling the trained carriage horses. She also bred goats prior to 2010. In both 2005 and in 2010, the taxpayer was injured in serious car accidents, preventing her from riding or training her horses. As such, the taxpayer worked from her bed in 2010 and 2011. In 2010, she created a website to educate children about animals. She believed the website would become operational in 2016 and generate at least $100,000 annually.

From 2008 through 2014 the gross receipts and expenses relating to the horse training activity, the horse and goat breeding activity, and the web site activity were as follows:

Year	2008	2009	2010	2011	2012	2013	2014
Gross receipts	---	---	---	$5,000	$7,922	$7,922	$5,000
Expenses	$18,456	$17,531	$36,276	$34,230	$28,296	$24,745	$22,493

In a notice of deficiency dated September 26, 2013, the IRS determined tax deficiencies of $17,319 and $16,675 in the taxpayers' 2010 and 2011 Federal income tax, respectively, and assessed accuracy-related penalties of $3,463 and $3,335 for 2010 and 2011, respectively. After concessions, the issues for decision were: (1) whether the taxpayer's horse training activity was engaged in for profit; and (2) whether the taxpayers are liable for the accuracy-related penalties for the years in issue.

The Court concluded that there is little evidence in this record that the taxpayer operated the horse training activity in a businesslike manner and there is nothing in the record which reflects the taxpayer's business plan or how she intended to make a profit. The Court found that while the taxpayer may have hoped to generate income from her horse training activity, there is no information as to how her receipts compare with her expenses. The Court noted that the taxpayer had years of losses generated by the horse training activity and she had no gross income for 2010 and very little gross income for 2011. Furthermore, she spent little if any time in the horse training activity during the years in issue.

In those same years the Court noted that the taxpayer operated her financial planning and insurance business which generated substantial gross receipts. The Court found the taxpayer used the losses from the horse training activity to offset income from the financial planning and insurance business. Finally, the Court noted that taxpayer had owned horses before engaging in the horse training activity and she acknowledged that she considered her horses to be like her children. The Court believed there to be no doubt she experienced personal pleasure in owning her horses.

The Court pointed to the taxpayer's consistent history of little to no gross income in the horse training activity. The Court concluded that while the taxpayer clearly has some level of business acumen in the operation of her financial planning and insurance business, she did not carry over these practices to the horse training activity.

Conclusion: Based on a careful review of the record, the Tax Court concluded that there was not sufficient evidence to lead the Court to believe that the taxpayer engaged in the horse training activity with the actual and honest objective of making a profit.

Accuracy-Related Penalties: The Court found that the taxpayers offered no evidence to show that there was reasonable cause for their failure to report the income tax refunds. The Court found that the taxpayer did not demonstrate that she acted with reasonable cause and in good faith with respect to reporting the horse training activity as an activity that was engaged in for profit. Therefore, the Court sustains the Government's determination of accuracy-related penalties under section 6662(a) for tax years 2010 and 2011.

[Kaiser v. Commissioner, T.C. Summary Opinion 2016-13]

Tax Bulletin No. 379

Attorney's Fees and Other Costs in Tax Cases: Opportunities Exist for Taxpayers to be Reimbursed Their Costs

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To date myself, I remember when a rate of $100 per hour for an attorney was a big deal. Today it is not unusual to find hourly professional fees in major metropolitan areas have broached $1,000 per hour and beyond. This article is not intended to examine the vagaries of hourly rates or their steady march up the scale but to make the observation that in the federal tax system where taxpayers generally bear the burden to prove that the determination of the IRS is not correct, it is often an expensive proposition for a taxpayer to contest an assessment. Moreover, in weighing settlement options with IRS Appeals which is charged to take into account the hazards of litigation, it is generally the taxpayer, not the government that is most concerned about the "hazard" of litigation costs. This article is intended to apprise the reader that in certain cases the taxpayer may be able to force the IRS to pay the taxpayer's attorney's fees and other litigation costs or at least give serious consideration to such risk in considering settlement of the case.

History. IRC §7430, added in 1982, amended in 1986, revised and restated in 1988, and amended several times subsequently, allows taxpayers to recover reasonable administrative or litigation costs from the government if the government's position in an administrative or court proceeding is not substantially justified and if various other requirements are met[1]. Much of IRC §7430 is borrowed from the Equal Access to Justice Act (EAJA), which allows awards of attorney fees and other litigation expenses to parties other than the government in various civil proceedings to which the government is a party. The EAJA originally applied to tax cases in courts other than the Tax Court, but it was superseded in this context by IRC §7430 for cases begun after February 28, 1983[2].

General Requirements. IRC §7430 describes the general requirements for a taxpayer's recovery of administrative costs and litigation costs incurred in connection with a federal tax controversy. The general requirements are:

1. The costs must be incurred in an administrative or court proceeding brought by or against the United States;

1 The IRS recently issued final regulations (TD 9756, 2/29/16) that reflect changes made to Section 7430 (relating to awards of administrative costs and attorneys' fees) by the Taxpayer Relief Act of 1997 (TRA) and the IRS Restructuring and Reform Act of 1998 (RRA). The IRS has also issued Rev. Proc. 2016-17, 2016-11 IRB 436) that sets out additional rules that representatives who provide their services on a pro bono basis must meet in order to be awarded costs under Section 7430.

2 Beyond IRC §7430, the government may be subject to sanctions under Rule 11 for filing meritless claims because sovereign immunity does not shield against Rule 11 sanctions, and Rule 11 is not wholly supplanted in this context by IRC §7430.

2. The taxpayer met the net worth limitations of IRC §7430(c)(4)(a), currently a $2 million cap for individuals ($4 million combined net worth cap for taxpayers who file joint returns)[1];
3. The taxpayer exhausted his administrative remedies[2] ;
4. The taxpayer did not unreasonably protract the proceedings[3] ;
5. The taxpayer must be the prevailing party; and
6. The costs must be allocable to the United States and not to any other party.

If the taxpayer meets these criteria he can recover his reasonable costs and fees, including litigation costs and administrative fees. Attorney's fees are limited by IRC §7430(c)(1)(B)(iii) and adjusted for inflation. Currently taxpayers may recover a maximum of $200.00 per hour for attorney's fees in 2016.

Prevailing Party. A taxpayer is required under IRC §7430(a) to establish that he is the prevailing party to recover costs and fees. In order to establish this the taxpayer must prove:

- That he substantially prevailed in the proceeding with respect to the amount in controversy or the most significant issues; and
- The government does not establish that its position was "substantially justified".

Substantially Justified. The position of the IRS will be deemed substantially justified if the position had a reasonable basis both in law and in fact, making "substantial justification" a reasonableness standard. Obviously, the Service losing an administrative appeal or court case is not sufficient to show its position was not reasonable, and the Service being mistaken in facts or the law does not necessarily amount to being unreasonable. Instead, a case by case determination must be made on each request for administrative costs, with a variety of situations that can indicate the Service position was not substantially justified. One factor in determining if the Service is substantially justified is whether or not the Service has been losing on similar issues in other courts; however, this does not completely preclude the Service from maintaining its position when it has lost the issue on prior occasions. Similarly, if the Service fails to investigate a matter, lacks evidence, ignores its own expert, persists in litigation simply to extract unjust concessions, fails to concede or respond in a reasonable time frame, or is unreasonable in its legal analysis, its position may not be substantially justified. Further, if the Service fails to if the Service fails to follow its own published guidance, there is a rebuttable presumption that the Service's position is not substantially justified.

1 The $2 million net worth limitation also applies to estates (for which the net worth is determined as of the date of the decedent's death) and to trusts (for which the net worth is determined as of the last day of the last tax year involved in the proceeding). For unincorporated businesses, TEFRA partnerships, corporations, associations, units of local government, and organizations, the net worth must not exceed $7 million at the time the civil action is filed, and the taxpayer must not have had more than 500 employees at that time.

2 This means that the taxpayer either requested and had a conference with the IRS Appeals Division or, if the taxpayer did not receive their 30 day letter prior to the Final Determination letter, they agree to participate in an appeals hearing. Treas. Reg. §301.7430-1.

3 A taxpayer's refusal to extend the statute of limitation on assessment does not constitute failure to exhaust available administrative remedies. IRC §7430(b)(1); Reg. §301.7430-1(b)(4).

Qualified Offers Can Negate IRS Position Being Substantially Justified. If a taxpayer makes a "Qualified Offer" that the IRS rejects and later wins a determination to pay less than the amount the taxpayer had offered, the government will not be able to establish that its position was substantially justified such that the taxpayer (who otherwise meets the net worth requirements noted) would be considered the prevailing party. Thus a Qualified Offer presents a tool for a taxpayer to use as leverage in the negotiation of a tax controversy.

For a settlement offer to constitute a "Qualified Offer", it must meet the following criteria:

1. The offer is written;
2. The offer is made by the taxpayer to the IRS during the "qualified offer period";
3. The offer specifies the amount of the taxpayer's liability;
4. The offer is designated as a qualified offer under IRC §7430(g); and
5. The offer remains open from the date it is made until the earlier of:

    (i) the date the offer is rejected;
    (ii) the date the trial begins, or
    (iii) the 90th day after the offer is made.

The Qualified Offer is required to be made during the "qualified offer period" which is the period of time that starts on the date of the proposed deficiency which allows the taxpayer an opportunity for administrative review with the IRS Office of Appeals and ends on the date which is 30 days before the trial is set to begin.

A Qualified Offer must be delivered to the United States office with which they are working with: either the Office of Appeals, Office of Chief Counsel (if litigating in the United States Tax Court) or the Department of Justice (if in refund litigation in Federal District Court) that has jurisdiction over the tax matter.

Implicit in the definition of a Qualified Offer is that there can be only one Qualified Offer with respect to any particular tax controversy. The last Qualified Offer will be the controlling "Qualified Offer" for the purpose of determining whether the judgment in a particular case is as favorable to the taxpayer as the taxpayer's Qualified Offer. A taxpayer representative can make a settlement offer on behalf of a taxpayer for a greater or lesser amount than the Qualified Offer, and specify that the settlement offer is not a Qualified Offer. The Qualified Offer will remain effective as the standard for determining whether the taxpayer is entitled to recover litigation costs even though other settlement offers are made after the Qualified Offer as long as all other offers of settlement are explicitly not to be construed as Qualified Offers.

The recovery of litigation costs based on a qualified offer will be limited to those costs that are incurred on or after the date of the qualified offer. Thus, in order to maximize the impact of a qualified offer, the qualified offer should be made at the earliest possible time – at the beginning of the qualified offer period, since for the taxpayer to recover expenses incurred prior to the time of making the Qualified Offer, he would have to overcome the IRS's substantial justification defense .

There is another reason for making an early, and reasonable, settlement offer for instance at Appeals. IRC §7430(g)(1)(D) allows a taxpayer to make a Qualified Offer that must be accepted within a 90-day period. An early Qualified Offer will expire on the 90th day after the offer is made. If a reasonable settlement offer is made to Appeals as Qualified Offer, it may convince the Appeals Officer to settle the case for an amount that the taxpayer considers a reasonable settlement.

If such a Qualified Offer does not produce a settlement, the Qualified Offer will expire without being accepted. However, assuming the case proceeds to Tax Court, this Qualified Offer, which is no longer open for acceptance, becomes the measure for the taxpayer's recovery of litigation costs.

Effect of Settlement on Qualified Offer. If the case settles, the Qualified Offer rules do not apply. Although the regular IRC §7430 rules still may be applied to receive an award of attorney's fees following a settlement, the taxpayer will have to prove that it substantially prevailed and that the IRS was substantially not justified in its position.

Settlement, in the traditional sense, seems to imply that the parties negotiated a mutually agreeable compromise, that the Tax Court entered a decision that reflected that compromise, and the dispute ended. If a case settles in the Tax Court after a Qualified Offer has been made, perhaps the Qualified Offer was accepted, or perhaps a different result was reached, and perhaps the Service was influenced to settle by the prospect of having to pay the attorney's fees of the taxpayer. In any event, a settlement ends the possibility that attorney's fees might be awarded under the Qualified Offer rules.

What happens if the IRS concedes the case after receipt of a Qualified Offer? The statute is silent and the regulations do not address a concession by the IRS. The IRS in such instances contends that a concession is akin to a settlement. Recently the Tax Court in Angle v. Commissioner, T.C. Memo 2016-27 considered this issue and stated that whether a concession constitutes a settlement under IRC §7430(c)(4)(E)(ii)(I) depends on whether, under the facts of the case, the concession can be construed as a contract to settle between the parties. In Angle the facts did not support a finding that the parties reached a settlement.

If taxpayer in a tax controversy hopes to receive attorney's fees after making a Qualified Offer is offered a concession by the IRS the taxpayer should specifically decline to accept the concession and should also decline to sign a stipulation of settled issues. Instead, the taxpayer should aggressively pursue a ruling on the merits, either by filing a summary judgment motion or by asking the court to proceed to the trial stage and/or to the post-trial briefing stage. In short, the taxpayer should ask the court to rule on both the merits of the case and on the application of the qualified offer rules. Preferably those efforts should precede the concession, in order to demonstrate to the court that the Service had conceded the case only in the face of an impending defeat.

Conclusion. The ability of taxpayers to actually recover administrative and litigation expenses in tax disputes is a bit of a mirage given that the net worth limitations oftentimes exclude a taxpayer from the benefits of IRC §7430 and the fact that most tax disputes are resolved through a negotiated settlement which are specifically excluded from the Qualified Offer rules. Nevertheless for the those taxpayers who otherwise satisfy the net worth limitations, the ability to make a Qualified Offer can be used to put some pressure on the government to consider litigation costs as a potential hazard of litigation in hopes of reach a settlement of the tax dispute.

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