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U.S. Court of Appeals Reverses Tax Court Decision Holding Horse Activity not Engaged in for Profit

In 2014, the U.S. Tax Court held that the taxpayer, Merrill Roberts, had erroneously deducted the expenses related to his horse-racing enterprise on his federal income tax return for 2005 and 2006 because the enterprise was a hobby rather than a business. The court assessed tax deficiencies of $89,710 for 2005 and $116,475 for 2006. However, the court also ruled that his business had ceased to be a hobby, and had become a bona fides business in 2007 and that status had not been challenged by the IRS for any year since then. [***Roberts v. Comm'r, T.C. 2014-74*** (Summarized in the Tax Handbook Book 2016 Update, p.49)] The taxpayer appealed the Tax Court's decision with respect to 2005 and 2006 to the U.S. Court of Appeals for the Seventh Circuit. Judge Posner wrote the opinion for the court.

Judge Posner noted that the Tax Court's ruling that Roberts' horse racing enterprise was a hobby in 2005 and 2006 but became a business in 2007 and remained so in 2008 and apparently has been one ever since, is "untenable." The judge said that this amounts to saying every business's start-up costs are not deductible business expenses - which every business starts as a hobby and becomes a business only when it achieves a certain level of profitability. Yet, the judge noted, Roberts' 2007 business did not begin that year, but rather evolved from his decision in 2005 to build a larger training facility and his attempt to do so on existing property (which the City of Indianapolis prevented). Judge Posner pointed to a large land purchase in 2006 which enabled improvements to his horse-training facility that year. Judge Posner then noted that the "Tax Court's finding that his land purchase and improvements were irrelevant to the issue of profit motive until he began using the facilities is unsupported and an offense to common sense. He intended the land and improvements for his horse-racing business, and intent to make a profit is what makes an activity a business." Furthermore, Judge Posner noted that the Tax Court seems not to have understood that the decision to build the facility, and its construction, are also indications of a profit motive.

Judge Posner wrote that "We mustn't be too hard on the Tax Court. It felt itself imprisoned by a goofy regulation" referring to the Treasury regulation that sets forth nine relevant factors that are taken into account in determining whether an activity is engaged in for profit. The judge also pointed to the introductory paragraph of the regulation which provides that "No one factor is determinative" and that "it is not intended that only the factors described in this paragraph are to be taken into account in making the determination" of whether the activity is a business or a hobby. In other words, the judge concluded that the Tax Court was not actually required to apply all of those factors to Roberts' horse racing enterprise. In fact, the Tax Court could have devised its own test, with its own factors, as long as it explained why the factors that "should normally be taken into account were insufficient."

Judge Posner went on to find that the factors listed in the Treasury regulation overwhelmingly favor Roberts' claim that even in 2005 and 2006 his horse racing enterprise was a business. The judge applied each of the 9 factors set forth in the Treasury regulation and concluded all 9 factors actually either supported or were at least consistent with Roberts' claim that his horse racing enterprise even as early as 2005 was a business, not a hobby. "It may have been a fun business, but fun doesn't convert a business to a hobby. If it did, Facebook would be a hobby, Microsoft and Apple would be hobbies, Amazon would be a hobby, etc. ad infinitum."

Judge Posner noted that even the Tax Court deemed only two factors to favor the IRS, factors 8 and 9, and that neither supported the court's determination that Roberts was a hobbyist until 2007. The circuit court judge found that "Numerous remarks in [the Tax Court's] opinion, moreover, support the existence of a profit motive, as when the court said that between 1999 and 2001 - the period in which Roberts increased his stock of horses from 2 to 10 - he was 'enticed by the profit potential of racing more horses.' Profit goes with businesses, not hobbies." Furthermore, Judge Posner pointed out that the Tax Court remarked that "around the time petitioner bought the Morris Street property [where he started his horse race enterprise], he was contemplating a career change." The judge noted that "A person deciding whether to take up a hobby is not 'contemplating a career change.' A hobby is not a career."

Then Judge Posner pointed to a further remark made by the Tax Court "that petitioner [Roberts] credibly testified that he spent significant effort and time to match the right horse to the right race. He spent this time matching each horse to a race with the *expectation of making a profit.*"

The judge found that all that emerges from the Tax Court's opinion and the record so far as bears on profit motive or the absence thereof are that Roberts enjoys his new career. "But 'a business will not be turned into a hobby merely because the owner finds it pleasurable; suffering has never been made a prerequisite to deductibility. Success in business is largely obtained by pleasurable interest therein,'" quoting *Jackson v. Commissioner*, 59 T.C. 312, 317 (1972).

The Court of Appeals concluded as follows: "Considering that most commercial enterprises are not hobbies, the Tax Court would be better off if rather than wading through nine factors it said simply that a business that is in an industry known to attract hobbyists (and horse racing is that business par excellence), and that loses large sums of money year after year that the owner of the business deducts from a very large income that he derives from other (and genuine) businesses or from trust or other conventional sources of income, is presumptively a hobby, though before deciding for sure the court must listen to the owner's protestations of business motive."

The Court of Appeals held for the taxpayer and dismissed all deficiencies.
[***Roberts v. Comm'r.***; No. 15-3396, 4/1/2016.]

Editorial Comment: It has been 32 years (1984), since a Federal Court of Appeals has reversed a Tax Court's decision holding that a horse related activity was a not a business engaged in for profit, in other words a hobby. The decision itself is also unusual in the way the judge took issue with the Treasury regulations. It also should be noted that Richard Craigo, a longtime member of the AHC tax bulletin team, was counsel for Roberts on appeal.

House Tax Reform Task Force Releases Blueprint for Tax Reform

On June 24, the Tax Task Force, one of six task forces announced by Speaker Ryan in early 2016, released a "Better Way for Tax Reform." The Ways and Means Committee, led by Chairman Kevin Brady of Texas, will develop legislation over the coming months that will encapsulate the policies and provisions reflected in the blueprint. This legislation will be ready for legislative action in 2017. A concept paper of the blueprint is summarized below:

A Better Way for Tax Reform

Our Principle
In a Confident America, the tax code and the IRS work for us, not against us.

Our Challenge
Our tax code is a mess, and that's putting it lightly. Multiple brackets. High rates. Special interest breaks everywhere. Rules and regulations that are too complicated to understand. It costs more and more each year just to do your taxes, let alone pay them. All of this drags people down and leaves businesses buried in paperwork and compliance problems. So instead of promoting growth, our tax code is pushing jobs overseas. And the agency charged with overseeing all of this—the IRS—has repeatedly violated the trust of the American taxpayer.

Our Vision
We need a new tax code. It needs to be fair and simple for everyone. It should be so simple that most Americans can do their taxes on a form as simple as a postcard. Our tax code should be built for growth. It should help make the United States the best place in the world to hire and invest. And if we're going to have a better tax code, we need a better IRS, one that puts the taxpayers first.

This blueprint offers a better way to dramatic reform—without increasing the deficit. It does so by promoting growth—of American jobs, wages, and ultimately the entire economy.

Our Ideas

- Simplicity and fairness. Our plan makes the tax code simpler, fairer, and flatter, so that it's not only easier to do your taxes, but it's also easier to have peace of mind at critical moments in life.
- Jobs and growth. Our plan makes it easier to create jobs, raise wages, and expand opportunity for all Americans.
- A service first IRS. Our plan matches a simpler, fairer tax code with a simpler, fairer IRS that puts taxpayers first.

SIMPLICITY AND FAIRNESS

Our plan makes the tax code simpler, fairer, and flatter, so that it's not only easier to do your taxes, but it's also easier to have peace of mind at critical moments, whether it's going to school, getting a job, raising a family, or planning for retirement.

- Save time and money by making it so that most Americans can do their taxes on a form as simple as a postcard.
- Consolidate the system down to three tax brackets, and lower the top individual income tax rate to 33 percent.
- Simplify tax filing for families by creating a larger standard deduction and a larger child and dependent tax credit.
- Make it easier to pay for college by streamlining the maze of education tax benefits.
- Eliminate the alternative minimum tax so you don't have to do your taxes twice a year.
- Reward work by improving the EITC.
- Encourage charitable giving by providing a real tax incentive.
- Help families plan for retirement by reforming savings provisions.
- Stop overtaxing "Made in America" products so that our manufacturers can compete.
- Repeal the death tax so that the loss of a family member will no longer be taxable.

JOBS AND GROWTH

Our plan will make it easier to create jobs, raise wages, and expand opportunity for all Americans.

- Cut taxes on small businesses by creating a separate, low tax rate of 25 percent for many on Main Street.
- Cut taxes on savings and investment by allowing families and individuals to deduct 50 percent of the dividends, capital gains, and interest received from stocks and mutual funds.
- Provide a tax-free return on new investment by allowing, for the first time ever, full and immediate write-offs.
- Restore American competitiveness by lowering our corporate tax rate from the highest in the industrialized world to 20 percent and shifting to a "territorial" system with more competitive rates.
- Create more certainty by eliminating the death tax, which can take up to 40 percent of a family business's assets if the owner passes away.

A SERVICE FIRST IRS

A simpler, farier tax code will require a simpler, fairer IRS with one mission: Put the taxpayers first.

- Restructure the IRS around three major units: one for individuals and families, one for businesses of all sizes, and one that provides an independent "small claims court" approach to resolving routine disputes quickly.
- Install a new commissioner, subject to term limits, who will be required to administer the new tax code with fairness and keep the politics out of the IRS.
- Cut down on IRS intimidation by creating an Office of Dispute Resolution to serve as an independent arbiter to protect your rights and resolve disputes in a timely manner.
- Clear out the bureaucracy by doing away with all the rules, regulations, forms, and instructions that won't be needed with a simpler, fairer tax code.
- Modernize information systems so that taxpayers have access to the resources they need when they need them—all while protecting privacy.

Tax-Free Lodging for Employees

By Matthew B. Lake, Esq. and John J. Kropp, Esq., Graydon Head & Ritchey LLP, Cincinnati, OH

Introduction:

Most horse businesses rely on dedicated employees who often work long and demanding hours. In addition, these same businesses battle increasing costs and expenses that challenge the profitability of the best run horse businesses. Therefore, many horse business owners are constantly searching for the best ways to compensate employees for their dedication while attempting to turn a profit.

These seem to be competing goals, but given the right circumstances, the Internal Revenue Code offers a win-win scenario to qualifying employees. Specifically in narrow circumstances, an employer may provide rent free housing tax free to an employee. A similar fringe benefit for qualifying tax free meals is beyond the scope of this article.

The key provision of the Internal Revenue Code that allows potential free lodging tax exempt for employees is Section 119. It states that "[t]here shall be excluded from gross income of an employee the value of any meals or lodging furnished to him, his spouse, or any of his dependents by or on behalf of his employer for the convenience of the employer…" Like any tax benefit, the applicability of this Code section can be illusory and is construed narrowly by the IRS. Therefore, any employer or employee hoping to use this Code section should always consult their attorney or accountant before attempting to qualify for tax free lodging.

In order for an employer to provide free lodging tax exempt to an employee under Code Section 119, the lodging must satisfy several specific factors. The most basic requirement is that the employer may only provide the rent-free lodging to an employee. The party receiving the tax free lodging must also be employed at the time the benefit is received. An independent contractor or prospective employee is ineligible to receive tax-free lodging under Code Section 119. Numerous articles exist to help the horse business owner evaluate whether a worker is an employee or independent contractor.

Once the employer/employee relationship has been clearly established, several additional requirements must also be met. First, the free lodging must be provided in kind (no cash advances or reimbursements). Second, the lodging must be located on the business premises of the employer. Third, the lodging must be offered for the benefit of the employer. Fourth and finally, the employee must accept the lodging as a condition to his employment. Failure to meet any of the above requirements results in taxable wage income to the employee equal to the fair market value rent of the premises.

As stated above, to qualify under Code Section 119, the employer must offer the benefit in kind. Therefore, the employer cannot and should not offer a cash advance to the employee or reimburse the employee's lodging expenses. The employer should not offer the employee an option to take either the free lodging or the cash equivalent and the employer should not contract with a third party to provide the lodging. The employer must simply provide the lodging to the employee free of charge. For instance, if a horse breeder requires an employee to reside in a trailer near the stables, the employer should own the trailer. The lease should then clearly state that no funds are advanced to the employee and that the cash consideration paid by the employee is zero.

The lodging offered by the employer in kind, whether it be an old farmhouse, trailer or an apartment over the barn, must be situated on the business premises of the employer. Generally, the lodging should be located where the employee conducts a significant portion of his or her activities on behalf of the employer. Examples of potentially qualifying arrangements include a trailer located near the horse stables, an apartment over the stables or an apartment above a veterinary clinic. If the lodging is not located on the employer's premises, the employee must conduct a significant portion of his or her duties at the lodging site. From a practical standpoint, if the employee resides off the employer's premises, it is often difficult for the employee to prove that he or she offers the majority of his or her services at the lodging site.

As stated previously, in most cases, the employee must reside on the business premises of the employer to qualify for the benefits of Section 119. However, this "on the premises of the employer" test was successfully challenged by one taxpayer in the Court of Appeals for the Eighth Circuit (Nebraska, South Dakota, North Dakota, Minnesota, Iowa, Missouri and Arkansas). In Erdelt v. U.S., 63 AFTR 2d 89-1247, a rural school board provided a house rent- free to the school superintendent. The school board argued that due to the lack of adequate housing in the community, the small size of the community and the high level of community interaction required by the superintendent, rent free housing was necessary to find and keep a qualified school superintendent. The school district emphasized that it did not own adequate housing on the school grounds, but instead provided lodging approximately one block from the school. In this case, the Court found that a reasonable connection existed between the free housing and the school district's business interests. The Internal Revenue Service has publicly disagreed with the result of this case and could challenge any variations in the fact pattern above.

Some secondary sources also suggest that an employee may live in employer provided lodging adjacent to or contiguous to the employer's place of business. In addition to Erdelt, these sources cite the case of Lindeman v. Comr., 60 T.C. 609 (1973) wherein a hotel manager lived across the street from the hotel he managed on a parcel leased by his employer and used for overflow parking for the hotel. The tax court noted the business use as overflow parking as part of its reasoning for supporting the exclusion under Section 119. This ruling is more generous than the position taken by the Internal Revenue Service.

In contrast, the Internal Revenue Service has consistently taken the position that lodging located "near" the employer's business premises, is not "on" the employer's premises. In fact, the Service has successfully argued that lodging provided to an employee free of charge two blocks from an employee's work is taxable income to the employee. See Comr. v. Anderson, 371 F.2d 59 (6th Cir. 1996). Therefore, in most cases, a trailer or farmhouse located on a neighboring farm will not qualify. Even if the lodging is within the premises of the employer, the Internal Revenue Service has successfully argued that housing located outside a university gates and separated by a six-lane highway did not qualify as on the business premises of the employer. See Bob Jones University v. U.S., 670 F.2d 167 (Ct.Cl. 1982). In a Private Letter Ruling, the Internal Revenue Service suggested that even some lodging within the employer's premises may be too remote to qualify for the exclusion.

Specifically, in Private Letter Ruling 9404005, the Service discussed the concept of a core business area within the employer's premises. In the Private Letter Ruling, the employer's business premises were a private educational institution and campus. The campus was apparently spread out over several miles and included a core or central campus where classes were held and the students lived and a more remote portion of campus where faculty and support staff lived. Throughout the Private Letter Ruling, the Service emphasized the fact that the majority of business activities and learning activities occurred in the central campus. The Service seemed to suggest that those employees living within the central campus were more likely to qualify for the benefits of Code Section 119. A conservative reading of the Private Letter Ruling would suggest that employers and employees hoping to apply Section 119 should make certain that employees reside not only on the employer's business premises, but close to or within the central or key work areas. This conservative reading might pose problems for horse business owners with multiple horse farms or large horse farms divided between horse activity areas and other farming activities.

As stated above, the employer must offer the lodging to the employee in kind and on the business premises of the employer. In most instances, the employer and employee can make a common sense or bright line evaluation of these requirements. The last two requirements are not as clear-cut. The last two requirements state that (1) the lodging must be furnished for the "benefit of the employer" and, (2) the employee must accept the lodging as a "condition of his or her employment." These tests often become intertwined, and in many cases and Rulings have been analyzed together. The cases and Rulings often characterize the combined tests as the "convenience of the employer" doctrine. A more conservative approach suggests that employers and employees analyze each of these tests independently.

Lodging is furnished for the "benefit of the employer" when a reasonable connection exists between the furnishing of the lodging and the business interests of the employer. A reasonable connection requires that the lodging is necessary so that the employee can adequately complete his or her duties. This is often the case when it is necessary for the employee to work beyond normal business hours or after hours in order to satisfy his or her employment obligations. An example of this type of activity might include a caretaker who feeds and watches horses after hours on a nightly or routine basis. Unfortunately, this guideline regarding after hours or beyond normal hours is vague at best. Further, most cases and Rulings are based on the particular facts and circumstances.

Due to the factual nature of the examination, the Internal Revenue Service and the employee have not seen eye-to-eye as to when the lodging is required for the benefit of the employer. For instance, the employers and employees often attempt to argue that the lodging is critical to the employee's job if the employee is on-call or must be available to handle potential emergencies. The Internal Revenue Service, in contrast, has fervently argued that an employee simply being on call after hours or who responds to infrequent emergencies does not satisfy the test. Instead, the Internal Revenue Service argues that the employee must work on site after hours or for additional hours on a frequent or recurring basis.

The case of *Winchell v. U.S.*, 52 AFTR 2d 83-5222 (1976) illustrates the arguments made above and the likelihood that the courts will support the position of the Internal Revenue Service. The facts of the case are fairly straightforward. A university president lived off-campus in a house provided by the university. The President entertained alumni, students, donors and dignitaries at the house. The President also asserted that the location of the house, a short distance from campus was critical to the taxpayer's responsibilities after hours or on an emergency basis.
The Internal Revenue Service did not dispute the facts regarding the President's duties or obligations. Instead, the Internal Revenue Service argued that the President while on call for emergency situations rarely was required to respond to late night or infrequent emergencies. The Internal Revenue Service stated that in order to qualify under Code Section 119, the employee must actually be on duty after hours and must actually respond to duty on a recurring or frequent basis. Further the Internal Revenue Service highlighted the fact that the majority of the President's duties were performed from his office on-campus. This position is further illustrated in Private Letter Ruling 9404005 discussed below.

In Private Letter Ruling 9404005, several groups of employees (teachers, janitors and dorm counselors) were on call late into the night or after hours. Some employees, like the teachers and janitors, were often on call after school hours, but only reported for actual duty in the case of infrequent emergencies. In contrast, the dorm counselors worked on-site in the residence halls on a daily basis. They were considered off-duty while the students were attending classes and were on-duty in the evening and at night. According to the Ruling, only the dorm counselors qualified for tax-free rent under Code Section 119. The Internal Revenue Service emphasized that only the dorm counselors worked after normal business hours on a frequent and recurring basis. In contrast, the teachers and janitors, while required to live on campus by the school, rarely responded to events after the school's normal business hours. Further, the Internal Revenue Service emphasized that due to the infrequent nature of their activities, the teachers and janitors could have just as easily satisfied their after hour obligations even if they lived off campus.

The "for the benefit of the employer" test focuses on the necessity of the lodging. Its counterpart, the "condition of employment" test, states that the employee must accept the lodging as a condition of his employment. Simply put, the employer must require that the employee reside on the employer's premises as part of the employee's job requirements. There is no discretion under this part of the test. In most instances, this condition of employment should be stated in writing.

This seemingly straightforward requirement is often a trap for the unwary. This is particularly true where an employer has several employees completing the same critical after hour or beyond normal work hour assignments. For instance, in Private Letter Ruling 8938014, a group of medical students argued that on-site, rent-free lodging provided by their employer, a hospital, qualified under Code Section 119. Unfortunately, several of the resident students negotiated agreements where they could live off-premises, but near the hospital. The fact that the hospital allowed a few of the residents to live off-site doomed the remaining residents' argument that they were required to live on-site.

Withholding and Deductions:

While many employers are not opposed to the idea of arranging a tax-free benefit for an employee, some employees may be reluctant to undertake a planning technique that will limit their own income and deductions. However, in the case of the lodging offered in kind to employees, most horse business owners are usually giving up only a small rental income. If the space is currently leased to an employee it is not likely that the horse owner is charging a true market rent. If the space is not currently leased it is unlikely that an unrelated third party tenant will want to pay a competitive market rate to live in a trailer on a horse farm, in an old farm house or in an apartment attached to a barn.

Even though a horse business owner will lose a small stream of rental income, the horse business owner may be pleasantly surprised to hear that he or she may be able to deduct the lodging offered as a business expense. In the case of Harrison, John, TC Memo 1981-22, employees of a farm received meals and lodging free of charge. The employer offered the meals and lodging so that the employees could be available for work on the business premises twenty-four hours a day. The Internal Revenue Service argued that the employer could not take an ordinary business deduction if the employee did not include the value of the meals and lodging in income. The tax court disagreed and held that the fact that the employees excluded the meals and lodging from income under Code Section 119 does not impact the deductibility of the expenses by the employer.

The employer and employees will also be glad to know that in many circumstances lodging that qualifies as tax free for income tax purposes under Code Section 119, is also not subject to withholding for employment tax purposes. In contrast, if the lodging does not qualify for the protections of Section 119, the employer must consider the value of the free or reduced lodging as wages and withhold accordingly. Although not discussed in this article, a similar rule applies for qualifying meals under Section 119.

Conclusion:

While not applicable to all situations, Code Section 119 is an often overlooked Code Section which may offer alternative rewards and benefits to horse business owners and their dedicated employees. In order to apply Section 119, all facts and circumstances must be carefully examined to determine if this valuable benefit applies. Employers and employees should discuss the particular facts and circumstances with an attorney or accountant to see if they qualify for this valuable benefit.

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