American Horse Council's Tax Bulletin

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Congress Adjourns for the Year

After a late night session in the Senate, for all intents and purposes, Congress adjourned the 2nd Session of the 114th Congress on December 10th. While technically still in session, no further business is expected to be conducted this year. Members of Congress will reconvene in early January to begin the 115th Congress. All pending legislation that did not pass in the 114th Congress will die. This means that three-year depreciation for all race horses will expire at the end of 2016.

In past years when three-year depreciation expired, it was extended retroactively in the following year, along with a number of other expired tax provisions, in a bill commonly referred to as an "extenders bill." However, 2017 is going to be a different year when it comes to tax legislation. As made evident in the past few months, the Republicans have made tax reform a major goal in 2017. As a result, the House and Senate leadership and chairs of the two tax-writing committees have been very reluctant to amend the present tax code while they are working on tax reform. For example, House leadership points out that a provision in its proposed tax reform blueprint would allow 100% expensing of all business property, including horses, placed in service during the year. This would replace depreciation altogether.

It is understandable why they do not want to add provisions to the tax code while they are writing a new code which will make major changes to the existing law. That said, it will likely take quite some time to write and pass a new tax code, no doubt longer than they anticipate. Furthermore, it will necessarily have a transition period for implementation of the new law and it certainly would not take effect in the middle of the tax year. Hopefully, there will be an opportunity while Congress works on tax reform to have three-year depreciation for race horses extended for the year 2017.

Deductions from ClassicStar's Mare Lease Program Come Back to Bite Taxpayer

Background

The IRS assessed Anthony and Jodie Boldin's 2001 and 2002 taxes when the Boldins jointly filed their tax returns for those years in October 2002 and November 2003. The Boldins did not pay the full amount assessed for either year, so the IRS filed a notice of federal tax lien against their property. On their 2003 tax return, the Boldins claimed farming losses from a horse breeding program, ClassicStar's Mare Lease Program, in which they had participated. The Boldins filed an application for a tentative carryback adjustment seeking to adjust their taxes for 2001, 2002, and earlier tax years based on these losses. The IRS allowed the tentative carryback adjustment, which abated the Boldins' outstanding taxes for 2001 and 2002, and filed a release of its tax lien.

Sometime later, the IRS determined that ClassicStar's Mare Lease Program was an abusive tax shelter. The IRS disallowed the Boldins' 2003 farming losses and the resulting tentative carryback adjustments. On March 7, 2005, the IRS assessed tax deficiencies for 2001 and 2002 in the amounts the Boldins owed for those years without their loss carrybacks. In April 2007, the IRS sent the Boldins a notice of deficiency that explained, among other things, that it had disallowed their claimed 2003 farming losses and the resulting tentative carryback adjustments.

Discussion

The Judge noted that the only dispute is whether the IRS brought this action before the applicable statute of limitations had run. The Tax Code (Section 6502(a)) gives the IRS ten years from the date it assesses a tax to bring an action in court to collect it. The IRS brought this action on March 2, 2015 to collect on deficiencies (i.e., taxes) that it assessed on March 7, 2005, so this action is not barred.

Boldin argues that the IRS is actually trying to collect his original 2001 and 2002 taxes, which the IRS assessed more than ten years before bringing this action… Boldin interprets this language to mean that when the IRS made these assessments, it merely corrected the equivalent of a clerical error and reinstated his original taxes for 2001 and 2002. He argues that correcting a clerical error is not sufficient to restart a statute of limitations.

The Judge found that the IRS had established the validity, timeliness, and amounts of its March 7, 2005 assessments. It assessed these deficiencies within the time allowed by § 6501 and notified Boldin of its assessments, as required by § 6213(b)(3), in April 2007 in a notice of deficiency. Per IRS records, Boldin owes $340,236.65 for 2001 and $316,997.13 for 2002 plus applicable statutory interest and penalties. Boldin does not contest these amounts, so the IRS has shown that it is entitled to judgment in these amounts.

UNITED STATES OF AMERICA v. ANTHONY J BOLDIN, et al., Case No. 15-CV-232

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The Path to Capital Gain Tax Treatment for Horse Sales

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The path to capital gain from selling a horse can be full of obstacles. This article addresses the requirements to overcome the obstacles and become eligible for generally favorable capital gain tax rates.

To begin the analysis, consider that a horse may be held as an asset of a business or of an activity not engaged in for profit (a "hobby"). After discussing the tax treatment of a sale of a horse held by a business (a "business horse"), the tax treatment resulting from a sale of a horse held in a hobby activity is covered.

Business Horse Sales

First Obstacle: Holding Period Requirement

The initial obstacle is the required holding period, which for horses is 24 months or longer (Internal Revenue Code ("IRC") § 1231(b)(3)(A)). If the holding period is not met, the sale results in ordinary gain or loss.

Second Obstacle: Seller's Primary Purpose for Holding the Horse

The second obstacle involves determining the seller's primary purpose for holding the horse. The horse must have been held by its owner for breeding or sporting purposes (see IRC § 1231(b)(3)(A)), not primarily for sale to customers.

Guidance in making this determination is found in Treasury Regulation ("Reg.") § 1.1231-2(b)(1), which states:

> Whether or not livestock is held by the taxpayer for draft, breeding, dairy, or sporting purposes depends upon all of the facts and circumstances in each case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. However, a draft, breeding, dairy, or sporting purpose may be present if an animal is disposed of within a reasonable time after its intended use for such purpose is prevented or made undesirable by reason of accident, disease, drought, unfitness of the animal for such purpose, or a similar factual circumstance. Under certain circumstances, an animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may be considered as held for draft, breeding, dairy, or sporting purposes. However, an animal is not held by the taxpayer for draft, breeding, dairy, or sporting purposes merely because it is suitable for such purposes or merely because it is held by the taxpayer for sale to other persons for use by them for such purposes. Furthermore, an animal held by the taxpayer for other purposes is not considered as held for draft, breeding, dairy, or sporting purposes merely because of a negligible use of the animal for such purposes or merely because of the use of the animal for such purposes as an ordinary or necessary incident to the other purposes for which the animal is held.

Reg. § 1.1231-2(b)(2) provides six examples relating to Reg. § 1.1231-2(b)(1). Reg. § 1.1231-2(c) deals specifically with horses. It makes clear that horses held for racing are to be treated as held for sporting purposes, and it provides three rules for determining whether a horse is held for racing purposes:

- A horse which has actually been raced at a public race track shall, except in rare and unusual circumstances, be considered as held for racing purposes.
- A horse which has not been raced at a public track shall be considered as held for racing purposes if it has been trained to race and other facts and circumstances in the particular case also indicate that the horse was held for this purpose. For example, assume that the taxpayer maintains a written training record on all horses he keeps in training status, which shows that a particular horse does not meet objective standards (including, but not limited to, such considerations as failure to achieve predetermined standards of performance during training, or the existence of a physical or other defect) established by the taxpayer for determining the fitness and quality of horses to be retained in his racing stable. Under such circumstances, if the taxpayer disposes of the horse within a reasonable time after he determined that it did not meet his objective standards for retention, the horse shall be considered as held for racing purposes.
- A horse which has neither been raced at a public track nor trained for racing shall not, except in rare and unusual circumstances, be considered as held for racing purposes.

Reg. § 1.1231-2(c)(2) provides two examples of the Reg. § 1231-2(c)(1) rules.

The issue presented, thus, is whether the horse was held primarily for (1) breeding or sporting purposes, or for (2) sale to customers. This answer depends on the facts and circumstances of the specific situation, and it often is not a clear answer. A thorough coverage of the issue is beyond the scope of this article, but the author refers you to Chapter 8 of Thomas A. Davis' <u>Horse Owners & Breeders Tax Handbook</u>, 2016 Edition, for good coverage of the issue.

If the horse was held by the seller primarily for sale to a customer, the result is an ordinary gain or loss. If the 24-month holding period is met and the seller held the horse for breeding or sporting purposes, further analysis is required to determine the character of the gain, if any. If the sale results in a loss, the loss is a "1231 loss" (discussed later in this article). If the sale results in a gain, depreciation recapture under IRC § 1245 must be considered. If the horse has no basis (e.g. many homebred horses), the result is "1231 gain" (also discussed later).

Third Obstacle: Section 1245 Recapture

The third obstacle to capital gain treatment is IRC § 1245 depreciation recapture. When "§ 1231 property" for which the owner has had allowable depreciation deductions is sold at a gain, such gain is treated as ordinary income to the extent of depreciation allowable on the horse during the seller's holding period.

Consider these examples, each of which involves a seller having met the 24-month holding period and having held the horse for breeding or sporting purposes:

Sales price	$25,000	$25,000	$15,000
Cost	20,000	0	30,000
Depreciation	10,000	0	5,000
Adjusted basis	$10,000	0	$ 25,000
Gain <loss>	$15,000	$25,000	<$10,000>
Type of gain <loss>:			
Ordinary (§ 1245)	$10,000		
(§ 1231)	$ 5,000	$25,000	<$10,000>

Section 1231

So far, our path to capital gain treatment has involved:

- meeting the 24-month holding period,
- holding the horse primarily for a breeding or sporting purpose, and
- having a gain exceeding accumulated depreciation.

These situations result in "1231 gains."

Fourth Obstacle: Nonrecaptured Net § 1231 Losses from Prior Years

The next step is to aggregate all § 1231 gains and losses for the tax year. If the aggregate is a net loss, that loss is treated as an ordinary loss (a favorable result). If the aggregate is a net gain, we move further down the path to capital gain treatment. Before we arrive at the capital gain target, though, we need to consider whether from prior years we had any net § 1231 losses – treated as ordinary losses – which have not already been recaptured as ordinary income. Such prior year losses are referred to as "nonrecaptured net § 1231 losses from prior years." If net § 1231 losses from prior years which have not yet been recaptured are present, the net § 1231 gain is converted to ordinary income to the extent of such nonrecaptured losses from prior years. Nonrecaptured net § 1231 losses are carried over for five years after the loss year. After that, they no longer result in conversion of what would have been net § 1231 gain to ordinary income. To the extent net § 1231 gain remains, then such gain is treated as a long-term capital gain. The desired result has been achieved. Consider the following example:

Year	Net § 1231 Gains <Losses>	Nonrecaptured § 1231 Losses
1	<25,000>	25,000
2	10,000	15,000
3	<10,000>	25,000
4	30,000	0

$10,000 of Year 2 and $25,000 of Year 4 net § 1231 gains are converted to ordinary income. The remaining $5,000 of Year 4 net § 1231 gain will be treated as long-term capital gain.

Caveats to the Analysis

Readers should note that our analysis does not take into account that gains or losses on involuntary conversions are part, along with sales, of the § 1231 netting computation. Also, certain sales to related parties can result in what may otherwise have been § 1231 gains being ordinary income.

Sales of Horses Held in an Activity Not Engaged for Profit

When the horse is held in an activity not engaged in for profit, the analysis in some regards is much simpler. A gain is a capital gain, short- or long-term depending on the seller's holding period (the normal more than one-year threshold for capital assets). If the sale is at a loss, such loss would seem to be nondeductible, just as in the case of other personal-use assets. Consider, though, the rules under § 183 which allow deductions to the extent of gross income associated with the hobby. The regulations (Reg. § 1.183-1(e)) make clear that gross income from the activity includes all gains from the sale of property used in the activity. Nothing in that paragraph refers to net gains. Reg § 1.183(b) addresses deductions allowable from a hobby; it includes (at Reg. § 1.183(b)(ii)):

> Amounts otherwise allocable as deductions during the taxable year under Chapter 1 of the Code, but only if such allowance does not result in an adjustment to the basis of property, determined as if the activity giving rise to such amounts was engaged in for profit...

Because under Chapter 1 of the Code capital losses would be allowable to an individual from an activity engaged in for profit, it follows that capital losses from a hobby should be allowed against capital gains from the activity.

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The following two articles are provided by the American Society of Association Executives. The American Horse Council felt its members should be aware of the important issues in these articles. Any opinions reflected in the articles are those of ASAE, and do not represent the American Horse Council in any way.

Overtime Rule

On November 22, 2016, a federal court in Texas blocked the Department of Labor's overtime rule from going into effect on December 1. The emergency motion was granted at the request of 21 states, ASAE, the U.S. Chamber of Commerce, and other like-minded organizations. The lawsuit argued that DOL had overstepped its authority by issuing an onerous regulation.

From the beginning, ASAE had said that it is not against an increase in the salary threshold for overtime eligibility, but that doubling the threshold and creating a one-size-fits-all rule would not work for employers and could harm employees.

Judge Amos L. Mazzant III, of the U.S. District Court for the Eastern District of Texas, granted a nationwide preliminary injunction against implementation of the rule, holding that the regulation exceeded the authority granted to DOL by Congress. The court's decision is temporary, and the agency will likely appeal.

"While the injunction is temporary and the legal process will continue, it is highly encouraging that the court agreed with ASAE and others' contention that the Labor Department exceeded its authority by drastically altering the minimum salary requirements for exemption and by establishing an automatic salary threshold increase every three years," said ASAE President and CEO John H. Graham IV, FASAE, CAE. "This action is a victory for the thousands of associations and nonprofit groups that voiced their concern with this overreach over the past two years. As we have emphasized throughout this process, we have never been against increasing the salary threshold, but creating a one-size-fits-all measuring stick for overtime eligibility across the country was simply not workable for many employers and, in fact, would have done more harm than good for many affected employees as well."

The overtime rule was finalized by the DOL in May. As it currently stands, the rule significantly increases the minimum salary level for "white collar" employees to qualify as exempt from overtime pay requirements. Under the new rule, no employee who has a guaranteed salary of less than $47,476 will qualify as exempt under the executive, administrative, or professional exemptions. That's more than double the current minimum salary level of $23,660 and only slightly lower than the Labor Department's proposed $50,440. The rule will not affect hourly or other nonexempt workers, who already are eligible for overtime pay.

The final rule includes a mechanism for automatically updating the salary threshold every three years. The next automatic update to the salary threshold will be on January 1, 2020, and the new salary level will be announced 150 days before it takes effect. The minimum salary level is set based on the 40th percentile of wages of full-time salaried employees in the lowest-wage census region (currently, the South).

ASAE is a member of the Partnership for Workplace Opportunity coalition, a diverse group of associations, nonprofits, and businesses advocating for a regulation that is more considerate of all stakeholders and the economic realities facing employers and employees across the country. ASAE also took this issue to Capitol Hill in March as part of American Associations Day, our annual legislative fly-in for association professionals. We held over 250 meetings on Capitol Hill to share our concern about how this rule will affect association professionals around the country.

Before the rule was finalized, ASAE submitted extensive written comments to DOL and met face to face in April with DOL and Office of Management and Budget officials to share our concerns that the new rule would adversely affect many nonprofit organizations and other employers with limited revenues—and could harm many affected employees as well.

ASAE will continue to monitor this issue closely.

Tax Reform Could Hurt Associations

Come January, the new Congress' take on tax reform could take aim at association revenues.

With the elections behind us, it's not too early to consider how a new Congress might prioritize policy issues when it convenes in January. Perhaps no issue holds greater implications for the association community than tax reform.

While there is broad agreement that the current tax system is broken, there are dramatic differences over what a simpler, fairer tax code should look like. Generally, Republicans support a revenue-neutral overhaul of the tax code, while most Democrats believe that meaningful tax reform must include additional tax revenue. Lawmakers are coalescing, however, around the idea that tax reform should reduce the size and number of tax expenditures in the code—tax subsidies that amount to $1.1 trillion a year—and use those savings in part to lower marginal tax rates for individuals and corporations.

That means some of the tax preferences associations enjoy could be targeted either as revenue offsets or as a way of simplifying the code.

The tax code contains a number of exclusions and exceptions to the unrelated business income tax (UBIT) statute, which dictates which association activities are taxable. Those exceptions exist because there is a connection between the advancement of an organization's tax-exempt purpose and the business activity in question. Any expansion of the UBIT statute to include activities that are currently excluded could harm an association's bottom line and impair its ability to carry out its mission.

As Congress works next year to produce specific recommendations to achieve the goal of a simpler, fairer tax code, ASAE will ask lawmakers to consider how potential changes to the tax treatment of associations' revenue-generating activities would affect their ability to carry out their core purposes.

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