American Horse Council's Tax Bulletin

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Tax Court Finds Thoroughbred Racing Activity Was Not Engaged In for Profit

The taxpayer, a sales representative who sells parts and services for helicopter engines, purchased his first interest in a race horse in 1987. Since that time, he has continued to own interests in and raced numerous thoroughbred horses. The taxpayer sustained losses from his horse racing activity every year beginning in 1990, although he did claim to have an overall profit in 2014 when sales of horses and racing equipment are included.

The IRS audited the taxpayer's tax returns for 2010-2012 and determined that his horse racing activity was not an activity engaged in for profit and therefore, losses from the activity were not deductible. The IRS assessed tax deficiencies of $29,212 for 2010, $25,486 for 2011, and $25,023 for 2012. They also assessed accuracy-related penalties totaling $15,944. The taxpayer disagreed with the assessments and took the dispute to the Tax Court.

Chief Judge Marvel wrote the opinion for the Court. The Judge first noted that "We focus on the factors that are most important and applicable in this case. Our analysis of these factors leads to the conclusion that the petitioner did not engage in his horse racing activity during the years at issue with the predominant, primary, or principal objective of making a profit independent of the tax savings."

The Court did dismiss the accuracy penalties related to the horse racing since the taxpayer relied on the advice of his accountant regarding the deductibility of his horse racing expenses.

Carmody v. Commissioner of Internal Revenue; T.C. Memo. 2016-225

Quarter Horse Operation Not Engaged In for Profit

In 1998, the taxpayer, who purchased her first quarter horse at age 12, started Hylton Quarter Horse (HQH), which breeds, shows, and sells quarter horses. In operating HQH, the taxpayer sought to raise the very best horses possible. Over the years 1998-2014, HQH had gross income which totaled $1,279,396 and expenses of $18,658,151, resulting in net losses of $17,378,825 for that period. HQH showed no profitable year during that period. During the same period, the taxpayer had Non-HQH income of $89,097,917, resulting in total income reported on her tax return of $70,719,092 for the period 1998-2014.

The IRS audited the taxpayer's tax returns for taxable years 2004-2011. They concluded that HOH "was not engaged in for profit" and assessed a total tax deficiency of $3,638,687 for the period 2004-2011. They also assessed penalties which totaled $972,250. The taxpayer disagreed with the IRS finding and filed in the U.S. Tax Court to reverse the tax deficiencies assessed by the IRS. Judge Ruwe wrote the opinion for the Court.

The Judge noted that in order to prevail, the taxpayer must show that she owned and operated HQH "primarily" for the purpose of making a profit. He concluded that the "evidence adduced at trial is more consistent with the conclusion that the petitioner has a passion for quarter horses and also has ample financial resources to own and operate a quarter horse activity to further her personal pleasure regardless of the consistent large losses." Accordingly, the Court found that the taxpayer's profit objective was not the primary or dominant reason for engaging in her quarter horse activity, and therefore, HQH was not engaged in for profit within the meaning of the tax code.

Cecilia Hylton v. Commissioner of Internal Revenue; T.C. Memo. 2016-234

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Selected Recent Equine Business Tax Cases

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The two principal areas in which horse businesses are challenged by the Internal Revenue Service are: (1) the so-called "Hobby Loss" rules, Section 183 of the Internal Revenue Code and Treasury Regulation 1.183; and (2) the "Passive Activity" rules, Section 469 of the Internal Revenue Code and Treasury Regulations 1.469, including both Temporary and Permanent regulations.

If the government prevails on a Section 183 challenge, the business deductions are lost forever. If the government prevails on a Section 469 challenge, but the suspended deductions may be usable at a future time.

Although many types of businesses have been challenged by the IRS under the color of Sections 183 and 469, including such diverse enterprises as aircraft chartering, antique sales, auto racing, coin and stamp collecting, filmmaking, travel agencies, tennis, yachting, boat chartering, pet stores and dog kennels among others, horse businesses seem to be a favorite target of the IRS. There have been **over 150 published Tax Court decisions in Section 183 cases involving horse businesses.** The challenged horse businesses include both race horses and show horse operations involving virtually every breed.

The law evolves through case law in both the Section 183 and 469 areas. Since 2014, there have been a few cases of significance which have influenced the law. In the Section 183 area, Metz v. Commissioner T.C. Memo 2015-54 and Roberts v. Commissioner, 820 F.3d. 247 (7th Cir. 2016), rev'g T.C. Memo. 2014-74 have made a difference; and in the realm of Section 469 cases applied to the horse business, Tolin v. Commissioner, T.C Memo. 2014-65 makes a difference. With a very brief introduction to Section 183 and Section 469, let's take a look at the aforementioned three cases that make a difference.

Section 183 – Generally

The basic rule behind Section 183 is that the taxpayer must conduct the activity with the objective of making a profit. It is the taxpayer's ***subjective*** state of mind that counts, but the subjective intent is to be determined by reference to ***objective*** factors. There are nine *non-exclusive* factors listed in Treasury Regulation 1.183-2(b)[1] for making this determination.

1(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.

These nine factors, which have been in the past usually the *only* factors considered, although the opinion by the distinguished jurist, economist and thinker, the Honorable Richard A. Posner of the Seventh Circuit Court of Appeal in the Roberts case calls them "goofy" and questioned their usefulness. The Metz case also casts down an erroneous doctrine, unjustified and harmful to horsemen, that has been followed without for decades without examining its logical underpinning, and also set straight two other interpretations urged by the IRS which have sometimes been applied to the detriment of horse businesses.

The Metz Decision

In the fairly recent Tax Court opinion in Metz v. Commissioner, T.C. Memo. 2015-054, the IRS attempted to move Section 183 into new economic territory. While there had been a few Section 183 Tax Court opinions involving losses totaling $1 million or even more during the years involved, it had been assumed by some practitioners that greater investments were off limits as not being compatible with a primary motivation of pleasure rather than profit. For example, in Smith v. Commissioner, T.C. Memo. 1979-324, a taxpayer-president had caused his steel products corporation to assemble a herd which grew to 400 Lipizanner horses and the substantial losses spanned 20 years. In finding the operation to be engaged in for profit, the Court noted that: "[A]ny pleasure that may accompany managing a herd of such size and involving so considerable a financial commitment must be only the satisfaction one derives from operating a business."

Metz involved owners of an Arabian horse operation including a farm. During the six years at issue the taxpayers had reported losses of over $7.2 million. And except for one year of profit when the farm property was sold for a gain followed by their move to a new farm in another state, the losses had spanned some 20 years. In finding for the taxpayers, the court noted the unfortunate economic effect on the Arabian horse market arising from a dispute between U.S. and worldwide Arabian horse membership organizations. The Court found that the taxpayers had carried on the activity in a business-like manner, using written contracts, advertising extensively, and modifying the operation substantially, with the Court stating, with regard to their books and records, that were criticized by the IRS, they were sufficient because they allowed the taxpayers to assess economic performance and identify strategies to reduce costs; the court said it would not "second-guess" what the taxpayers could have done better.

The taxpayers also devoted a substantial amount of their available income to the operation and as to that level of investment the Court approved of a statement from another case that, "The investment of large sums in an activity seems like the kind of objective fact that a taxpayer should be able to use to bolster his claim that he's in it to make a profit."

Metz also addresses insightfully several of the set pieces regularly advanced by the IRS in Section 183 cases, including the following:

1. No taxpayer can have a profit motive unless all past losses can be recouped;

2. Land used in a business is a separate activity from the business and its appreciation does not count as appreciation of an asset used in the business; and

3. Horse business owners must account for their horse businesses on a horse by horse basis.

1. The Recoupment of Loss Doctrine

The concept that a taxpayer cannot have an effective profit objective unless the taxpayer intends that all past losses be recouped is based on a particular interpretation of dicta (gratuitous language unnecessary to the decision) from a case that predated the enactment of Section 183, Bessenyey v. Commissioner.[1] Although the concept that all prior losses must be recouped, or no profit motive can exist, is not compelled by statutory or regulatory authority, it was followed in numerous cases until it was confronted, and its interpretation narrowed sensibly in Helmick v. Commissioner[2] where it was explained as follows:

> "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 which future profits were expected. See Bessenyey v. Commissioner (citation omitted), 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 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 years merely because they would never recoup their losses from years prior to 1997."

In Metz the Court reaffirmed the narrowed interpretation of Bessenyey in accordance with the analysis in Helmick 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, (citation omitted) (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 (citation omitted). 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."

1 Bessenyey v. Commissioner 45 T.C. 261 (1965)
2 Helmick v. Commissioner T.C. Memo 2009-200

2. Is Land a Part of the Business or is it a Separate Activity?

Treas. Reg. 1.183-2(b)(4) provides that appreciation of assets used in the activity is to be considered as if it were a profit. The regulation specifically mentions land as an example of an asset the appreciation of which can be taken into account in evaluating an activity. Nonetheless, the IRS usually makes the argument that the land was bought primarily to hold for appreciation; thus holding the land is a separate activity, and the land appreciation should not be included as an asset of the activity at issue. In Metz the government made precisely that argument about the land. The Metz court responded:

> "The Commissioner, however, points us to another part of the rule: "[w]here land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value." Id. This rule doesn't apply to the present case. **The Metzes didn't purchase the Florida or California properties primarily with the intent to profit from the increase in their values. On the contrary, the record clearly establishes that the Metzes moved to Florida and bought the Naples property to move their farming operation down there.** The Commissioner notes that the Metzes also "acquired and held the [Florida property] for its potential appreciation." Even if true, the observation misses the point. The Commissioner makes the leap from saying that the Florida property was purchased for the dual purpose of horse farming and capital gain to saying that the land's potential appreciation was the primary reason for the Metzes' purchase of the property. The record doesn't support this claim. The same holds true for the Metzes' properties in California." [emphasis added]

The key to a correct decision in the definition of activity is generally the purpose for which the property was purchased, as was set forth in the seminal 1979 case of Engdahl v. Commissioner 72 T.C. 659 (1979).

3. Is Accounting on a Horse by Horse Basis Required?

Metz also concluded that a horse activity is not required to account on a horse-by-horse basis. Instead, the format of the record-keeping is not as important as what is done with the records – are they used to benefit the business? The standard enunciated in Metz was: **did the system used allow the taxpayers to assess their activity's economic performance and identify cost-cutting strategies for the activity**?

The Roberts Decision

In Roberts v. Commissioner[1], the taxpayer was a small Indiana owner and breeder of thoroughbred horses. He had also, early in his horse operation, obtained a trainer's license in order to train and race his own horses without professional assistance. He had begun in 1998 with two inexpensive horses, after attending a thoroughbred racing event at an Indiana race track. It was designed to encourage potential race horse owners. At that time the taxpayer was a formerly successful owner of night clubs and restaurants who was trying to make a career change, but he still had a financial interest in a night club property as a source of outside income.

1 Roberts v. Commissioner, 820 F.3d. 247 (7th Cir. 2016), rev'g T.C. Memo. 2014-74.

At the time he purchased the first two horses, he had also owned a small farm. By 2005, his horses had increased to over 10, and he tried to upgrade the farm with horse-related improvements but ran into zoning problems. So in 2006, he sold the farm property, purchased a new and larger property for about $1 million and, still during 2006, spent some $500,000 on horse-related improvements on that new property. By 2007 he had completed the new farm's improvements and training facilities and had begun to use it in his horse operation.

During the initial period through 2006, the taxpayer had taken a leadership role in a horse owners' organization and had also begun helping to lobby for legislation that would allow slot machines at Indiana race tracks, designed in part to increase the purse awards to winning owners of horses. The legislation was passed in early 2007.

The only profit shown by the taxpayer was a small one in 1999, the first year that his first two horses raced. The issue before the Tax Court was whether Section 183 applied to the loss years of 2005, 2006, 2007, and 2008, as by then there were nine consecutive loss years. The Tax Court acknowledged the taxpayer's hard work and productive lobbying prior to 2007 and found that in 2007 (and 2008), when he began actually using his new farm facility and the slot-machine legislation had passed, that his primary motive had become profit-oriented. But as for the two prior years, 2005 and 2006, the Tax Court said that the motive for his presence at the race track to train and race his horses was more for pleasure and recreation, since a race track is primarily a social venue.

The taxpayer appealed the results as to 2005 and 2006 to the Seventh Circuit Court of Appeals. For the first time in about 30 years and about 15 different appeals of horse-related Section 183 cases a federal appeals court reversed the Tax Court.

A primary taxpayer argument related to the nine regulatory factors, each of which the Tax Court had addressed. As to 2005 and 2006, the Tax Court had found that two factors favored the IRS, the personal pleasure factor and the owner's financial status factor. Four factors had favored the taxpayer and the other three were found to be "neutral". A court can consider some factors more important than others, but the taxpayer argued that there is a limit to such an imbalance. Another taxpayer argument was that although not used until 2007, the investment in the new farm and training facility was largely completed before 2007. And by 2007 even the Tax Court had found the necessary profit motive. The Tax Court decision seemed to be drawing a very fine timeline between pleasure motive and profit motive.

In its decision, the appeals court covered the nine regulations in detail and found no single factor favoring the IRS for 2005 or 2006. And as to that nine –factor test it said that, "We mustn't be too hard on the Tax Court. It felt it was imprisoned by a goofy regulation." It went on to say that the lower-court finding that the taxpayer's land purchase and improvements were irrelevant to the issue of profit motive until he began using the new facility was "an offense to common sense" noting, in effect, that any business is entitled to a reasonable starting period where profits are not to be expected, as has occurred in many of the most successful enterprises in the U.S.

Section 469 "Passive Losses"

A. In General

Section 469 was enacted in 1986. This so-called "passive activity loss" provision places limitations on the use of losses against other income in years in which the owner of a business activity does not "materially participate" in that activity. But unlike the "hobby-loss" provision which forever bars the losses generated by an activity which is not engaged in for profit, "passive losses" can be utilized to offset future income in certain situations.

"Material participation" must be on a "regular, continuous, and substantial basis,"[1] all undefined terms. There are seven regulatory tests for determining whether an owner has "materially participated" during the taxable year.[2] For example, if an owner (or husband and wife combined[3]) can show that at least 500 qualifying hours were devoted during a taxable year, then the owner(s) will have materially participated in the activity for that year. Other regulatory tests require only 100 or fewer qualifying hours, but the safest way to assure material participation is to prove the 500-hour test, since the IRS frequently challenges the other tests, the prevailing attitude being that if a taxpayer cannot meet the 500-hour "safe harbor" test, then material participation is suspect. In the case of a partnership, each partner must establish that he or she materially participated in the activity. The same is true of each shareholder or member of a pass-through entity—an S corporation or limited liability company. Thus, one partner or shareholder may materially participate although another doesn't.

The key to successfully defending a Section 469 attack will involve proof of time spent participating. Especially when one includes the Section 469 rules concerning real estate one find numerous exceptions to the rules, and exceptions to the exceptions to the Section 469 related rules, but these exceptions and exceptions to the exceptions are beyond the scope of this article.

The recent Section 469 horse case, Tolin v. Commissioner, addresses the means of proving "material participation in a horse business context, and it is a most valuable citation insofar as it permitted documentary proof to be developed after the events took place.

The Tolin Decision

Tolin v. Commissioner, T.C Memo. 2014-65, is a significant recent Tax Court case dealing primarily with the level of proof required to establish "material participation" from standard proofs such as travel records, telephone records, credit card receipts and from the testimony of the taxpayer and two corroborative witnesses.

The case was a challenge because it clearly involved absentee ownership. The petitioner was single and was a practicing Minnesota attorney. He was also involved in thoroughbred horse racing pursuits. One horse he owned had become moderately successful, winning some important races. When the horse had to be retired from the track, the petitioner began efforts to make a successful commercial stallion of the horse. After a couple of false starts at breeding in New Mexico and Texas, he investigated Louisiana and through several contacts there decided to stand the stallion at stud at a small farm establishment, and the stallion's career in Louisiana began.

1 Section 469(h)(1).
2 Treas. Reg. § 1.469-5T(a)(1) through (7).
3 Section 469(h)(5).

The taxpayer was challenged under Section 469 as to his losses during the three years of initially promoting the stallion in Louisiana. (There was never a question raised as to the Section 183 "hobby loss" provision).

The principal IRS ground was that the petitioner operated the stallion's Louisiana breeding career primarily from his home in Minnesota and that it was unlikely that his "work done" could meet the annual statutory tests, especially the 500-hour "safe harbor" test. The petitioner argued that he had readily met at least two regulatory tests—the 500-hour test and the 100-hour "facts and circumstances" test.

The taxpayer did not maintain a definitive "calendar" or "log" of his time, but he did have extensive records of his annual travel to Louisiana to do hands-on management with numerous persons including the farm manager where his stallion stood, and a high official in the Louisiana breeders' association which the taxpayer visited often, taking an active interest in the organization in order to promote his stallion. While in Louisiana, with several trips and up to 20 or more days spent there annually, he usually stayed as a guest of the stallion-farm manager who testified that the taxpayer apparently spent full days in Louisiana engaged in promotional and related efforts, as the Louisiana breeders' association official also testified. (The taxpayer also owned a few other horses being boarded and trained in Louisiana and spent time and effort on overseeing their care and development.) While in Louisiana, the taxpayer rented an automobile and drove long distances to the farms of potential breeders to his stallion and to the offices and functions of the Louisiana breeders' association.

The case boiled down to the proofs in the form of a "narrative summary," with virtually each entry supported by some documentation and testimony. Because the "narrative summary" was not a contemporaneous document, but was prepared solely for trial, it was challenged by the IRS from the onset although finally admitted on the understanding that each entry was the subject of supporting proof. The compilation of the narrative summary was hugely time-consuming for the taxpayer's team. It attempted to cover virtually every day in each year at issue, especially the days on which telephone calls or travel to and in Louisiana were involved. To this end, all travel to and from Louisiana and rental car usage within Louisiana was proven. Voluminous telephone logs of hundreds of calls were produced, primarily from Minnesota to the Louisiana farm manager and other Louisiana advisors and to potential Louisiana breeders, in order to oversee day-to-day management and operations and to promote the stallion. Very complete records of air travel and ground travel relative to the Louisiana trips were shown, along with proofs of substantial promotional activities, especially through preparing and sending extensive brochures and other materials, including videos, from Minnesota to potential Louisiana breeders to his stallion.

The narrative summary, along with the taxpayer's testimony and that of the farm manager and breeders' association representative, carried the day. The taxpayer had claimed some 700 or more hours (including all travel time relative to Louisianan) in each year. The Court found the hours claimed to be reasonable and in each year to be in excess of the 500-hour "safe harbor" rule. In the process, the Court was "counting" in petitioner's favor the Louisiana-related travel time claimed despite the IRS opposition. The Court dismissed the IRS position that much of the work done was "investor time." But because the 500-hour test was met, the Court saw no reason to address the argument that the taxpayer had also met test No. 7—the 100-hour "facts and circumstances" test. The definitive scope of that regulation will have to await another day.

Conclusion

Section 183 and Section 469 continue to be used to challenge horse businesses that report multiple loss years or have recreational aspects. Sometimes the IRS will raise both challenges against one activity in hopes that one or the other will succeed. The best way for owners to be relatively safe, is to conduct a thorough program of preventative planning with their tax advisors before the challenge arises.

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