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By Thomas A. Davis, Esq., Davis & Harman LLP, Washington, DC

Horse Owner Loses Appeal of Tax Court Case to Ninth Circuit Court of Appeals

The U.S. Tax Court found that the taxpayer did not engage in her dressage horse breeding, showing, competing, and training activity as a business for profit. The activity had never shown a profit year. (*McMillan v. Commissioner*, T.C. 2013-40). The taxpayer appealed the case to the United States Court of Appeals for the Ninth Circuit.

On appeal, the Ninth Circuit affirmed the Tax Court's judgement. They found that the "Tax Court properly considered factors in the regulations and did not clearly err in finding that McMillan did not engage in the horse activity for profit in 2007 and 2008, and therefore was not entitled to take income tax deductions from expenses arising from that activity." In response to arguments made by the taxpayer, the Circuit Court noted that the "Commissioner was not bound to allow deductions permitted in prior tax years."

The taxpayer also claimed a casualty loss on the basis of the death of her horse from disease, which the Tax Court did not allow. The Ninth Circuit found that the Tax Court did not err in disallowing the deduction since the tax law and previous cases make it clear that the casualty losses to horses, largely due to illness or disease, are not allowable.

***McMillan v. Commissioner of Internal Revenue*; United States Court of Appeals for the Ninth Circuit; No.4590-11, May 15, 2017**

Horsing Around With Tax Extenders in Full-Expensing System

Article By: Colleen Murphy, Bloomberg BNA

(BNA) -- Racehorse owners could be the real winners if Republicans are able to pass their sweeping tax reform plan.

Allowing businesses to fully and immediately write off the cost of investments is a key plank in the House GOP tax overhaul blueprint. Such a provision would mean that tax extenders dealing with depreciation schedules, like a measure renewing three-year depreciation for some racehorses, would no longer be necessary—a shift that supporters say would bring certainty to business owners and simplicity to the tax code.

"All those complex, myriad depreciation schedules go away because you've simplified it to a different number: zero," House Ways and Means Committee Chairman Kevin Brady (R-Texas) told Bloomberg BNA.

It would also be a boon to racehorse owners and spur job growth in a multibillion-dollar industry, Rep. Andy Barr (R-Ky.) told Bloomberg BNA. From 2009 to 2016, the amount spent buying qualifying racehorses could be deducted over a period of three years instead of seven years, an incentive Congress let expire beginning in 2017 with the expectation that it would be addressed in tax reform.

A shorter depreciation schedule is more appealing because it lets individuals write off more each year and recover the full cost of an investment faster. On March 30, Barr introduced two bills, H.R. 1806 and H.R. 1804, that, respectively, allow the expensing of any racehorse and make permanent the three-year recovery period for any racehorse.

The prospects for comprehensive tax reform as Republicans envision it have dimmed in recent weeks as lawmakers squabble over a plan and efforts to repeal the Affordable Care Act have languished. But Barr is holding out hope for broader tax changes—and so is the industry.

"So the bottom line is if we can get 100 percent expensing, and that includes equine assets, then that eliminates the need for depreciation all together," he said.

Betting on It

The three-year depreciation provision would lose $55 million in federal revenue from 2016 to 2020, according to the Joint Committee on Taxation.

Senate Majority Leader Mitch McConnell (R-Ky.) has previously taken credit for securing the three-year depreciation tax break for racehorses. Supporters say three years, rather than seven as it had been previously, more accurately reflects the racing life of a horse.

A spokesman for McConnell declined to comment. The two lawmakers regularly discuss the issue, Barr said. Kentucky's equine industry had an economic impact of about $3 billion and created 40,665 jobs in 2012, according to a report from the University of Kentucky.

“We want this to be permanent law for the certainty, and expensing to be permanent law as well, so that investors and people who are interested in investing in the thoroughbred industry or any other racehorse can go out and buy it and know they’re getting the tax advantages associated with that,” Barr said.

Alex Waldrop, CEO and president of the National Thoroughbred Racing Association, said in a statement to Bloomberg BNA that the group has prioritized racehorse depreciation since it was included in the Food, Conservation, and Energy Act of 2008 (Pub. L. No. 110-234). The NTRA has “been examining the potential impacts of any tax reform effort, including how depreciation and expensing changes might interact or alter this specific provision,” he said.

“The road to comprehensive tax reform will be long and difficult but we will continue to promote the best interests of Thoroughbred racing whether it be via Rep. Barr’s provision or a larger tax reform effort,” Waldrop said.

Pros and Cons

Full expensing ideally “removes a lot of noise” and could keep businesses from making investment decisions based solely on tax breaks, Rep. David Schweikert (R-Ariz.), a member of Ways and Means and the House Freedom Caucus, told Bloomberg BNA.

“Hopefully, removing that noise stops the game of ‘let’s invest in this because we get this depreciation cycle or this tax credit, but don’t invest in that because it’s not a tax benefit,’” he said.

Still, some are skeptical. Opponents say that full expensing is costly and may not live up to what Republican leaders project. The provision would cost $2.2 trillion over a decade on a static basis, a total that would drop to $883 billion over a decade after considering economic growth, the Tax Foundation estimates.

The difference between immediate expensing and a three-year depreciation schedule also doesn’t provide much “bang for the buck,” because three years is on the short end of recovery periods, said Leslie J. Schneider, a partner at Ivins, Phillips & Barker, Chartered.

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Tax Treaty Limitation of Benefits and Form W8-BENE-E

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Introduction

Oftentimes tax advisors find themselves assisting foreign owners in structuring their U.S. equine operations. These engagements involve consideration of a myriad of U. S. tax considerations, such as income tax, withholding tax, and transfer taxes as well as the effect of treaties that may be available to the foreign horse owner. I have previously written about many of these considerations in prior articles appearing in this Tax Bulletin.[1]

This article is intended to familiarize tax advisors and foreign horse owners desiring to engage in business in the U.S. with the potential limitation of benefits that foreign horse owners may face in qualifying for favorable U.S. treaty benefits.

U.S. Tax Treaties – In General

Over the past few decades, the United States has entered into over 60 bilateral income tax conventions with foreign governments. A primary purpose of these conventions is to ease the burden of double taxation on individuals and companies resident in each of the contracting states. The ultimate goal of these treaties is to ease barriers to international business and transactions by making the establishment of business activities as attractive, predictable and simple as possible to potential cross-border investors of the participating parties.

With the rise of these bilateral income tax conventions came the need to ensure the benefits granted under the conventions were restricted to the intended parties. Such potential income tax treaty benefits typically include the reduction or elimination of the general 30% U.S. withholding tax that applies to payments of U.S. sourced income made to foreign persons or reduction or elimination of the branch profits tax imposed on foreign corporations that may conduct a U.S. trade or business without a U.S. permanent establishment.

U.S. Tax Treaties – Limitation of Benefits

To restrict such benefits, a limitation on benefits ("LOB") clause has been included in the tax conventions and treaties to which the United States is a party. LOB clauses are drafted with the intention of avoiding treaty shopping, whereby a third-party national or corporation sets up a shell company in a contracting state through which income will be passed by the owners in an attempt to achieve a minimal tax rate, or to eliminate tax on the income altogether with no expense or real investment. The shell companies have no legitimate business purpose beyond minimizing tax exposure.

1 U. S. Tax Considerations for Foreign Horse Owners, AHC Tax Bulletin #324 (2006AHC 2006-5).

The limitation on benefits clause in each treaty contains certain tests to determine the applicability of the treaty to international transactions. These LOB clauses are constantly being reviewed and are subject to further negotiation between the U.S. and its treaty partners.[1] The 2016 U.S. Model Treaty of February 17, 2016 (the "2016 U.S. Model Treaty") is the most recently published U.S. Model Treaty drafted by the U.S. Treasury Department and is the baseline text the Treasury Department uses when it negotiates income tax treaties. The 2016 U.S. Model Treaty includes technical improvements and certain policy changes to longstanding Article 22, Limitation on Benefits, which is intended to prevent treaty shopping by third-country residents that are not intended beneficiaries of the treaty.

LOB Clauses Applicable to Closely Held Entities[2]

While limitation on benefits clauses vary from treaty to treaty, they all have some common elements. Where a corporation is privately held the LOB provisions most commonly utilized by closely held companies include the ownership-base erosion test, the derivative benefits test, or the active trade or business test. These three tests are discussed below.

Ownership-Base Erosion Test

The ownership-base erosion test generally requires that more than 50% of the vote and value of the company's shares be owned, directly or indirectly, by residents of the same country as the company. This is the "ownership" prong of the test. In general, the second requirement is that less than 50% of the company's gross income is accrued or paid, directly or indirectly, to persons who are not residents of the same country as the company. This is the "base erosion" prong of the test.

Stock owned by (directly or indirectly) by a corporation, partnership, trust or estate is treated as being owned proportionately by its shareholders, partners or beneficiaries.

Derivative Benefits Test

The derivative benefits test is generally limited to NAFTA, EU, and EEA country treaties, and may apply to all benefits or only to certain items of income (interest, dividends, and royalties). It generally requires that more than 95% of the aggregate vote and value of the company's shares be owned, directly or indirectly, by seven or fewer equivalent beneficiaries. Equivalent beneficiaries are ultimate owners who are resident in a NAFTA, EU, or EEA country and are entitled to identical benefits under their own treaty with the U.S. under one of the ownership tests included within the LOB article (other than the ownership-base erosion test).

In addition, the derivative benefits test requires that less than 50% of the company's gross income be paid or accrued, directly or indirectly, to persons who would not be equivalent beneficiaries.

1 As Treasury continues to work to update the U.S. tax treaty network, the U.S. Senate has not approved a tax treaty or protocol since 2010 even though several are pending before it, including agreement with Chile, Hungary, Japan, Luxembourg, Poland, Spain and Switzerland. Sen. Rand Paul (R-Ky.) has been blocking the accords for years on the grounds they infringe on U.S. citizens' constitutional right to privacy, steadfastly rejecting pleas from businesses, pressure from fellow senators.

2 The typical ultimate beneficial foreign horse owner is an individual or group of related individuals rather than a publicly traded corporation or subsidiary of a publicly traded corporations so this discussion focuses on the LOB tests typically available to closely held entities.

Active Trade or Business Test

The active trade or business test generally requires that the company be engaged in an active trade or business in its country of residence, that its activities in that country be substantial in relation to its U.S. activities, if the payer is a related party, and the income be derived in connection with or incidental to that trade or business. The treaties oftentimes vary on what constitutes "substantial income". Some treaties such as the U.S./Ireland Income Tax Treaties provide a three-part factor test that acts as a safe harbor guideline in this regard. Under the ratio test, income earned by the Irish entity is considered substantial if the value of assets held by the entity, the gross income derived from the active trade or business, and the payroll expense related to the trade or business is at least 7.5 percent in the preceding year when compared against the U.S. trade or business. The average of all three factors must exceed 10 percent in the preceding year. The Irish treaty allows for the use of ratios from the preceding three years should one of the factors fail to meet the test. Each ratio will be calculated to the extent that each item is connected to the trade or business, and will be adjusted for the proportionate ownership of the resident. Under the 2016 U.S. Model Treaty, "substantiality" will be determined based on all the facts and circumstances.

Form W8-BEN-E

If a foreign entity qualifies for a reduced rate of U.S. withholding tax provided by a treaty, it must generally provide Form W-8BEN-E, Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting, to the U.S. payor. Among other things, on Form W-8BEN-E the foreign entity certifies under penalties of perjury that it qualifies for benefits under the relevant income tax treaty. Form W-8BEN-E is not filed with the IRS. Instead, the U.S. payor retains Form W-8BEN-E to substantiate the reduced rate of withholding in the case of an audit.

Form 1042-S must be filed annually by U.S. payors who have made payments of U.S. sourced income to foreign persons. In general, the form reports to the IRS the amount of income, type of income, name of recipient, and amount of U.S. tax withheld (if any).

Recently the IRS released new versions of Form W-8BEN-E and Form 1042-S. In the past, a foreign entity claiming treaty benefits did not need to identify which specific LOB provision it satisfied. It would simply certify that it satisfied at least one of the LOB provisions in the relevant treaty. Form W-8BEN-E now requires that a foreign entity claiming treaty benefits specifically identify which LOB provision it satisfies. The U.S. payor is now required to communicate this information to the IRS on the updated Form 1042-S, which now asks for the coinciding LOB code in box 13j.

The new requirement to report the LOB provision on Form W-8BEN-E is onerous because it essentially requires withholding agents to pull the income tax treaty and protocols for each treaty claim submitted on a Form W-8BEN-E to validate that the appropriate LOB test is accurately reflected by the box checked on the form.

Conclusions

The ultimate beneficial foreign owners of horses to be used in a trade or business in the U.S. face a myriad of U.S. tax rules and potential obstacles to qualify for U.S. treaty benefits if the foreign owners are not residents of foreign countries party to U.S. treaties. Nevertheless, with proper planning such obstacles may be reduced or eliminated.

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