AMERICAN HORSE COUNCIL'S
TAX BULLETIN
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Tax Bulletin No. 386

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

Tax Reform Bill Continues to be Work in Progress

President Trump's top aides and congressional leaders (known as the "Big 6") say they have made "significant strides in shaping a tax overhaul, moving far beyond the six-paragraph framework pushed out in July." The team says it has reached broad consensus on some of the best ways to pay for cutting both individual and corporate tax rates.

Some of the options include: 1) Scaling back the mortgage interest deduction for home owners; 2) Scrapping the taxpayer's ability to deduct state and local taxes; 3)Eliminating the deduction for business interest expenses; 4)Phasing in (rather than immediately implementing) full expensing that allows businesses to deduct capital investments such as the cost of new equipment or facilities. Apparently there has been no agreement on whether the tax bill should add to the deficit and whether any cuts should be permanent. House Ways and Means Committee Chairman Kevin Brady (R-TX) has publicly said that they will be open to losing revenue during the early years.

According to inside sources, the tax reform team has also settled on a tax proposal that will require U.S. companies to bring back earnings from overseas at a one-time low tax. This will provide much needed revenue for tax reform and/or infrastructure.

There is no agreement on corporate tax rates at this point since a number of factors that will have a significant impact on the rate have yet to be decided. There is speculation that the corporate rate will likely be somewhere between 22% and 25% with some possibility that it could go to 20%, but no lower.

Gary Cohn, the National Economic Council Director and a key member of the Big 6 who are writing the tax bill, recently said "We've got a great, I would say, 'skeleton for tax reform.' We need the Ways and Means Committee to put some muscle and skin on the skeleton and drive tax reform forward, and it is our objective to do that between now and the end of the year."

It is easy to conclude that the "Big 6" members still have a lot more to do before they have a comprehensive tax reform bill ready to release – in other words, there is still a lot of "muscle and skin to put on the skeleton."

On September 8th Chairman Brady said no decisions have been made but stated, "I feel like we're getting close on a number of key issues, which allows the committee to translate that into the actual bill."

Horse Council, Business Groups Urge Repeal of Estate Tax

On September 12, the American Horse Council (AHC) cosigned a letter with 144 advocacy groups, which largely represent the interests of small business, urging permanent repeal of the estate tax. While the estate tax is one of many issues to be addressed within the context of tax reform, calling attention to the estate tax – which is a 40% flat rate on non-exempt estates – helps illustrate the disproportionate tax burdens carried by the large number AHC members filing as sole proprietorships, S-corporations, and other pass-through entities. Repeal of the estate tax has been a longtime priority of congressional leaders wanting to streamline the current code. AHC is also participating in a coalition led by the American Farm Bureau Federation to explore other opportunities to engage lawmakers in the tax reform debate.

To view the letter, please click here.

Tax Court Rules Owner Did Not Operate Horse Activity as a Business for Profit

Since childhood, the taxpayer has been an amateur horsewoman. In 2005, she started Big Dog Farms (BDF) for the purpose of breeding, selling, and showing horses. Operations at BDF ceased in 2011.

She also practiced medicine as an independent contractor from January 2004 through 2010, but did not renew her medical license when it expired in 2011.

During the period 2005-2011, the taxpayer reported BDF losses every year which totaled $581,919 for the seven year period. She reported expenses related to BDF for tax years 2008-11 which totaled $445,181 and gross receipts in 2008 and 2010 which totaled $1,370.

The IRS audited the taxpayer's tax returns for the tax years 2008-2012. They concluded that the taxpayer did not operate BDF as a business for profit and therefore expenses related to BDF were not deductible. They also assessed penalties. The taxpayer disagreed with the IRS findings and took the dispute to the U.S. Tax Court.

Judge Kerrigan decided the case for the Court. The Judge pointed to several key factors in reaching the court's decision: No evidence that the taxpayer maintained books and records or conducted BDF in a manner similar to that of a profitable horse farm; No evidence regarding the assets held by BDF and whether these assets are expected to appreciate; BDF had substantial losses all of its years of operation; Taxpayer is a medical doctor who had significant income during the tax years at issue, and the losses from BDF generated substantial tax benefits for her.

Based on the above factors, the Court concluded that the taxpayer "did not operate BDF with the actual and honest objective of making a profit." The Court also found the taxpayer was liable for the fraud penalty for years 2011-2012 and accuracy-related penalties for tax years 2008-2010.

[**Margaret Knowles v. Commissioner,** TC Memo 2017-152]

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Big Changes in IRS Partnership Audit Procedures Create Potential Inequities for Current and Future Partners

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

Most business owners – including horse business owners – give little or no thought to IRS audit procedures - until they are audited. However, for tax years beginning after December 31, 2017, partners or members of business entities taxed as partnerships (such as general partnerships, limited partnerships and multi-member LLCs filing Federal Form 1065) face significant new audit procedures impacting past, current and future partners/members. These changes make it easier for the IRS to audit partnerships, can result in inequitable allocations for tax liabilities between future, current and past partners, and may result in an increase in IRS audits for partnerships. With this background in mind, horse business owners of entities taxed as partnerships should contact their tax representatives to learn more about these changes and how they might prepare for future audits now.

Current IRS audit procedures for partnerships often require the IRS to allocate adjustments and assessments against individual partners (as opposed to the partnership itself) for the year under review. This is a burdensome task for the IRS especially when reviewing partnerships with numerous partners/members. However, new IRS procedures for audits of partnerships (for tax years beginning after December 31, 2017) allow the IRS to assess the partnership itself (as opposed to the individual partners) in the year the audit is resolved (as opposed to the year under review). This means partners for the year an audit concludes could bear the burden for the assessment – not the partners for the actual year under audit. The following simplified scenario should help explain the inequities that could occur under the new partnership audit procedures:

Example: A horse racing syndication (taxed as a partnership) has five partners A, B, C, D and E in tax year 2018. During tax year 2018, the partnership takes several aggressive tax deductions resulting in a tax benefit on each of the partners' individual tax returns. In 2021, the IRS audits the 2018 tax return of the syndication and determines a tax adjustment against the syndication of $250,000. Under the new rules, the actual tax liability is determined based on the highest individual income tax rate (currently 39.6%). The partners in the syndication in 2021 are A, B, C, Y and Z and they ultimately share the tax burden of $99,000. Unless specific elections (if allowed) are timely made, partners Y and Z will share in the burden during tax year 2021 for a year (2018) when they were not partners. Partners D and E (who personally benefitted from the aggressive deductions in 2018) could walk away without issue.

In order to avoid this inequitable result, the new audit provisions do allow several potential limited exclusions. For instance, per Internal Revenue Code Section 6225, certain partnerships can "Opt Out" of the new partnership audit rules. Unfortunately, this exemption is only available for partnerships owned by individuals, corporations (both C and S corps.) and estates of deceased partners. This means some partnerships with trusts and multi-member LLCs as partners, may not make the election. Further, the Opt Out is available only for partnerships with less than 100 partners. Finally, the election must be made on the partnership return for the year the partnership is opting out. In the example above, the election for tax year 2018 must be filed with Form 1065 for tax year 2018. It is too late to make the election once the IRS initiates its audit in 2021. If the year the partnership is opting out. In the example above, the election for tax year 2018 must be filed with Form 1065 for tax year 2018. It is too late to make the election once the IRS initiates its audit in 2021. If partners A, B, C, D and E did not file the Opt Out election with the syndication's Form 1065 for tax year 2018, partners Y and Z could suffer (as partners in the syndication) a portion of the burden in 2021.

If the syndication in the example did not make or did not qualify for the Opt Out election of IRC Section 6221, the syndication can file an election pursuant to IRC 6226 (a "Push Out" election). If the Section 6226 Push Out election is made by the partnership, the partners for the year under review (2018, partners A, B, C, D and E) must make amendments to their individual returns for the year the partners receive the amended K-1 (2021 in the example). This election protects new partners (such as Y and Z) who become partners after the year(s) under review. This election must be filed by the partnership within 45 days of receiving the notice of the final audit adjustment. While on its surface a Push Out election in tax year 2021 appears more equitable to new partners X and Z, former partners D and E who no longer participate in the syndication will likely feel that the Push Out election in 2021 which impacts D and Es' 2021 individual tax returns is unfair or inequitable to them.

In addition to the potential Opt Out and Push Out elections described above, the syndication in our example could potentially elect treatment under IRC 6225. Instead, of the partnership paying the assessment, each partner owning an interest during the years under review (2018) must file amended returns for each of the years under review (2018) and pay the assessments based on the amended returns. This could benefit partners with lower tax rates from the years under review (in our example 2018). This technique likely works only where the partners have not changed since the year under review (here 2018) or the syndication agreement requires past partners to participate in such filings. In the example above, D and E have no incentive to cooperate unless forced by the syndications governing documents.

Besides the mind numbing complexities of various elections like the Opt Out and Push Out elections, the new partnership audit provisions, also impact who speaks for the partnership and the level of authority this person has. Under current rules, a Tax Matter Partner has limited power regarding partnership audit procedures and individual partners have the right to remain informed of and participate in the proceedings. The new partnership audit procedures replace the concept of a Tax Matter Partner with a Partnership Representative. As opposed to a Tax Matters Partner, a Partnership Representative has complete authority and control to act on behalf of the partnership for audit purposes. Unchecked, the Partnership Representative could make choices that favor certain members without input, consent or even the knowledge of other members. For this reason, partners should review their governance documents to determine what restrictions might be appropriate on the powers of the Partnership Representatives. For instance, the governance document could attempt to define when elections under the "Opt Out" or "Push Out" elections discussed above may or may not be required.

Partners A, B, C, D, E and Partners Y and Z certainly were not planning for and are likely unprepared for the drastic rule changes and impacts described above. The simplified example only begins to raise issues regarding the inequities and complexities that may result under a partnership audit for partnerships for tax years beginning after December 31, 2017. In the meantime, partners in horse businesses taxed as partnerships should consult their tax advisors to discuss what potential risks they bear under the new audit provisions. They should also discuss how the governance documents for these entities taxed as partnerships might be amended to mitigate these risks and uncertainties.

* **Matthew B. Lake, Esq**., is an attorney with the Cincinnati, Ohio law firm of Graydon. Mr. Lake graduated from the University of Cincinnati College of Law and has written numerous tax related articles for the horse industry.

* **John J. Kropp, Esq.**, is a practicing equine law attorney, with the Cincinnati, Ohio law firm of Graydon. Mr. Kropp is a graduate of the Georgetown University Law Center and has written and lectured extensively on topics of interest to the horse industry.

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Editor-in-Chief
Thomas A. Davis, Esq
Davis and Harman, Washington, DC

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