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Tax Court Finds Thoroughbred Owner's Horse Activity Was a Business in 2007 and 2008 but Was Not in the Two Previous Years

The taxpayer owned and operated a bar as a gentleman's club called Dancers. Dancers turned into a very profitable venture, and the taxpayer expanded his business by opening five other nightclubs and restaurants in the Indianapolis area.

The taxpayer purchased two lots, totaling 95 acres, across the street from Dancers, referred to as the Morris Street property. One of the two parcels, which he purchased in 1997 or 1998, had been used to board horses, and there was an operational stable on the property. He purchased the land for appreciation, not for stable rental receipts. Because he owned a horse boarding stable, he was invited by the Indiana Thoroughbred Owners and Breeders to a dinner and tour of Hoosier Park, the first horse racetrack to be opened in Indiana. As a result of the meeting, he became interested in horse racing. He asked the trainer who worked at his boarding stable to show him the ropes of horse racing.

In 1999, the taxpayer bought his first two young horses and built his first training track on his boarding property. In his first year of racing, the two horses brought him a net income of $18,000. He increased his racing stable to 10 horses in 2001 and also purchased a breeding stallion. In 2002, he passed the trainer's license test. In 2006, he sold the 95 acres of property. He purchased 185 acres nearby, referred to as the Mooresville property. He built a first-class training facility on the property, including a large training track. It was completed in 2007. He hired a full-time assistant trainer when he started the horse operations at the new facility, to assist him with training and racing the horses.

During the four year period of 2005 through 2008, the horse activity had the following gross income, deductions, and net income or loss:

	2005	2006	2007	2008
Gross Income	$112,195	$222,674	$258,433	$65,563
Deductions	$265,615	$253,278	$356,684	$357,451
Losses	$153,420	$30,604	$98,251	$291,888

After an audit of the taxpayer's tax returns for those years, the IRS determined that he was not engaged in the horse activity with the actual and honest objective of making a profit, and therefore, disallowed the deduction of the losses generated by the activity. The IRS also assessed penalties for each of the years. The taxpayer disagreed with the IRS determination, and took the matter to the Tax

Court.

Judge Paris wrote the opinion for the Court. In reaching her decision, the Judge turned to the nine factors set forth in the Treasury regulations that may be considered in deciding whether a profit objective exists.

Manner of Carrying on the Activity – The Court concluded that the taxpayer demonstrated significant changes in operation, adoption of new techniques, and abandonment of unprofitable methods when he moved his horse racing activities to the Mooresville property in 2007. He recognized that the Morris Street property was not suitable. The larger Mooresville property allowed the taxpayer to build larger, better and new facilities, and the increased size also allowed him to reduce feeding costs by growing his own high quality hay and renting out part of the property.

The Judge found the taxpayer significantly changed his business model when he hired an assistant trainer after moving to the Mooresville property. This allowed him to spend more of his time training horses, while his assistant coordinated racing activities. The Judge also concluded that the taxpayer treated other aspects of his horse-related activities in a professional manner. While rudimentary, the Court found the taxpayer's system of record keeping allowed him to make informed business decisions. His daily costs for each horse were consistent, and he had a method of keeping receipts or bank documents to track additional expenses. A publicly available Internet database was used to track the starts, placement, earnings and other information of each horse he raced.

The Judge concluded that this factor was neutral in years 2005 and 2006, but in 2007 and 2008, when he made significant changes to his operating procedure and location, this factor favored the taxpayer.

Expertise of Taxpayer or Advisors – The Court noted that the taxpayer immersed himself in all aspects of the horse racing business, becoming an expert in his own right. The IRS argued that the taxpayer developed no expertise in the financial aspects of the horse related activities. Judge Paris responded by pointing out that to enter a horse into a race, the taxpayer must have an in-depth understanding of the financial aspects of racing. He learned about how to enter races and how to pick a horse for a specific race to maximize his potential prize. The taxpayer testified that he spent significant effort and time to match each horse to the right race.

The Judge noted that the taxpayer also displayed his expertise through his participation in trade associations. Further, he demonstrated his expertise in the financial aspects of the horse racing industry by participating in the horse racing lobbying effort for slots in Indiana, which eventually led to the legislature passing a bill allowing slots. This in turn significantly improved the profit potential for horse racing in Indiana. Accordingly the Judge found this factor weighed in favor of the taxpayer's profit objective for all the years in issue.

Time and Effort Devoted to the Activity – By 2002, the taxpayer was working on horse related activities some portion of every day and full-time by at least 2005. He performed other unpleasant and burdensome activities, such as administering shots and rebuilding fences. He devoted a significant amount of his personal time and effort to carry on the activities which did not have substantial personal or recreational aspects. The IRS challenged whether the taxpayer could spend the amount of reported time dedicated to horse related activities and still perform functions deserving the redirection from other sources. The taxpayer explained that cell phones allowed him to consult with business contacts several times a day and did not detract from time spent dedicated to training horses. Accordingly, the Judge concluded, by the tax year 2005, petitioner devoted time and effort appropriate to demonstrate a profit objective for all the years in issue.

Expectation that the Assets Used in the Activity Will Appreciate in Value - The taxpayer argued that he had two different types of depreciable assets: the horses that he bred and trained, and the real property and capital improvements associated with his training facility. The IRS did not dispute the taxpayer's purchase and breeding of each horse with expectation of an increase in value, but contended that the real property was not an asset used in the activities and that any expectation of appreciation was not a factor to be considered. The Court concluded that the IRS was correct for the 2005 and 2006 tax years and incorrect for the 2007 and 2008 tax years because the taxpayer moved his horse related activities during the 2007 tax year. The taxpayer responded that his primary purpose in purchasing the Morris Street property was to gain from real estate appreciation; however, he testified that he specifically purchased and held the Mooresville property to breed and train horses. His primary intent was to build a horse training facility and he purchased the property to suit his needs. Based on these facts, the Court found that Mooresville's expected appreciation was relevant to whether the taxpayer carried on his horse related activities with intent to profit under section 183. The Court concluded the first year expectation of real estate appreciation weighed in favor of the taxpayer's profit objective was in 2007, when the taxpayer transferred the headquarters of the horse related activities from Morris Street to Mooresville. The Judge concluded the factor was neutral for the tax years 2005 and 2006.

Success in Carrying on Other Activities - The Court noted the taxpayer's success in building a nightclub business from very humble beginnings and ultimately having a network of up to six different establishments. Based on his hard work and initiative and other qualities that lead to success in other businesses, the Court concluded that he had reason to believe in eventual success in horse related activities. Thus, the Court concluded this factor weighed in the taxpayer's favor.

History of Income or Losses - Judge Paris first noted that the startup phase for some horse related activities can be between 5 and 10 years. The taxpayer started his horse related activities in 1998 and the years in issue fall within the startup phase. If the losses go beyond the startup phase, this does not necessarily mean that a taxpayer is not engaged in horseracing activities for profit where losses can be explained. In this case, some of the taxpayer's losses can be explained by a series of unfortunate events beyond his control, including the untimely death of several racing and breeding prospects, an enforcement quarantine during racing season, contractors building a shoddy fence that factored into the actual death of two stallions, and the need to hire and fire several different trainers. Therefore, the Court concluded that the startup phase and unforeseen expenses balanced the history of large losses, thus this factor is neutral for all tax years in issue.

The Amount of Occasional Profits - The taxpayer had success with his first two horses and expected the success to continue, but realized that continuing to race horses was a highly speculative activity, although there was a possibility of large profits. Furthermore, because of his activities within various organizations and assistance with lobbying efforts to allow slots at Indiana racetracks, the taxpayer knew that the prize purses were going to increase in Indiana, which would ultimately significantly improve the profit potential of racing. The Court concluded the taxpayer's expectation of future profits was consistent with the existence of a profit objective for all of the tax years in issue.

Financial Status - The taxpayer was not an excessively wealthy individual and his house was mortgaged. Additionally, he continued to work long hours in physically demanding endeavors after resigning from several successful ventures. Furthermore, he participated less in personal and recreational aspects of the horse related activities starting in 2007. The Judge concluded under the strict wording of the regulations, this factor favored the government for all tax years in issue.

Elements of Personal Pleasure or Recreation - Judge Paris noted that from 1998 until 2007, the petitioner divided his time between racetracks and training facilities. The Judge noted that while there is certainly work involved at a racetrack, there is a higher level of recreation and social activity available at a racetrack. During the years 2005 and 2006, the taxpayer attended both the track and the training activities of his operation, in other words, the taxpayer participated equally in the social and business aspects of horseracing, which indicates that before tax year 2007 taxpayer enjoyed some recreational aspects of horseracing. But starting in 2007, when he moved his horse activity to the Mooresville property, he became more interested in the business aspects of the activity. Accordingly, the judge concluded that elements of personal pleasure or recreation weigh in favor of the IRS before 2007 and in the taxpayer's favor for tax years 2007 and 2008.

Finding of the Court

> "On the basis of the record and considering the nine factors discussed above, the Court found the petitioner did not engage in the horse related activities for profit during the 2005 and 2006 tax years. However, petitioner demonstrated a profit objective beginning in the tax year 2007, when he significantly changed operations, opened a new facility on real estate specifically purchased for horse related activities, and transitioned out of the recreational aspects of horseracing. Accordingly, petitioner demonstrated the curricular requisite profit objective under section 183 to deduct business expenses for tax years 2007 and 2008, but not for the tax years 2005 and 2006."

Penalties

The IRS assessed the accuracy related penalty on deficiencies for the years 2005, 2006, 2007, and 2008. The Court dismissed this penalty because the taxpayer demonstrated reasonable cause [through good faith] for tax years 2005 and 2006. No such penalty was applicable with respect to adjustments for tax years 2007 and 2008 because there was no deficiency once the activity was determined to be a business for profit.

The IRS also assessed a late filing penalty with respect to the taxpayer's 2007 tax return. The taxpayer argued that he had reasonable cause to file his return late because some of the records were burned in a fireplace by a former girlfriend. He also argued that he thought his 2007 return would likely be audited and spent extra time to make sure the return was correct. The Court found that neither the "wrath of a former girlfriend," nor preoccupation with an audit constituted a reasonable cause for failure to file a Federal tax return on a timely basis.

[*Roberts v. Comm'r,* **T.C. Memo 2014-74**]

Court of Appeals for the Ninth Circuit Upholds Tax Court Decision that Horse Activity Was Not Engaged In as a Business for Profit

The Tax Court concluded that the taxpayers lacked the requisite factual and honest objective of making a profit with respect to their Welsh pony and cob breeding and training activity. [Bronson v. Comm'r, T.C. Memo. 2012-17] The Bronson's appealed the Tax Court's decision to the Ninth Circuit Court of Appeals. The Ninth Circuit found that the Tax Court did not clearly err in determining that the preponderance of the evidence showed that the Bronson's were not engaged in horse training and breeding activity for profit within the meaning of the tax code. The Court of Appeals also upheld the accuracy-related penalty imposed by the Tax Court due to the taxpayers' substantial understatement of income tax.

[*Bronson v. Comm'r*, No. 12-72342 (9th Cir. 2015)]

Treasury and IRS Announce Intention to Amend Pari-mutuel Wager Regulations

On March 4, 2015, the U.S. Treasury Department proposed updated regulations for reporting winnings form bingo, keno, and slot machine play.

The proposal also stated that the Treasury Department and the IRS are aware that taxpayers required to report winnings from pari-mutuel gambling may have concerns about the reporting rules relating to when wagers with respect horse races may be treated as identical. Identical wagers are combined and offset against winnings to determine proceeds from the wager for purposes of determining whether the reporting thresholds are satisfied.

Accordingly, it was announced that the Treasury Department and the IRS intend to amend the withholding regulations (Sec.31.3402(q)-1) in a manner consistent with the new proposed regulations relating to bingo, keno and slot machine play and request comments from the public on this subject.

This announcement gives the horse racing industry a very good opportunity to make the case to the government that the reporting and withholding rules that currently apply to pari-mutuel wagering on horse racing are not only outdated, but are unfair to taxpayers who wager on horse racing.

Comments on these proposals may be submitted by June 2, 2015.

The full rule proposal may be viewed at: http://www.gpo.gov/fdsys/pkg/FR-2015-03-04/pdf/2015-04437.pdf

Tax Bulletin No. 373

Are You "Responsible" for Company Tax Liabilities? The Answer May Surprise You!

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Based on the advice of their CPAs or attorneys, most horse business owners participate in horse operations through separate legal entities like limited liability companies ("LLCs") or Sub-chapter S-corporations. This (proper) advice is often made to help limit or shield the personal assets of horse business owners, operators and investors from the unpredictable risks and liabilities of equine ventures. Many horse business owners sleep better at night believing their house, cars and bank accounts are secure and protected. Unfortunately, these business owners are unaware that in certain situations the Internal Revenue Service and many state taxing authorities have legal tools at their disposal to attack the careful planning of CPAs and attorneys and reach the personal assets of certain business owners, operators and participants.

Trust Fund Taxes

Clearly, equine business owners are aware that they are responsible for their personal income taxes that flow through to them under the passthrough taxation of LLCs and S-corporations. However, many equine business owners are surprised to learn that they may be personally liable for certain taxes or civil penalties due at the entity level. Specifically, the Internal Revenue Service and many state taxing authorizes have the ability to assess and collect unpaid taxes or civil penalties for "trust fund taxes" owed by the business or entity. In other cases, taxes like a gross receipts or a business earnings tax may be collectible against an individual by state or local statute.

A trust fund tax is typically a tax where the business entity collects and receives taxes owed by a third party and then has the obligation to periodically report and pay these collected taxes to the taxing authority. Example of trust fund taxes include, but are not limited to, federal, state and local employment withholding taxes and sales and use taxes. In some instances an equine business participant may be individually liable for the tax or a civil penalty if the taxing authority determines that the participant is a responsible party of the business.

Who is a responsible party?

While federal, state and local statutes and case law differ as to who is a responsible party, the current position of the Internal Revenue Service provides a good starting point to examine who is a responsible party. The IRS website at www.irs.gov lists the following as a description of who is a responsible party:

> . . . "responsible party" is the person who has a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the individual, directly or indirectly, to control, manage or direct the entity and the disposition of its funds and assets. The ability to fund the entity or the entitlement to the property of the entity alone, however, without any corresponding authority to control, manage, or direct the entity (such as in the case of a minor child beneficiary), does not cause the individual to be a responsible party.

The language above clearly illustrates that the determination of who is a responsible party may be broader than most business owners would have imagined. For instance, the IRS standard does not require that a responsible party have majority control. Further, it does not require that the responsible party be an officer, director, manager or owner of the entity. The definition does not even require that the responsible party work with or have knowledge about the workings of the underlying tax. This means that a minority owner, certain officers or even employees (even if they are not owners of the business) may be responsible parties. Case law even supports the concept that an officer of a nonprofit corporation may be a responsible party. This is a fact a volunteer should keep in mind before volunteering as an officer of a nonprofit corporation. Finally, in numerous instances the Internal Revenue Service identifies multiple parties within an entity as responsible parties.

In order to determine who is a responsible party, the taxing authority typically interviews potential, responsible parties. The IRS interview is based on Form 4180. In a broad sense the IRS is looking for any person who has the right to control the use and/or distribution of funds even if that person does not act on that authority. For instance, many taxpayers mistakenly believe that they are not a responsible party because they have delegated their authority over certain taxes to a third party. This is particularly true where a person has delegated tax payment authority to a CPA or payroll company. Unfortunately, numerous cases have proven these taxpayers wrong.

In addition to interviewing a potential responsible party, taxing authorities, like the IRS, look for written evidence regarding the authority and control of a potential responsible party. For instance, the IRS often asks for the signature card for the entity's bank account. Clearly, individuals who are currently on these signature cards for convenience as opposed to the necessity of the business should remove their names from the signature cards. The IRS also checks minute books and operating documents to see who holds particular titles such as Manager, President or Treasurer. Depending on the written, actual or theoretical responsibilities of these positions, it may be difficult to convince a taxing authority that these parties lack the requisite authority as a responsible party for the business. Anyone holding the aforementioned title who no longer actively participates in a business should consider resigning from such positions. As mentioned previously, officers of nonprofit organizations are also subject to these rules and a taxpayer should not accept an officer position or title unless he or she is willing to perform the oversight required.

Passive or minority members of LLCs or S-corps must also remain vigilant. Some operating documents (often at the request of the minority member) grant super powers, or require super majority votes for certain payments or expenditures. Depending on the breadth of the power granted or even the level of actual activity in the entity by the minority members, a minority or passive member could be a responsible party. Passive members and minority members should review the entity's operating documents to determine what "apparent" authority they may have.

Regardless of a person's position with an entity, there are a few steps all investors, owners, employees and potential responsible parties can take to protect themselves from personal liability for unpaid entity taxes. First and foremost, potential responsible parties should determine if the proper procedures are in place to monitor trust tax payment obligations. This means verifying that the proper forms are filed, payments are made and proof of payment is maintained. These tasks should involve more than one person to provide the proper checks and balances. Second, if a mistake or error is discovered, the business should call its CPA or attorney immediately. Errors in trust fund type taxes like employer withholding or sales and use typically require a quick and decisive response to avoid penalty and interest. Third, business personnel should review all contractor relationships to make certain that the contractor could not be viewed as an employee. This is currently a point of emphasis with the IRS. Finally, if the business has a cash flow issue, the business should pay trust fund taxes before most other liabilities. Late or unpaid trust fund taxes typically involve large penalties that become problematic very quickly. Potential personal liability makes the choice of paying other creditors ahead of the IRS or other taxing authorities a bad choice.

Responsible party liability for certain taxes like trust fund taxes is a scary realty that should not be ignored and cannot be delegated with a blind eye. If you are a potential responsible party, be prepared to roll up your sleeves and meet with your tax advisor to review your equine business' payment practices and tax risks. Your additional attention and preparation could save you real headaches and real money in the future.

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