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Tax Court Finds Thoroughbred Racing and Breeding Activity Engaged in as a Business for Profit

The taxpayers, husband and wife, owned and operated a very successful concrete company in San Francisco, California. The husband had been president of the company for more than two decades. His wife worked part-time at the company and had principal responsibility for the company's finances, including the bookkeeping and accounting. She also kept the books and records of the thoroughbred activity.

In the early 1980s, the taxpayers began to purchase race horses, and expanded the thoroughbred activity substantially during the next decade. They hoped to make money by winning purses at horse races, by selling race horses at a profit, and by breeding foals that they could race successfully or sell. Since 1981, the taxpayers co-owned most of their horses with their trainer, who normally owned a 50% interest in the horses with the taxpayers. He was a very successful trainer and over the years, he co-owned more than 50 horses with the taxpayers and trained virtually all of their horses.

Between the years 1981 and 2000, taxpayers mainly purchased claiming horses and focused on claiming races. In 2001, they changed their approach and stopped buying horses from claiming races and began purchasing young race horses. Their trainer wisely invested in "the sons and daughters of some of California's best stallions." In 2007, the taxpayers and their trainer again adjusted their business plan to put a greater emphasis on breeding horses.

Between 1981 and 1994 the taxpayers had some success in the thoroughbred activity, earning modest profits in 1983, 1984, 1987, 1988, and 1994. Taxpayers suffered annual losses from 1995 through 2010. After an audit of the taxpayers' returns for 2009 and 2010, the IRS determined that during those years the taxpayers did not engage in their thoroughbred activity with the intent to make a profit. The IRS therefore denied the deduction of losses of $81,114 and $55,974 for 2009 and 2010, respectively. The taxpayers disagreed with the IRS determination and took the matter to the US Tax Court. Judge Lauber was assigned the case on behalf of the Court.

Opinion

Judge Lauber decided the case for the Court based on application of the nine factors listed in the Treasury regulations.

Manner in which activity is conducted - The Judge found that the taxpayers kept thorough and

accurate records of the thoroughbred activity. The wife maintained detailed spreadsheets that enabled the petitioners to determine the profitability of each horse on the basis of the original cost, expenses of training and upkeep, purses won, and the potential for breeding. The taxpayers used these records, in consultation with their trainer, to reduce losses by culling unprofitable horses, and if a horse became injured or raced poorly, the taxpayer disposed of that horse, unless it had significant breeding potential.

Although the taxpayers did not have a written business plan, they had a business plan developed in conjunction with their expert horse trainer, and they consistently pursued it. The Judge noted that the evidence established that formal cash projections for a horseracing business would be speculative. In addition, the taxpayers established that they were able to run the very profitable concrete business without a written business plan or formal income projections.

The Judge found that the taxpayers conducted their thoroughbred activity in the same manner as other successful practitioners, including their trainer, a highly successful thoroughbred trainer. The taxpayers' expert at trial testified that good managers in the thoroughbred business "watched the competition, and are consistently evaluating their inventory." The record establishes that the taxpayers followed this to the maxim. They constantly observed races, studied sales catalogs and, in consultation with the trainer, purchased the sons and daughters of some of California's best stallions. Their lack of nostalgic attachment and willingness to sell unproductive horses was further evidence of the taxpayers' managerial skill.

The Judge noted that the taxpayers also changed their operating procedures in a manner consistent with intent to improve profitability. Together with the trainer, the taxpayers made several major adjustments to their business plan over time, such as getting out of claiming horses and shifting to higher-priced horses so that they could credibly compete for significantly larger purses. They made a further change to their operating procedures by placing greater emphasis on breeding horses, which resulted in the birth of foals with excellent potential for profits.

The Judge pointed out that the taxpayers and their trainer ultimately lost a large number of horses during 2007-2009, an "anomalous" level of losses that the trainer later attributed to the installation of artificial turf on California racetracks.

The Court concluded that all in all, the taxpayers conducted their thoroughbred activity in a businesslike manner. According to the Judge, each of the elements discussed indicated that they had the requisite profit objective, and therefore, this factor strongly favored the taxpayers.

Expertise of the taxpayers or their advisors - The Judge pointed to the fact that the taxpayers began their thoroughbred activity in 1981, and during the ensuing decades, developed considerable expertise and immersed themselves in all aspects of the business. Furthermore, the taxpayers constantly sought and received advice from their trainer. an indisputable expert in thoroughbred racing, and purchased most of their horses in conjunction with him. The Judge concluded that co-ownership of thoroughbreds with an expert trainer suggests a profit motive. During his career, he trained horses that earned almost $12.7 million. The Judge concluded that the central thrust of the taxpayers' business plan was to leverage the trainers' expertise to help them win large purses. The Court found this factor to be important in their analysis and overall it strongly favored the taxpayers.

Taxpayers' time and effort - The taxpayers estimated that they jointly devoted to their thorough-

bred activity between 55 and 60 hours of their time a week, an uncorroborated estimate which struck the Court as a high amount of time. On the other hand, the Court noted that the taxpayers did employ highly competent professionals to assist them, including first and foremost their trainer, who devoted 10 to 16 hours a week training taxpayers' horses and additional time to consultations about buying, breeding, and selling thoroughbreds. Taxpayers also employed other professionals, such as high quality veterinarians. Primarily because of their trainer's intense involvement, the Court concluded that this factor favored the taxpayers, but only slightly.

Expectation of appreciation in value - The Judge noted that horses can appreciate in value while they are racing and can generate income from breeding foals or earning stud fees. Since 2008, the Judge noted that two of the taxpayers' horses earned more than $100,000 and five others earned more than $20,000. They received offers of $250,000 for a horse they claimed for $8,000, $150,000 for a horse they purchased for $17,000, and $150,000 for a horse they bred. The Judge concluded that given the relatively low acquisition cost, good bloodlines of their horses, and expert training that their trainer provided, taxpayers could, and did expect to realize significant appreciation in the value of their thoroughbred assets. The Court concluded that this factor pointed fairly strongly in the taxpayers' favor.

Taxpayers' success in other activities - The taxpayers pointed to extraordinary success in growing their concrete business as a factor in their favor. The Judge countered by pointing out that there is little synergy between the concrete business and their thoroughbred activity. The record is devoid of any evidence of the taxpayers' past efforts to convert an unprofitable business into a profitable one. Thus, the Court found this factor neutral.

History of income or losses - The Court pointed out that the thoroughbred activity had generated continuous losses since 1995. While they were relatively modest during the 1990s and early 2000s, the losses increased during 2002-2007, averaging $44,640 annually when the taxpayers and their trainer began buying yearlings. In 2007, losses increased again when taxpayers began placing increased emphasis on breeding foals which could not race for at least two years. The losses increased substantially during 2008-2010, averaging $64,753 annually.

The Court recognized that this was not an impressive track record, but three facts mitigated the negative implications that might be drawn from it. First, taxpayers' losses during 2007 through 2009 were exacerbated by injuries to several promising horses, apparently traceable to the 2007 switch to artificial turf at most California racetracks. Second, taxpayers' shift in 2007 to a significantly higher level breeding activity made it necessary to increase current expenses while deferring income. Third, taxpayers received six-figure offers for three of their horses and had they accepted these offers they would have had profits for those years and gone a long way toward eliminating their cumulative losses. While in hindsight the decision to reject the offers may have been unfortunate, the Court found they were rational business judgments not inconsistent with intent to derive a profit from the thoroughbred activity. Consequently, the Court concluded that the losses did not negate taxpayers' actual intent to profit from the thoroughbred activity, and therefore the factor weighed in favor of the taxpayers.

Amount of occasional profits - The Court noted that the taxpayers' thoroughbred activity was highly speculative and had been profitable only for five of the past 30 years, but the activity did give the taxpayers a real chance to earn a substantial profit. According to the Court, the record supported taxpayers' belief that their trainer possessed expertise to produce winning thoroughbreds. As co-owner of these horses, he had every incentive to train them well and believed from the outset that it would

be a profitable endeavor. While taxpayers have yet to win a purse exceeding $100,000, that goes with the nature of the speculative business - its outcomes are uncertain. Despite minimal profits that the taxpayers earned from their thoroughbred activity over the years, the Court concluded that this factor slightly favored taxpayers.

Taxpayers' financial status - The Court pointed out that the taxpayers' concrete business was quite profitable, enabling the husband to derive an annual salary averaging about $1 million during the tax years at issue. Losses flowing from taxpayers' thoroughbred activity generated substantial tax benefits, as well as giving the taxpayers considerable pleasure from the recreational aspects of the activity. Thus, the Court concluded that this factor strongly favored the IRS.

Elements of personal pleasure - While clearly the taxpayers did not own or ride horses for pleasure, the Court found that they did derive immense pleasure from the thoroughbred activity. They took regular vacations to Delmar Thoroughbred Club, traveled annually to Las Vegas to watch the Kentucky Derby on the big screen and watched their horses almost daily. Overall, the Court concluded that this factor favored the IRS.

Conclusion - Overall, the Court concluded that the taxpayers predominant, primary, or principal objective in engaging in their thoroughbred activity was to realize an economic profit independent of tax savings. The Court based its conclusion on a qualitative judgment, not just on adding up the factors. Central to the Court's conclusion is their trainer's involvement, not only as a trainer, but also as co-owner of taxpayers' horses. The Court found that the evidence clearly established that the trainer embarked on the venture with the intent to make a profit. The Court concluded that the taxpayers' motivation was the same as the trainer.

[*Annuzzi v. Commissioner,* T.C.Memo 2014-233]

Editor's Note: The co-counsel for the taxpayers in this case were Richard Craigo and Paul Husband. Mr. Craigo was a member of the American Horse Council Tax Bulletin Advisory Board for many years and Mr. Husband still is.

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Worker Classification Issues for Federal Tax Purposes

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Historically, worker classification has been a subjective and highly scrutinized issue that has been influenced by various political considerations. Recently, in an effort to offset some of their growing budgetary needs, the federal and state governments have renewed their focus on identifying businesses that have misclassified their workers as independent contractors. For example, in the Obama Administration's 2014 Department of Labor budget proposal, $14 million was allocated to the states and Department of Labor personnel to pursue worker misclassification issues.

Thus, for individuals and businesses that employ workers, it is crucial that such workers are properly classified as either an employee or independent contractor. The misclassification of an employee as an independent contractor can have numerous negative effects, including, but not limited to the following: (1) a failure to withhold and remit employment taxes to the IRS; (2) exposure to Department of Labor issues; (3) exposure to state-level employment taxes and fees; and (4) a failure to comply with the Affordable Care Act. The misclassification of a worker as an independent contractor resulting in the failure to withhold and remit employment taxes to the IRS can carry with it significant monetary penalties and, in some instances, may result in criminal charges being filed against the individual responsible for the misclassification of the worker.

I. Federal Employment Taxes

Under the Internal Revenue Code (the "I.R.C."), employers are subject to numerous obligations with respect to their employees (collectively, the "Employment Tax"). First, the I.R.C. requires that employers remit the Federal Unemployment Tax ("FUTA") and the Social Security and Medicare Tax ("FICA") based on the wages paid to its employees during the taxable year. Additionally, the I.R.C. also requires that employers withhold and remit their employees' FICA and federal income tax withholding obligations. For businesses utilizing independent contractors, there are no similar Employment Tax obligations.

A. What is an Employee for Federal Employment Tax Purposes?

When analyzing a worker classification issue for Employment Tax purposes, the IRS will look at the entire relationship between a business and its workers. In this analysis, the IRS will generally focus on the following factors: (1) Does the business control or have the right to control what the worker does and how the worker does their job; (2)Who controls the business aspects of the worker's job; (3) Are there written contracts or employee type benefits being provided to the worker; (4) Will the relationship between the worker and the business continue; and (5) Is the work being performed by the worker a key aspect of the business. Importantly, none of these factors alone are determinative to the analysis of whether a worker is an employee. The IRS will make its determination based on the entire relationship between the business and its workers. Generally, the more control that a business exerts over its workers, the more likely it will be for the IRS to determine that there is an employer-employee relationship using these factors.

For purposes of an employer's obligation to withhold and remit their employer's federal income tax obligations, a worker will be considered to be an employee in situations where the business has the right to control such worker. To determine whether a business maintains the right to control a worker, both the Courts and the IRS will apply a variety of factors, including, but not limited to the following: (1) instructions provided by the business to the worker; (2) training provided by the business to the worker; (3) any continuing relationship between the worker and the business; (4) whether the worker could suffer an economic loss from the work performed; and (5) the ability and terms by which the parties can end the working relationship. Importantly, like the general IRS test, no one factor is controlling and whether or not a worker should be classified as an employee will be determined by an analysis of the entire working relationship.

B. Enforcement of Federal Employment Taxes / Civil and Criminal Penalties

According to IRS estimates, Employment Tax underreporting constitutes almost $72 billion of the total Tax Gap. As such, the IRS has been extremely motivated in recent years to ensure that businesses properly classify their workers for Employment Tax purposes. For example, in 2010 alone, the IRS undertook examinations of the worker classification utilized by roughly 60,000 businesses nationwide.

To encourage compliance with the Employment Tax provisions, the I.R.C. imposes numerous civil and criminal penalties. The IRS has the authority to impose penalties for numerous reasons where it finds that a business has misclassified some of its workers as independent contractors, including penalties for the failure to timely file Forms 941 reporting the correct Employment Tax liability, the failure to timely pay the correct Employment Tax liability, the failure to timely provide workers with a Form W-2, and the failure to timely file a Form W-2 with the IRS. In addition to these civil penalties against the business itself, the IRS also has the authority to impose a civil penalty against any responsible person that willfully failed to collect and remit the Employment Taxes up to the full amount of the business' Employment Tax liability. Lastly, in situations where the IRS determines that an individually intentionally misclassified workers as independent contractors to avoid the federal Employment Taxes, the IRS will likely bring criminal charges against such an individual for either a failure to pay the Employment Taxes to the IRS, a failure to provide Forms W-2 to their workers, or tax evasion.

C. Potential Defenses

While the penalties for businesses misclassifying their workers as independent contractors can be substantial, there are several defenses available to such businesses. One of the most common defenses is the safe harbor provision created in Section 530 of the Revenue Act of 1978, which provides businesses with an alternative argument to the general employee tests used by the IRS. Additionally, the IRS has also created a program by which businesses can voluntarily recharacterize their independent contractors as employees to become compliant with the Employment Tax laws without the threat of future civil or criminal ramifications.

i. Section 530 Safe Harbor

A safe harbor was created under Section 530 of the Revenue Act of 1978 for businesses employing independent contractors. Under this safe harbor provision, workers will be deemed not to be an employee for purposes of the federal Employment Taxes provided that the business had a reasonable basis for not treating such worker as an employee. For a business to establish that they had a reasonable basis for treating a worker as an independent contractor, the business needs to show either that: (1) it reasonably relied on a court case about federal taxes or a ruling issued to it by the IRS; (2) its Employment Tax liabilities were audited by the IRS at a time when it treated similar workers as independent contractors and the IRS did not reclassify those workers as employees; (3) it treated the workers as independent contractors because it knew that was how a significant segment of its industry treated similar workers; or (4) it relied on some other reasonable basis, such as a reliance on the written advice of a business lawyer or accountant who knew the facts about its business. To establish a reasonable basis based on the reliance of an industry practice, the business needs to be able to show that it knew at the time it began treating its workers as independent contractors that this was a standard practice within its industry to establish a reasonable basis.

In addition to the reasonable basis requirement, businesses seeking to take advantage of this Section 530 safe harbor provision must establish a few additional facts. First, the business must establish that the workers under scrutiny have not have been treated by the business as an employee in the past. Second, the business must establish that it has consistently filed forms with the government treating such workers as independent contractors. Lastly, the business must establish that it does not treat any workers holding substantially similar positions to that of the workers at issue as an employee. If the business can establish these additional facts, the business should be able to defend their independent contractor classification for federal Employment Tax purposes in the event the IRS initiates an Employment Tax examination.

ii. Voluntary Classification Settlement Program

In the fall of 2011, the IRS implemented its Voluntary Classification Settlement Program (the "VCSP") which allows eligible businesses to reclassify their workers for federal Employment Tax purposes. Under the VCSP, a business must pay 10% of what their Employment Tax obligations would have been had the employer treated the reclassified workers as employees during the previous full calendar year. Importantly, businesses choosing to reclassify their workers as employees under the VCSP will not be liable for any interest or penalties on their Employment Tax liability and will further not be subjected to an Employment Tax audit for any prior years. To be considered an eligible business for purposes of the VCSP, the business

must meet the following requirements: (1) the business has consistently treated the reclassified workers as independent contractors and filed Forms 1099 for these workers for the previous three years; (2) the business is not currently under an Employment Tax audit; and (3) the business is not currently being examined by the Department of Labor or any state government agency for its worker classification system. If a business can meet all of these requirements, then such business can fix their workers classification issues for a minimal cost and gain some protection from a future IRS examination.

II. Affordable Care Act

Under the Affordable Care Act (the "Act"), businesses are now required to comply with an employer mandate requiring that such businesses provide their employees with access to qualifying health insurance coverage. Under this employer mandate, what qualifies as adequate health insurance coverage is based on the number of employees employed by such business. Additionally, the penalties for failing to comply with this employer mandate are also based on the number of employees employed by the business. To determine whether or not a worker is an employee for purposes of this employer mandate, the Department of Treasury has indicated in its proposed regulations that the common law test utilized for the federal income tax withholding requirements will be used. Therefore, if a business is required to withhold federal income taxes from its workers' paychecks, such business will likely be subject to the Act's employer mandate. It is important to point out, however, that a small business (defined in the Act as a business employing 50 or less full time employees) is exempt from the Act's employer mandate. Therefore, worker classification is only important, for purposes of the Act, for businesses employing more than fifty workers.

III. Worker Classification Issues at the State Level

All fifty states have laws impacted by whether a worker is classified as an employee or an independent contractor. For example, in Kentucky, worker classification can become an issue under Kentucky's unemployment compensation, workers' compensation, and income tax laws. Unsurprisingly, there is no unified test among the fifty states as to whether or not a worker should be classified as an employee, but most states rely on one or a combination of the following tests in some form or fashion: (1) common law test; (2) ABC test; and/or (3) right to control test.

Under the common law test, states will rely on and perform an analysis of the various factors identified by that state's courts which establish an employer-employee relationship. Under the ABC test, the states will analyze the level of control exercised over the worker, whether the work performed is in the usual course of business, and whether the work performed is an independently established trade or business. Under the right to control test, the states will analyze the businesses' ability to control the worker under series of various factors. As a result of the variety of tests used by the states, businesses operating in multiple states need to pay close attention to each state's respective worker classification test because it is possible for a worker to be an employee in one state and an independent contractor in another.

IV. Compliance Considerations

If you operate a business employing independent contractors, there are several steps that may be taken to ensure compliance with the various worker classification standards.

First and most importantly, a business should seek to identify any potential compliance gaps with its current worker classification system, i.e. identify whether there is the potential for the business' independent contractors to be reclassified as employees by a state or federal governmental agency. If any potential compliance gaps are identified, it will be important to perform a full analysis under the appropriate worker classification test to determine the full extent of the business' potential liabilities. Once you know the full extent of the potential problems, steps to mitigate the damages caused by your potential incorrect classification of a worker as an independent contractor may be taken.

If unable to identify any potential compliance gaps with the business' usage of independent contractors, there is still the potential that the IRS, Department of Labor, or some other governmental agency may challenge the business' worker classification system. Therefore, it is extremely important that proper documentation is produced and retained in the business' records to support the business' independent contractor classification. The failure to maintain sufficient records supporting usage of independent contractors could result in a governmental agency reclassifying workers as employees.

Lastly, regardless of whether any potential compliance gaps are identified in connection with the business' usage of independent contractors, it is imperative that the facts and circumstance surrounding the working relationship with independent contractors is continually monitored and properly documented. Just because a worker qualifies as an independent contractor today does not mean that the facts of the relationship won't change in the future making such independent contractor an employee. As has been previously discussed, errors made by a business in classifying their workers as independent contractors can be extremely costly to the business and the individual controlling such business. Thus, constant monitoring will help minimize the risk of a worker classification error being made in the future.

V. Example of Worker Classification Issue in the Equine Industry

In Twin Rivers Farm, Inc. v. Comm., T.C. Memo 2012-184, the United States Tax Court (the "Court") upheld the results of an Employment Tax examination that resulted in the taxpayer being assessed a $25,800 Employment Tax liability and an additional $6,300 in civil penalties. The taxpayer at issue in this case operated an equine business that raised, trained, marketed, and showed horses for future sales.

In a scenario that should resonate with many equine business operators, the Tax Court made it abundantly clear that improperly classifying employees as independent contractors can be a very costly error. In its opinion, the Court held against the taxpayer on virtually every factor considered in the determination whether the two individuals providing labor at the equine operation were independent contractors or employees. This is a classic case of the taxpayer leaving itself totally defenseless by needlessly ignoring the factors to be considered in making the critical determination differentiating independent contractors from employees.

To assist with the taxpayer's business, the taxpayer hired two workers that provided cleaning and maintenance services throughout the taxpayer's farm property. Important to this case, the two workers lived in a trailer on the taxpayer's farm rent-free, used tools and equipment provided by the taxpayer, relied on the taxpayer to pay for any needed supplies, were paid a fixed weekly salary, and were covered under the taxpayer's worker compensation and employer liability insurance coverage.

In analyzing the relationship between the taxpayer and its two workers, the Court relied upon seven of the common law factors used to determine whether an employer-employee relationship exists. The Court's analysis under these seven factors is as follows:

1. Degree of Control: The Court found that this factor supported a finding of an employer-employee relationship because the Court determined that it was highly unlikely that the taxpayer-owner would not exercise control over the workers considering the workers' use of the taxpayer's valuable equipment and responsibilities with the taxpayer's horses.
2. Investment in Facilities: The Court found that this factor supported a finding of an employer-employee relationship because the taxpayer provided the two workers with everything they needed to perform their duties.
3. Opportunity for Profit or Loss: The Court found that this factor supported a finding of an employer-employee relationship because the two workers were paid a fixed salary and had no opportunity to make a profit or loss with respect to their duties because the taxpayer provided them with all necessary equipment and supplies.
4. Right to Discharge: The Court found that this factor supported a finding of an employer-employee relationship because the taxpayer presented no evidence showing that the taxpayer was limited in its ability to discharge the two workers.
5. Work Is Part of Principal's Regular Business: The Court found that this factor supported a finding of an employer-employee relationship because the two workers supported the taxpayer's business by keeping the taxpayer's farm presentable for potential buyers, keeping the farm grounds safe for the horses, and aiding in the care of the taxpayer's horses.
6. Permanency of Relationship: The Court found that this factor supported a finding of an employer-employee relationship because the two workers were long-term employees that actually resided on the farm property.
7. Relationship the Parties Thought They Created: Despite the taxpayer's contention that they intended for the two workers to be classified as independent contractors, the Court determined that the actual relationship between the taxpayers and the two workers did not support that intent. The Court reasoned that the taxpayer's actions in purchasing workers' compensation and employment liability insurance, covering all the workers' job-related expenses, and providing the workers a residence on the farm property all indicated the intent to create an employer-employee relationship.

Since all seven factors utilized by the Court supported a finding that an employer-employee relationship was created, the Court upheld the Employment Tax examination reclassifying the two workers as employees.

Under the circumstances, the taxpayer appeared to either be ignorant of the factors, simply ignored the factors, or was not in a position to reshape the nature of the relationship so that the taxpayer would at least have a fighting chance to characterize the two men hired to work on the farm as independent contractors. Equine business proprietors should be well aware of these factors discussed herein in much detail in advance of hiring decisions and, with some modest level of sophistication in planning – put the business in a position to at least better argue that farm workers might be able to be classified as independent contractors rather than employees.

For more information, or to respond to any questions you may have, please contact Joel B. Turner by email: jturner@fbtlaw.com, or phone: 502-568-0392.

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