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Tax Court Finds Arabian Farm Not Engaged in as a Business for Profit

The taxpayers owned and operated several highly successful automobile dealerships. The husband grew up around horses and his family became involved with Arabian horses when he was very young. In 1993, the taxpayers began their Arabian horse activity. In September of 2011 the taxpayers formed Rock Ledge Arabians, LLC, and had since operated their horse activity under this name. (Hereinafter, the Arabian horse activity will be referred to for all years as Rock Ledge.) According to the taxpayers, the goal of Rock Ledge was to operate a full-service horse farm with breeding, boarding, training, hauling and showing the horses. The husband believed that breeding-only farms are no longer profitable in the Arabian horse industry. He chose to breed Half-Arabians, because he believed the market for Half-Arabian horses to be competitive with purebred Arabians.

For the taxable years 2005 through 2012 the taxpayers reported losses on schedule F as follows:

Tax Year	2005	2006	2007	2008	2009	2010	2011	2012
Loss	$91,710	$83,503	$151,849	$225,544	$174,492	$195,904	$147,242	$85,022

Rock Ledge had not made a profit since it opened for business in 1993. During the years listed above, Rock Ledge did not generate enough income to cover the costs associated with feeding the horses.

The IRS had audited taxpayers' 1999 and 2007 tax returns and Rock Ledge was determined to be conducted with a profit objective. Two years later, the IRS audited the taxpayers' returns for the years 2009 through 2011 and determined that Rock Ledge was not conducted with a profit objective. They assessed tax deficiencies of $75,802, $69,836, and $61,667 for the years 2009, 2010, and 2011, respectively. The taxpayers did not agree with the IRS assessments and filed a petition with the U.S. Tax Court. The case was assigned to Judge Nega.

Opinion

Are the Arabian horse activity and the auto dealerships a single activity?

Taxpayers argued that Rock Ledge was engaged in for profit, and that Rock Ledge and the automobile dealerships were sufficiently interrelated to make them one activity for purposes of section 183 of the Internal Revenue Code (Code). The IRS took the position that if the Court determined Rock Ledge and the automobile dealership activity constituted one activity the government would concede

that Rock Ledge was engaged in for profit within the meaning of Code section 183.

Taxpayers cited the Court's decision in *Topping v. Commissioner*, T.C. Memo. 2007-92, which held that the taxpayer's interior design and equestrian activities were a single activity for purposes of Code section 183. In that case, the Court concluded that more than 90% of her interior design client base was generated through equestrian activity contacts.

The Court was not convinced that in the case of the two activities in question, the benefits of each activity derived from the other are anything more than incidental. The Court found that there was no evidence that Rock Ledge obtained economic benefit from the dealership, except for the inclusion of Rock Ledge employers in dealership insurance plans and payroll accounts. Consequently, based on that finding, as well as the fact that the businesses are in totally different locations and there is no similarity between the two activities, the Court found Rock Ledge and the auto dealership were not sufficiently interconnected to be treated as a single enterprise.

Whether the taxpayers conducted Rock Ledge for profit

The Court next turned to the question of whether Rock Ledge was an activity engaged in for profit. In reaching this decision, the Court referred to the nine factors set forth in the Treasury regulations to be considered.

1. The manner in which the taxpayers carries on the activity

The Court noted that the taxpayers had not submitted any books and records containing projected profit and loss of balance sheets or budgets. The business plan they did submit is undated and appears to have been "created solely for passing muster under section 183." Also, the Court pointed out that the evidence that was presented to show expected profits is devoid of any calculations of expenses. Furthermore, the Court noted, the taxpayers had not provided the Court with a consistent list of horses owned by Rock Ledge. In sum, the Court concluded that the inventories submitted to the Court were incomplete, some appeared to be incorrect, and they were not kept in a businesslike manner.

Taxpayers argued that they conducted Rock Ledge in a manner substantially similar to profitable activities of the same nature. The Court disagreed concluding that on balance, the lack of breeding services, horse sales, horse leasing, and riding lessons during the years at issue points to a lack of profit objective during those years. The Court noted that Rock Ledge during the years at issue did not report any income from breeding, no income from sales of horses, and no income from leases or riding lessons. The Court also found that the taxpayers had not undertaken any efforts to reduce expenses and the taxpayers had changed very little about the operations of Rock Ledge to make it profitable. The Court concluded that, overall, the numerous un-businesslike practices of Rock Ledge indicated the taxpayers did not have a profit objective. Thus, the Court concluded that this factor favored the IRS.

2. Expertise of the taxpayer or his advisers

The taxpayers argued that they had the requisite expertise because: the husband grew up breeding and training Arabian horses, they had been recognized as top breeders by the Arabian Horse World Magazine, and the husband had consulted with advisers knowledgeable about horse breeding operations. The Court responded by noting that extensive knowledge of horse breeding and training is, by itself,

insufficient to show that the taxpayer had the expertise required for a for-profit activity. In addition, the fact that the taxpayers had been recognized as top breeders did not necessarily show a profit objective. While the husband testified that he had spoken to several people who were successful in the industry, the Court noted that he did not identify any specific practices they might have advised him on. The Court also noted that he testified that he was influenced by the success of friends of his parents, who sold horses for up to $500,000, but that did not make them his advisers in any way relevant to whether he was in the horse business for profit. The Court concluded that the taxpayers had not shown that they had sought professional advice on the business aspects of operating a profitable horse business. The Court found this factor favored the IRS.

3. Time and effort expended in the activity

Taxpayers argued that the husband spent a substantial amount of time on Rock Ledge and therefore a profit objective is indicated. The Court responded by pointing out that the husband worked over 60 hours per week at his dealerships and has not withdrawn from his occupation in order to devote more time and energy to Rock Ledge. Furthermore, the Court noted, to the extent that the taxpayer is involved with Rock Ledge, much of his time appears to have been directed toward the more enjoyable aspects of the activity, such as attending horse shows. Nonetheless, the Court noted that the taxpayers employed a barn manager throughout the years at issue, as well as trainers during the portions of the years at issue. Therefore, the Court concluded that the fact that husband did not withdraw from his primary occupation did not weigh against the taxpayers. The Court found this factor to be neutral.

4. Expectation that the assets used in the activity may appreciate in value

The taxpayers argued that Rock Ledge was conducted with a profit objective because the horses were very valuable and the property, when sold, would generate income in excess of $1 million. The taxpayers argued that on the basis of the appraisal, the value of the horses was $575,000. In response, the Court found that to believe the taxpayers would suddenly have such increased success in a breeding program after 20 consecutive years of losses, ignores the reality of past sales as well as taxpayers' own business plan. The plan called for an average sale price of $15,000 per horse. The Court also noted that the taxpayers' argument that they would have an unrecognized gain of $575,000 in the herd is premised on the homebred horses having a zero basis, but Rock Ledge used the accrual method of accounting on schedule F for each of the years at issue, which means the horses did not have a zero cost basis. Finally, the Court noted that even if the taxpayers were able to sell the horses for $575,000, they would recoup less than half of the losses over the period from 2005 through 2012. Consequently, the Court concluded the value of the horses did not support taxpayers' assertion that when sold, Rock Ledge would become profitable.

As for the unrealized gain in the property being $1 million, the Court responded that the taxpayers had not provided adequate information about the assessed value of the land, except for providing the Court with the original purchase price of $150,000. The taxpayers argued that they did not purchase the property to profit from its increase in value, but instead they purchased the property to begin a horse farm. Therefore, the taxpayers believed that the land and Rock Ledge necessarily constituted the same activity, and the value of the land should be taken into account in determining whether the Arabian horse activity was engaged in for profit. The Court disagreed, finding that there was no economic or organizational relationship between the property and Rock Ledge. The Court pointed to the fact that the taxpayers had purchased the property in 1985 and began using the farmhouse as their principal

residence in 1987 and but didn't begin Rock Ledge until 1993. Had the taxpayers truly intended to put a horse farm on the property when they bought it, the Court concluded that they would have done so within the first few years of purchase. Further, the Court found that the sale of part of the property in 1997 was evidence that the land was appreciating independently from Rock Ledge and not as a result of it. The Court concluded that since the property was not an asset of Rock Ledge, and the value of the herd did not support a finding that the assets were appreciating, this factor weighed in favor of the IRS.

5. Taxpayers' success in similar or dissimilar activities

Taxpayers argued that the husband's success in operating their automobile dealerships demonstrated his ability to turn unprofitable businesses into profitable enterprises. They pointed to the fact that he had transformed more than one bankrupt dealership into a profitable business and his overall growth in car sales from fewer than 100 units per year, to an excess of 8,000 vehicles sold per year. The Court responded that while he was a successful businessman, it did not appear that he imported any of the core principles of his own business philosophy into Rock Ledge, principles such as controlling margins, volume, and expenses. The Court noted that the taxpayers had failed to operate Rock Ledge in a businesslike manner and had not sought to make changes that would reverse the 20-year trend of losses. Thus, the Court found that this factor favored the IRS.

6. History of income or loss with respect to the activity

The Court first pointed out that the taxpayers had not realized a profit from Rock Ledge since it began over 20 years ago in 1993. The taxpayers argued that the sale of part of the property in 1997 made Rock Ledge profitable for that year. The Court responded, noting again that they did not find the property to be an asset of Rock Ledge, and therefore, do not attribute the gain on that sale to Rock Ledge's profitability. Taxpayers also argued that the loss of their Arabian stallion, Reflection RL, spontaneous abortions suffered by multiple mares, and reduced market conditions for Arabian horses during 2009-2011 caused their lack of profits. The Court did not agree that the economic recession or conditions within the Arabian horse market during the years at issue were "unforeseen or fortuitous circumstances" that would explain petitioners' lack of a profit during those years. The Court found that this factor favored the IRS.

7. Amount of occasional profits, if any, which are earned

Despite a 20 year history of losses, the Court noted that the taxpayers argued that they would realize a substantial profit upon the sale of their high quality horses with excellent bloodlines. The Court responded by pointing out that the taxpayers had provided no independent evidence of the value of syndicated stallions or proven that their broodmare band contained the mares that would supposedly produce high-value offspring. To the contrary, the Court found that the taxpayers had not shown that they could reasonably expect to earn a substantial profit. Based on the facts presented, the Court concluded that this factor weighed in favor of the IRS.

8. Financial status of the taxpayer

The Court noted that the taxpayers' gross income from other sources during the years at issue, excluding the losses from Rock Ledge, was substantial, totaling approximately $2.5 million, $1.2 million, and $1.9 million for 2009, 2010, and 2011, respectively. The Court concluded that the taxpayers' income was sufficient to enable a comfortable lifestyle during the years at issue despite the losses from Rock Ledge. The Court found this factor weighed in favor of the IRS.

9. Elements of personal pleasure or recreation

The Court noted that the husband had been involved with horses from a young age and clearly obtains personal enjoyment from working with the horses. Further, the taxpayers' daughter had a love of horses and both the husband and his daughter competed in horse shows during the years at issue. The Court concluded that this factor favored the IRS.

Finding: The Court found, after weighing the nine factors set forth in the opinion as applied to the facts and circumstances in this case, that Rock Ledge was not engaged in the Half-Arabian horse activity with the objective to make a profit.

Whether the taxpayers were liable for the accuracy-related penalty

The IRS determined that the taxpayers were not liable for accuracy-related penalties. The Court found that the taxpayers relied on an accountant to prepare their returns and he made good faith efforts to assess their tax liability and discuss these efforts with the taxpayers when they hired him as their accountant. The Court concluded that while falling short of the requirements for profit objective, the taxpayers took Rock Ledge seriously. Accordingly, the Court held the taxpayers had reasonable cause and good faith for their position and found that they were not liable for any of the accuracy related penalties.

[Raymond Price, III and Lynn M. Price v. Commissioner, T.C. Memo. 2014-253.]

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Conservation Easements Update

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In the last couple of years there has been an increase in the number of tax court decisions involving conservation easements. In some of the cases the Internal Revenue Service is completely disallowing the charitable deduction for the donation of the conservation easement if the donor has not strictly complied with all of the statutory and regulatory requirements. It is very important that the donor and his or her advisors make sure all of the documents associated with the donation are prepared to be in compliance of these requirements. The following are a few of the requirements that have drawn the IRS's attention.

Qualified Appraisal

Code Section § 170(f)(11)(C) states that a qualified appraisal must be obtained by any donor of property for which a deduction of more than $5,000 is claimed.   Treas. Reg. § 1.170A-13(c)(3) further defines a qualified appraisal as follows:

An appraisal document that –

(A) Relates to an appraisal that is made no earlier than 60 days prior to the date of contribution of the appraised property nor later than the date specified in paragraph (c)(3)(iv)(B) of this section;
(B) Is prepared, signed, and dated by a qualified appraiser (within the meaning of paragraph (c)(5) of this section);
(C) Includes the information required by paragraph (c)(3)(ii) of this section; and
(D) Does not involve an appraisal fee prohibited by paragraph (c)(6) of this section.

<u>Information included in qualified appraisal.</u> A qualified appraisal shall include the following information:

(A) A description of the property in sufficient detail for a person who is not generally familiar with the type of property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;
(B) In the case of tangible property, the physical condition of the property;
(C) The date (or expected date) of contribution to the done;

(D) The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed, including, for example, the terms of any agreement or understanding that—

(1) Restricts temporarily or permanently a donee's right to use or dispose of the donated property,

(2) Reserves to, or confers upon, anyone any right to the income from the contributed property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or

(3)Earmarks donated property for a particular use;

(E) The name, address, and the identifying number of the qualified appraiser

(F) The qualifications of the qualified appraiser who signs the appraisal, including the appraiser's background, experience, education and membership, if any, in professional appraisal associations;

(G) A statement that the appraisal was prepared for income tax purposes;

(H) The date (or dates) on which the property was appraised;

(I) The appraised fair market value (within the meaning of §1.170A-1(c)(2)) of the property on the date (or expected date) of contribution;

(J) The method of valuation used to determine the fair market value, such as the income approach, the market-data approach, and the replacement-cost-less-depreciation approach; and

(K) The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

Swaps or Substitutions

A swap is defined as the removal of some or all of the originally protected property from the terms of the original deed of conservation easement in exchange for either the protection of some other property or the payment of cash. In *Belk v.Comm'r,* 774 F.3d 221 (4th Cir.2014), the 4th Circuit affirmed the Tax Court in holding that a conservation easement that authorizes the parties to agree to remove some or all of the original protected land from the easement in exchange for the protection of other land is not eligible for a deduction because it is not a restriction on the use which may be made of the real property as required under § 170(h)(2)(C).

Extinguishment by Judicial Proceeding

Treas. Reg. § 1.170A-14(g)(6)(i) states "If a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation under this paragraph can make impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding…..". In *Carpenter v. Comm'r,* T.C. Memo 2012-1, the Tax Court held that conservation easements extinguishable by mutual agreement of the parties, even if subject to a standard such as impossibility, fail as a matter of law to satisfy the judicial extinguishment requirement. The case was reconsidered by the Tax Court (T.C. Memo 2013-172) which confirmed that extinguishment by judicial proceedings is mandatory.

Contemporaneous Written Acknowledgment

Code Section § 170(f)(8)(A) requires that for a charitable donation of $250 or more the taxpayer must substantiate the contribution with a contemporaneous written acknowledgment obtained from the donee. The acknowledgment must include the amount of cash or a description of any property contributed, whether the donee provided any goods or services in consideration for the contributed property, and if goods or services were provided, a description and good faith estimate of the value of the goods and services. In *Schrimsher V. Comm'r*, T.C. Memo 2011-71, the Tax Court ruled that the conservation easement deed could not serve as a contemporaneous written acknowledgment. However, in *Averyt v. Comm'r,* T.C. Memo 2012-198 and *RP Golf, LLC v. Comm'r*, T.C. Memo 2012-282, the Tax Court held that the conservation easement deed could serve as a contemporaneous written acknowledgment. Given the inconsistencies of the rulings, it is advisable for donors to obtain a letter from the donee that includes the required language.

If you ever decide to donate a conservation easement it is important that you engage tax and legal advisors who are experienced with these easements.

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