AMERICAN HORSE COUNCIL'S TAX BULLETIN

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Tax Court Finds Arabian Breeding Farm Operated as a Business

For over two decades, the taxpayers, who are husband and wife, have owned an Arabian horse breeding farm, known as Silver Maple Farm (SMF). Between 2004 and 2009, the operation lost millions of dollars. The IRS determined that any business that had lost this much money could not be motivated by the desire to turn a profit and therefore disallowed the losses. The taxpayers disagreed and took the issue to the United States Tax Court. Judge Holmes wrote the opinion for the Court.

Judge Holmes started with a discussion of the history of the Arabian horse in the United States. He noted that the popularity of Arabians grew from 71 registered Arabians in 1908, to 300,000 registered horses by 1984. The taxpayers, whose wealth came from a successful baking business, bought their first Arabian in 1989 and claimed to have made Arabian horses into a business in 1991. They began purchasing quality Arabians when the price dropped dramatically, as the husband thought prices had reached the bottom. The Judge noted that with the exception of 2004 when the taxpayer sold the Naples, FL farm for $2.2 million, and moved the breeding farm to California, SMF never had a profitable year between 1991 and 2009. SMF averaged over a $900,000 annual loss between 1999 and 2002, even after taking into account the sale of the Naples property.

Judge Holmes began his analysis by stating: "While we organize our analysis by the nine factors listed in the regulation…we don't use a reasonable-person standard or substitute our own business judgment for what the Metzes could have done better. Our focus is instead on the Metzes' subjective intent and we use the factors to establish that intent."

Manner in which the activity is conducted – The Court found that the taxpayers kept records in a business-like manner. They used QuickBooks for bookkeeping and hired a CPA firm to perform monthly bank reports, including profit-and-loss statements. The taxpayers also hired a law firm to prepare written contracts for horses and semen sales. They made annual sets of alphabetized customer-oriented prospect lists and kept good records of when they contacted each customer, as well as relevant details of the discussions.

The Court noted that the taxpayers had annual written business plans for SMF, which included goals, job descriptions, policies and procedures, and descriptions of the farm's individual horses, as well as proposed advertising and promotion opportunities for the upcoming year. The Court also pointed out that the extensive advertising and promotion, and a very attractive website which generated a high percentage of SMF's contacts, showed that the taxpayers ran SMF in a business-like manner. The IRS asserted that the lack of individualized records on each horse showed a lack of profit motive. The Court

found that the monthly QuickBooks reports that the CPA firm produced, allowed them to properly assess economic performance and identify cost-reducing strategies, which were far more organized than others the Court had found adequate.

The Court concluded that the records the taxpayers kept did allow them to assess SMF's economic performance and identify strategies to reduce cost. Thus, the Court found that the taxpayer records showed that they did have a profit motive.

The Court also found that the taxpayers "…haven't just sat idly by while losses mounted. They've made changes in an effort to improve profits." The Court pointed to the sale of the retiree-friendly Naples farm, to move almost 3,000 miles away to the Valley of the Arabian horse, where there would be increased foot traffic, an excellent vet clinic, lower cost of supporting the herd where they were competing, and readily available suppliers. The taxpayers also responded to an increasing interest in the Arabian horse market from the Middle East and were successful in selling five horses in 2011, at an average price of over $70,000 per horse, all to foreigners. The Court found that the taxpayers have carried on SMF in a manner substantially similar to successful horse breeders and, therefore, this factor weighs in their favor.

Expertise of taxpayers or advisers - The Court pointed out that over the years the taxpayers showed a dedication to learning from experts in the Arabian horse business. They themselves demonstrated their expertise through education and leadership in the industry. Furthermore, even the IRS admitted the wife became highly knowledgeable about the scientific, technical, and aesthetic aspects of breeding Arabian horses. Furthermore, the Court noted that the taxpayers turned to a number of professionals to handle aspects of horse breeding that were not part of their expertise, including professionals to show their horses. Accordingly, the Court found that this factor weighs in favor of the taxpayers.

Time and effort expended on the activity – The Court found that the taxpayers worked regularly and continuously throughout the years at issue. In addition, they showed that their management and development of SMF was aimed at breeding horses to sell, and worked personally and with great effort. Thus, the Court found that this factor weighs in favor of the taxpayers.

Expectation that the assets used in activity may appreciate in value - The IRS argued that the appreciation in the value of the farmland used for the Arabian horse activity should not be taken into account, because the holding of the land should be treated as a separate activity, since the Arabian activity did not reduce the net cost of carrying the land for its appreciation in value. The Court found that this rule does not apply to the present case because the taxpayers did not purchase the Florida or the California properties primarily with the intent to profit from the increase in their values. To the contrary, the Court concluded that the record clearly establishes that the taxpayers moved to Florida and bought the Naples property to move their horse operation down there. The Court concluded that it was convinced that the taxpayers bought and held the properties in connection with the operation of their horse farm, and held that land ownership and horse breeding constitutes one activity for purposes of applying Sec. 183 of the tax code.

The Court found that the total appreciation of the properties was $4.4 million, the appreciation of the horses was $1.6 million, and horse fluids were worth about $500,000, for a total appreciation of $6.5 million for all of SMF's assets. The Court noted that this may not be enough to make up for the losses that the taxpayers have already suffered, as the IRS argues, but that's not the point. Thus, the Court

concluded that this factor is on the list, because taxpayers who buy or grow assets that they actually and honestly think will increase in value, are more likely to have the subjective profit motive that the Court has to look for. Therefore, the Court held that this factor weighs in the taxpayers' favor.

Success of the taxpayers in carrying on other similar or dissimilar activities – The Court noted that the husband helped turn Metz Baking from a business that lost about $1 million a year into one that was profitable enough to draw corporate suitors. This factor, according to the Court, put particular emphasis on experience converting activities from unprofitable to profitable enterprises. Business acumen and the ability to develop and improve business counts for this factor and the Court concluded that the husband had such experience. Therefore, the Court found that this factor weighs in the taxpayers' favor.

History of income or losses with respect to the activity - The Court first pointed out that SMF sustained on average losses of around $1 million each year, except for the year when they sold the Florida property. Nonetheless, the Court found that the series of unfortunate events, including depressed market conditions, goes a long way to explain why SMF continued losing money, and concluded that it cuts against this factor being one that clearly favors the IRS. The IRS argued that the taxpayers' activity can only be considered to be a for-profit activity if taxpayers have a bona fide expectation that the amount of the future profits would more than offset the $20 million of losses incurred since the inception of the activity. The Court did not agree. It found that, "if a taxpayer can expect to generate an overall profit from the current year, then it cannot be said that he lacks a profit objective simply because he will never generate a profit over the lifetime of the activity." The Court was convinced that at the time of their move to California in 2003, the taxpayers expected to generate an overall profit in the coming years. Thus, the Court concluded that while the SMF losses during the years at issue don't weigh in favor of the taxpayers, they do have a reasonable explanation, and therefore, this factor is neutral.

Amount of occasional profits, if any, from the activity - Noting that this "factor poses a pickle," the Court stated that in analyzing this factor it must "remember the sale of the horse farm in Florida is considered part of the … activity." The Court pointed out that the taxpayers horse activity had one year with a large profit and the remaining years with large losses. The Court also noted that horse farming is a speculative venture and more horses are duds than champions, but a few do command multimillion-dollar syndication fees. While the taxpayers may not breed such a stallion, the Court, referring to the income tax regulations, noted that the potential for "substantial ultimate profit" bears on the issue of subjective intent to make a profit. Accordingly, looking for the taxpayers' subjective intent, the Court found that "they actually – perhaps unreasonably, but actually – intended to make a profit."

Financial success of the taxpayers – The Court noted that taxpayers invested large sums of money into the horse activity prior to 2008, but in 2008, as a result of a margin call on their J.P. Morgan account, the taxpayers were "wiped out", yet they did not quit the farm. Despite few liquid assets, the taxpayers continued the horse farm with operating income from the farm and lines of credit, and they invested large percentages of their personal income in SMF. The Court pointed out that during 2008 and 2009, a large proportion of the taxpayers' net worth was "roped" into SMF. Based on these facts, the Court found that this factor weighs in favor of the taxpayers.

Elements of personal pleasure or recreation - The Court found that the taxpayers definitely took personal satisfaction from their farm, but the IRS exaggerated the degree. The Court pointed out that because the taxpayers understandably enjoyed their work didn't imply they enjoyed every aspect. Therefore, the Court found the elements of personal pleasure that exist for the taxpayers did not render SMF a hobby because of their enjoyment alone. Thus, this factor is neutral.

Conclusion

Based on the factors considered, and in light of the record and extent of the taxpayers' involvement and the time spent working on Silver Maple Farms, the Court found that the taxpayers did have a subjective intent of making a profit.

[Henry and Cristie Metz v. Comm.; T.C. Memo 2015 -54]

Editorial Comment – This case is a good reference for taxpayers who have losses from a horse related activity, which IRS determines are not deductible, because the activity is not engaged in as a business for profit. The Court's finding that the land on which the horse activity was conducted is part of a single activity, and therefore, appreciation of the land is included in the income of the activity, is particularly noteworthy. The Court makes it quite clear that under the Treasury regulation, the land should be treated as part of a single activity, unless the land was purchased "primarily" for its appreciation, which the Court found was clearly not the reason the Metz's purchased the property. Too often, the Tax Court has misapplied this factor. Another noteworthy finding was, "…if a taxpayer can expect to generate an overall profit from the current year, then it cannot be said that he lacks a profit objective simply because he will never generate a profit over the lifetime of the activity." This finding rejects the so-called "recoupment" requirement that the IRS quite often asserts. On balance, the findings in this case are almost all favorable to the taxpayers.

Note – Counsel for the taxpayers was Paul Husband, a long-time member of the AHC Tax Bulletin Advisory Board.

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Income Tax Considerations in Buying and Selling Farms

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Purchases and sales of horse farms may seem to be somewhat straightforward transactions from an income tax perspective, but this article is intended to describe some of the more significant income tax aspects and planning opportunities associated with these transactions. We first will look at the purchaser's side of the transaction, then turn to the seller's side. In this discussion we assume that the parties to the transaction are not related parties under applicable tax rules and are not engaged in a like-kind exchange under Internal Revenue Code (IRC) § 1031 and that the seller is not a C-Corporation.

Purchaser - Determination of the Purchase Price Required to be Capitalized

The buyer is required to capitalize the amount paid to the seller plus other costs associated with the purchase ("transaction costs"). If the buyer is assuming any liabilities of the seller, the amount of such liabilities is considered to be part of the amount paid by the buyer.

IRC § 263(a) and related regulations govern transaction costs required to be capitalized by buyers. These costs include:

- securing an appraisal or otherwise determining the value or price of property
- structuring and negotiating the transaction and obtaining related tax advice
- preparing purchase agreements
- conveying property from buyer to seller
- finder's fees or buyer commissions
- architectural, geological, survey, engineering, environmental, or inspection fees pertaining to properties being acquired.

Note that if the farm purchase is being debt-financed, some costs are likely to be associated more closely with obtaining the debt-financing than obtaining the property. Such costs would be capitalized as loan costs, not into the property's cost, and these costs should be amortized over the life of the loan for income tax purposes.

Purchaser - Purchase Price Allocation

Normally, a number of different assets are acquired in a farm purchase. In addition to the land itself, the purchase of a farm may involve the following assets:

- Tangible personal property, such as farm equipment, office equipment, farm vehicles, and horses or other animals
- Farm supplies, such as tack, fuel, straw and hay, small tools, and other farm and office supplies
- Furniture and fixtures, such as appliances, carpets, drapes, and furniture in farm offices and residences
- Growing crops
- Trees and other landscaping
- Farm buildings, such as barns, run-in-sheds, farm office buildings, and equipment maintenance buildings
- Farm residences, including the owner's home, other residences used to house farm employees, and still other residences that may be rented
- Land improvements, such as fences, roads, water systems, and training track
- Intangible assets, such as the farm's name, an assembled work force, and relationships with vendors and customers

Note that some of these items represent tangible and intangible personal property which would not be part of the real estate transaction, while others would be real property under local law.

The following table is intended to provide some guidance as to the tax treatment of these different assets, to the extent they are amont the assets being purchased:

Depreciation/Recovery Periods	
Type of Horse Farm Property	**Recovery Period**
Automobiles and general-purpose light-duty trucks (actual unloaded weight of less than 13,000 pounds)	5
Tractors and other farm machinery and equipment	7
Horse trailers and vans	5
Heavy trucks	5
Fences	7
Feed and grain bins	7
Single-purpose agricultural structures	10
Office furniture and equipment	7
Land improvements, such as walkways, roads, waterways, drainage facilities, sewers, and landscaping shrubbery	15
Barns, stables, and other nonresidential farm buildings	20
Residential housing	27.5
Broodmares, stallions (or stallion shares), or other horses if the animal is more than 12 years old	3
Broodmares or stallions (or stallion shares) if the animal is 12 years old or younger	7
Race horses	3
Show horses, hunters, jumpers, equestrian horses and any other depreciable horses if 12 years old or younger	7
Goodwill and other IRC § 197 intangibles	15

How does the buyer determine the allocation of the total price to these assets? In general, the sum of the amount paid to the seller and capitalized transaction costs is allocated based on the fair market values of the separate assets being acquired. An appraisal of the value contributed to the deal by each component is the preferable way to allocate. If the buyer chooses not to incur the expense of an appraisal, it may be possible to obtain from the seller a copy of an appraisal the seller may have gotten to determine a selling price for the property. In the absence of an appraisal, some of the purchase price, such as the price allocated to farm buildings, may be estimated by reference to the values at which these structures are insured. However, insured values will not facilitate separately valuing such items as roads, fences, and water systems and often represent replacement cost, not fair market value.

Purchaser and Seller - Application of IRC § 1060, Special Allocation Rules for Certain Asset Acquisitions

If the purchase is an "applicable asset acquisition" under IRC § 1060 and the related regulations, the buyer's basis in the acquired assets (and the seller's amount realized) are allocated among such assets in accordance with the "residual method" described below.

An "applicable asset acquisition" means any transfer (1) of a group of assets which constitutes a trade or business (in the hands of either the buyer or seller), and (2) with respect to which the buyer's basis in such assets is determined wholly by reference to the consideration paid for such assets. This definition presents a question in the context of a purchase of a horse farm. If the farm purchase does not include any horses, does the farm property itself constitute a business? Further provisions in the regulations help answer this question: A group of assets constitutes a business if goodwill or going concern value could under any circumstances attach to such group. See Treasury Regulation § 1.1060-1(b). Unless the farm will be re-named and retain no employees, customers, or other ongoing business relationships, it may be difficult to conclude that the farm is not a business within the meaning of these rules.

Under the residual method for allocating cost among different assets, different types of assets are assigned to classes. Classes I, II, and III, which are unlikely to be involved in farm purchases, include cash (Class I); other highly liquid assets, such as certificates of deposit, U.S. government securities, and publicly-traded stock (Class II); and amounts owed to the business, such as accounts receivable (Class III). If these types of assets are included in an "applicable asset acquisition," fair market values are assigned to them in order: Class I followed by Class II, etc. Class IV, next in line, includes inventory-type assets, which may be present in some farm sales. Skipping Class V for now, Class VI includes intangible assets other than goodwill and going concern value. Examples of Class VI assets that could be included in a farm transaction are trade names, trademarks, workforce in place, books and records, operating systems, customer lists, and contracts with customers or suppliers. Class VII assets are goodwill and going concern value. Class V, which includes all other assets, encompasses most, if not all, assets included in a farm purchase: land and depreciable real and tangible personal property. Class V assets are assigned fair market values after Class IV and before Class VI, followed by Class VII. The result is that goodwill and going concern are assigned the residual value, if any, after allocations to assets in all the other classes.

IRC § 1060(a)(2) further provides that if the buyer and seller agree in writing as to the allocation of any consideration involved in the transaction or as to the fair market value of any of the assets being transferred, such agreement is binding on both parties unless the Treasury determines that such allocation (or fair market value) is not appropriate.

If the farm transaction is an "applicable asset acquisition," both buyer and seller must attach a completed Form 8594 - Asset Acquisition Statement Under Section 1060 to their tax returns. Because Form 8594 just shows allocations by totals per Class (I-VII), rather than asset-by-asset, farm buyers and sellers may allocate most or all the consideration to Class V assets even as they allocate different amounts to individual assets within the class. In the author's experience, disparities in buyer's and seller's Form 8594 allocations by class do not necessarily lead to an IRS audit; however, it is logical to believe that material differences could lead to a greater chance of one or both parties having their tax returns for the year of sale being audited.

Seller's Tax Considerations

Overall, the seller will have gain or loss measured by the gross sales price reduced by selling expenses and the aggregate of each transferred property's adjusted tax basis. Just as the farm buyer should consider the allocation of the cost associated with acquiring the farm, the seller's allocation of the sales price to each identifiable asset sold is likely to have tax impacts. The seller generally will have transferred one or more of these categories of assets:

- tangible personal property which is depreciable, such as vehicles, farm and office equipment, and horses and other animals
- nondepreciable tangible property, such as consumable supplies
- depreciable real property, such as farm buildings, residences (other than the owner's residence), and other land improvements
- owner's residence
- goodwill and most other intangible assets (§ 197 intangibles)

The character of gains or losses and the top tax rates applicable to gains depend on the category of the asset sold.

For depreciable tangible personal property, which is "Section 1245 property," gains are treated as ordinary income to the extent of depreciation allowable, a result sellers generally want to minimize. Note that farm fences, even though they constitute real estate improvements, generally are treated as Section 1245 property (under IRC § 1245(a)(3)(B)(i)). Intangible property also is treated as § 1245 property, so a seller who has amortized the cost of purchased intangibles will recognize ordinary income to the extent of the lesser of (1) the seller's accumulated amortization, or (2) the gain on selling the intangible personal property.

Values allocated to nondepreciable tangible personal property, which may be referred to as "materials and supplies," are ordinary income to the extent of gains on them. If these items have been expensed as incurred, thus having no tax basis, as may often be the case, the values assigned to them will be ordinary income in full. Similarly, if the seller maintains an inventory of property held for sale, gains or losses on inventory will be ordinary income or loss.

For buildings and other real estate improvements (exclusive of Section 1245 property – fences), IRC § 1250 may cause some ordinary income recapture. Except in the case of residences, IRC § 1250 provides that the excess of (1) accumulated depreciation adjustments over (2) the amount that depreciation adjustments would have been had the straight-line depreciation method been used is treated as ordinary income (but limited to the amount of gain). The depreciation method for residences is straight-line, so no § 1250 recapture occurs on residences.

Most farm property is Section 1231 property. Such property includes depreciable property and land, in each case held, in general, for more than one year. An exception requires a 24-month holding period for horses held for draft, breeding, or sporting purposes.

When farm property is sold, one of the first steps in analyzing the types of gain or loss to be recognized is to determine the gains and losses on Section 1231 property. [Gains and losses on non-Section 1231 property will be ordinary gains and losses, unless the property involved is a capital asset.] Then, gains are analyzed to determine the amounts that are treated as ordinary income under § 1245 and § 1250. The balance of the gains and losses would be net § 1231 gain or loss.

The next step is to combine all of the taxpayer's § 1231 gains and losses to determine if the net is a gain or loss. If the net is a loss, it gets favorable treatment as an ordinary loss. If the net is a gain, it generally gets favorable treatment as long-term capital gain. However, net § 1231 losses in a year are tracked forward, and if the taxpayers have net § 1231 gains within the five following years, they are treated as ordinary income to the extent of the amount tracked forward.

If, after the analysis just described, the seller recognizes capital gain from the farm sale, the seller's capital gain must be further analyzed to determine the applicable capital gain tax rates. Capital gains, in general, are taxed at federal rates of 15% or 20%, depending on the taxpayer's overall level of income. [The 3.8% supplemental tax on investment income may or may not apply to the gain, depending on a number of factors which are beyond the scope of this article.] However, a special rule for depreciable real estate raises the general 15%/20% rate to 25% on the gain on buildings and other depreciable land improvements to the extent of related accumulated depreciation not recaptured as ordinary income under § 1245 or § 1250.

Finally, if the property being sold is owned by an individual (or the individual is treated as the owner under single member LLC or grantor trust rules) and includes the owner's principal residence, the seller may qualify for the $250,000 single / $500,000 joint gain exclusion provided for in IRC § 121.

So, what can the seller do to reduce income taxes if a gain is to be recognized from selling the farm? Here are a few basic ideas:

- Take advantage, if possible, of the principal residence gain exclusion rules.
- Maximize the allocation of the sales price to land, avoiding § 1245 and § 1250 ordinary income and the 25% capital gain rate on this part of the allocation. [**Note:** The buyer likely will not find this approach to be attractive, since his land cost is nondepreciable.]
- To the extent reasonable, and if the seller has no purchased intangibles associated with the farm, allocate sales price to intangible assets, again avoiding ordinary income and the 25% capital gain rate. [Note: The buyer ordinarily would be able to amortize the cost applicable to intangibles over 15 years, which is more favorable than allocations to land or buildings.]
- Allocate to buildings and land improvements (other than fences) instead of to tangible personal property and fences to take advantage of the 25% capital gain rate instead of ordinary income rates. [Note: The buyer may push-back, due to the shorter cost recovery periods for tangible personal property and fences.] Consider, however, the potential large impact of Section 1250 ordinary income recapture when farm buildings and other depreciable land improvements were placed in service by the seller in years when bonus depreciation was available and was claimed by the seller.

Closing Comments

As can be seen, what on the surface may appear to be a fairly straightforward real estate transaction can be a complex transaction involving several material tax considerations and tax planning opportunities for farm buyers and sellers. Much of the tax impact relates to purchase price allocations. Although not required, buyers and sellers may be able to reduce their exposure to IRS audit adjustments relating to allocations by contractually agreeing to asset-by-asset allocations. Absent contractual agreements, a sound appraisal of the values of the different assets included in the sale may be advisable.

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