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Does the Hobby Loss Rule Still Apply in a COVID Economy?

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Federal tax policy is designed to encourage business formation and business activity. Equine-based business activity falls under this tax policy. The policy allows for the deduction of expenses and costs of business operations so long as the equine activity is engaged in for profit. This is confirmed in Sections 162, 212 and 183 of the Internal Revenue Code. The 1969 Tax Reform Act modified the law which defined activities engaged in for profit. Section 183 of the Internal Revenue Code and the regulations promulgated thereunder set forth a mechanism the Internal Revenue Service will use to determine if claimed business deductions for a horse operation will be permitted or whether the claimed business deductions will be rejected because the activity is not one for profit. This is generally known as the "Hobby Loss Rule."

26 CFR §1.183-2 sets forth the general law regarding an activity not engaged in for profit and relevant factors which the Service will consider in its evaluation of whether the horse activity is for profit. There are 9 factors identified. These factors generally include how the taxpayer operates the business, how much time the taxpayer is personally involved in the business, the history of profit or loss of the business, the financial status of the taxpayer and whether the taxpayer derives personal pleasure from the activity. How are these factors impacted by the COVID-19 economy?

In general, live horse events have been canceled, or they have been significantly curtailed. Moreover, the ever-changing state rules and mandates which restrict business and social activity have also made it very difficult to conduct horse activity – whether for profit or non-profit – in the normal course. Competing with horses requires an actual hands-on experience with judges and participants, at a minimum. Further, the sale and purchase of horses requires human interaction and contact. There may be some remote sales but given the very nature of a horse, a prospective buyer will want to have their veterinarian look at the animal and the prospective buyer will want to try the animal. These are just a couple of examples which illustrate why equine activities are unlikely to make a profit even when the business owner makes every effort to realize a profit from the activity.

In the COVID-19 business environment it is very important for any taxpayer engaged in equine activities where tax deductions are claimed to document all efforts to make a profit. A taxpayer should not assume that the Service will automatically accept an argument that a profit could not be made in the COVID-19 economy. If horses cannot be shown or horses cannot be raced due to COVID-19 restrictions that should be documented by the taxpayer. Likewise, if a particular state regulation or law prohibits public horse sales or events where horses can be shown or offered for sale that too should be documented by the taxpayer. If the taxpayer offers a horse for sale on the Internet and if a potential buyer requests a discount on the sale price because they cannot examine or test the horse in person that should also be documented by the taxpayer. *In short, any interference with the taxpayer's normal equine business operations caused by COVID-19 should be documented by the taxpayer. This includes a calculation of the COVID-19 direct losses.* (A recent case discussing Section 183 can be found at James P. Donoghue and Elaine S. Donoghue, 2019 T.C. Memo. 71, filed 6/11/19.)

In conclusion, any person seeking tax deductions from their horse activity should document all efforts to make a profit and they should document any COVID-19-related interference with those efforts.

2020 Tax Planning for Sub-Chapter S Small Business Owners in the Wake of SBA Loans

By Marsha Heinke, DVM, EA, CPA, CVPM, Grafton, OH

Many small business owners are surprised to find themselves navigating the fourth calendar quarter of 2020, wondering how quickly it seems to have arrived and how long-ago January 2020 is in the past. While politics and pandemic take center stage, it is imperative for business owners to stay focused on tax planning steps before December 31 appears. Be aware: when a tax year concludes (for most small businesses, this is December 31), the transactions that occurred in it can have very real adverse tax consequences if not timed correctly.

Subchapter S corporation shareholders must be acutely sensitive to significant issues that could result in unnecessary taxes, without a careful plan executed in the final quarter of this unusual and stress-filled year.

Not Business as Usual

Let's recap unique 2020 business issues that will have income and deduction effects most probably spanning two tax years.

The COVID19 pandemic caused the federal government to craft economic relief into several laws, starting in early March. The second major legislation, the CARES ACT, introduced the Paycheck Protection Program (PPP, March 27, 2020) to provide $349 billion of forgivable loans to small businesses.

Many businesses scrambled to apply for PPP loans, due to significant uncertainty about pandemic impacts on sales activity, revenue realization, and ability to keep employees gainfully employed. The funds quickly depleted. Later, on June 5, 2020, the Paycheck Protection Program

Flexibility Act (PPPFA) increased fund availability and extended the measurement period for fund use, including those from the original tranche.

In order for PPP loans to be forgiven, the funds must be used for designated business expenses primarily related to payroll. Additionally, the acceptable time for using the funds extended from 8 weeks to 24 weeks from the date of loan funds receipt (the "covered period"). The PPPFA also extended the deferral period for repayment of loan principal, interest, and fees, even if the original promissory note indicated only a six-month deferral as original provided in the CARES Act.

The new rules allow all PPPL borrowers to wait to apply for forgiveness up to 10 months after the end of the forgiveness covered period, which is generally 24 weeks from the date loan proceeds were received into the borrower's business bank account.

In rulemaking around the CARES Act and PPPF Act, the SBA and IRS have continuously expanded regulatory guidance which at times has conflicted with the original laws and caused much confusion about how to comply. These treasury rules also caused very real concern among business owners about having borrowed SBA money. If one thing has been certain about PPP loans, it has been bank and borrower uncertainty about compliance.

Currently, many of the lending banks are still not ready to accept forgiveness applications, that document the employer's borrowed fund use for designated purposes, predominantly payroll. The banks' hesitancy to open up the forgiveness application process is in part due to their own uncertainty of how SBA guidance will play out, as well as complying with the required computer software use in submitting borrower forgiveness applications to the SBA.

<u>Extrapolating Timelines for PPP Loan Deadlines</u>

Once a borrower files the forgiveness application and supporting documentation with its lending bank, the bank has up to 60 days to evaluate and approve it, before advancing it to the SBA. The SBA then has up to 90 days to evaluate the application and determine if the borrower meets the requirement for full or partial loan forgiveness or fails to do so. There is an appeals process if a borrower is rejected.

Consider the possible maximum length of time from loan funding to loan approval. As an example, a borrower receiving funds on July 31, 2020, would have a covered period of 24 weeks (through January 14, 2021.) Then the borrower would have another 10 months to apply for loan forgiveness (mid-November 2021). The borrower's bank now has up to 60 days to approve the application and forward it to the SBA, which has another 90 days to make final determination. Assuming the SBA does not reject forgiveness and ensuing borrower appeal, the borrower is now out to mid-April 2022.

Being October 12, 2020, borrowers filing loan forgiveness applications now, may well not know until 2021 as to whether their loans are forgiven or not. Until that time, the full amount of the loan stays on the business's books as a liability. In the meantime, the loan proceeds that were deposited to the business checking account may have been completely expended or possibly not at all.

Plenty of Businesses Stayed Strong

Businesses that experienced continued customer demand had revenues that negated immediate capital need from SBA loans, despite COVID related stay-at home orders and shut-downs. Much discussion continues as to COVID's economic impact in the wake of new case resurgence. Additional business closures and employee lay-off in service and travel sectors may be expected to cause indirect downturn on other businesses that stayed sound in 2020. Certainly a rash of employee-positive cases and quarantines could cause temporary closure of any business. At some point, employers may experience cash-flow squeeze and be thankful for previously obtained emergency SBA funding.

Businesses that have continued to experience good sales in 2020 may now have surplus cash in low-rate interest-bearing accounts. Some owners have temptation to make S corporation distributions and put the cash into higher yielding investments outside the business.

Extreme care and planning are essential! If the S corporation distributes heavily in the 2020 year, it is very possible the receiving shareholder ends up with capital gains tax on some of the S corporation distributions. This occurs when the shareholder's *tax basis* in his stock falls below zero.

As an example, say Sally's tax basis in her S corporation stock was $1,000 at the end of 2019. Sally's business generates 2020 profits and cash of $200,000 plus also received a PPP loan of $150,000 that it did not need to use since the business continued to perform well throughout the pandemic crisis. Sally decides to take a distribution of $300,000 out of the $350,000 available. The $200,000 of taxable profit adds to her basis, making it $201,000. The PPP Loan does not provide any basis. The $300,000 distribution reduces her basis to minus $99,000 as of December 31, 2020. Tax law does not allow negative basis. Sally must recognize $99,000 of capital gain in 2020 to bring her basis back up to zero.

What to Know About S Corporation Basis Schedules

Shareholder basis schedules are maintained independently of the corporation or individual tax returns. The basis schedule starts with the first day a shareholder becomes an owner, and are to be updated each and every year, to reflect the shareholder's allocable portions of taxable income, nondeductible expenses, gains and losses, and distributions from the S corporation.

Unfortunately, many shareholders have not maintained such schedules and neither have their tax accountants. In this situation, the basis schedule must be reconstructed, starting with the first corporate tax return.

Since 2018, basis schedules now must be attached to shareholder federal tax returns pursuant IRS guidance, in certain situations. The required times are when:

- The S corporation allocates a loss and/or deduction item to the shareholder
- The S corporation makes a non-dividend distribution to the shareholder
- The shareholder disposes of his or her stock

The safest approach this year: An S Corporation should not make any distributions until the portion that can safely be made without causing any shareholder to experience a deficit tax basis situation. In the event an S corporation did take an SBA PPP loan (or any loan for that matter), it should not make a distribution that results from use of the principal portion of the loan.

Uncertainty About PPP Loan Treatment

Additional clarity is needed for how SBA loan forgiveness will impact deduction reporting in either 2020 or 2021. In theory, the loan keeps its character as a business liability until the date of forgiveness. Yet the event of forgiveness depends on the expenses that were purportedly paid by the loan. The IRS currently says the expenses forgiven by the loan cannot be allowed as a deduction against income. But if the loan forgiveness does not occur until the subsequent 2021 (or even 2022!) year, how will payroll expense in 2020 that allowed the forgiveness be handled?

If the 2020 tax return has already been filed with those expenses deducted against income, will the return need be amended to reflect higher taxable income through the fact the expenses can no longer be deducted? Or are they simply not allowed in the subsequent 2021 or 2022 year? These issues have not been sorted out and may still be murky until next year. By then it will be too late to alleviate the impact of a poorly timed distributions that may result in negative basis and resultant capital gains taxation.

And there is yet more uncertainty about how expenses causing loan forgiveness might shake out as non-deductible or deductible. Congress made it clear that it intended the CARES Act to allow the deduction of expenses that enabled loan forgiveness. Yet on April 30, 2020, the IRS issued Notice 2020-32 that denied deduction. Congress has been expected to add language to the next economic relief legislation that would clarify its intent and undo the IRS ruling. However the ability of Congress to negotiate the next round of relief has been fraught with political conflict. Without Congress's amplification, many accountants and tax attorneys believe that lawsuits would occur due to prior legal case precedent that seems to support the deductibility of forgiven expenses as described in the CARES Act.

No Deduction Results in Taxation

If the expenses are not allowed as deductions when the loan is forgiven up to the amount of those expenditures, shareholders must plan for the ordinary income taxation of that additional profit. Shareholders should consider the highest tax bracket they may be in for the 2020 year. The highest backet is 27% on AGI exceeding $622,050 (married filing joint). Assuming both PPP loan forgiveness and disallowed deductions occurring all within 2020, plan for cash reserves to cover the tax amount as of the April 15, 2021 tax date.

Let's say a business with a single owner has a $100K PPP Loan and expects the entire amount to be forgiven by December 31, 2020. It can document over $100K of qualified payroll expenses. As currently understood and without further action by Congress or Treasury, those expenses would not be deductible and would result in an additional $100K of taxable income. A shareholder in the highest tax bracket would have a projected federal tax as high as $27,000. How all this shakes out for any state's income taxation is another planning consideration.

Fourth Quarter Recommendations

For many business owners, there is much money on the table as to how these various complexities play out. These lines of planning are clearly required for this unusual 2020 tax year:

- Assure S corporation shareholder basis schedules are up to date.
- Plan for how much distribution each shareholder can safely take in 2020. If any doubt, be conservative and delay distribution of excess cash until 2021.
- Extend 2020 S corporation and shareholder tax returns and hold off filing until late in 2021, giving engaged tax professionals enough time to see and recommend the best courses of action.
- Extension of returns does not extend the time to pay the full amount of tax predicted due with each shareholder's individual return.
- Put aside adequate cash to cover taxes on the amount of income that will be generated if forgiven expenses are deemed to be non-deductible so that it is available for the April 15, 2021 date.
- Be prepared to amend 2020 returns at later dates, if additional regulations or litigation result in changes to application of PPP Loan rules.

S Corporation officers and shareholders should be conversing with their tax professionals now. The end of the year will arrive in short order. This is a unique time that requires extra care in tax planning.

Good Reasons to Incorporate Your Horse Business

By T. Randolph Catanese, Esq., Los Angeles, CA

Persons engaged in horse activity can do so individually, through a partnership, a corporation or a limited liability company. Selecting a corporation or a limited liability company (which combines the benefits of a corporation and a partnership) as the vehicle to use in the horse activity carries several benefits. These benefits include limiting personal liability and enhancing tax benefits.

Forming a corporation or a limited liability company is an inexpensive way to limit personal liability. In most states, a corporation or a limited liability company can be formed without excessive cost or expense. Many states offer online assistance with the formation of these entities. Generally, a person who properly operates a corporation or a limited liability company will not have personal liability for the entity's debts or activities. Of course, there are exceptions where the person fails to properly conduct the operations of the entity or where the person engages in intentional wrongful conduct.

Once the corporation or limited liability company is formed the owner/operator is permitted to claim expenses and costs of the business against the income of the business. In cases where there is an S-election for the corporation and for limited liability companies any losses or tax credits are passed through the entity directly to the owner/operator. That means they can claim these losses or tax credits against other income from whatever source.

Finally, the use of a corporation or a limited liability company allows the owner/operator to take investment in exchange for a transfer of an ownership interest in the entity. This allows for capital formation in exchange for an ownership interest. An investment is not a loan and the owner/operator of the horse business is not required to repay the investment.

All of these reasons support the use of a corporation or a limited liability company by anyone involved in the horse business.