**AHC TAX BULLETIN – APRIL 2021**

**Best Breeding Practices for First Time Horse Breeders**

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

When a person or entity starts a horse breeding program, it is very important to consider multiple factors regardless of the size of the program. Tax considerations are very important with respect to the activity given the “hobby loss” rules. Moreover, consideration should be given to the ultimate goal of the program and whether the purpose of the program is for the joy of breeding a particular horse or whether the program is designed for significant sales at auction or at private treaty.

Section 183 of the Internal Revenue Code limits tax losses if there is a determination the horse breeding program is not a program which exhibits a for profit intent by the taxpayer. IRS regulations state that an activity involving horse breeding is presumed not to be a hobby if it produced a profit in two out of seven consecutive tax years. Note that a special election on Form 5213 permits suspension of the presumption until after the sixth tax year for horse breeding after the taxpayer first engages in the activity. But, filing the form automatically extends the statute of limitation for the IRS to assess a deficiency for any deductions of the activity in any year during the seven year period and for two years after the due date of the return for the last year of the period. So, keep in mind that it is important for the taxpayer to document efforts in the horse breeding program to make a profit.

For many horse owners, a logical next step is to establish a breeding program. The breeding of horses many times produces revenue which will offset other costs of the equine farm operation. Further, stallion owners have many opportunities to create income. For some breeds, the sale of frozen semen can create income. For other breeds which require natural cover, income can be obtained through a book of mares matched to the stallion. Contracts involving stallions contain many opportunities for the breeder to produce income (i.e., one option is a lease). Income from the breeding of a mare such as foal sales or leasing and income from stallion activity will significantly help establish the equine business is operated with the intention of making a profit.

Depending on the breed and the contract, “live foal” guarantees are also useful in securing a buyer for a breeding right.

In summary, an equine breeding program can bring great satisfaction to the taxpayer when they establish the validity of their breeding program, but the breeding activity many times also meets the IRS requirements for operating an equine business for a profit.

**Five Things to Know About Paycheck Protection Program Loans**

*By, Erica Horn, CPA, JD and Maddie Schueler, JD, LLM, Dean Dorton, Lexington, KY*

Yes, there are still things to learn about the Paycheck Protection Program (PPP or Program). Originally enacted into law on March 27, 2020, as part of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), the Program has been modified by Congress three times, with the most recent change extending the deadline for applying for a PPP loan to May 31, 2021. Businesses interested in obtaining a PPP loan should act immediately as funds are expected to run out soon.

The Consolidated Appropriations Act, 2021 (Appropriations Act), signed in December 2020, and the recent American Rescue Plan (Rescue Plan) also made favorable changes to the PPP, including changes that may benefit horse and farm owners. Here are five things you need to know.

First, the Appropriations Act explicitly provides that expenses paid with a PPP loan are deductible for federal income tax purposes if otherwise eligible. The forgiveness of the PPP loan is not taxable either. Each state decides whether it will follow the federal law on the taxability of PPP loans.

Second, the Program has been modified to be more generous toward sole proprietors and farmers and ranchers. Previously, to qualify, the potential borrowers either had to report net self-employment income on their tax return (often difficult to achieve given current tax incentives) or have employees. Now, farmers and ranchers may use 2019 gross revenues as reported on Form 1040, Schedule F. Similarly, sole proprietors filing a Form 1040, Schedule C may use 2019 gross profits to determine eligibility and loan amount. Note that total 2019 Schedule F gross revenues or Schedule C gross profits are limited to $100,000. Thus, borrowers without employees and gross revenues or gross profits of more than $100,000 are limited to a PPP loan of $20,833.

Third, businesses that previously obtained a PPP loan may qualify for a “Second Draw” PPP loan. Eligible applicants must have:

* 300 employees or less,
* a 25% reduction in gross revenue between 2019 and 2020 or comparable quarters in 2019 and 2020, and
* used or will use all First Draw funds (including any increase of the First Draw) on eligible expenses on or before the expected date of the Second Draw loan disbursement.

Fourth, the loan amount for horse and farm owners remains 2.5 times the average monthly payroll for 2019. However, eligible expenses have been expanded to include employer-provided group dental, vision, disability, and life insurance, as well as costs such as software, human resources, accounting, and personal protective equipment purchased to comply with federal health and safety guidelines. A borrower may elect a covered period between 8 – 24 weeks after receipt of its PPP loan proceeds.

Finally, borrowers will qualify for forgiveness up to the full principal amount of the loan and accrued interest if:

* the loan proceeds are used for forgivable purposes during the borrower’s covered period,
* the number of full-time equivalent employees (FTEs) and employee compensation levels are maintained or an applicable safe harbor or exemption applies, and
* at least 60% of the PPP loan proceeds are used for payroll costs.

Borrowers with loans of $150,000 or less can use a simplified forgiveness form, Form 3508S. On Form 3508S, all that is required of the borrower is the following: attesting to the necessity of the loan in light of uncertain economic conditions and compliance with PPP requirements, reporting an estimate of the loan amount spent on payroll and the number of employees retained, and maintaining the required documentation. As with any PPP loan, SBA may review and audit loans of $150,000 or less.

Borrowers with loans over $150,000 can use Form 3508EZ if the form criteria are met. If not, the borrower must use Form 3508. Borrowers that can use Form 3508EZ must certify that either:

* the borrower did not reduce the salary or hourly wages of any employee by more than 25% during the covered period AND did not reduce the number of employees or the average paid hours of employees between January 1, 2020, and the end of the covered period; or
* the borrower did not reduce the salary or hourly wages of any employee by more than 25% during the covered period, AND the borrower was unable to operate during the covered period at the same level of business activity as before February 15, 2020, because of a government order.

There you have it – five key things to know about the PPP. Don’t forget - on both the loan applications and forgiveness applications, applicants and borrowers must certify that “current economic uncertainty” made the loan “necessary to support the ongoing operations” of the business. Horse and farm owners seeking to apply for a First or Second Draw loans should reach out to their lender as soon as possible.

**Reducing Withholding Taxes on Payments to Foreign Jockeys and Trainers**

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Payers of U.S.-source compensation to a foreign person, such as a foreign jockey or trainer, must withhold 30 percent of each payment for the IRS. As a result, foreign persons working in the United States will incur withholding tax at 30 percent of the gross amount of compensation. After the tax year closes, the foreign person should file a return and pay tax on the net income at marginal rates. These foreign persons often incur significant expenses to generate a refund because the tax at marginal rates on net income will be less than the 30-percent withholding tax on gross income. As a result, the foreign jockey or trainer will only receive a refund when later filing a return.

At the same time, the IRS is concerned with the administrative burden of dealing with numerous potential withholding agents that pay compensation to the foreign jockey or trainer. Potential withholding agents include *everyone* in the chain of custody, control or receipt of payment.

A central withholding agreement ("CWA") is an agreement between the foreign person with the IRS to have one withholding agent withhold the estimated tax liability that would be ultimately reported when using marginal rates based on net income. The IRS provides further guidance for CWAs in Rev. Proc. 89-47.

Suppose, for example, that a great Argentinian jockey will race at a Churchill Downs meet that will result in $700,000 of gross income. If the jockey incurs expenses of $200,000 for lodging, meals, transportation, and other expenses, his net income will be $500,000. A marginal rate of 35 percent on net income of $500,000 results in a tax liability of only $175,000, which is $35,000 less than the withholding tax of $210,000 at a 30-percent rate on the $700,000 of gross income. The CWA program allows the jockey to designate a single agent to withhold the $175,000 (typically, his attorney), instead of pursuing the many holders of the jockey's money for the $210,000.

To obtain a CWA, the foreign jockey must file a Form 13930. When filing the Form 13930, the foreign jockey must also submit a budget, the name of the proposed withholding agent, and each contract relating to the income-producing activity in the United States. These contracts include letters of understanding, agent representation, promoter agreements, *etc.* Provision of these contracts ensures that the IRS and the foreign jockey agrees to a good estimate of the ultimate tax liability for the income from the activity.

Soon after filing the Form 13930, the representative will receive a CWA for the designated withholding agent and the foreign jockey to sign. The CWA will specify the dates and amounts of the withholding payments, while specifying that any review of the books and records is not an audit.

**Administration, Congressional Democrats Target TCJA Gains**

*By, Bryan Brendle, American Horse Council, Washington, DC*

With the March 31 rollout of a massive infrastructure proposal, the Administration made it official that it would be placing corporate tax rates on the chopping block as a means of paying for the $2 trillion package. According to a White House briefing document outlining the “American Jobs Plan,” aka, the infrastructure package, raising the corporate rate from 21 percent to 28 percent will help “pay for the investments called for in the plan” [AJP-Briefer-Talking-Points.pdf (punchbowl.news)](https://punchbowl.news/wp-content/uploads/AJP-Briefer-Talking-Points.pdf).  The industry-supported “Tax Cuts and Jobs Act (TCJA) of 2017” reduced corporate rates from 35 percent to 21 percent. While a rise in corporate rates is the most often discussed revenue raiser among policy makers this spring, other TCJA flexibilities are at risk of being rolled back.

The 2017 tax law established a 20 percent deduction under Section 199A for certain businesses organized as “pass-through” entities.  This delivered tax relief for horse industry operations such as partnerships, sole proprietorships and S corporations.   On February 25, Reps. Smith (R-M) and Cuellar (D-TX), introduced “The Main Street Tax Certainty Act” (H.R. 1381) legislation to make the Sec. 199A deduction permanent.  Under current law, the deduction would expire in 2026.

A diverse coalition including the horse industry, the American Farm Bureau Federation, and National Association of Manufacturers, among others, is advocating to preserve estate tax flexibility.  Specifically, the tax reform law doubled the exemption for estate taxes – a key priority for the horse industry - from $5.49 million to $11 million for individuals.  Doubling the exemption reduced the number of farms and family businesses subject to the tax.  President Biden has expressed an interest in returning the exemption levels to pre-tax reform levels, which could amount to $3.5 million for individuals and $7 million for married couples filing jointly. On March 16, AHC joined its allies in the Family Business Estate Tax Coalition in a letter to express support for legislation that would repeal the estate tax altogether. Stay tuned for details related to tax policy debates that will surround almost every initiative tied to infrastructure or other pandemic relief, as policymakers examine revenue raisers to offset climbing federal deficit spending.

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