AMERICAN HORSE COUNCIL'S
TAX BULLETIN
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LAND AS AN ASSET OF A HORSE BUSINESS – REVISITED

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About 20 years ago, the American Horse Council Tax Bulletin published an article entitled: **Consideration of Land as an Asset of a Horse Business in a "Hobby Loss" Case.** A copy of that article is appended to this article, as Exhibit A, in its format as reprinted in **DAVIS:** HORSE OWNERS AND BREEDERS TAX HANDBOOK (Am. Horse Council 2011). The general rule stated there is still correct.

If a horse operation is considered to be a profit-motivated business, then the owner can use losses that they may incur in the horse business to offset other income. The "Nine Point Test" found in Treasury Regulation 1.183-2(b)(1) through (9) is almost always applied by the IRS and courts to help them make the determination whether the horse-owning taxpayer is telling the truth about being in the horse business primarily for profit and therefore able to offset losses, or not.

The nine points were not created equally. The first, "manner of operation" is generally considered the most important. The fourth, concerning appreciation of assets is often considered to be the second most important of the nine. The fourth criterion: "Expectation that assets used in the activity will appreciate in value" seems simple on its face. And this criterion even mentions land. But as applied by the IRS and courts, it can be tricky.

The earlier article, attached as Exhibit A, goes through this criterion, and even proposes a practical rule of thumb for applying it correctly.

This article revisits this topic, and looks at the recent application. Is the application of this criterion better or worse than before?

Tr. Reg. 1.183-2(b) (4) provides:
"4) **Expectation that assets used in activity may appreciate in value**.—The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity

together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of § 1.183-1 for definition of an activity in this connection.

Tr. Reg. 1.183-1 (d) to which reference is made, provides:

Activity defined -

(1) Ascertainment of activity. In order to determine whether, and to what extent, section 183 and the regulations thereunder apply, the activity or activities of the taxpayer must be ascertained. For instance, where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity. In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account.

Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings.

Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities.

The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case. If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183.

Where land is purchased or held primarily with the intent to profit from increase in its value, *and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value.*

Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land). [emphasis and spacing added]

Treatment of land is important, since many horse businesses own and use land in their horse businesses, and generally, land will appreciate in value. And the regulation specifically

mentions land: **“ The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity.”** And, by the express terms of the regulation, ***profit*** encompasses ***appreciation.*** So a proper evaluation of a horse business will consider land appreciation as if it were a profit. However, notwithstanding the plain language of the regulation, the IRS urges restrictive arguments to the application of The Treasury Regulation and some courts will buy those arguments, whether correct or incorrect.

In the original article, there are examples of cases in which the court correctly applied Tr. Reg. 1.183-2(b)(4) were presented; examples of cases in which the court did not correctly apply Tr. Reg. 1.183-2(b)(4) were presented, and some cases in which the taxpayer lost the point because they failed to submit adequate proof were presented.

What follows is brief discussion of selected horse business Section 183 cases subsequent to the publishing of the original article. The question will be: Has progress been made?

Turning first to the positive, Helmick v. Commissioner T. C. Memo 2009-220 is a case in which the taxpayers had real property, which was used in their operation, on which they boarded 40 horses. Simultaneously with the Tax Court case, Helmicks were in a dispute concerning zoning of their land. They kept their favorable agricultural zoning, which required, as a condition, that they keep 40 horses on the property. The court took the valuable zoning rights on the land into account in finding in favor of the taxpayers concerning the inclusion of land appreciation in the evaluation whether they were in business for a profit. The Court found that they were in business primarily for profit.

The Helmick case is also a key precedent in its debunking of an old heresy, which held that in order to have a recognizable profit motive, it was necessary that that all past losses be recouped. Helmick held that it is sufficient if the taxpayer intends to make a profit sufficient to

earn back losses from the present until the activity reaches ongoing profitability. Taxpayers are NOT required to recoup all past losses from the inception of the business. This commonsense ruling is very important since it "modifies" an old poorly reasoned requirement set forth in a case called Bessenyey which held that a taxpayer must recoup all past losses in order to have a profit motive. The Helmick modification to the Bessenyey ruling is a bit like telling the Emperor in "The Emperor's New Clothes" that the Emperor is naked. Not difficult conceptually, but it took courage for the Helmick court to so state.

Another example of a correct application of Tr. Reg. 1.183-2(b) (4) is Metz v. Commissioner T.C. Memo 2015-54. The taxpayers purchased a farm in Florida then moved to California and purchased a ranch there because they felt that horse business opportunities would be better in California. The government argued that Metzes bought the real property primarily to hold it for appreciation, and therefore the land would have been a separate activity and the land appreciation would not have counted in an evaluation of Metzes' Silver Maple Farm. The Court rejected the government's specious argument and found that the land ownership and horse breeding were part of one activity in the course of recognizing the primary profit motivation of the horse business owners. The correct interpretation of Tr. Reg. 1.183-2(b) (4) is demonstrated in Metz.

Unfortunately, certain judicial decisions have misinterpreted and/or misapplied Tr. Reg. 1.183-2(b) (4). For example, Dennis v. Commissioner T.C. Memo2010-216. The Court *almost* got it right, and then misread one element and decided wrongly on this point.

The Dennis Court started on right foot, when it stated:

> "The word 'profit' can encompass appreciation in the value of assets, such as land, used in the activity. See sec. 1.183-2(b)(4), Income Tax Regs. Even if no profit is derived from the current operation, a taxpayer may intend that an overall profit will result when appreciation in the value of the land used in the activity is realized because income from the activity together with the appreciation of land will exceed the operations' expenses .
>
> Mr. Dennis expected that the land would appreciate. He cultivated the land substantially and erected barns, horse arenas, gates, and fences on the land. Having this expectation, he used the land as collateral for a loan. ***However he does not intend to sell the land to offset the losses his horse breeding activity incurred.***
>
> ***Although this factor indicates that that petitioners lacked a profit motive****, one factor cannot alone determine the outcome.'* [emphasis added]

The court assumed, incorrectly, that the petitioners HAD to sell the land or intend to sell the land in order for its appreciation to be considered. This interpretation ignores the first sentence of Tr. Reg. 1.183-2(b) (4). Under a correct reading of the regulation, it is not necessary to intend to sell the land to have its's appreciation considered for Section 183 purposes.

The rest of the quotation states – Mr. Dennis built barns, arenas, fences and gates, and cultivated the land. Such activities read like he was using the land in his horse activity. Still, the court held against Dennis on criterion no. 4 because he did not intend to sell the land. But all was not lost. Notwithstanding this error in criterion no. 4, The Dennis court recognized the profit-motivated nature of the business and the horse-owning taxpayers won the Section 183 case anyway.

Another decision that badly misapplied Tr. Reg. 1.183-2(b) (4) was Price v. Commissioner T.C. Memo 2014-253. In Price, The court found that the land upon which petitioners built barns, paddocks, an indoor arena, and a customer viewing lounge, as well as

keeping, breeding and selling horses on it was found by the Court NOT to be economically or organizationally related to the horse farm operated upon it.

Further, the court found that because the land was purchased 6 years prior to the date that the horse operation commenced (3 years after the old farmhouse was refurbished so Prices could live in the house) that the court found that the land could not have been purchased for the purpose of operating a horse business on it, despite uncontradicted direct testimony to the contrary. The court expressly assumed that the land was purchased primarily to hold it for appreciation, again, despite uncontradicted testimony to the contrary, and evidence of the nature of the development of the land upon which barns, paddocks, an indoor arena, and a customer lounge were built.

The court refused to consider land appreciation, despite evidence of the purchase price and present value, of the land on the ostensible ground that evidence of the cost of improvements was not in the record. The decision specifically stated as an additional ground for refusing to consider the land appreciation that appreciation was the result of generally rising land prices and not due to petitioner's use of it as a horse farm.

Actually, Tr. Reg. 1.183-2(b) (4) does not specify any requirement to show why the land is appreciating, just that it has appreciated.

The decision in Price was made against the taxpayers. The errors of both law and fact were flagrant in this case including but not limited to criterion No. 4. It appeared that the decision was intended to endorse the government's position and decide against the horse-

business-owning taxpayers, and neither the facts nor the law would be permitted to stand in the way.

Despite its importance, a favorable finding on Tr. Reg. 1.183-2(b) (4) is not a "Get out of Jail Free" card for the entire case.

There are cases in which the Tr. Reg. 1.183-2(b) (4) issue is correctly decided, but for other reasons, the result was still adverse. An examples of this situation would be Betts v. Commissioner T.C. Memo 2010-164, and Giles v. Commissioner T.C. Memo 2006-15.

A few decisions show that there are new government initiatives designed to defeat land owning, horse business owning, taxpayers from offsetting their losses against other income by placing an additional limitation on the includability of appreciation from land in an Equine Section 183 case, that have no basis whatsoever in the Treasury Regulations, nor in the Internal Revenue Code. For example: IRS litigators are inquiring as to **why the land appreciated** rather than simply the fact that is did appreciate. They contend that it was not the taxpayer's use of that land in the taxpayer's horse activity that caused the appreciation. Under this paradigm, if farmland appreciated due to overall land appreciation in a booming area, or because of inflation, or because the land was located near a growing city which grew out to make the farmland useful for other purposes, then the appreciation of the land would not count. This limitation lacks any basis in authority.

It does not make difference does it make WHY a land asset of a horse business appreciates? What matters is that it did appreciate. Examples of this dubious standard include

Dennis, supra Robert s v. Commissioner T.C. Memo 2014-74; and Stuller v. U.S. 2014-2 U. S.T.C. Par. 50,379.

Overall, concerning Tr. Reg. 1.183- 2 (b)(4), the situation has not changed much since the first article was written and published in the *American Horse Council Tax Bulletin*. Courts get the rule of Tr. Reg. 1.183-2(b) (4) right sometimes and they get it wrong sometimes. Therefore, it is important to discuss the proper application of Tr. Reg. 1.183-2(b) (4) in a pre-trial brief. Help your judge.

How Bookkeepers Are Scammed
SCAM Alert!

By Marsha Hienke

How easy it is to get punked, especially when multitasking, rapidly knocking off text and email requests, and delegating to others in the effort to be as efficient as possible.

Stop. SLOW DOWN.

When your bookkeeper receives a request that looks like it comes from you, The Boss, what do they do? Immediately respond! And if it is from a scammer, the scammer starts up a conversation with the bookkeeper, working aggressively towards a monetary pay off.

It is easy, too, for email addresses, to LOOK authentic, and consequently misleading the recipient. For example, marsha.heinke@gmail.com could easily be corrupted to rnarsha.heinke@gmail.com or any number of other fraudulent look-a-likes (could you see the "m" was replaced with an "r" and an "n"?)

Today, our bookkeeper was hooked with such a scam.

The message appeared to be from me:

> Subject: Invoice 34267
>
> Text: Please pay the attached invoice. Let me know when handled. Marsha

Fortunately, after a couple of emails with the scammer, our bookkeeper started a fresh email, using my correct email address, to tell me I would have to handle wiring funds, because she was unable to do it.

> Hi Marsha,
>
> The invoice you wanted me to pay, I can't locate a phone number anywhere on the invoice or a website. Not sure if I can pay this over the phone since they want a wire transfer. That would be something you would have to do.

Prevention through employee awareness is important, but not adequate in and of itself. Our firm constantly reminds all employees of scammer ploys. While regular reminders are helpful, that is not enough when people are trying to work quickly.

This is where standard systems become crucial. For example, institute a multi-person approval process for unfamiliar vendors or transactions above a certain amount. And when receiving a directive to pay an invoice, require that the employee start a new email to the boss (or use FORWARD, instead of REPLY) to verify the directive.

Even when forwarding or starting a fresh email, it is still important to remain attentive to the email address that is being typed, especially if prior correspondence with a fraudulent email address has occurred within the bookkeeper's email account, which could autofill the incorrect email address in the "to" box when initiating a new email chain.

When your practice is a scammer target, report the fraud here https://reportfraud.ftc.gov/#/?orgcode=CYBERSN, to two agencies, the FTC and the FBI.

Here is an article describing CEO imposter schemes that you can share with your practice teams.

https://www.ftc.gov/news-events/blogs/business-blog/2016/05/ceo-imposter-scams-boss-real

Keep up with continuous training and regularly sharing warnings among your employees. And remind everyone: "always double check."

Crypto Complexities

By Marsha Hienke

No surprise that with massive buzz around cryptocurrency, the exponential acceleration of its creation and use is remarkable. Note well rapid introduction of new coin varieties, e-platforms, company promotion (think Tesla, Microsoft, Starbucks, and Burger King), and crypto-oriented investments like ETFs[1].

Unfortunately, few individuals recognize or understand the income tax and foreign reporting requirements pertaining to cryptocurrency transactions. Taxpayers must be fully aware of cryptocurrency transaction implications, before dipping a toe in the water with the first purchase or acceptance of Bitcoin, Ethereum, or Dogecoin.

As of June 2021, the United States and most developed countries made bitcoin legal. Yet, bitcoin has no centralized issuing authority and is created and traded in a deregulated marketplace. Recognizing the implications of how cryptocurrency might be used for illegal activity as well as its desire to track and collect tax on taxable transaction, the IRS has been issuing guidance and legal requirements since 2014 (IRS Notice 2014-21).

The sweeping Infrastructure Investment and Jobs Act signed into law on November 11, 2021 includes new reporting requirements for cryptocurrency transactions. The IRS will develop regulations around the law, including significant civil and criminal penalties for virtual currency (cryptocurrency) transactions.

For 2020, the IRS added this question to the Form 1040, individual income tax return: "At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"

Thus, ANY taxpayer actions in dealing in cryptocurrency/virtual currency must be fully disclosed. Reporting crypto transactions can be extremely complex. Taxpayers may need to invest in special software to track their basis in the crypto transactions they have made. The more transactions made, the more challenging the endeavor. Virtual currency transactions are reported on Form 8949/instructions here.

The lowest price that online tax trackers charge to prepare a return that has cryptocurrency transactions is $2,500. You can expect that tax preparer charges for taxpayers dealing in crypto will be pricey. Tax preparers are seeing returns requiring as many as 20,000 separate entries on a tax return.[2] Several hundred entries are not unusual for taxpayers trading crypto or using it to purchase anything from a cup of coffee to a new car.

Taxpayers should remember the two most basic rules of investing: first, understand the investment and second, know what the tax reporting requirements are. Unfortunately, a large proportion of people new to cryptocurrency transactions have no understanding of either.

Seven activities require individual transaction reporting *in addition* to just disclosing the existence of the crypto account. **Each** individual transaction must be **individually reported**. For example, if you buy a Starbucks latte with crypto currency, that individual transaction must be reported on your tax return.[3]

1. Selling (converting) cryptocurrency to U.S. Dollars
2. Trading one cryptocurrency for another (like-kind exchange rules do NOT apply)
3. Spending cryptocurrency directly for goods or services
4. Mining cryptocurrency from the taxpayer's own computers
5. Staking or lending cryptocurrency and receiving payment in cryptocurrency or dollars
6. Receiving airdrop cryptocurrency
7. Getting paid in cryptocurrency

Items one through three require that every transaction be separately reported on your return. Potentially hundreds or thousands of transactions must be reported if you are spending cryptocurrency, trading (even via a "Bot"), mining, or just about any other variation you can fathom.

In summary, remember that all cryptocurrency activities must be disclosed, and supported by careful, detailed record keeping. Penalties can be massive. If you are already involved in cryptocurrency, please talk with your CPA professional now.

P.S. The underlying computer technology and cryptographic theory underlying cryptocurrency mining and finance is fascinating and complex. To learn more, here are several links to information about cryptocurrency and the underlying blockchain data structure that allows its propagation.

What is Crypto Mining? How Cryptocurrency Mining Works

How Does Bitcoin Mining Work?

Blockchain Explained

Five Issues Holding Back Cryptocurrency

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[1] ETF – Exchange Traded Fund

[2] Bob Jennings, CPA. TaxSpeaker newsletter. November 17, 2021.

[3] Ibid.