Section 183 – Hobby Losses: An Overview & Update

I. Profit Intent.

A. General Principles

1. Rationale Behind Section 183.

Section 183 of the Internal Revenue Code serves to express the intention of Congress to disallow expenses generated from activities which are carried on primarily as sport, hobby or recreation. The determination of whether an activity is engaged in for profit is to be made by reference to the objective standards, taking into account all the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity or continued the activity with an honest and actual objective of making an economic profit independent of the tax considerations. Antonides v. Commissioner, 91 T.C. 686, 694 (1988), *aff'd.* 893 F.2d 656 (4th Cir. 1990); Dreicer v. Commissioner, 78 T.C. 642, 645 (1982), *aff'd.* without opinion 702 F.2d 1205 (D.C. Cir. 1983).

2. Subjective Intent Determined by Objective Standard.

The goal must be to realize a profit on the entire operation, which presupposes sufficient net earnings to recoup earlier losses. King, T.C. Memo 1993-237. In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent. Engdahl v. Commissioner, 72 T.C. 659, 666 (1979).

3. "Not engaged in for profit" Defined.

The term "not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under Section 162 or Section 212 (1) and (2). If an activity is not engaged in for a profit, the amount of deductions which the taxpayer may take against gross income will be limited to the amount of income produced by that activity. *Compare* Toth v. Comr., 128 TC No 1 (01/18/2007) holding that Section 195(a) does not require the taxpayer's expenses for horse boarding and training activity to be capitalized as start up expenses. The taxpayer and IRS stipulated that the expenses were deductible under Section 212 as income producing expenses rather than trade or business expenses deductible under Section 162.

4. Presumption of Profit Motive: General Rule.

Section 183 (d) creates a presumption of a profit motive if the taxpayer can show that in three out of five consecutive years the activity in question produced more income than expenses.

5. Presumption of Profit Motive: Application to Equine Industry.

If the activity is one which consists in major part of breeding, training, showing or racing of horses, the requirements for receiving the benefits of the presumption are lessened and a showing of profit in two out of seven consecutive years will suffice to create the presumption that the activity was engaged in for profit. The regulations under Section 183 set out the presumption that the activity consists in major part of the breeding, training, showing or racing of horses if fifty percent of the expenses incurred during the preceding three tax years are attributable to the horse business.

6. Results of Meeting the Presumption.

   Once the taxpayer has met the requirements of the presumption set up in Section 183(d), the burden of proof will be upon the Commissioner to show that the main objective of the taxpayer was one other than profit. Specifically, the Commissioner will need to show that the main objective of the taxpayer was the reduction of tax liability produced by the deductions created by the activity. If the taxpayer fails to meet the requirements of Section 183(d), no inference that the activities not engaged in for profit shall arise by reason of the provisions of Section 183. However, once the Commissioner has assessed a deficiency, the burden of proving that a profit motive was present is placed on the taxpayer. Baxter v. Commissioner, 816 F. 2d 493, 495 (9th Cir. 19).

7. Election.

   (a) Delaying Determination of Profit Motive.

   Section 183 permits the taxpayer to elect to receive the benefit of the presumption set out in Section 183(d) and to have the final determination of whether the activity was engaged in for profit postponed until the close of the relevant period. Regarding activity which consists in major part of breeding, training, showing or racing of horses, the final determination of whether the taxpayer has met the requirements of the presumption would be postponed until the close of the sixth taxable year after the first taxable year in which the activity was first engaged in. For the purposes of setting the time period of consecutive years, a short taxable year will be considered a full taxable year.

   (b) Extended Period for Assessing Deficiencies.

   To protect the Commissioner's ability to assess a deficiency against the taxpayer who has made an election under Section 183 to receive the benefits of the presumption set out in Section 183(d), the Commissioner is given express authority to assess a deficiency against a taxpayer who has made the election for an additional two years following the close of the last taxable year to which the election relates, regardless of any other limitations imposed upon the Commissioner's ability to asses a deficiency against a taxpayer.

   (c) Results of Failure to Meet Requirements.

   The failure of the taxpayer to meet the requirements set out in the safe harbor provisions of Section 183(d), creates no inference that the activity is not engaged in for profit. The final determination of whether the activity is engaged in for profit shall be made pursuant to the facts and circumstances of each case, taking into account the relevant factors which the Code sets out in the regulations under Section 183.

8. Segregation of Separate Activities.

(a) General Principles.

A taxpayer may be involved in several undertakings which may constitute a single activity or a series of separate activities. 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 organization 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.

(b) Acceptance of Taxpayer Determination if Reasonable.

The Commissioner will accept the taxpayer's characterization of the activities as related or separate as long as his characterization does not appear artificial and can be reasonably supported by the facts and circumstances of the case. The regulations under Section 183 set out the presumption that the activity consists in major part of the breeding, training, showing, or racing of horses if fifty percent of the expenses incurred during the preceding three tax years are attributable to the horse business.

(c) Case law.

(i) Topping v. Comr., T.C. Memo 2007-92 (04/17/07) Tax Court allowed the taxpayer to aggregate her equestrian activity, which consistently generated a loss, with her profitable business of designing homes and barns for wealthy horse owners. As a result the hobby loss rules didn't apply and the equestrian activity deductions were allowed. The close organizational and economic relationship between the activities overcame the fact that the taxpayer reported the activity and business on separate Schedule Cs for the years at issue. The court stated that the success of the taxpayer's interior design business was far from incidental to her equestrian contacts and that the taxpayer's involvement in the equestrian world was the cornerstone of her relationship with her clients.

(ii) Compare the following in which no integration and interdependence were found so as to permit aggregation: DeMendoza v Comr., 1994-314 (real estate law firm/farming and polo activities); Wilkinson v. Comr., T.C. Memo 1996-39 (cosmetic plastic surgeon/polo horse ranch); and Zdun v. Comr., T.C. Memo 1998-296 (dentist/organic apple orchard).

(d) Similar Activities in Different Locations.

(i) The Tax Court ruled in Davis v. Commissioner of Internal Revenue, 29 T.C. 878 (1958), that farming operations in different geographic locations were separate activities even though all locations were engaged in farming.

(ii) In Stuckey v. Commissioner of Internal Revenue, T.C. Memo. 1982-537, the court held that the activity of grain farming in Iowa constituted a separate activity from horse breeding in Ohio.

9. Deductions.

If the activity is ruled to be one that is not engaged in for profit, Section 183 sets out the amount of deductions which may be taken for that activity. The deductions which may be taken are allocated among three tiers as set out in the regulations.

(a) Tier One.

Tier One involves deductions which are allowable regardless of whether the activity is determined to be engaged in for profit, such as real estate taxes. First tier deductions are deductible in their entirety, subject to the limitations which are set out in the other provisions of the Internal Revenue Code.

(b) Tier Two.

Second tier expenses are those out-of-pocket expense which are attributable to the activity which has been deemed not to be engaged in for profit. If the activity has produced income which exceeds the amount of the Tier One deductions, then the remaining income will first be allocated to Tier Two deductions, and if there is any income remaining after Tier Two deductions, then the remainder of the income will be allocated to the Tier Three deductions.

(c) Tier Three.

Third tier deductions are those expenses which affect, the basis of property, such as depreciation, partial losses with respect to property, partially worthless debts, amortization and amortizable bond premiums. As stated above, Tier Three deductions relate to the adjustment in the basis of property used in the activity. To determine the reduction in the basis of Tier Three property, the following formula is set out in Treas. Reg., Section 1.183-1(2). Take the amount of the basis adjustment which would have been allowed for the particular property had the activity been ruled as engaged in for profit and multiply by the basis adjustment fraction.

(i) Basis Adjustment Fraction.

(a) Numerator.

The numerator of this fraction is the total amount of income which is remaining after deductions are allocated to Tier One and Tier Two.

(b) Denominator.

The denominator is the total amount of deductions for all Tier Three property had the activity been ruled as engaged in for profit.

(ii) Actual Adjustment to Basis in Tier Three Property.

The basis in the Tier Three property will only be reduced by the amount of the deduction allowed to the taxpayer for that property.

(d) Further Limitations on Deductions: Sections 67 & 68.

The amount of deductions allowable for an activity which is deemed not to be engaged in for profit are further limited by Sections 67 and 68 of the Internal Revenue Code.

(i) Section 67.

Section 67 of the Internal Revenue Code states that no deduction shall be allowed unless the amount of the deduction exceeds two percent of the adjusted gross income of the taxpayer. However, Tier One deductions are unaffected by this provision. Thus, no deductions for Tier Two or Tier Three may be taken unless the amount of income which is leftover after Tier One deductions have been taken exceeds two percent of the adjusted gross income of the taxpayer.

(ii) Section 68.

Section 68 is a further restriction upon the deductions which may be taken by the taxpayer. If the adjusted gross income of the taxpayer exceeds $100,000.00 for the year in question or $50,000.00 for a married individual filing separately, the amount of the deduction shall be reduced by the lesser of three percent of adjusted gross income in excess of $100,000.00 or eighty percent of the itemized deductions that the taxpayer has for the year in question.

(e) Effect of Net Operating Loss.

A net operating loss deduction is not taken into account as a deduction for the purposes of this determination.

II. Objective Factors Used in Making Profit Motive Determination.

The regulations set out nine factors to be considered in making the determination ofwhether or not the activity is engaged in for profit. No single factor is considered to be conclusive in making this determination, nor are these nine factors considered to be the only factors which will be considered in making the determination of whether the activity was engaged in for profit. Engdahl v. Commissioner, 72 T.C. 659, 666 (1979).

A. Manner in which the taxpayer carries on the activity.

The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

The term businesslike manner contemplates the use of cost accounting techniques that provide the taxpayer with information required to make informed business decisions. The purpose of maintaining business books and records is more than to memorialize for tax purposes the existence of the transactions and includes providing a means of periodically determining profitability and analyzing expenses. In the context of horse breeding activities, the courts have indicated that an absence of detailed monthly expense records for each animal may indicate a lack of profit motive.

Conversely the commingling of funds between personal and activity funds is not indicative of businesslike manner.

It is also good businesslike practice to prepare a written business plan which should be reviewed with competent business advisors and modified from time to time to reflect changes in operations and methods to improve profitability.

B. The expertise of the taxpayer or his advisors.

Preparation for the activity by extensive study of the accepted business, economic and scientific practices or consultation with those who are expert therein may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice but does not carry on the activity in accordance with such practices, lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity. Mere conversations with a CPA or financial advisor without advice regarding the economic aspects of carrying on a horse activity for profit are not sufficient.

C. The time and effort expended by the taxpayer in carrying on the activity.

The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity. With respect to consideration of the time and effort spent by the taxpayer in carrying on the activity in question, the courts in the context of thoroughbred breeding and racing operations demonstrate that the full time personal involvement of a the taxpayer is not required. What is required in such cases is the engagement of competent persons to carry on the activity. *See*, Shane v. Commissioner, 70 TCM 1052 (1995); Dawson v. Commissioner, TCM 1996- 417 (1996).

D. Expectation that assets used in the 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 operation is derived, an overall profit will result when appreciation in the value of the land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation.

A horse breeder may also include the increase in the value of his farmland used in relation to the activity in his attempt to prove a profit motive. However, under the Treasury Regulations Section 1.183-1(d)., "where land is purchased or held primarily with the intent to profit from the increase of its value, and where the taxpayer also engages in farming on such land, the farming and holding of the land will ordinarily be considered a single activity only if the income derived from farming exceed the deductions attributable to the farming activity which are not directly attributable to the holding of the land." If land appreciation of a horse farm is to be considered a positive factor in determining whether the farm is operated for a profit, the land must be used directly in connection with the horse operations and any increase in values should be substantiated with competent appraisal.

Similarly any claimed appreciation in horse values should likewise be properly documented.

E. The success of the taxpayer in carrying on other similar or dissimilar activities.

The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the activity for profit even though the activity is presently unprofitable. Cases interpreting this factor of the regulation in the context of thoroughbred racing and racing operations make it clear that even if the taxpayer has not engaged in any similar activities, the taxpayer's history of engaging in other successful activities can be indicative of a profit motive in the horse business. *See*, Meagher v. Commissioner, 51 TCM 676 (1986) (court noted that the taxpayers had not engaged in any horse activities in the past, but noted that the taxpayers' success in other endeavors, i.e., successful accounting practice and profitable real estate investments supported their arguments that the horse activity was engaged in for profit).

F. The taxpayer's history of income or losses with respect to the activity.

A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. For horse breeding activities, the courts have recognized that a 5 to 10 year start up period can be expected. *See*, Pirnia v. Commissioner, 58 TCM 740 (1979) ("the objective to make a profit may exist even in the face of a history of losses unaccompanied by any gains. This is particularly true when such losses occur in the formative years of a business, especially one involving horses"); Engdahl v. Commissioner, 72 TC 659 (1979) (court held there was a profit motive despite 12 years of losses from thoroughbred breeding business; the court noted that a series of losses during the first 5 to 10 years of a thoroughbred breeding operation does not necessarily indicated the activity was not engaged in for profit); Shane v. Commissioner, 7 TCM 1052 (1995) (history of losses from thoroughbred breeding operation did not lack of a requisite profit motive since those losses occurred during normal 5 to 10 year start up phase);. Holbrook v. Commissioner, 66 TCM 484 (1993) (8 years of consecutive losses did not indicate lack of profit motive because losses were within typical 5 to 10 years startup period for thoroughbred breeding operations). However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status, such continued losses, if not explained as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, or other involuntary conversions or depressed market conditions, such losses would not be indicative that the activity is not engaged in for profit. *See*, Trafficante v. Commissioner, 60 TCM 110 (1990) (the court was willing to discount the fact that the taxpayer's horse racing and breeding operations had sustained net losses in 10 straight years since some of the losses were attributable to unforeseen circumstances, including the sudden death of a broodmare, the death of four foals and the worthlessness of three other foals determined to be unsuitable for racing.

G. The amount of occasional profits, if any, which are earned.

The amount of profits in relation to the amount of losses incurred and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses or from an activity in which the taxpayer has made a large investment would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit, even though loses or only occasional small profits are actually generated. The thoroughbred horse breeding and racing business has been likened to wildcat oil operations as specifically referenced in the regulations. *See*, Dawson v. Commissioner, TCM 1996-417 (1996) (the court likened the taxpayer's horse breeding operations to wildcat oil wells and thus found that the expectation of future profits was consistent with the existence of a profit motive).

The potential for big profits has been borne out in a number of well publicized examples. For instance, Seattle Slew was purchased for a yearling $17,500 and at one time was valued at approximately $140 million. Similarly Spectacular Bid was purchased as a yearling for a mere $37,000 and was later syndicated for approximately $22 million while John Henry was purchased for $2,000, later gelded and won almost $7 million in purses. Hansel, the winner of the Preakness and Belmont Stakes, was purchased for $150,000 and was sold for approximately $10 million. The broodmare of Hansel, then aged 16, went on to produce foals over her remaining useful life that totaled approximately $7 million. The cases and these examples clearly demonstrate the potential for huge profits which is an important element to consider when determining whether the taxpayers possessed a subjective profit intent.

H. The financial status of the taxpayer.

The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity, particularly if the losses from the activity generate substantial tax benefits, may indicate that the activity is not engaged in for profit, especially if there are personal or recreational elements involved. The better analysis on this point of is to look to whether the taxpayer has invested only a minimal amount of money and yet been able to claim large deductions, for example through illusory debt obligations and inflated valuations. *See*, Scheidt v. Commissioner, 63 TCM 1726 (1992).

I. Elements of personal pleasure or recreation.

The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return or which would be more likely to be profitable is not evidence the activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit. *See*, Faulconer v. Commissioner, 748 F.2d 890 (4th Cir. 1984) (court determined that the personal pleasure or satisfaction receive by a taxpayer from his involvement in the horse racing profession and his work on the horse farm was insufficient in itself to cause the activity to be considered not engaged in for profit).

Passive Loss Limitations

A. ***General***

- If a horse owner (or any other taxpayer) does not "materially participate" in a business activity, losses and credits from that passive activity are not allowed as a current deduction against income from salaries or from a business in which the owner does participate, or from portfolio income (i.e., interest, dividends or royalties).
- Passive loss restrictions only apply to a business, they do not apply to a horse activity that is not carried on by the owner with the intent to make a profit. If the IRS determines that the horse activity is not engaged in with the intent to make a profit (i.e., not a business), it is common for the IRS to take an alternative position in the legal audit process that *if* the horse activity is a business, it is a passive activity because the owner did not "materially participate" in such business.
- Losses and credits from a "passive" business activity are deductible against other "passive" income. Losses which are not currently allowed may be carried forward indefinitely to be used in later years to offset future passive income. And, passive losses that could not be previously deducted, can be deducted in full in the year when the entire interest in the activity is sold or otherwise terminated.
- A passive activity includes a limited partner's interest in a limited partnership. It also includes a horse owner's interest in a general partnership, LLC, or S corporation if the owner does not "materially participate" in the operations of that business.

B. ***Material Participation***

- Material participation means regular, continuous, and substantial involvement. According to IRS regulations, a person who spends at least 500 hours on an activity during the year is deemed to meet the material participation test, if based on all the facts and circumstances, the individual participates on a regular, continuous, and substantial basis during the year.
- An individual who spends less than 500 hours but more than 100 hours on the activity during the year can also meet the material participation test if, based on all the facts and circumstances, the individual participates on a regular, continuous, and substantial basis during the year and is the manager of the activity. A person who spends less than 100 hours cannot meet the material participation test. Time spent by a spouse is included in the time spent by the other spouse.
- Since "material participation" is determined each year, it is possible to have a business activity found to be passive activity one year and not the next.

Tax Tip - It is important to keep a record of the time you spend on your horse business. You will probably find that you can at least meet the "100 hour test."

C. ***What Constitutes a Single Activity***

- One or more trade or business activities are treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of the passive loss rules. The IRS regulations provide that whether activities are treated as a single activity depends upon all the relevant facts and circumstances. A person may use any reasonable method of applying the relevant facts and circumstances in grouping activities. The regulations state that the most important factors are: (1) similarities in types of business, (2) control, (3) common ownership, (4) geographical location, and (5) interdependency between activities.

Tax Tip - Under the IRS regulations, it may be possible to group a passive horse operation that is losing money with some other passive operation that is profitable into a single activity thereby utilizing the losses. Another approach is to create separate activities for various aspects of a "passive" horse operation. This means that completely terminating one of the activities will allow all losses that have not been deducted to be fully deductible in the year of termination.

Sales, Like-Kind Exchanges, & Other Dispositions

Introduction

A fundamental question when it comes to sales and other dispositions of thoroughbreds in the equine *business* (the following assumes that dispositions occur in a business vs. a hobby) is:

> Is the thoroughbred owned for use in the business – e.g., for racing or breeding – or is the thoroughbred held for re-sale – i.e., inventory?

The issue is very fact intensive and depends on the intent of the owner when he acquires the animal, his customary practice, and his actual use.

Note that the answer to this question also impacts the imposition of sales taxes.

The question is a difficult one for breeders who regularly sell some of their foals and retain some for racing with an eye to future breeding if the foal is successful on the track. Often, these individuals don't know what they'll do with the foal at the time it is acquired (birth). What the owner does with the horse depends on the development and conformation of the animal in the first year or two.

In general, the cost, if any, of a horse held for use in a business will be depreciated once it is placed in service. A cost of a horse held as inventory will be parked until the horse is sold.

Sales of Breeding and Racing Horses - §1231

Sales of breeding and racing horses owned for more than 24 months often get the best overall tax result.

- Appreciation in the value of the horse will be taxed at long-term capital gains rates.
- Depreciation taken on the horse will be "recaptured" as ordinary income.
- Losses will be netted against other section 1231 gains and losses and an overall loss will reduce other ordinary income (rather than being subject to the limitations on deductions of capital losses).
- To the extent that losses of breeding and racing horses or other business property were taxed as ordinary income in the last five years, net gains from the sale of these types of horses will be recharacterized as ordinary income.

Gains and losses on sales of breeding and racing horses owned for 24 months or less will taxed as ordinary income.

The netting of section 1231 gains on losses on an annual basis is an important concept to remember when planning for sales of racing and breeding horses.

The holding period for purposes of meeting the 24 month test generally begins and ends when title to the horse passes.

Gains and losses on sales of breeding and racing horses – no matter how long owned – will not be subject to self-employment tax.

Commissions paid on the sale of breeding and racing horses reduce the gain or increase the loss on the sale and do not reduce self-employment income.

Sales of Horses Held for Re-Sale

Gains on sales of horses held for re-sale will be taxed at ordinary rates and will be self-employment income.

Losses from sales of these horses will reduce ordinary income and will reduce self-employment income.

Examples:

1) Homebred sold as a yearling for $50,000
2) 2 year old homebred sold in January for $40,000; foaled in March
3) 2 year old homebred sold in June for $60,000; foaled in March
4) 3 year old sold in June for $20,000; purchased as a yearling in September for $40,000; $30,000 of accumulated depreciation
5) Same as 4), but sold for $5,000
6) Same as 4), but sold as a 4 year old
7) Same as 6), but sold for $100,000
8) Same as 6), but sold for $5,000
9) Combine examples 4 through 6
10) Pinhooked 2 year old sold for $120,000; bought as a yearling for $80,000

Factors to consider:

- Holding period
- Purpose
- Depreciation recapture
- Timing of payments
- Customary practice

Like-Kind Exchanges – see IRC §1031

You can defer gain on the disposition of a horse by using a like-kind exchange (also called a 1031 exchange).

The horse must be one that you used in your trade or business – not an inventory type asset.

You must use an outright trade or involve a qualified intermediary – do NOT touch the money.

Horses must be of the same sex (prefer same use as well – e.g., racing stock for racing stock).

Horses used predominantly outside of the US are not of like-kind to horses used predominantly within the US.

Involuntary Conversions – see IRC §1033

The death of a horse may result in an involuntary conversion for tax purposes.

If the horse was insured, and the proceeds exceed the adjusted basis of the horse, the gain may be deferred if you use the proceeds to replace the horse with another horse that is "similar or related in service or use."

You have 2 years from the end of the year in which you received the insurance proceeds to replace the horse.

> *Example*: A colt in training dies in December of 2008. You receive insurance proceeds of $100,000 in January of 2009. You must purchase another horse (or horses) for training by December 31, 2011.

To qualify, the replacement horse must be similar or related in service or use – racehorse for racehorse (prefer same sex); mare for mare; stallion for stallion.

Installment sales – see IRC §453

Where proceeds from the sales of racing or breeding horses will be received over more than one year and a gain results from the sale, the installment method may be used to defer some or all of the profit ratably to years when the cash will actually be received.

The installment method is not available for loss sales.

The installment method is not available for inventory type assets.

Installment sale treatment is not available for the portion of the gain that represents depreciation recapture. Thus, if you acquired a horse for $100,000 and had taken depreciation of $75,000 at the time that you sold the horse for $110,000, the total gain on the sale is $85,000, but the $75,000 in depreciation recapture is not eligible for installment sale treatment. Rather, all of the depreciation recapture is taxed in the year of sale, regardless of when the funds are received.

You can elect out of the installment method by reporting the full gain on your return in the year of the sale. E.g., if you make a sale in 2010 and believe rates on long-term capital gains will rise in 2011, you may want to consider electing out.

Example:

3 year old sold in November for $100,000, purchased as a yearling in September for $40,000; $30,000 of accumulated depreciation. $50,000 received in December and $50,000 received in the following January.

Adjusted Basis

Gain or loss on the sale of a horse is determined by subtracting the adjusted basis of the animal from the proceeds received on the sale.

Basis in a horse is usually the original cost of the horse, including commissions and sales taxes. If the horse is placed in service, its basis will be reduced for depreciation (including section 179 expensing).

A cash method taxpayer's basis in a home-bred is zero, as he will have previously deducted the costs of producing the foal (e.g., stud fees, costs of using the mare, vet bills, and other costs).

When a horse is acquired in a like-kind exchange, the basis in the new horse is its cost less the gain deferred on the disposition of the old horse. The same is true in the case of a horse acquired as a result of an involuntary conversion.

When you purchase a mare in foal, the cost must be allocated between the mare and the foal based on their relative fair market values at the time of acquisition.

Sales of Personal/Hobby Horses

Gains from the sale of personal use or hobby use horses are taxable either at long-term (held more than one year) or short-term (held one year or less) capital gains rates.

Losses from the sale of personal-use and/or hobby horses are not deductible.

Charitable Contributions

Many donors are familiar with the benefits of donating appreciated property – assets with fair market values in excess of their tax basis. With some exceptions, donors are entitled to charitable contribution deductions measured by the donated property's fair market value and are not taxed on the property's appreciation.

Exceptions:

(1) The fair market value of the contributed property must be reduced by the amount of gain on a sale that would be ordinary income if the property were sold at its fair market value. Thus the deduction for a contribution of inventory type property and horses owned 24 months or less would be limited to tax basis in the horse.

Likewise, for horses owned more than 24 months that have been depreciated, the amount of the depreciation taken will reduce the amount of the charitable deduction.

Example:

A horse held more than 24 months which cost $15,000 and on which $10,000 of depreciation has been taken is worth $25,000 at the time of the contribution (and a qualified appraisal is obtained). The charitable contribution deduction will be the $25,000 fair market value less the $10,000 of depreciation recapture – or $15,000.

The owner has given up property worth $25,000 and has obtained a charitable deduction valued at $15,000. If he is in a combined federal-state tax bracket of 40%, the value of his deduction is $6,000.

If he had sold the horse for $25,000, he would have had $10,000 taxed at long term capital gains rates (combined federal-state rate of 20%) and $10,000 taxed at ordinary rates of 40%. His tax on the sale would be $6,000 and his after-tax cash would be $19,000. If he were to then donate the $19,000 cash to a charity, his tax benefit would be $7,600.

(2) The deduction for contributions of tangible personal property is limited to the horse's tax basis if the donation is made to an organization which would not use the horse to further its charitable purposes. For example, a gift of a horse to the United Way or a church or an equine charity that will sell the horse in a charity auction would result in a deduction limited basis in the horse. A gift of a horse to an organization that uses horses to help troubled children and will use the horse in its programs will qualify for a fair market value deduction reduced per (1) above.

(3) Owners of stallion seasons often donate an annual breeding right to charity auctions. Except in the rare case where the annual breeding right has a tax basis, the donor will not have a charitable deduction, but he also won't recognize income on the sale by the charity of the breeding right.

Outline of Depreciation, Cost Recovery, and the 2009 Tax Breaks

A. ***2009 Tax Breaks.*** This will cover extension to 2009 of the 50% Bonus Depreciation Rules and the I.R.C. Section 179 Expensing Election of up to $250,000, as well as the new treatment of Yearling Depreciation starting in 2009. An in-depth explanation of each tax break will be presented, with examples, including how to calculate the expense when one is eligible for both Section 179 Expensing and 50% Bonus Depreciation, and instances when an owner will elect against using either the Expensing Election or Bonus Depreciation.

B. ***Normal Depreciation and Cost Recovery.*** This will cover the normal MACRS depreciation schedules for both horses and other farm assets. The exceptions to the normal schedules that will be discussed are:

- Purchases During the Last Quarter of the Year
- Purchases of Horses by "Non-Farmers"
- Purchases of Horses for Predominant Use Overseas

A hand-out is provided showing MACRS depreciation schedules for the different categories of assets.

MACRS Depreciation Schedule

A. For Horses

3-Year Property
"Farmer" Race Horses and Race Horse Prospects (Except Weanlings) and Breeding Stock Over Age 12

Year	Basis Percentage Claimed
1	25.00% of basis
2	37.50% of basis
3	25.00% of basis
4	12.50% of basis

7-Year Property
Breeding Horses Under Age 12

Year	Basis Percentage Claimed
1	10.715% of basis
2	19.134% of basis
3	15.033% of basis
4	12.248% of basis
5	12.248% of basis
6	12.248% of basis
7	12.248% of basis
8	6.126% of basis

3-Year Property
"Non-Farmer" Race Horses and Race Horse Prospects (Except Weanlings)

Year	Basis Percentage Claimed
1	33.33% of basis
2	44.45% of basis
3	14.81% of basis
4	7.41% of basis

B. For Other Than Horses

5-Year Property
Autos and Light Trucks*

Year	Basis Percentage Claimed
1	15.00% of basis
2	25.50% of basis
3	17.85% of basis
4	16.66% of basis
5	16.66% of basis
6	8.33% of basis

* Special restrictions limit amounts deductible for autos – see I.R.C.§ 280F(a) and Rev. Proc. 96-25.

7-Year Property
Farm Equipment and Machinery

Year	Basis Percentage Claimed
1	10.715% of basis
2	19.134% of basis
3	15.033% of basis
4	12.248% of basis
5	12.248% of basis
6	12.248% of basis
7	12.248% of basis
8	6.126% of basis

20-Year Property
Barns and Farm Buildings

Year	Basis Percentage Claimed
1	3.75 % of basis
2	7.219% of basis
3	6.677% of basis
4	6.177% of basis
5	5.713% of basis
6	5.285% of basis
7	4.888% of basis
8	4.522% of basis
9	4.462% of basis
10	4.461% of basis
11-20	4.462% of basis
21	2.231% of basis

Forms of Doing Business

A. *Sole Proprietorship*

- Sole proprietorships are the simplest form of doing business but obviously can be used only if there is just one owner of the business. Normally, spouses are treated as one owner if a joint return is filed.
- There is no separate entity for tax filing purposes. The income and expenses of a horse business are normally reported on Schedule F of Form 1040. It is appropriate to use Schedule C if the business only involves racing.
- All profits and losses are taxed directly to the owner. Capital gains and losses are also taxed to the owner.
- A sale of the entire business is treated as sale of each separate asset for tax purposes.

B. *Partnership*

- For Federal income tax purposes, the term "partnership" includes a "syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, . . . a trust or estate or a corporation." [IRC Sec. 7701(a)(2).]
- A limited partnership, while legally different from a regular partnership, generally follows the same tax rules that apply to a regular partnership.
- A partnership is a separate entity for purposes of making elections regarding income computations, computing income and filing an income tax information return.
- The original tax basis of a partner's interest normally is (1) the total amount of the money contributed, plus (2) the amount of the tax basis of property contributed, if any. If non-business property is contributed, the tax basis is the fair market value or the cost, whichever is lower.
- Special rules allow a partnership to elect to increase the tax basis of the partnership property when the price a purchaser pays for a partnership interest exceeds his or her share of the tax basis of the partnership property. [IRC Sec. 734(b) and 754.]
- The income, loss and credits of a partnership pass through to the partners according to each partner's share of the partnership and are reported on their tax returns. The character of the items of income and losses, for example capital gains, is determined at the partnership level, and is generally passed through to the partner. [IRC Sec. 733.]
- Distributions to a partner of cash or property are not taxed but reduce the partner's tax basis in the partnership. [IRC Sec. 733.]
- Sale of a partnership interest is generally treated as the sale of a single capital asset (except that portion of the price attributable to certain ordinary income). [IRC Sec. 741.] The sale is treated as a short term or long term capital gain depending on how long the partner has held the partnership interest, not how long the assets in the partnership have been held.

- There is considerable flexibility in allocating income, losses, etc., among the partners as long as the tax allocation corresponds with the economic effect of the allocation. [IRC Sec. 704.]
- Partnerships range from relatively simple means of doing business to very complicated ones, depending on the agreement of the partners. From a tax standpoint, the rules can become quite complex.
- Generally, there are fewer state law requirements than for a corporation, but more than for a sole proprietorship.
- Check the Box- IRS regulations allow most unincorporated business to elect to be treated as a partnership for tax purposes. These regulations do not allow a partnership to be treated as a joint venture or sole proprietorship. [Treas. Reg. Sec. 301.7701-1 – 3.]

C. *Syndicate*

- A horse syndicate, such as a stallion syndicate, which does not engage in any business activities of its own, is normally treated for tax purposes as the co-ownership of property. Each co-owner treats his or her share in the stallion as a part of their own horse business.
- If the syndicate engages in business activities of its own (e.g., racing or selling excess nominations and dividing the proceeds), it may have to be treated as a partnership.

D. *S Corporations*

- An S corporation is a corporation with no more than 100 shareholders that makes an election to have its income and loss taxed directly to the shareholders. As with a partner in a partnership, the shareholder in an S corporation has to pay tax on their share of profits whether or not distributed to the shareholder. Likewise, the shareholder deducts their share of losses. Shareholders must be individuals who are U. S. residents, estates, or certain kinds of trusts. Only one class of stock is allowed. [IRC Sec. 1361.]
- Except in rare circumstances, an S corporation pays no tax, but income and loss are computed at the corporate level and information returns showing the income and expenses of the S corporation are filed with the IRS -- the same as for partnerships. Capital gains and losses retain their character when passed through to the shareholder.
- The sale of shares in an S corporation is normally treated as the sale of a capital asset, either long term or short term.
- There is relatively little flexibility in allocating income, losses, etc. among shareholders. And, there are a few situations where income and losses pass through to the shareholders in a manner less favorable than with a partnership pass-through.
- Use of an S corporation is a more complicated way of doing business than a partnership or proprietorship. The advantages of limited liability from an S corporation may be outweighed by (1) the lack of flexibility, (2) the additional costs of doing business in the corporate form, and (3) the difficulties of

getting the assets in the business out of the corporate form. The advent of limited liability companies, which have fewer restrictions and tax pitfalls, have made S corporations less desirable as a business form.

E. *Limited Liability Company*

- A relatively new form of business entity called a limited liability company ("LLC") has gained more and more acceptance and has become a common business form for a horse business.
- As a general rule, a LLC contains the limited liability immunities of a corporation and the flexible tax advantages of a partnership, the best of all worlds. The LLC is a corporation for purposes of lawsuits and legal liability, and a partnership for federal tax purposes.
- LLC characteristics compare very favorably with those of either a corporation and/or a partnership.

F. *Regular Corporation*

- A regular corporation is a separate taxable entity which pays taxes on its own income and cannot pass its losses through to shareholders.
- The shareholder or shareholders are taxed on dividend distributions even though the corporation has already been taxed on that income. However, this double tax on profits was mitigated by Congress to some extent for dividends received during 2003 through 2009, when the maximum tax rate on dividends was reduce to 15%, the same as the tax on capital gains.
- The sale of shares in a corporation is normally treated as the sale of a capital asset.
- Since a corporation is a separate taxable entity, the income may be taxed at a lower rate than it would be if taxed directly to the owner.
- Use of a regular corporation is a more complicated way of doing business than a partnership or proprietorship. A lower tax rate and limited liability may be offset by the additional costs of doing business in the corporate form, the double tax on dividend distributions, and the difficulties of getting the assets of the business out of the corporate form at some later time.

G. *Comparison of Business Forms*

The chart below, which was prepared by Robert Hill,* compares the attributes of each of the business forms discussed above.

CORP	*S CORP*	*LLC*	*PARTNERSHIP*	*PROPRIETORSHIP*
Limited Liability	Limited Liability	Limited Liability	Personal Liability	Personal Liability
No pass-through of tax characteristics	Pass-through of tax characteristics	Pass-through of tax characteristics	Pass-through of tax characteristics	Pass-through of tax characteristics
Likely double taxation	Possible double taxation	No double taxation	No double taxation	No double taxation
No allocation of income to owners	Income allocated to owners based on ownership	Income may be allocated based on economic realities	Income may be allocated based on economic realities	Owners gets taxed on all income
No limitations placed on types of owners	Owners are practically limited to resident individuals	No limitations placed on types of owners	No limitations placed on types of owners	No limitations placed on types of owners

* Robert Hill is a shareholder and Director of Taxation at Eskew & Gresham, PSC, in Louisville, Kentucky.

Tax Tip - It is normally best to use the simplest form of business that is available under your circumstances. This means using a proprietorship for most people who operate their horse business on their own. LLC's are becoming a favored form of doing business if there is more than one owner and limited liability is a factor.