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AMERICAN HORSE COUNCIL'S TAX BULLETIN

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The American Horse Council keeps you up to date with important tax court cases and regulations with its quarterly Tax Bulletin. The Tax Bulletin is a member benefit, and thus is not intended for reproduction. For more information on federal legislation, equine health and regulatory issues, taxes, animal welfare, racing, recreation, and showing please visit our website at [www.horsecouncil.org].

Handling the "HOBBY LOSS" Challenge: When the IRS Tries to Bite the Horseman

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An IRS auditor has a difficult job. He or she is often called on the make judgments about taxpayers' business activities in highly specialized activities, he may have limited, if any, knowledge of those activities. In such situations, errors are bound to occur. This problem is frequently apparent in audits involving horse businesses. In addition to this understandable, problem, many horsemen report that some auditors seen to assume that they are all trying to cheat the government, and in such cases, auditors do not fairly evaluate horse businesses.

The problem is sometimes exacerbated when a tax return preparer, due to his or her unfamiliarity with the horse industry, makes errors on the taxpayer's return. The situation becomes more complicated when the government's representative also does not understand the horse business.

In approaching an audit or an administrative appeal in which the IRS seeks to disallow losses incurred by a horseman on the grounds that the activity was not engaged in primarily for a profit under Section 183 of the

Code, the taxpayer's representative should generally prepare for the task of educating the auditor and/or hearing officer, assuming, that is, that the taxpayer is in fact pursuing the horse business primarily for a profit. In this regard, it is important to utilize appropriate experts and package the educational process in a form that the auditor/hearing officer is likely to understand. It is also of paramount importance to remember at all times that the test under the statute (I.R.C. §183) is a *subjective test.* The so-called objective criteria are valuated merely to corroborate the subjective intent of the taxpayer.

In educating the government's agent, the representative is well advised to utilize various experts, at least one of whom should be an expert in the horse business. It is also advisable, in light of the distinction between horse "business" experts and horse breeding or training experts made by the Tax Court in *Golanty v. Comm'r*,[1] to use more than one equine expert to explain the various aspects of the business. For example, if a client breeds running quarter horses and includes breeding, sales, and racing among his business activities, a practitioner may wish to use a Quarter Horse race trainer to explain the racing aspects of the business, and a Quarter Horse bloodstock agent to explain market trends and to appraise the taxpayer's current herd.

Generally, equine experts are "breed-specific." An expert on Arabian horses is apt to know very little about Thoroughbreds, and vice versa. Some equine experts do have broad expertise, but an astute practitioner will be sure his or her equine expert is actually well-versed and familiar with the particular breed or activity that is at issue.

If the taxpayer owns a ranch, an appraisal of the ranch property by a qualified land appraiser is also recommended. There is a split of authority concerning whether the anticipated appreciation in ranchland used in a horse business may be taken into account in the overall profitability of the venture. [2] Any evidence available that the taxpayer intended to take ranchland appreciation into account in the profitability of the overall venture should be brought to the government's attention. In *Golanty*, the Tax Court refused to recognize a profitable sale of ranch land used in the horse business; by contrast, the Tax Court in *Engdahil* permitted the land appreciation to be taken into account. One reconciling possibility for the two apparently contradictory decisions is that in *Engdahl,* the taxpayer convinced the court that he or she intended to take land appreciation into account, whereas in *Golanty*, the taxpayer was not successful in convincing the court that he intended to take potential profit from land sale into account with respect to his horse business.

In preparing for the audit and/or administrative appeal, it is best to format the presentation in terms of the nine points listed in the regulations under Section 183. While the Treasury regulations expressly state that the nine points are not the only ones to be considered, as a practical matter, the nine points are usually the only sources of inquiry for corroboration of a taxpayer's testimony concerning his state of mind. Since the auditor/hearing officer is generally concerned with these nine points, it seems only natural that he would be led to a correct result most readily by a presentation that is in a form familiar to him. The nine points are as follows;

1. *Manner in which taxpayer carries out the activity*. This is probably the most important criterion. It strongly corroborates a taxpayer's business purpose by showing that his or her business is run in a substantially similar manner to the taxpayer's other business and/or to other bona fide horse businesses. Preferably this means that the taxpayer should have businesslike books and records for the horse business should resemble the books and records kept by the taxpayer in other business pursuits.

2. *Expertise of taxpayer or his adviser*. The more expertise a business owner has in a business, the more it looks like he is in business. However, an owner's lack of the business aspects of the hose business, as well as the breeding, racing and/or

[2]Compare *id.* with the factually similar but better-reasoned decision in *Engdahl v. Comm'r* 72 T.C. 659 (1979).

expertise can be overcome by showing that the owner with experts in the business. The *Golanty* opinion indicates that expertise may be required in well as the breeding, racing, and/or showing aspects.

3. *Time and effort expended by taxpayer* in carrying out the activity. The more time and effort the taxpayer spends, the better the prospects are that the government will believe that the taxpayer is in business.

4. *Expectation that assets used in the activity may appreciate in value*. This is another extremely important criterion. If, for example, it can be demonstrated that the present value of the taxpayer's hard is equal to twice the taxpayer's cumulative total losses, such a showing proves that the assets used in the activity (i.e., the horses) have in fact appreciated. This would strongly corroborate the taxpayer's profit motivation, even in the face of successive loss years. If the taxpayer also intended to take into account the appreciation of the land used in his or her horse business, this fact should also be discussed.

5.*Success of taxpayer in carrying out other similar or dissimilar activities.* In practice, this criterion does not seem to be as important as the four criteria mentioned above. Nonetheless, the fact that in the past the taxpayer has successfully bred other livestock can be a plus. Alternatively, the fact that the taxpayer had been successful in other entrepreneurial ventures can also be a plus.

6. *Taxpayer's history of income or loss with respect to the activity*. Business history and trends can help or harm a taxpayer.

7. *Amount of occasional profit, if any, that is earned*. Again, a very substantial profit, even though occasional, is more corroborative of a taxpayer's profit motivation than a minuscule profit.

8. *Financial status of taxpayer*. The taxpayer's wealth or poverty in and of itself would not seem to be relevant to the true mature of the taxpayer's subjective motivation in engaging in a horse business. From a practical standpoint, however, a wealthy taxpayer may have to make a stronger showing of profit motivation than a taxpayer of more modest means.

9. *Whether the elements of personal pleasure or recreation are involved*. This criterion is not particularly helpful in most cases. On one hand, if the taxpayer's herd consisted of two riding horses, which were trail ridden by the taxpayer and spouse but were not bred, shown raced, or used in some other income-seeking activity, such an activity would be viewed primarily as a recreational pursuit of the taxpayer. However, the fact that a horseman likes horses by no means disqualifies him or her form having a profit motivation. Presumably, a widget manufacturer can like widgets without making suspect his or her profit motivation.

The bottom line is whether the taxpayer's primary motivation when engaging in the activity was to make a profit. That is the all-or-none determination. If it is determined that this was the taxpayer is primary motivation, the taxpayer is entitled to offset horse business losses against other income, regardless of whether he or she ever makes a profit. Sometimes auditors/hearing officers lose sight of this fact and attempt to apply the nine so called objective criteria discussed above as a litmus test. It is important to focus on the real issue, that is, the taxpayer's primary motivation.

<u>*Conclusion*</u>

In general, an IRS challenge to a horse business under Section 183 should be approached as an educational exercise. Experts should be utilized to corroborate the reasonable business nature of the taxpayer's operation. The practitioner must not permit the government to lose sight of the fact that the entire determination is really one of subjective intent, and that the taxpayer's truthful testimony that he or she entered the horse business primarily for profit is sufficient evidence on which to base such a finding. The points listed in the regulations are properly viewed as either corroborative or Non -corroborative, rather than determinative.

The Snyder Case

On October 22, 1987 the United States Tax Court decided the case of *Snyder v. Comm'r*,[3] in which the IRS disputed the taxpayer's testimony that she was engaged in a horse business with a primary motivation of profit, despite having incurred losses for seven consecutive years. Judge Nims applied the proper rule of law, citing *Dreicer v. Comm'r* [4] for the standard: "[D]id the individual engage in the activity 'with the actual and honest objective of making a profit.' "[5]

The Tax Court in *Snyder* also correctly noted, citing *Allen v. Comm'r*,[6] that the issue is "one of fact to be resolved, not on the basis of any one factor, but on the basis of all the surrounding facts and circumstances, and the regulations so provide."[7]

The court weighed the evidence and found in favor of the taxpayer. The *Snyder* case is a good example of utilization of the proper standard for review in a case based on Section 183 of the Internal Revenue Code.

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[3] 54 T.C.M.953 (1987).
[4] 78 T.C. 642 (1982*), aff'd without opinion*, 702 F.2d 1205 (D.C. Cir. 1983).
[5] Id. at 645.
[6] 72 T.C. 28 (1979).
[7] Snyder, none 3, *supra* at 956 (quoting Allen, note 6, *supra* at 34).

Two Recent Tax Court Decisions Regarding Breeding Animals and Hobby Losses: The Miniature Donkey Breeder Had a "Little" Better Facts

By Joel N. Crouch

The U.S. Tax Court recently issued two memorandum opinions regarding animal breeding activities and whether the taxpayers at issue could deduct expenses in excess of income from the activity. In Skolnick v. Commissioner, the Tax Court found that a pair of horse breeders were not engaged in the activity for profit, and thus the deductions were limited by IRC Section 183(b). In Huff v. Commissioner, the Tax Court found that a miniature-donkey-breeder venture was engaged in for profit, and therefore expenses in excess of income were allowable deductions under Section 162(a).

IRC Section 162(a) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". If an activity is not engaged in for profit, no deduction is allowed except to the extent of gross income derived from the activity, reduced by deductions allowable without regard to whether the activity was engaged in for profit. IRC Section 183(b). Therefore, losses are not allowable for an activity that a taxpayer carries on primarily for sport, as a hobby, or for recreation. To be entitled to deductions under Section 162(a), the taxpayer must show that he engaged in the activity with an actual and honest objective of making a profit. Although the taxpayer's expectation of profit does not have to be reasonable, the intent to make a profit must be genuine.

The Section 183 regulations set forth a nonexclusive list of nine factors the IRS and courts use in determining whether a taxpayer conducted an activity with the intent to earn a profit. No factor or group of factors is controlling, nor is it necessary that a majority of factors point to one outcome. The factors to be considered are: (1) the manner in which the taxpayer conducts the activity; (2) the expertise of the taxpayer or his advisers; (3) the time and effort spent by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any;

(8) the financial status of the taxpayer; and (9) elements of personal pleasure.

In Skolnick, Mitchell Skolnick and Eric Freeman co-founded Bluestone Farms a partnership, whose stated mission was to acquire land, establish a horse breeding farm and sell the yearlings at public auction. After considering the nine factors, the IRS, and ultimately the Tax Court, disallowed the taxpayers' losses from Bluestone Farms for the years 2010-2013. Although Section 183(d) has a safe harbor for breeding, training, showing, or racing horses when the activity produces gross income in excess of deductions for any two of the seven consecutive years, Bluestone failed to produce any gross income for any year from 1998 to 2013. In fact, Bluestone incurred expenses that ranged from 150% to 300% of its income annually. In addition, the taxpayers failed to maintain accurate or complete business records and according to the court there was a "persistent blending" of personal and business elements. The taxpayers lived on the Bluestone property without paying rent, used business credit cards to pay personal expenses and allowed personal horses to stay on the business property at no charge. The court also noted that the taxpayers did not spend any significant time running the business and "avoided most of the unpleasant aspects of running the farm, like cleaning the stalls and maintaining the grounds". The only good news was the court determined the taxpayers were not liable for an accuracy-related penalty because their CPA had prepared returns for two other horse farms and had advised the taxpayers that the losses were properly deducted.

In Huff, the husband and wife were a hedge fund manager and an attorney, respectively, with a net worth in the range of $750 million. However, the taxpayers were concerned about their adult daughter Jennifer's modest earnings and founded Ecotone Farm LLC, which ran an operation breeding miniature donkeys. According to the opinion, "Mr. Huff believed that he could turn the miniature donkey operation over to his daughter once the breeding program had been properly established, allowing her to benefit from his sweat equity. He was particularly enamored with this idea given Jennifer's passion for animals and the proximity between their farms." The IRS disallowed the taxpayers' losses they claimed in 2013 and 2014 from Ecotone because the couple didn't engage in the breeding activity for the primary purpose of making a profit. Although the breeding operation had not been profitable, the court reviewed the nine factor test under the Section 183 regulations and concluded that the taxpayers formed the breeding operation with the dominant hope and intent of making a profit. The court cited the taxpayers extensive research and consultations they conducted, hiring of experts, and the determination to turn over an established, successful business to their daughter. The court also referenced Mr. Huff's testimony that he derived "zero personal pleasure" from being around miniature donkeys, found the animals to be "quite ugly", and did not like to pet or cuddle them.

These two cases are good examples of how the IRS attacks and the Tax Court reviews business ventures that annually report losses and how taxpayers can lose and win a hobby loss case. They are also more evidence that Donkeys Are The Ones With Real Horse Sense.

WHEN CAN YOU RECOVER ATTORNEYS' FEES IN LITIGATION AND ARE ATTORNEYS' FEES DEDUCTIBLE FROM ORDINARY INCOME?

By T. Randolph Catanese, Esq.

When disputes arise involving any equine or related business or ranch activity the dispute will usually involve attorneys who represent the parties having the dispute. As service providers, the attorneys charge legal fees and costs for their time in representing a party who has a dispute. This article will focus on when a person can recover their attorneys' fees from another person and whether or not incurred or paid legal fees are deductible against gross income of the person making payment of the legal fees and costs.

When the United States was formed it had the choice of following the "English Rule" regarding which party should pay legal fees in any dispute. Under prevailing English law at the time our country was formed, the losing party in a lawsuit was required to pay the prevailing party their attorneys' fees and costs. In other words, the person who lost a lawsuit was responsible to not only pay their legal fees and costs, but they were also required to pay the prevailing party's attorneys' fees and costs as well. As you might imagine, the English Rule can heavily influence whether a party initiates and pursues litigation against another party.

The United States adopted what is known as the "American Rule" related to recovery of legal fees and costs. Generally, the policy of the United States is to encourage its citizens to seek redress of grievances to foster a more equal society. Under the American Rule a party who prevails in a lawsuit against another party is only permitted recovery of their legal fees and costs against another party in the lawsuit if provided by statute. In other words, if a state legislature or the United States Congress passed a statute which permitted recovery of attorneys' fees and costs then, based on the statute, the prevailing party could recover their legal fees and costs from the losing party. *See Alyeska Pipeline Service Company v. The Wilderness Society* (1975) 95 S. Ct. 1612, 1616-1617 (*citing Arcambel v. Wiseman* (1796) 3 U.S. 306).

California, Florida and Kentucky (as well as many other states) permit the recovery of legal fees and costs from the losing party by the prevailing party if within an applicable statute allowing for such recovery. These "fee shifting" statutes generally require that the legal fees be reasonable. Ultimately, legal fees are awarded by the court and the court will determine whether the fees are reasonable or not given state or federal caselaw or other statutory guidelines. *See California Civil Code* §1717; *Florida Statutes* §§57.105, 120.595 and 768.79; and, *Dulworth & Burress Tobacco Warehouse Co. v. Burress* (Ky. 196) 369 S.W. 2d 129.

If you operate an equine business like a corporation or even a sole proprietorship, actual paid legal fees are treated as a normal business expense under Section 162 of the Internal Revenue Code. If you are an amateur and you are engaged in equine activities without an intent to make a profit, then, any paid legal fees likely will not be allowed to reduce your ordinary income under Section 162 and by reason of the limitations imposed by Section 183 of the Internal Revenue Code. However, for tax years beginning before 2018 and after 2025 an individual, estate or trust may claim a miscellaneous itemized deduction for non-business legal expenses. (Internal Revenue Code Section 212; Reg. §1.212-1; IRS Pub. 529 (2017)). The deduction is subject to the 2% of adjusted gross income limit.

Given time it is likely you may become involved in a horse dispute. The dispute may be with a partner, a trainer, a boarding facility or a buyer or seller of a horse. Remember, if you do hire an attorney to assist you in the dispute identify if you are able to recover your attorneys' fees and costs should you prevail in any lawsuit or arbitration. Your ability to recover legal fees from the opposing party and your ability to deduct those fees if you are required to pay legal fees of any kind should be part of any process involving a resolution of a dispute.

Professional Association of Therapeutic Horsemanship International Seeks Board Volunteers; No Horse Experience Necessary

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