HURLEY & HURLEY, INC.

Income Tax and Business Services

222 West Main Street, Suite 203

Tustin, California 92780-7704

Phone: (800) 996-2204 *Fax: (714) 996-1582*

TAX LAW REQUIRES ACTIVE HORSE PARTICIPATION

Are you a passive investor or a material participant in your horse business? Why does it matter?

Beginning in 1987, many individuals had to determine if they were material participants or passive investors in the horse business. This distinction will determine when and if any horse losses are deductible.

While defining passive investor and material participant, the effects of being one or the other will be considered and suggestions for restructuring your operation to avoid the negative impact of being a passive investor will be made.

Before dealing with the passive loss rules in detail, let us see how they fit into the present framework of Hobby Loss Rules.

Remember, you must be sure your horse operation is a business (as defined by the IRS) and not a hobby. Otherwise, your losses are not deductible. It is important that you keep adequate records to prove that you intend to make a profit at the start of your horse venture. A written plan that shows how you intended to be profitable is very important in proving your intent. It shows a profit motive which is one of the most important points in proving that you have a business and not a hobby.

If your business meets this definition, you are then deemed to have active income with material participation and not classified as a passive investor. What are the tax consequences of being in one of these groups?

A material participant will deduct his horse losses against ordinary income (including salaries and wages) in the current year as he is now doing. A passive investor cannot deduct horse losses against ordinary income in the current year, only against horse income or other passive income (except interest or dividends). If losses are not deducted in the current year, they are available to be used against passive income in later years.

WE ALL WANT TO BE MATERIAL PARTICIPANTS

1. You must have a "substantial and bona fide involvement in the activity."

2. Your approach to the activity should have a "significant non-tax economic profit motive."

3. You will have formed a "sound judgment as to whether the activity has genuine economic significance and value."

4. The amount of money lost or at risk does not determine material participation except for investments in the oil business.

5. A limited partner in a horse venture cannot be a material participant.

6. A material participant is one who is involved on a regular, continuous and substantial basis. This is true no matter what the form of the business, i.e. individual ownership, partnership or S corporation.

7. An exception to the above is active participation in the horse business through a regular taxpaying corporation which is not primarily in the horse business. This type of involvement may allow you to circumvent rules limiting a passive investor. If you now have a regular corporation and it operates an active business other than personal services (medical, legal, consulting, etc.), it may offset passive horse losses against in regular active income. This method is not foolproof, but it may offer a better solution for a horse operation than merely "throwing in the towel" as a passive investor. This may also be attractive simply because corporate tax rates will be higher than individual rates under the new rate schedules.

WHAT HAPPENS TO THE LOSSES OF A PASSIVE INVESTOR?

1. Passive losses in the current year: If you have only losses from your passive horse activities, they are not deductible now but are set aside to be deducted from passive horse income you might have in future years. This is called a loss "carry-over" or "carry-forward", as the terms are used interchangeably.

2. Both passive gains and passive losses in current year: If you have both losses and gains from involvement in passive activities such as horses, cattle or equipment leasing, you can, for example, offset your horse and cattle losses against passive leasing profit. If there is still a remaining loss, it is carried forward to next year and used against each activity's gains.

3. Passive loss carryovers: If you have passive gains from horses or cattle this year and passive loss carryovers from horses or cattle last year, you may offset last year's losses against this year's gains from each passive activity separately.

4. Unused passive losses: Unused passive losses can be deducted from ordinary income when the passive activity is entirely sold or liquidated. It must be emphasized that congress talks about an "activity" as opposed to specific investment. Disposing of an activity involves the disposing of all related investments in that activity, it is possible, then, that as long as you remain in the horse business in any form, you could have unused passive losses. Congress takes almost three full pages to define "what is an activity". It would be too lengthy to try to summarize their definition, but suffice it to say that with careful planning and bookkeeping you will be able to preserve your tax benefits.

5. Special Rules: There will be special rules to cover installment sales, inheritances and gifts.

This is merely the tip of the iceberg insofar as the passive-loss rules are concerned. Congress gives the IRS a free hand to write regulations interpreting the law. It is probable that the regulations will be more conservative than Congress intended, as the IRS has advocated reform in this area for many years. The game, then, is going to revolve around demonstrating that you are a material participant in all of your horse activities. The committee did offer some examples that apply to the horse industry.

MATERIAL PARTICIPATION, as defined by the Senate Finance Committee Report of the Reform Tax Act, seems to revolve around the phrase "regular, continuous and substantial involvement". Again, the infinite wisdom of the government has given us a few clues defining "regular, continuous and substantial".

1. It is not periodic consultation or general management decisions.

2. It is a significant contribution to the operation of the enterprise.

3. It is spending 35 hours per week, for example, at the activity and a lesser amount of time at the businesses.

4. Principal activity - if an activity is not your principal activity, it may be more difficult to show the necessary involvement.

5. Physical presence - if you are physically present at the location where most of the activity is taking place, it is more likely that you will meet the criteria. For example, an individual who raises horses at or near his home is more likely to be a material participant than if the operation is hundreds of miles away.

6. Involvement shown by hiring and supervising those responsible for the care of the horses, even though you may not be physically present, and making decisions regarding the purchase, sale and breeding of the animals would be considered substantial involvement.

7. Providing service to the activity (providing substantial service to the activity, such as finding customers, contracting for purchases or performing management functions other than mere nominal attendance at meetings will help a great deal). Management can be shown by the "genuine exercise of independent discretion and judgment."

8. Can you be both active and passive? Apparently, yes. The committee does not find a conflict here. You may be active in the horse business and also have a limited partnership interest in a horse operation that would be considered passive. As a result, you could have some horse losses that are deductible and others that are not deductible.

HOW DO WE PROVE THAT WE ARE MATERIAL PARTICIPANTS?

PROPER STRUCTURE: In structuring our horse operations, it is obvious to avoid limited partnerships. Probably the best forms of doing business are individual ownership or small general partnerships. The use of a regular corporation that conducts other profit-making operations can probably be used effectively.

DOCUMENTATION AND PROOF: As in anything we do in the tax area, this is a major factor. We will have to rely on this even more when it comes to proving something as subjective as material participation.

What is good documentation and proof? We can go back to some of the criteria that have been developed under the Hobby Loss cases;

1. A written business plan stating how you planned to operate your horse business and why your participation is material. It is most important to take a positive position at the outset. Try to shift the burden, at lease informally, to the IRS. These rules are all new to the IRS as well as to us, so they may not have hard and fast policies for some time.

2. Correspondence with trainers, bloodstock agents, farm managers and other experts with whom you have consulted.

3. Minutes of meetings with your advisors that are signed by other parties, or correspondence confirming discussions held at such meetings will tend to show active participation.

4. Records of phone calls, including items discussed, and a diary or confirming correspondence are very helpful.

5. Separate bank account and backup records of money spent just as you would have in any business venture.

6. Diary showing dates, times and hours devoted to various phases of the horse business, including farm visits, attendance at auctions, attendance at meetings of breeders associations and seminars, etc.

It is most important that these records be maintained on a current basis. Spur of the moment reconstruction of these records does not work. You may try to rely on affidavits from persons trying to remember events from years previous. This does not work. It carries less weight and tends to show lack of continuous involvement. The best defense is a good offense.

A good set of documents tends to put the burden on the IRS to disprove the position you are taking. If you are, on the other hand, put in a defensive posture and try to reconstruct your case after the fact, the burden is tough to overcome.

In summary, we have reviewed some of the rules, defined new terms as they apply to the horse industry and addressed some of the more obvious difficulties that may arise. Each horse person's situation is unique and must be addressed in a special manner. You should look at your individual circumstance with your tax advisor and determine what steps are necessary to continue to give you the best chance of preserving tax deductions for the horse losses you might incur in the future.

I firmly suggest that you consult with you tax advisor on the guidelines for active or passive involvement. Specific questions regarding this article should be addressed to Patrick J. Hurley at (800) 996-1040.