

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

BUSINESS OR HOBBY - IRS GUIDELINES HELP

Horse owners, whether their involvement is because of their love of the sport or purely for investment purposes, must be aware of the federal tax laws. The cost of owning a horse is such that it is nearly impossible to be part of the equine industry unless it is done as a business. Otherwise, during those inevitable loss years, it will not be possible to deduct losses against income from other sources.

The 1969 Tax Reform Act modified the law on "activities engaged in for profit" and the IRS subsequently issued regulations for assessing when a venture, such as horse racing or breeding, is a business or a hobby. In addition, there have been numerous court decisions, which have further defined the lines between a business and participation primarily for pleasure and recreation. Still, many horse owners remain uncertain about the factors involved in being treated as a business.

Section 183 of the Internal Revenue Code provides that if a horse business engaged in by an individual, partnership or subchapter S corporation shows a profit in two years within a seven year period (beginning with the first profit year), it will be presumed to be engaged in for profit, with a separate special election available for a new enterprise. If the activity is one engaged in for profit, then losses resulting from the business may be deducted from other income.

However, the two-out-of-seven presumption is not absolute. There is no negative presumption in the rule. Even if an activity does not have two profit years during a seven year period, it is not necessarily a hobby; the burden of proof is merely shifted to the taxpayer to prove he entered into and/or continued the activity with the objective of making a profit.

Conversely, two profit years occurring during the seven year period do not assure that the IRS will not consider the operation to be a hobby if the profits during those two years are minimal and the losses were substantial.

The regulations list nine objective factors, which will be taken into consideration in determining whether an activity is engaged in for profit. No single factor is controlling, and the IRS and courts do not reach a decision solely by comparing the number of positive factors versus the number of negative factors.

1. THE MANNER IN WHICH THE TAXPAYER CARRIES ON THE ACTIVITY.

Is the venture carried on in a businesslike manner? Are separate and accurate books and records maintained? Are new techniques and methods of operation adopted and unprofitable strategies abandoned?

The courts have also cited failures to carry on the venture in a business-like manner in determining a horse operation to be a hobby. Sound business practices, having a plan to guide business decisions toward a profitable operation and modifying methods of carrying on the operation, which have not been, successful are key elements for the courts in deciding hobby loss cases.

2. THE EXPERTISE OF THE TAXPAYER OR HIS ADVISORS.

The horseman's knowledge or effort to learn how to manage a successful enterprise has been considered by the courts in several Section 183 cases. For example, if the taxpayer intends to sell some or all of the horses he owns, a knowledge of the potential market and the selection of bloodlines, which should appeal to the market, will be considered a positive factor in the taxpayer's favor.

3. THE TIME AND EFFORT EXPENDED BY THE TAXPAYER IN CARRYING ON THE ACTIVITY.

The time devoted to the horse activity, either in planning and supervising it or in performing labor connected with the operation of a horse business, is an important consideration in determining whether it is a business or a hobby. If the taxpayer devotes considerable time to the venture, including partial or total withdrawal from another occupation, this will be considered evidence that the business is one engaged in profit. If there is no substantial time devoted by the taxpayer but he employs qualified people to run it for him, the lack of time he spends on it will not necessarily indicate the lack of profit objective.

4. EXPECTATION THAT THE ASSETS USED IN ACTIVITY WILL INCREASE IN VALUE.

This factor has not been a major element in previous court decisions, but the expectation of appreciation of assets in establishing a plan for profitable operation of a horse business can be important in proving a profit motive. Such assets obviously include the horse owned by the taxpayer, but can also include real estate or other assets of the business.

This factor may be of special importance to a new business. It is reasonable to expect losses in the early years of a horse activity, but the taxpayer can demonstrate an objective of making a profit through the development of winners or through the purchase of quality breeding stock. The appreciation on one major stakes winner can compensate for several years of losses incurred while seeking that top quality horse.

5. THE SUCCESS OF THE TAXPAYER IN OTHER ACTIVITIES.

If the taxpayer has a history of turning unprofitable activities into money-making enterprises, this is evidence that current losses in a horse venture may eventually result in future profits. However, the courts in recent hobby loss cases have not considered this factor

6. THE TAXPAYER'S HISTORY OF INCOME OR LOSSES IN THIS ACTIVITY.

The profitable operation of a horse activity obviously is sound evidence that it is engaged in for profit, but the reverse is not necessarily true. Losses during the first years of a horse enterprise are not unusual and may not be an indication it is not engaged in for profit.

If the losses continue well beyond the early years, this can be evidence that it is not an activity engaged in for profit. However, this is not necessarily a controlling factor. The taxpayer may be able to demonstrate mitigating circumstances, which have caused the continued losses. For example, the accidental death of one or more horses, which had demonstrated potential between a profitable undertaking and continued losses.

To the extent such events have caused what appeared to be a successful plan of operation to go awry, the courts have considered them important in determining whether a horse venture was a business or a hobby. For that reason, good records again are emphasized. Being able to show the dates and effects of disease, accident or other setbacks can confirm the profit potential, which was present before the unforeseen event occurred.

7. THE AMOUNT OF OCCASIONAL PROFITS, IF ANY, WHICH ARE EARNED.

As mentioned earlier, achieving two profit years during a seven-year period will not necessarily assure that an activity will be judged to be engaged in for profit. If the two profit years are small in comparison to the amount of losses in other years, or in relation to the size of the taxpayer's investment, the IRS and the courts may still find that the activity was not engaged in for profit.

The reverse is also true. A substantial profit year in relation to a number of small losses or in relation to the limited investment in the operation would tend to buttress in the taxpayer's position that he was engaged in the activity for profit.

Every horse owner is well aware of the negative economic situation in racing. The costs of maintaining horses in training are far greater than the amount of purse monies available. Due to this experience a loss then will show a profit during any given year.

This is tolerable to owners because most of them have a desire to be a part of a sport they enjoy and because of the potential for profit, which does exist. Like the prospector who spends years searching for gold with little or no success, the horse owner knows all the effort and money invested will be worthwhile if he can strike it rich with one horse. Every owner hopes that he will breed the next champion, and the returns from that mating can offset the expense of the many horses he bred which were slow to get out of their own way.

This potential is the one element, which can overcome the loss years and the minimal profits, and the courts have generally recognized this fact. If the operation meets the other tests mentioned, this factor may be of only minor importance.

8. THE FINANCIAL STATUS OF THE TAXPAYER.

According to the regulations, the lack of substantial income from other sources will be in your favor in determining whether your horse operation is a business or a hobby. On the other hand, a large income from other sources may weigh against you. The degree of personal pleasure or recreation you derive from owning horses and the fact that the losses from your horses create substantial tax benefits will be taken into consideration in weighing this factor.

Some IRS agents seem to place considerable emphasis on this factor. To these agents large income or capital seems to be akin to waving a red flag in front of a bull. Fortunately, the courts generally do not share the IRS view. As an example, one court noted the taxpayer "...surely could have found a venture far less demanding of his physical and financial energies in which to "shelter" a portion of his income."

9. ELEMENTS OF PERSONAL PLEASURE OR RECREATION.

The regulations note that the personal motives may indicate the activity was not engaged in for profit, particularly if it provides recreation or pleasure for the taxpayer. This does not mean the taxpayer should not enjoy the activity, but the motive for carrying on the enterprise must include an objective of making a profit. So long as the other factors indicate a profit motive, personal pleasure will not cause the activity to be classified as a hobby. However, if the previous factors do not clearly substantiate a profit motive and the taxpayer or his family clearly derive enjoyment from the horse operation, this could weigh as a negative factor.

In a 1977 case, the Tax Court ruling turned on this issue. The court noted the taxpayer activities might be consistent with a profit motive, but the taxpayer had failed to prove they were other than purely recreational in nature.

SUMMARY:

It should be emphasized that the IRS does not add up the number of positive and negative factors and base its decision on a mathematical result. In addition, the courts appear to have placed greater emphasis on some of the factors than they have on others.

Most experts have concluded that one of the most crucial elements is the manner in which the taxpayer carries on the activity. The failure to maintain adequate, accurate books and records has been the key to several rulings that a horse activity was a hobby. Further, the lack of these records will make the task of reaching a positive conclusion on other factors more difficult. While good records alone will not insure the activity is engaged in for profit, the absence greatly increases the chance that the operation will be judged a hobby.

As with all tax issues, the facts and circumstances of each individual operation must be considered and the horseman should consult their tax accountant or an accountant familiar with horse racing, breeding and showing operations for advice and specific situations. Specific questions regarding this article may be addressed to Patrick J. Hurley at (800) 996-1040.