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DEDUCTIONS FOR HORSE EXPENSES

**With Taxes Skyrocketing Every Year,
Ways To Save Taxes Are More Important Than Ever**

Being involved with our friend the horse, whether as an owner, breeder, trainer or just a rider, not only concerns you with care, feed and lots of work, but also with our friend, Uncle Sam. Right or wrong, it may be difficult to avoid hassles with the IRS. Hopefully, your tax advisor can assist the horse owner in becoming prepared for the IRS agent.

DEDUCTING EXPENSES WHEN A HOBBY

Suppose you buy your daughter a horse for \$500 in early 2001, and due to her exceptional riding and training ability, you are able to sell the horse late in 2001 for \$6,500, resulting in a profit of \$6,000 in 2001. Many people would conclude that you do not report the sale of your horse and should not deduct any of your horse expenses to reduce the \$6,000 profit because you had a "hobby", but this erroneous. Thus, if the expenses related to the horse were \$6,000 or higher, no income would be taxed as a result of the sale for the horse in that taxable year.

There is no exclusion in tax law to omit the sale and profit on your tax return for the sale of your horse and not report the gain derived from the profit.

The next question is when can you deduct horse expenses, which were greater than the \$6,000 profit under the tax laws? To be able to do this, the horseman has to show that the expenditures were paid or incurred in connection with his "trade or business." Hobby losses are deducted only to extent of income derived and no loss can be claimed on your tax return.

The government income tax laws and regulations, along with tax court cases discuss many factors to make the determination that a person is in the "horse business." But what they are basically looking for is evidence that the horseman is trying to make a profit.

How you conduct your business affairs is very important to the determination of whether or not you can write off losses from your horse business. The government can call your horse activity; a hobby, a passive or non-passive activity, or a normal business with the intent to make a profit.

FACTORS IN DETERMINING HOBBY VS BUSINESS

The following represents summary of holdings on factors considered by the courts and the Internal Revenue Service in determining if a taxpayer has a “business or hobby” for tax purposes:

1. A mere failure to make a profit does not in itself determine if a taxpayer is engaged in a trade or business; the question is one of good faith and intent.
2. A judge suggested in one case that the tax courts should “well give more serious consideration to such factors or whether the expectation of an ultimate profit is reasonable, how the operation is conducted, to what extent the taxpayer personally participates therein, and the likelihood that the activity the taxpayer personally participates in is encompassed with the normal activities that occupy the time of other wealthy taxpayers.”
3. Another case held that the taxpayer’s knowledge of horses, the business-like control of the operations and expenses, and the inexpensive facilities constructed on the farm, all showed that a venture was intended for profit making purposes.
4. Of interest to all horse owners, a recent tax court case provided important guidelines for horse businesses where the court indicated that an obstetrician-gynecologist could deduct losses incurred in the breeding of Arabian horses. The doctor convinced the court of his intention to make a profit for his horse breeding operation by doing most of the necessary manual work by himself, such as aiding in the building of a barn, cleaning stalls, feeding the horses and putting up fencing.
5. The court found that the first years of a horse breeding business by necessity had to have little or no income, since most horses could not be bred until they were three years old. The time needed to establish the reputation of a stallion, brood mares and stables can be long. Also, there was no evidence that the taxpayer or his family used the horses for recreational purposes. The tax courts have observed that it takes from six to fifteen years before a horse racing or breeding business shows a profit because of the difficulty in establishing oneself in the business, the time it takes to upgrade breeding stock and the time to attain a reputation in a particular breed.

INTERNAL REVENUE SERVICE GUIDELINES

The Internal Revenue Service sets forth some other factors it considers in determining whether or not an activity is engaged in a business for “profit.”

- A. **Start-Up Costs:** Don’t worry about a series of losses during the start-up phase of an activity. Start worrying if the losses continue beyond a period of time that might be considered customary.
- B. **Hopeful Signs Of Decline:** Even if you have been losing money steadily over a span of time, a declining loss ratio may suggest that “profitability is imminent.”
- C. **Bad Luck:** Losses sustained because of unforeseen or fortuitous circumstances are no indication that an activity is not for profit. Keep detailed records of all unusual problems that occur.

D. **Past Success:** If you can show that you have engaged in other activities in the past which started out being unprofitable and you were able to make them profitable, this is an indication that you are in the present activity for a profit even though it is not profitable.

E. **Outside Income:** Here the regulations say that if an individual does not have substantial income from outside sources, this is an indication that he's engaged in the activity in question for profit. On the other hand, if an individual has substantial outside income, this may indicate that their not engaged in the activity for profit, particularly if the losses give a substantial tax benefit.

F. **Time Spent:** If you spend a lot of time and effort in an activity, that is a fairly good indication that you are in it for profit, particularly if the activity doesn't offer any pleasure or recreation.

G. **Expertise:** If you can show you're something of an expert in the field, that's a plus factor. Actually, you don't have to an expert yourself, as it is enough that you consult with knowledgeable and professional advisors. Keep records of courses taken, books read and experts consulted.

H. **Profitable Methods:** If you are on the lookout for ways of making the operations profitable, that's a good sign. Here again, keep records so that you can show how progressive you are.

I. **Profit Expectations:** If the activity is one similar to activities, which are profitable, that's a plus. But, if the activity is one that couldn't reasonably be expected to turn a profit, that's negative. Keep a record of reports of similar activities that are profitable.

J. **Personal Pleasure and Recreation:** The fact that an activity results in personal pleasure and satisfaction is not sufficient to cause it to be classified as "not engaged in for profit." But personal pleasure and recreational value may have some bearing on the question. Under recent changes in the tax law, an activity is presumed not to be a hobby if profits result in two out of seven consecutive years, unless the commissioner of the IRS proves otherwise. This presumption arises for an activity involving breeding, training, showing or racing of horses. A special election permits a suspension of the question until there are seven years in existence from the time the taxpayer first engages in the horse activity.

However, it should be noted that the election must be filed within three years of commencing operations of your horse activity. Otherwise, you will lose the benefit of and the right to make the election.

In summary, as far as possible, try to make and conduct your activities in a way that allows the profit motive to "shine " through. Get involved. Spend time at the activity. Study, become an expert. Advertise your business. Adopt cost-conscious, profit-oriented procedures.

Find out what others in similar activities are doing and how much they are making. Make it your business to keep records that will permit you to show these things, as well as bad luck or fortuitous changes in market conditions. The records themselves may have value showing your profit motives. It is very, very clear from the cases, that the courts weigh very heavily on the records a horse person keeps and maintains on his horse activity, in determination of whether or not the person's intent is to make a profit.

WHAT DOES THE 2 OUT OF 7 YEAR RULE REALLY MEAN?

After any level of government passes legislation, the interpretation of that section has to be examined. When you consider the vast amount of legislation passed at the federal level and the limited time our legislators have to deal with such legislation, it's no wonder that severe interpretation problems are encountered.

In 1969, Section 183 of the Internal revenue Code was passed. This section relates directly to the horse business in determining whether or not a horse operation is a "hobby" or a "business for tax purposes." The pertinent parts of the code section are set forth below.

A. General Rule-in the case of an activity engaged in by an individual or electing small business corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

B. Presumption-if the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years, which ends with the taxable years, exceeds the deductions attributable to such activity (determined without regard to whether or not such an activity is engaged in for profit), then, unless the secretary or his delegate establishes to the contrary, the activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit.

In the case of an activity which consists in major part of breeding, training, showing or racing of horses, the preceding sentence shall be applied by substituting the period of 2 or more taxable years in the period of 7 consecutive taxable years.

Obviously a horseman should clearly understand what Section 183 means to them in tax and business planning. Hopefully, the discussion below will assist you.

WHAT 2 OUT OF 7 DOES NOT MEAN

After review of the regulations of the Treasury and the history of the law, it is clear that no inference that the activity isn't engaged in for profit is to arise from the fact that the 2 out of 7 test is not met. This means that whether or not you make a profit in 2 out of 7 years, your horse operation will be considered on its own merits. Such as; is the horseman in the business to make a profit? Thus, even if your horse business has lost money for even 5, 10, 12 or 15 years, it is still possible that a court would hold your operation to be a "business" and not a "hobby."

The rule doesn't mean that the IRS won't contest whether or not you are in the business to make a profit. For example, one of the leading tax services observed that possible the "forced" profit for 2 years will be used against the horseman in overcoming the presumption.

"Forced profit" means accelerating income or postponing deductions or both to time income so as to produce 2 profitable years. However, the tax service doesn't explain what "accelerating" income means. Will the selling or auctioning of a large part of the horses in a 2 year period be considered "accelerated income"? Unfortunately, there are no cases yet to be decided by the courts on Section 183, and we can only speculate what the courts will do in interpreting Section 183, or whether "forced" profit will be used against a horseman by the IRS to overcome the presumption.

PROCEDURE TO ELECT THE PRESUMPTION

A horseman can elect to suspend the determination of application of the presumption until the end of the sixth year of the horse activity operation. However, Section 183 can still apply to loss years by having 2 profit years. The presumption will only apply, however, to loss years following the profitable years. Thus, the "election" gives the presumption for loss years preceding the profit years. It should be noted that the election must be made within five years of the due date of the total return for the year after the taxpayer first engages in the horse business.

So, if a horse person did not have the election within the first five year period, he will not be able to use two profitable years to obtain the presumption for any prior loss years. The election is made on Form 5213 and Form 5214, which can be obtained from any IRS office.

VALUE OF THE PRESUMPTION

Some tax experts point out that filing the election will "red flag" your tax returns, and may encourage the IRS to audit or follow your tax returns closely. Further, when we review the cases prior to Section 183 coming into existence, one can readily see that the IRS had to put on a strong case before they would prevail in court having a horse business declared to be a hobby.

SUMMARY

Considering the above two points, a thorough discussion with your tax attorney or tax advisor before filing the election is highly recommended. Obviously, the interpretation by the courts of Section 183 will clear up some of the questions raised. Until then, we will have to deal only with the "policy" or "philosophy" of the law - that is to give the benefit of doubt to whether or not a horseman is in business if he makes 2 profitable years, but with the IRS being able to argue against the presumption on a case by case basis. Specific questions regarding this article should be addressed to Patrick Hurley at (800) 996-1040.