HURLEY & ASSOCIATES, INC.
Income Tax and Business Services
500 South Kraemer Boulevard, Suite 250
Brea, California 92821-6792
Phone: (714) 996-2204 *Fax: (714) 996-1582*

OPERATING YOUR HORSE BUSINESS AS A PARTNERSHIP

The manner in which a taxpayer carries on a horse racing or breeding activity is one of the most important factors in determining whether the activity qualifies as a business rather than a hobby for tax purposes under current IRS regulations. An increasingly favorite form of doing business is the general partnership, which is the subject of this article.

The decision on which form of business is best for a person or group engaged in the horse business must take into account various factors. For example, a sole proprietorship is usually the most convenient form of doing business for a single individual or a married couple. However, if a group of unrelated people decides to go into the horse business together, probably the most advantageous form of business from a legal and tax standpoint is the general partnership.

The general partnership has become very attractive because it is a convenient vehicle to help spread the costs and risks of engaging in racing or breeding, as well as a good method of sharing responsibilities and decision-making powers.

A general partnership is formed when two or more people join together to carry on a business activity, with each person contributing money, property, labor or services. The Tax Code says that a partnership is a syndicate, group, pool, joint venture or other unincorporated organization under which any type of business or financial operation is conducted, and which is not, within the meaning of the Code, a corporation, trust or an estate.

Technically, a general partnership can be formed merely upon an oral or implied agreement between or among the parties. However, the realities of business dealings necessitate a written partnership agreement to insure that the rights and duties of the parties are clearly set forth in the event of a future misunderstanding or dispute. Usually a written partnership agreement can be drawn up at fairly low legal costs, although there is no such thing as a "standard form" partnership agreement for horse activities.

The biggest advantage of operating as a general partnership is that the partnership entity itself does not pay any taxes. Instead, the partnership reports profits and losses to the IRS on an "information" return, which sets forth each partner's share of the income or losses of the partnership as determined by the partnership agreement. In turn, each partner is responsible for reporting on his own income tax return his share of the profits or losses and will be taxed according to his particular tax bracket.

For tax planning purposes, a general partnership can be a useful method of diverting income from high bracket parents to their children. Under the Tax Code there are special rules on the subject of family partnerships, which permit income to be allocated in accordance with the amount of labor or personal services, each family member performs. There are other rules in the Code, which tend to favor family partnerships, provided each designated family member is a bona fide participant in the partnership. Similar tax planning devices can be achieved through a Subchapter S corporation, but frequently the partnership form is favored because of the less burdensome procedures in administering a general partnership.

Any losses incurred by the partnership: depreciation deductions, charitable contributions of money or horses and similar items are permitted to be passed through to the partners in accordance with the distributive shares set forth in the partnership agreement. Similarly, any gains from sales or exchanges of horses or other property used in the horse business, prizes or purses won and other income or gains are reported separately on the 1040 return of each partner.

It is permissible to designate a "managing partner" for certain purposes, such as to break any deadlock in decision-making or to carry out specific managerial functions. However, it is necessary for each member of the partnership to actually have specific decision-making powers and, in fact, to exercise these powers in order to meet the "material participation test" under the 1986 Tax Reform Act, which has been previously discussed in this column.

Each partner is required to report his share of partnership income, whether or not income is actually distributed to the partners. Quite often, for example, the partners will decide not to distribute income and instead to retain monies for future operating expenses or to reinvest the capital for improvements or to acquire new horses. Nevertheless, the undistributed income must be allocated to each partner and reported and tax paid thereon in accordance with each person's particular tax bracket.

Another feature of a general partnership (also applicable to limited partnerships) is that IRS regulations make it possible to allocate all or part of specific items of partnership income or losses to a particular partner.

For example, all depreciation deductions can be allocated to one partner. In order to do this the allocations must have "substantial economic effect" in accordance with IRS regulations. If you contemplate setting up a partnership, which will have special allocations, you should seek expert advice in order to comply with the "substantial economic effect" test.

Also available under IRS regulations is a method by which you can elect to increase the tax basis of a partnership horse when a partner purchases an interest in the partnership. This can occur when the amount of money contributed by a partner in fact reflects a higher value for a horse or group of horses than reflected in their existing tax basis. Making this type of adjustment is quite complicated and requires expert advice.

Finally, it should be noted that a partnership is not automatically insulated from being audited by the IRS, and that in order to insure compliance with the hobby loss rule, the records of the activities should be kept in a businesslike manner, and the other elements of the hobby loss rule must be observed overall by all partners.

A general partnership is less costly to start than an LLC in California, because California does not require a state-filing fee to form a general partnership. You have a minimum fee of $800 to the state of California along with legal fees to have your attorney to write the Limited Liability Company agreement and file all the necessary proper paper work. The major downside to running a general partnership over an LLC is the exposure to personal liability by each of the general partners. You can purchase a business liability insurance package in which to mitigate possible effects, and each partner is still personally responsible for any liabilities and debts not picked up by the business's insurance policy. LLC owners, on the other hand, avoid this personal problem altogether.

Partnership law and partnership record keeping can be difficult to follow and understand. You should always discuss specific issues with your tax advisor or your tax attorney. Specific questions regarding this article should be addressed to Patrick J. Hurley at (800) 996-1040.