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**PASSIVE LOSS ACTIVITIES**

The Tax Reform Act of 1986 put into the law a limitation on the deduction of losses from any business activity in which you do not "materially participate", referred to as passive losses. The Internal Revenue Code Section 469 and IRS Regulations 1.469 explain fully, the limitation on passive losses.

The most important aspect of the regulations concerns what is necessary in order to materially participate in an activity. If you materially participate, any losses from a horse business are fully and currently deductible. However, that income which is principally from the rental of tangible property is generally deemed to be passive income even if you materially participate in the rental activity.

If you do not materially participate, then losses from the horse activity can only be deducted against income from other passive activities. In this regard, portfolio income, such as interest, royalties, dividends and annuities, and income from sales of investment property is not treated as income from a passive activity even if generated by an activity in which you do not materially participate. Thus, passive losses cannot be deducted against portfolio income.

If you do not have any current passive income against which to use the passive losses from the horse activity, the non-deductible losses can be used in later tax years when there is enough net passive income. Any losses, which have not been previously deducted, can be totally deducted against active, passive or portfolio income in the tax year you completely terminate your interest in that horse activity.

Under Internal Revenue Service Tax Regulations, an individual is deemed to have materially participated in a horse business or other activity during the tax year only if the individual satisfies at least "one" of the seven tests set forth below:

1. The individual participates in the activity for more than 500 hours during the year.
2. The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals including individuals who are not owners of interests in the activity for such year.

3. The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual, including individuals who are not owners of interests in the activity for such year.
4. The activity is a "significant participation activity" for the taxable year, and the individual's aggregate participation in all significant participation during such year exceeds 500 hours. A significant participation activity is a business in which the individual participates more than 100 hours during the tax year, but does not materially participate within the meaning of one of the other tests.
5. The individual materially participated in the activity for any five taxable years, whether or not consecutive, during the ten taxable years that immediately precede the taxable year. Under this test, an individual will only be considered to have materially participated in an activity during any year prior to 1987 if that individual has put in over 500 hours during that year.
6. The activity is a personal service activity and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year. A personal service activity is a business such as law, medicine, accounting, performing arts or any other business where capital is not a material income-producing factor.
7. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous and substantial basis during such year. The regulations do not discuss what facts and circumstances are important and are to be taken into consideration, but state that they will be addressed in future regulations. However, the regulations do say that an individual's services performed in management of the business shall not be taken into account in applying the facts and circumstances test if:
  - (i) a paid manager participates in the business, or
  - (ii) the management services performed by such individual are exceeded by those performed by any other individual.

In addition, the regulations state that an individual who does not participate for more than 100 hours during the tax year cannot, in any event, meet the facts and circumstances test. In other words, if you do not spend more than 100 hours on the horse business during the tax year (which are counted as hours under the rules), there is no way you can be treated as materially participating in a business. Thus, profits and losses are passive.

A limited partner is treated as a passive investor, not a material participant, unless the limited partner (1) spends more than 500 hours during the year, or (2) is treated as materially participating in the business because the business is a personal service activity and he materially participated in it in these previous years. Also, if an individual is a general partner and a limited partner in the same business, that individual, in effect, will be treated as a general partner and therefore will be a material participant if he or she meets one of the seven tests discussed previously.

In simplest terms, it appears 100 ( or approximately two hours a week) is a minimum requirement which may, depending on other factors, qualify you as a "material participant"; 500 hours (10 hours a week) seems certain to satisfy the definition. The large gray area between 100 and 500 hours is likely to place you within a "facts and circumstances" test, which will require good records and documentation to validate your participation as "regular, continuous and substantial."

What kind of work is taken into account in determining participation? Normally, all work done in connection with a business in which you own an interest is taken into account. However, work that is customarily not done by an owner is not counted if done for the principal purpose of avoiding the passive loss rules. Also, work done in your capacity as an investor is not taken into account; for example, studying and reviewing financial statements and reports on operations of the business, preparing summaries or analyses of the finances of the operations of the business for the individual's own use, and monitoring the finances or operations of the business in a non-management capacity.

On the other hand, the list of activities of horse owners and investors, which can satisfy the material participation test, is lengthy and may include some that are easily overlooked. For example, time spent on:

- Meetings, telephone conversations and other discussions of the horse business in general and your horse(s) in particular with partners, other owners, etc.
- Discussions with trainers and caretakers about your horse(s) including training schedules and other plans, classification of the horse(s), breeding and farm location, etc.
- Attendance at races, shows, and other public events to judge the capabilities of your horse(s) and or the competition
- Attendance at (and participation in) horse sales
- Attendance at (and participation in) horse-related associations and group meetings or workshops (state breed associations, national conventions, etc.)
- Reading and considering trade publications, particularly as they contribute to breeding and other business decisions
- Attending to registration, licensing and other regulatory requirements

Work done by an individual's spouse is treated as work done by the individual, without regard to whether the spouse owns an interest in the business, whether the spouse materially participates or whether a joint return is filed.

According to the regulations, you can prove the requisite number of hours by any reasonable means, including appointment books, calendars and narrative summaries. It is not necessary to keep contemporaneous records or detail hours spent in connection with the business.

The regulations also cover several other aspects of the passive loss provisions; for example, activities of partnerships and certain corporations, characterization of gain from dispositions, anti-conversion rules and transitional rules.

A passive guideline that determines your involvement is often complex and difficult to understand. I strongly recommend you discuss this activity with your tax advisor or tax accountant. Specific questions can be addressed to Patrick J. Hurley at (800) 996-1040.