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PASSIVE LOSSES AND MATERIAL PARTICIPATION

Every astute horseman is aware of the high costs associated with racing and breeding Thoroughbreds. Since expenses are a reality, a horse owner must be familiar with basic tax principles affecting their industry. One such principle is an "artificial loss". Artificial losses may be real enough to the horse owner, yet still not come within the purview of basic deduction concepts in the 1986 Tax Code.

An artificial loss is created when a taxpayer generates deductions that are granted by statute; but, their impact may seem to only occur on paper. Thus, artificial losses are commonly known as "paper losses".

An activity whose primary purpose is to generate paper losses and then use such losses to the taxpayer's benefit is known as a tax shelter. In principal, a tax shelter benefits the taxpayer by using the excess deductions from activity A to reduce income from activity B. Thus, the income from activity B is "sheltered" from tax liability by the excess deductions of activity A.

The 1986 Tax Reform Act gutted the majority of tax shelters with the creation of Subsection 469, the Passive Loss Limitation. The reason Congress instituted the Passive Loss Limitation was to eliminate those tax shelters that had no economic purpose or profit motive. Under this new rule, a horseman who utilizes deductions must be ready and able to prove that his horse activity has a true profit motive, and that he materially participates in the quest for profits.

For horse owners to materially participate in an activity they must be involved in the business on a regular, continuous, and substantial basis. Senate Finance Committee Report No. 9999-313 states that the following factors are crucial in establishing that the owner is an active participant:

1. The incursion of embryo transplant or breeding expenses;

2. The purchase, sale, and leasing of capital items, such as cropland, animals, machinery, and equipment;

3. Making of breeding and mating decisions; and

4. The selection of herd or stable managers who act on behest of the taxpayer, rather than as paid advisors directing the conduct of the taxpayer.

Of these factors, numbers one through three appear to be relatively straightforward. Factor number four is subjective in nature and presents a trap for the unwary taxpayer. The primary issue in regard to factor four is whether or not the horse owner is acting independently.

The Senate Finance Committee Report notes that horse owners who periodically seek consultation or general management advice will not be deemed active participants. The I. R. S. will construe this horse owner's activity as one where the owner is acting primarily upon the advice of paid experts. An example of this is an owner who only calls his trainer to "check on" the horses. Such an owner risks losing all deductions in excess of the business's earned income.

On the other hand, the Senate Report notes that the performance of "management activities" may be sufficient to show an owner's material participation. These management duties do not have to include physical work at the farm or stable.

If a horse owner is relying upon his "management activities" to establish his active participation in the business, such management must involve a "genuine exercise of independent discretion and judgment". This means that the horse owner, not the paid advisor, should make those decisions upon which the success of the operation depends. These decisions must be accompanied by documented facts, which indicate that the owner has such knowledge and experience that his decisions are meaningful to the business.

It is unclear how often these "meaningful decisions" have to be made by the owner. Simple labeling an investment as active will not meet Subsection 469 scrutiny. Some Thoroughbred investment companies may offer packages labeled as active investments based upon monthly meetings between the owners. Such packaging is likely to be discredited by the IRS's "Substance Over Form" doctrine.

The "Substance Over Form" doctrine pierces operations that claim one legal status in theory, but which in practice, show themselves to be something else. In the monthly meeting example the IRS can reasonably assert that "once-a-month" meetings do not represent actual ownership duties. The argument by the IRS would be that it is unreasonable for a profit-seeking owner to base his participation upon such an inflexible and arbitrary standard.

For instance, horse owners may be required to meet with partners or co-owners or key personnel on a moment's notice. One example of this would be in a time casualty loss.

The point to be made here is that owners should not claim active participation based upon any inflexible or meaningless standard. Any language detailing the amount of owner participation should be worded broadly, accenting the flexibility and importance of the owner's constant involvement.

Such wording should be careful not to inadvertently limit the scope of an owner's participation, like the once-a-month example does.

The reason for this planning is two-fold:

1. The IRS seems ready to go to great lengths to prevent all activities which shelter income and;

2. The nature of the horse business is such that any inflexible ownership standard will appear to be obvious attempt to avoid the passive loss rule in form only.

Factor four necessitates an additional word of warning. The Senate Finance committee report on the Tax Act cautions about undue reliance on management participation in qualifying the horse owner as an active participant.

The reason for the Senate's tough stance is that the genuineness and quality of management participation is difficult to verify. The safest bet for all owners is to rely upon all of the factors noted in Senate Report No. 99-313 (stated above)

Many of the factors determinative of the Passive Loss Limitation are also relevant in determining whether an activity is a hobby or a business. Ideally, non-passive records should evidence greater detail than their business-versus-hobby counterparts.

This is important, since a non-passive activity record must show the extent of an owner's involvement and the importance of his decisions. In making a determination whether an activity is a business or hobby, owner reliance on expert advice is often enough.

As should be apparent, satisfying the requirements of the new passive loss limitation involves a degree of uncertainty. Pending court decisions will further define the parameters set by Congress. Horse owners should structure their operations accordingly by seeking the advice of legal and tax experts.

Above all else, horse owners must make sure their existing records evidence facts which indicate that their participation is material as defined by Section 469 of the Internal Revenue Code. Passive loss guidelines are extremely complex. You should discuss this in detail with your tax advisor or tax attorney. Specific questions regarding this article should be addressed to Patrick J. Hurley at (800) 996-1040.