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# Horse Activity Question: For Fun or For Profit?

Daryl V. Burckel

Zoel W. Daughtrey

Radie Bunn

# The Horse Activity Question: For Fun or For Profit?

*By Daryl V. Burckel, DBA, CPA, Zoel W. Daughtrey, Ph.D., CPA, and Radie Bunn, J.D., CPA*

A taxpayer may be a horseman, but is he engaged in a business? One way to prove a business intent is to make a profit. However, in the horse industry profitability rarely occurs. Although a significant number of participants have shown that a profit can be generated, the fact still remains that for every one who has been financially successful, there are hundreds of participants who have demonstrated that thee is no other business more difficult. As a result, horse investments have acquired a reputation as a "tax favored" investment. In a number of cases (Burnett, Faulkner, Nittler, Tripi, Boddy, Harris), the government has largely subsidized part-time activities of wealthy taxpayers involved in horse operations who have succeeded in convincing the courts they are engaged in a second business.[1] Such conclusions have enabled the taxpayer to deduct losses against ordinary income even if these losses have extended over a substantial period. This has been particularly true where proof has been made that the horse operation was conducted in a "business-like manner."[2]

## 1986 TRA Impact

As a result of the Tax Reform Act of 1986 (1986 TRA) passive loss rules, "gentleman horse breeder" status may no longer be desirable. The 1986 TRA limits losses and credits from "passive" business activities. If the taxpayer "materially participates" in the activity, he can deduct all losses in the year that they occur. However, if the taxpayer does not "materially participate," he has a passive activity and any losses incurred can only be deducted if the taxpayer has passive income to offset the passive losses. In other words, passive losses will no longer be available to offset other income such as interest, dividends, salary, and other active business income.

When passive losses are greater than passive income, the excess passive losses are not deducted (subject to a phase-in rule), but are carried forward to later years to be deducted when passive income is generated.[3] When a taxpayer disposes of his entire interest in an activity, losses and credits which have been carried forward for the activity are allowed in full.[4] Thus, it is critical to understand what is meant by material participation.

### *Material Participation*

Material participation is defined in the 1986 TRA as involvement in the operations of the activity on a "regular, continuous and substantial basis."[5] Regardless of whether an individual directly owns an interest in a trade or business activity (e.g., proprietorship) or owns an interest in an activity conducted by a pass-through entity such as a general partnership or S corporation, the taxpayer must be involved in the operation to be materially participating.

Temporary regulations [6] provide seven alternative tests to use to determine if a taxpayer can qualify as determiners of participation in an activity. A person is treated as materially participating if he meets only one of the seven tests. The seven tests can generally be classified into three categories: (A) quantitative tests (based on hours of participation during the year), (B) prior participation tests (based on participation in past years), and (C) the facts and circumstances test. Six of the seven tests apply to farming activities.

The definition of an "activity" is vital to the application of the passive loss rules. In order to apply the quantitative tests, for example, the taxpayer must be able to determine whether to aggregate or separate activities. Notice 88-94[7] provides the definition of an activity for purposes of Section 469, but this definition is transitional, since it only applies until section a. 469-4T of the regulations are issued. In general, the notice states that a taxpayer's operations may be treated as one or more activities under any reasonable method (at least for 1987 and 1988). In addition, the notice specifically states that all of a taxpayer's operations that involve farming within the meaning of Code Section 464(e)(1) may generally be treated as one activity.

### *Passive Activity Status vs. Hobby Activity Status*

While passive activity status is bad, hobby status is even worse. A taxpayer must establish that he pursues an activity with the objective of making a profit if the expenses of the activity are to be deductible as business or production of income expenses. Section 183 generally provides that hobby expenses of a taxpayer are deductible only to the extent of gross income from the hobby. Therefore, the tax treatment of hobby expenses differs significantly from "for-profit" expenses if the expenses of the activity exceed the income, generating a net loss. If the loss is treated as arising from a "for-profit" activity, then the taxpayer (subject to the constraints of the passive activity rules) may use the loss to offset income from other sources. However, if the activity is a hobby, no loss is deductible.

If the activity is determined to be a hobby, the associated expenses are deductible to the extent of the activity's gross income as reduced by otherwise allowable deductions. Otherwise allowable deductions are those expenses which are deductible under other code sections regardless of the nature of the activity. Thus, property taxes would be deductible under Code Section 164. All expenses otherwise allowable (such as property taxes) are deducted first to determine the gross income limitations. The other expenses are allowed to the extent of remaining gross income. These other deductible expenses are normally considered miscellaneous itemized deductions and are aggregated with other miscellaneous deductions. Only the amount of such aggregated expenses which exceeds two percent of the taxpayer's adjusted gross income (including income of the hobby activity) is allowed. If interest expense is incurred in the hobby activity, it would be considered personal interest and subject to the rules of Code Section 163(h), which generally disallows a deduction for personal interest, subject to the phase-in limitations. If the taxpayer claims the standard deduction, no hobby expenses are deductible.

The following example illustrates the application of the above rules.

*Example*

Joe Cashrich raises and races horses as a hobby. His A.G.I. excluding the hobby activity is $96,000. In 1989 Hoe won two races and received income of $4,000. He paid $6,000 in expenses, consisting of $900 property taxes related to the hobby farm and $5,100 for feed and veterinary fees. If Joe itemizes deductions, he will compute his hobby-related deductions as shown in the table.

| | | |
|---|---|---|
| Gross income | $4000 | |
| Otherwise allowable deductions: | | |
| Property Taxes | 900 | $900 |
| Gross income limitation | $3100 | |
| Feed and veterinary expense: | | |
| $5,100 but limited to remaining gross income | | $3100 |
| Total potentially deductible expenses | | $4000 |

Joe now includes the race winnings of $4,000 in his gross income, increasing his A.G.I. to $100,000. The property taxes of $900 are deductible in full. However, the feed and veterinary fees are considered as miscellaneous itemized deductions and are subjected to the two percent of A.G.I. floor. Add only the amount which exceeds $2,000 [2% x $100,000 A.G.I.] can be deducted. If Joe has no other miscellaneous expenses, his allowable miscellaneous deduction is $1,100 [$3,100 minus $2,000]. No deduction is allowed for the $2,000 amount used to satisfy the two percent floor, nor for the excess $2,000 of feed and veterinary expenses which exceed the gross income limitation. Thus Joe reports income of $4,000 but only has offsetting deductions of $2,000 ($900 taxes + $1,100 feed and veterinary fees), resulting in taxable income of $2,000 from a venture that actually incurred $6,000 of expenses and received only $4,000 in revenues.

Thus, while applications of the passive loss rules may produce undesirable tax consequences, the hobby loss rules are even more detrimental. Passive activity status results in a deferral of losses or deductions, while hobby activity status results in a permanent disallowance of such losses or deductions. Obviously, deferral is preferable to disallowance.

## Presumption Rule

Section 1983(d) provides a safe harbor rule that a racing and breeding activity is presumed to be for profit if the taxpayer shows a profit in two of seven consecutive tax years. This shifts the burden of proof to the IRS. A taxpayer with a horse farm has more years to establish the presumption than other farmers, who are given a five year test period and must show a profit in three of those years. This is consistent with the inherent risk involved in operating a racing stable or breeding farm that can result in many years of start-up losses. (For example, returns on racing are very inconsistent. Race horses are expensive to maintain and statistics show that a horse earns on the average $6,970 a year, far below the cost of upkeep. Also, only 5.6% of starters won more than $25,000 in 1980.[8]

## The Significant Factors

Regulation 1.183-2(b) sets forth nine factors, developed in court cases over the years, that should be considered in determining the presence of a profit motive. These factors are listed in Table 1 along with the results of a discriminate factor analysis of 44 court cases.

Four factors listed in Table 1 were of greater importance in the 44 court cases than were the other five. This analysis determined that carrying on the operation in a businesslike manner, the expertise of the taxpayer or his advisors, the expectation of related asset appreciation, and the amount of occasional profits were given more emphasis in Tax Court discussions.

## Analysis of Significant Factors

A taxpayer engaged in horse activities should attempt to satisfy as many as possible of the relevant factors indicative of a profit motive. All factors must be taken into account, as no one factor or group of factors is decisive. However, as a taxpayer complies with a greater number of factors, his probability of being allowed to deduct horse activity losses also increases.

*Manner in which the Taxpayer Carries on the Activity*

It is important to carry on horse activities in a businesslike manner. Complete and accurate records indicate a businesslike conduct of the activity, which evidences a profit motive.[9] In Meagher[10], an accountant and his wife ran a Massachusetts horse farm in a professional manner by keeping separate books and a separate bank account for their horse operations. This helped demonstrate to the court that they intended to make a profit from the farm. In Boddy[11] a horse breeding farm was not regarded as a business transaction when advertising expenses in a year were only $369, while total farm expenditures amounted to $32,279. In Harvey v Commissioner[12] Richard W. Harvey and his wife, Karen, persuaded the court that losses from their quarter horse breeding activity were incurred with an honest intent to make a profit. Their losses of $83,943 in 1981 and 1982 were deductible since the horse breeding activity was run in a businesslike manner.

The Tax Court has also found that changing or abandoning unprofitable methods is a significant factor indicating the taxpayer's profit motive. In Doyle,[13] the petitioners discovered they could substantially reduce their fixed costs by growing their own alfalfa on a converted three-acre lot adjacent to their home. The entire family watered, fertilized, and tended the field. They also minimized travel expenses by sleeping in a converted house trailer. Likewise in Faulconer,[14] the Fourth Circuit Court of Appeals reversed the Tax Court's decision when a profit motive was established through the implementation of changes in farm operations. It was one of the many factors cited by the Court which contributed to the progressive reduction of losses.

Also in Meagher,[15] the Tax Court was impressed by the fact that the horse owner had prepared budgets and operating procedures that indicated the horse operations would be profitable even though the profits did not come to pass. Similarly, in Yancy[16] a breeding and racing activity produced no income during the years under review; nonetheless, the Tax Court held the activity was a business partly because of a business plan that made sense to the Court.

The importance of using sound business practices, having a plan toward profit, altering methods of operation or abandoning losing methods, and keeping adequate records cannot be overemphasized if a taxpayer is to satisfy the IRS that a profit motive exists. Past and current studies omit the fact that even though this is only one of the nine IRS factors, it must be present if a profit motive is to be demonstrated.

*Expertise of the Taxpayer or his Advisors*

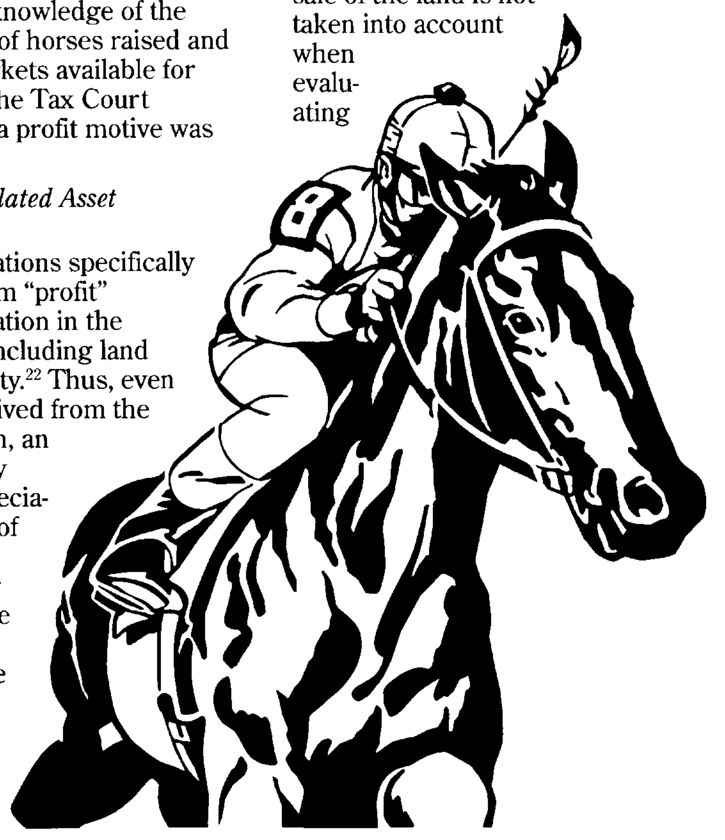
It is necessary for the taxpayer to increase his expertise in the activity if he is not already an expert in the field. If a person has another full-time job, such as a law practice, he must show that competent people have been engaged to carry on the activity in the same manner and with the same skill as he would have devoted to it.[17] Faulconer's[18] expertise in the breeding and training of horses also helped substantiate his profit motive. Ellis[19] read extensively in horse journals and used professionals to show and train his horses which helped in the activities being determined a business. Even though Power[20] hired adequate trainers for her horses, they were not experts in cost control or revenue enhancement and this lack of expertise was part of the reason the operation was deemed a hobby. In Coe,[21] where the taxpayer had a thorough knowledge of the particular breed of horses raised and the potential markets available for sale of animals, the Tax Court determined that a profit motive was present.

*Expectation of Related Asset Appreciation*

The IRS regulations specifically state that the term "profit" includes appreciation in the value of assets, including land used in the activity.[22] Thus, even if no profit is derived from the current operation, an overall profit may result if the appreciation in the value of the land, horses,and other assets used in the activity is taken into account. The IRS regulations provide that if land is purchased primarily for the purpose of its appreciation, and at the same time is used for a farm activity, the land and the farm activity may be treated by the IRS as two separate activities.[23]

The courts have differed as to whether appreciation helps support a profit motive. In Faulconer[24] the Fourth Circuit held that the holding of the land, which the taxpayers had used for raising horses for over twenty years, and the horse activity were part of a single activity, not two activities as the Tax Court had found. In Estate of Elizabeth L. Power [25] the Tax Court held that the operation of the horse farm and the holding of the land were separate activities. The taxpayer used most of the land for other purposes and had utilized the land for horse operations only on occasion.

In the Engdahl[26] case, the Tax Court pointed to the appreciation of land from $83,146 to about $225,000 and the appreciation of the horses (about $18,000) as indications of a profit motive. In Meagher,[27] the same court looked with favor on the appreciation of two horses. However, in the 1986 Reben[28] litigation, the court stated that when a ranch appreciated "independently of the horse-related activities,the gain on sale of the land is not taken into account when evaluating



losses and profits from ranching operations." The Court concluded that the population of the area and the potential of land for residential and commercial development were the reasons for the appreciation.

The previous cases are indicative of the uncertainty that surrounds this factor. If land appreciation of the horse farm is to be considered a positive factor, the majority of the land must be directly used in connection with the horse breeding, training, or showing activities. Appreciation must also be substantiated with proper appraisals.

*Amount of Occasional Profits, If Any, Which are Earned*

While the regulations seem to minimize the significance of an occasional small profit, over the years the courts have frequently looked on an occasional profit year, even if modest compared to overall losses, as an important factor indicating a profit motive rather than a hobby. Appley[29] had over four hundred and fifty thousand dollars in losses from his horse breeding operations in the twelve years ending in 1976. He had small profits in 1977 and 1978 from the sale of horses, which raised revenues and reduced costs. The court decided for the taxpayer.

Moreover, the regulations also state that "an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate the activity is engaged in for profit, even though losses or occasional small profits are actually generated."[30] This statement is advantageous for the horse industry, since it is an industry in which it is easy to lose money and difficult to make money. It is on the balance a "loss" industry as it relates to horse owners and breeders.[31] However, a horse owner can "hit" a great horse with the result that a relatively small investment will turn into a million dollar asset. An example of this is Triple Crown winner Seattle Slew who was purchased for $17,500, won over a million dollars in purses from racing, and was syndicated in 1978 for $12 million.[32]

*Time and Effort Expended*

If the taxpayer devotes a substantial amount of effort and personal time to the conduct of the activity, especially if the activity is not mainly recreational, a profit motive may be indicated.[33] It is also acceptable for the taxpayer to hire professional trainers and riders to show and develop the horses and thus not be heavily involved in daily activities. In Appley[34] the taxpayer raised Morgan horses and hired an outstanding trainer and breeder of Morgan horses. Appley devoted 25 to 30 percent of his time to the horse farm and another 25 percent to the American Morgan Horse Association. Since the taxpayer employed an acknowledged expert in breeding and training of horses, it was not necessary for him to take a more active role in day-to-day operations in order to demonstrate a profit motive.

*History of Income or Loss for the Activity*

It has been held in a number of cases that the mere fact that the venture has shown continuous losses is not sufficient alone to warrant the conclusion that the stable is not being operated for a profit. In Engdahl,[35] the court held for the taxpayer despite the fact that twelve continuous years of losses resulted from his horse breeding activities. A contributing factor to the allowance of a business loss deduction in Faulconer[36] was the similarity of the horse operation to a farm presently earning significant profits after many years of losses. The start-up phase for the typical horse breeding operation is from 5 to 10 years. Accordingly, there is a reasonable possibility of losses being allowed as long as the activity is being managed by an experienced individual who is prepared to abandon the enterprise when it becomes obvious that the venture is definitely unsuccessful. However, there is a limit on the number of years a taxpayer can claim losses. The length of the loss period was discussed in Ellis, where the Tax Court, in holding for the taxpayer, noted that:

> However, in so holding, we do not intend to give the petitioners a "blank check" for the indefinite future. While their unforeseen misfortunes persisted through 1981, nonetheless, at some time, if the losses continue unabated, petitioners may be deemed to have abandoned any possible profit objective.[37]

*Success of the Taxpayer in other Similar or Dissimilar Activities*

The IRS regulations state that the fact the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he/she is engaged in the present activity for profit, even though the activity is presently unprofitable. In both Ellis[38] and Meagher[39] the court considered as a positive factor the fact that the taxpayer was very successful in a

**TABLE 1**

**Dicriminant Analysis Results for the Nine Relevant Factors Indicative of a Profit Motive 44 Post-1969 Cases**

*Factors Identified as More Significant to Taxpayer's Success*

1. Manner in which the taxpayer carries on the activity
2. Expertise of the taxpayer or his advisors
3. Amount of occasional profits, if any, which are earned
4. Expectation that assets used in the activity may appreciate in value

*Factors Identified as Less Significant to Taxpayer's Success*

1. Elements of personal pleasure or recreation
2. Taxpayer's history of income or losses with respect to the activity
3. Time and effort expended by the taxpayer in carrying on the activity
4. Success of the taxpayer in carrying on other similar or dissimilar activities
5. Financial status of the taxpayer

dissimilar activity. The courts, in more recent cases, do not appear to have placed much emphasis on this factor.

*Financial Status of the Taxpayer*

The Tax Court usually differentiates between a modest income horse breeder and a horse breeder with a large outside income who can finance his horse activity losses with that income. For example, in Bishop,[40] the court noted that it was difficult to imagine that a person of relatively modest income would make such large expenditures and engage in the physical labor of breeding and showing horses without having the intention to make a profit. In Yancy,[41] the court recognized the fact that the taxpayers had no wealth on which to rely other than wages from their jobs. In some cases, however, the existence of significant nonfarm income is not fatal to deductibility of farm losses. For example, a taxpayer's significant income from his orthodontic practice did not indicate a lack of a profit motive, even though his losses from horse breeding and showing produced significant tax benefits.[42] The other relevant factors overcame this issue.

*Elements of Personal Pleasure or Recreation*

This factor is clearly the one that popularized the term "hobby." Even though personal as well as business motives may exist, the regulations do not require that an activity be engaged in with the sole intention of deriving a profit or maximizing profits. An activity will not be treated as a hobby merely because the taxpayer has purposes or motivations in addition to making a profit. Regulation 1.183-2(b)(9) provides that personal pleasure derived from engaging in an activity is not sufficient to cause the activity to be classified as a hobby if other factors indicate a profit motive.

The courts do scrutinize the recreational aspects of a horse related activity, particularly where riding horses are involved.

In Holderness,[43] the Tax Court stated that although it was possible that the activities of riding and showing horses by the taxpayer's daughter "might be consistent with a profit motive," the taxpayer had "failed to convince us the activities were other than purely recreational in nature." In Faulkner[44] the Tax Court concluded that the taxpayer's quarter horse activity was a hobby because he engaged in it mainly for his personal pleasure and satisfaction.

## Conclusion

In the final analysis, the facts and circumstances of a taxpayer's horse activity are the most significant considerations in distinguishing whether the activity is a business or a hobby.[45] It is important to strengthen those factors within the taxpayer's control that indicate a profit motive.

In reviewing the court decisions since 1969 that held that the taxpayer's horse activity was a business, the courts appear to have most frequently relied on: 1) the manner in which the taxpayer carries on the activity; 2) the expertise of the taxpayer or his advisors; 3) the amount of occasional profits, if any, which are earned; and 4) the expectation that assets used in the activity may appreciate in value. A taxpayer may not realistically be able to comply fully with all factors discusses, but conscientious efforts toward maximizing compliance with these factors may greatly improve chances of deductibility of expenditures.

**Daryl V. Burckel,** *DBA, CPA is an Assistant Professor at McNeese State University.*

**Zoel W. Daughtrey,** *Ph.D., CPA, is a Professor at Mississippi State University.*

**Radie Bunn,** *J.D., CPA is an Assistant Professor at Southwest Missouri State University.*

1 Burnett v Comm, T.C. Memo, 1985-620; Faulkner v Comm, T.C. Memo, 1985-536; Nittler v Comm, T.C. Memo, 1979-440; Tripi v Comm, T.C. Memo, 1983-483; Boddy v Comm, T.C. Memo 1984-156; Harris v Comm, T.C. Memo, 1986-225.

2 Doyle v Comm, T.C. Memo, 1982-694; Meagher v Comm, T.C. Memo, 1986-116; Appley v Comm, T.C. Memo, 1979-433.

3 IRC Sec. 469(b).

4 IRC Sec. 459(g).

5 IRC Sec. 459(h)(1).

6 Temp. Reg. 1.459-5T(a).

7 Notice 88-94, IRB 1988-35, p. 25.

8 "A Run For Your Money," Inc., October 1982, p. 150.

9 IRS Reg. Sec. 1.183-2(b)(1).

10 Meagher v Commissioner, 51 T.C.M. 676 (1986).

11 Boddy v Commissioner, 47 T.C.M. 1381 (1984).

12 Harvey v Commission, T.C. Memo 1988-13.

13 Doyle v Commissioner, T.C. Memo, 1983-694.

14 Faulconer v Commissioner, 748 F. 2d 890 (4th Cir., 1984), rev'g T.C. Memo 1983-165.

15 Supra, n. 13.

16 Yancy v Commissioner, T.C. Memo, 1984-431.

17 Fields v Commissioner, 42 T.C.M. 1220 (1981).

18 Supra, n. 17.

19 Ellis v Commissioner, 47 T.C.M. 991 (1984).

20 Estate of Elizabeth L. Power v Commissioner, 46 T.C.M. 133 (1983), aff'd 736 F 2d. 826 (1st Cir., 1984).

21 Cor v Commissioner, 33 T.C.M. 592 (1974).

22 IRS Reg. Sec. 1.183-2(b)(4).

23 IRS Reg. Sec. 1.183-1(d)(1).

24 Supra, n. 17.

25 Supra, n. 23.

26 Engdahl v Commissioner, 72 T.C. 659 (1980).

27 Supra, n. 13.

28 Ruben v Commissioner, T.C. Memo 1986-260.

29 Appley v Commissioner, 39 T.C.M. 386 (1979).

30 IRS Regs. Sec. 1.183-2(b)(7).

31 The Future of the Thoroughbred Industry, a 1975 study by Pugh-Roberts, Cambridge, Massachusetts.

32 "Horse Investors Hope for Galloping Profit at Finish Line," USA Today, May 3, 1985, 5B.

33 IRS Reg. Sec. 1.183-2(b)(3).

34 Supra, n. 32.

35 Supra, n. 29.

36 Supra, n. 17.

37 Supra, n. 22.

38 Supra, n. 22.

39 Supra, n. 13.

40 Bishop v Commissioner, 31 T.C.M. 829 (1972).

41 Supra, n. 19.

42 Supra, n. 20.

43 Holderness v Commissioner, 36 T.C.M. 13 (1977), af'd 80-1 USTC para. 9267 (6th Cir., 1980).

44 Faulkner v Commissioner, 50 T.C.M. 1314 (1985).

45 For further analysis and discussion, see the Horse Owner and Breeders Tax Manual, Thomas A. Davis, Chapter 1, (1987), American Horse Council.