11.0l(i) Consideration of Land as an Asset of a Horse Business in a "Hobby Loss" Case

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One of the ongoing problems in the evaluation of so-called "hobby loss" horse business before the IRS is whether or not the appreciated value of ranch or farmland counts as an asset of the horse business.

The Treasury Regulations provide that appreciated assets of a horse business including ranch or farm land <u>are</u> to be taken into account in evaluating the profitability of the horse business for purposes of determining whether or not the horse business is motivated primarily for profit; that is, whether or not a horse business owner can deduct his or her losses against other income. However, Tax Court cases which have applied this rule have done so inconsistently over the years.

The application of the rules about inclusion of the value of farmland seems to fall into three groups, as illustrated by the Tax Court case law:

1) Cases in which the rules are applied properly;

2) Cases in which the rules are not applied properly; and

3) Cases in which the rules are applied properly, but proof is found defective.

This article will describe proper application of the rule, as well as categorize briefly on Tax Court decisions which have implemented it.

The proper rule to be used in making this decision is distilled from a combination of two parts of the Treasury Regulations. It can be accurately stated as follows:

> If land is purchased for the purpose of using it in a horse business, then its value as an asset should be considered in an evaluation of the business under Section 183 (the "Hobby Loss" section of the Code). However, if the primary purpose of purchasing the land is to hold it for appreciation, then the value of the land is counted as an asset of a horse business operated on top of it <u>only if the horse business is profitable</u>, after the costs of carrying the land such as mortgage interest, property taxes and building depreciation are removed from the calculation.

The issue is extremely important to many cases. One of the reasons for this importance is that horse businesses tend to be "asset businesses," rather than "cash flow businesses," that is, the value of the assets is an important factor. A breeding and showing business, for example, that has spent $1 million investing in land and horses, but is holding land and horses worth $2 million has increased the owner's net worth, even if no taxable income has been reported. Under Treasury Regulation l.183-2(b)(4) the appreciated value of property used in an activity is counted as if it were a profit. Thus, in the $2 million value example, if the land is worth $1.25 million and the herd is worth $750,000, the inclusion of the land would make the difference between a business which should be considered in a loss position.

The rule described above for making the determination whether land appreciation should be taken into account is fairly straight forward. The determinative factor is plainly the <u>purpose</u> for which the taxpayer purchases the land.

Nonetheless, the application of this rule has been inconsistent by the courts. The interplay between two sections of the regulation, which combine to form the rule, has sometimes been misinterpreted.

The relevant portions of the Treasury Regulations in question are as follows: Treasury Regulation l.183(b)(4):

“Expectation that Assets Used in Activity May Appreciate in Value”

> The term 'profit' encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profits from current operations is derived, an overall profit will result when appreciation in the value of the land used in the activity is realized since income from the activity together with appreciation of land will exceed expenses of operation. See, however. paragraph (d) of Section 1.183-1 for definition of an activity within this connection. [emphasis added)

Turning to Treasury Regulation 1.183-l(d)(l):

(d) Activity Defined

(1) Ascertainment of Activity

> In order to determine whether, and to what extent, section 183 and the regulations thereunder apply, the activity or activities of the taxpayer must be ascertained. For instance, where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity. In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings. Generally the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case. If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183. Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land). [emphasis added]

To a horseman, it seems obvious that the use of land by a farmer or rancher raising horses on a farm or ranch presents a direct economic and organizational interrelationship. A horse business owner needs and uses land to pasture or otherwise keep horses, to train them, to breed them and to sell them. Thus, especially when "Generally the Commissioner will accept the characterization by the taxpayer" there should seem to be no problem characterizing land ownership and use as a single activity with horse farming or ranching.

The two 1979 Tax Court opinions, *Golanty v. Commissioner*, 72, T.C. 411 and *Engdahl v. Commisioner*, 72 T.C. 659 (1979), illustrate the correct application, legally speaking, of these principals.

In the *Engdahl* case, the Tax Court, in footnote 4, correctly applied this principle, stating as follows:

> Petitioners purchased the Morgan Hill property primarily for the purpose of breeding, raising and selling horses. Thus, the holding of the land and the activity for purposes of determining expected appreciation of value in assets under Sec. 183-2(b)(4), Income Tax Regs. See 183-l(d)(l), Income Tax Regs.; Allen V. Commissioner, 72 T.C. 28 (1979)

To the same effect, correctly construing and applying these rules, *see Hoyle v. Commissioner*, T.C. Memo 1994-592; *Ellis v. Commissioner*, T.C. Memo 1984-50.

In *Golanty v. Commissioner*, a case which was won by the Commissioner, despite the fact that the evidence showed that the taxpayers had purchased a ranch, and then later sold it for a profit. the *Golanty* Court stated

> [T]here is no evidence indicating that the Hemet ranch was held with a view of subsequently selling it for a profit; particularly, there is no evidence that the petitioner ever contemplated that such ranch could be sold at a profit so as to defray some of the costs of operating the horse-breeding enterprise<u>. In fact, the evidence suggests that the Hemet ranch was sold merely to reduce the costs of operation, not to realize a profit. These circumstances suggest that the sale of the Hemet ranch was a wholly independent activity</u> and that the profit on its sale should not be taken into consideration in judging the petitioner's motive in conducting the horse-breeding operation.

However dubious the factual interpretation may be, the Court found that the primary purpose for the taxpayer in *Golanty* to hold the Hemet ranch was merely to reduce the cost of operation i.e., that the profit on its sale was made because it had been held primarily for appreciation. If that view is accepted, then the decision of the *Golanty* Court not to include the profit on the sale of that ranch in an evaluation of the profitability of the taxpayer's horse breeding activity can be understood as correct.

A recent example of a proper application of the rule was in the 1997 case of *Perry v. Commissioner*, T.C. Memo 1997-417, where Judge Whalen analyzed the issue as follows:

> Petitioners characterize all of the undertakings relating to their horse-breeding and boarding, including holding the land on which those undertakings were conducted, as a single activity for section 183 purposes. Respondent, on the other hand, contends that petitioners' holding the land for its appreciation in value should be treated as a separate activity. Respondent maintains that any appreciation in the value of the Union Country property 'is clearly not the result of, or even related to, the horse-related activity. Respondent maintains that any appreciation was not attributable to petitioner's horse breeding and boarding. Respondent argues that any

> appreciation in the value of the land should therefore not be considered in determining whether petitioners engaged in horse breeding and boarding with the requisite profit motive.
>
> Section 1.183-l(d) (1), *Income Tax Regs.*, provides the following guidance for determining whether 'farming' and the holding of the farm. land will be considered a single activity:
>
>> Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and the holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land).
>
> Under its terms, the above rule applies only where 'land is purchased or held primarily with the intent to profit from increase in its value.' [citation omitted]; Section 1.183-l(d)(l) Income Tax Regs. 'If the taxpayer's primary intent is not to profit from appreciation of the land, then the general rule of the regulation applies in determining whether there is a single activity.' [citation omitted] Under the general rule, all facts and circumstances are taken into account in determining whether several undertakings constitute one activity for purposes of Section 183.
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> In this case, we find that petitioners' primary intent was not to profit from the increase in the value of the land used to conduct their horse breeding and boarding. Rather, petitioners' primary intent was to breed and board horses. [citation omitted] In determining whether petitioners' horse breeding and boarding and their holding of land constitute a single activity, we apply the general rule contained in Section 1.183-l(d)(l), Income Tax Regs., and take all facts and circumstances into account [citation omitted].
>
> We find petitioners' characterization of their horse breeding and boarding activity to be fully supported by the facts of this case. [citation omitted] Petitioners purchased the subject land in Union County, Ohio for the purpose of breeding and boarding horses thereon. They considered the cost of the land as part of the cost of horse breeding and boarding undertakings. Petitioners constructed horse barns on the land, and converted the use of the land to pasture, alfalfa, and hay fields for the purpose of grazing and feeding their horses. Thus, a close organizational and economic relationship exists between the breeding and boarding operation and the holding of the land for appreciation in value. [citations omitted][emphasis added]

Judge Whalen's analysis, set forth above, is correct. Yet, in reliance on the latter portion of Treasury Regulation 1.183-l(d) quoted above, or more accurately, selected parts of it, some courts have held the horse farm and the land upon which it sits to be difference activities, and therefore, discount appreciation in land value.

Problems in the application of the rule have occurred when a court focuses on only the last sentence of Treasury Regulation 1.183-l(d)(l), rather than the last two sentences, which are meant to be read together. The last sentence says:

> This, the farming and the holding of the land will be considered a single activity only if the income derived from the farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributed to the land and improvements, and depreciation of improvements to the land).

The problem with this reading is that it ignores context, i.e., the preceding sentence in the Treasury Regulations, which makes it clear that portion of 1.183-l(d) is intended by the Regulations to apply only:

> Where land is purchased or held <u>primarily</u> with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value.

The sentence which follows, which begins with the word "thus," is explanatory of the previous sentence. The word "thus" should be interpreted to mean "as an example of what immediately precedes" or "for this reason." In this instance, the last sentence of Treasury Regulation 1.183- 1 (d) is intended to apply only to situations where the land was purchased or held primarily with the intent to profit from the increase in value.

A recent example of a case which erred in this manner is *Sanders v. Commissioner*, T.C. Memo 1999-2 08. In *Sanders*, the taxpayer retired from another occupation and was engaged in a cutting horse breeding, training and showing operation. The petitioner initially acquired a ranch in partnership on which cattle and horse ranching took place, then later bought out the partner and moved from the original ranch location to a 212 acre ranch in Texas. The *Sanders* Court quoted portions of both Treasury Regulation Section 1.183-2(b)(4) and also 1.183-l(d)(l). However, the *Sanders* Court, in its quotation of Section 1.183-l(d)(l) <u>omitted</u> the relevant sentence, i.e. the portion that begins: *"Where the land is purchased or held primarily with the intent to profit from increase in its value ... "*

Having made that omission the Court then held:

> At the time of the trial, the Arkansas ranch was on the market for $1.5 million. Petitioners argue the unrealized appreciation in the Arkansas ranch should be taken into account in determining the profitability of the Schedule F activity. We disagree. Petitioner's investment in the land encompassing the Arkansas ranch was an activity separate from the Schedule F activity. The Schedule F activity did not produce profits that reduced the net costs of carrying the land.

Another example of this same type of misapplication of the rule occurred *in Butler v. Commissioner*, T.C. Memo 1997- 408. In *Butler*, despite the fact that the Tax Court quoted an appropriate section of Treasury Regulation 1.183-1 (d) (beginning with *"Where the land is held primarily with the intent to profit from the increase of its value ... "*), the opinion completely ignored the issue of intent of the taxpayer and merely cited the shortfall of taxable income from the farmland to reduce the deductions of the farming activity, and therefore concluded that the holding of the land was a separate activity. Such reasoning fails to apply the regulations logically or fairly.

In other instances, misapplication of Treasury Regulation 1.183-1 (d) tends to occur in situations where the facts of the case, as a whole, indicate that the taxpayer's primary motivation is not to profit.

However, the specific facts concerning the land issue might, in such a case, where appreciation of assets is considered profit, as the regulation directs, indicate that business would have to be considered profitable, or nearly so. In some of these cases, rather than face squarely the fact that one criterion of the non-exclusive list of nine criteria set forth in Treasury Regulation l.183-2(b) favors the taxpayer, but the overall decision should go against the taxpayer (because the trier of fact has determined that the taxpayer's <u>real</u> primary motive in engaging in the horse activity was <u>not</u> to make a profit), Courts have fallen into the trap of misapplying the rule.

An example of this type of misapplication of the law is found in *Stubblefield v. Commissioner*, T.C. Memo 1988-480.

In *Stubblefield*, the opinion indicates the books and records were poor, no taxable profit ever made, the credibility of petitioners was discounted by the Court, because all of the income items were allocated to the son who did the riding and training, but who had little other income, while all of the deductions were allocated to the father who had substantial income to offset. The case looked like a winner for the government. Yet, at the last second, the taxpayer ran into court with an offer on the ranchland which would have eclipsed all past losses. What the Court should have done was say: "Sorry, I don't believe you." Instead, the court refused to recognize the land appreciation on the ostensible ground that the appreciation of the land was no attributable to the farming use! Such a position is not supported by the regulations. Nor is it supported by logic. The reason for appreciation is irrelevant. It is the <u>fact</u> of appreciation which is meaningful in a business sense. A fair application of the tax law has no different requirement.

The third category, cases in which the rule was correctly applied, but the horse owning taxpayer nonetheless loses due to failure of proof are illustrated recently by *Wesinger v. Commissioner*, T.C. Memo 1999-372. The rule was correctly stated as follows:

> Section 1.183-2(b)(4), Income Tax Regs., identifies asset appreciation as potentially relevant to the profit analysis. However, in the case of farm property, the standard for determining if such appreciation may be considered differs depending on whether land is held primarily for appreciation or primarily for farming. [citations omitted] If land is held primarily to profit from the increase in value, 'the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land,' such that 'the farming activity reduces the net cost of carrying the land.' Sec. 1.183-l(d)(l). <u>Income Tax Regs.</u> Conversely, if asset appreciation is merely collateral to a primary purpose of farming, courts have permitted unrealized appreciation to be considered as part of an overall intent to profit from the property, irrespective of the amount of income from farming [citations omitted].

However, in the <u>Wesinger</u> case, the correct statement of the rule by the Tax Court did not significantly help the taxpayers because, *"even if farming was the primary objective, a claimed expectation of appreciation cannot help petitioners. Because no appraisal or value of the ranch was offered as evidence ... "*

Thus, recognition of the rule will not avail the taxpayer much unless there is also proper proof of the value of the land appreciation. Land appreciation which would have helped the taxpayer was similarly excluded from consideration due to proof failure in *Haun v. Commissioner*, T.C. Memo 1998-349, despite the taxpayer's testimony concerning increase in value of the ranch.

In *Jorgenson v. Commissioner*, T.C. Memo 200-38, two physicians had extensive ranching operations involving land and cattle. The Commissioner prevailed, despite the testimony of the taxpayer that the appreciation on the four properties exceeded the historical losses and that one ranch alone could be sold for more than historical losses. However, the Court disregarded the testimony, stating*, "Mr. Jorgenson, however, failed to explain to the Court how he knows his claims to be true."*

Generally, under the rules of evidence, an owner is always permitted to testify to the value of his property. However, repeatedly, in the *Haun* case, *supra*, the *Jorgenson* case, and *Reinheart v. Commissioner*, T.C. Memo 1998-205, evidence concerning the appreciated value of land was disregarded, evidence which came from the taxpayers themselves.

The obvious conclusion to be drawn from the line of cases is that when the value of the land is an important issue in your case, it is essential to present expert testimony concerning the value of the land.

Conclusion

The land appreciation issue remains critically important. The proper rule for determining the issue is frequently misapplied.

When this rule is properly understood, it can be a powerful aid in convincing a revenue· agent or the Tax Court of a profit motive. Thus, aggressive presentation of the law in the area, together with evidence concerning land value, including expert testimony when in Tax Court, may be necessary to achieve a just result.

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