IMPORTANT ISSUES IN HORSE BUSINESS TAXATION:

Sales, Exchanges, Depreciation,
Expense Deductions
and Workers Employment Taxes

or

Yes, You Are Hitched to the Federal Government . . .
Here Are Some Tips on How to Best Fasten the Harness

I. Introduction

As with all businesses in the United States, horse businesses have a non-riskbearing partner in our Uncle Sam, the federal government.

For horse breeding businesses, and horse show businesses, sales of horses are the most significant aspect of income. The way these transactions are taxed is discussed below.

In some instances, horses can be traded for other horses without being taxed.

Horses that are purchased by horse businesses can be depreciated. So can other horse business assets such as fences, barns, trucks and other equipment. Depreciation deductions are discussed below in Section III. Depreciation deductions can lower tax bills, and also need to be taken into account when calculating gains on sales as discussed below in Section II.

Like other businesses, business expenses in a horse business can be deducted. As discussed below in Section IV, because farmers have been historically "cash basis" taxpayers, usually expenses can be deducted in the year that payment is made. This situation can be advantageous for horsemen, although there are rules that must be followed. Some of the most significant rules are discussed below.

The IRS is particularly concerned that employment taxes, like FICA (Social Security) and FUTA (federal unemployment taxes) be paid on horse business employees. But just who is an employee? Trainers? Barn help? It is not always clear, but there are some guidelines. See Section V below.

II. Sales

A. Reportable. When sales or exchanges of horses occur, profits or losses result which are reportable (except for like-kind exchanges -- see Section F below) on a horse business owner's tax return.

B. Gain or Loss. The amount of gain or loss which must be reported will be the amount of money, and/or fair market value of property received, less the basis of the horse sold.

1. What is basis?

   a. The term "basis" usually means the purchase price, subject to adjustments.

   b. The "basis" of a homebred horse will usually be zero, since the stud fee is usually deducted when paid as an expense, and the expenses of caring for the mare are also deducted currently as an expense.

2. Basis adjustments.

   a. Depreciation deductions reduce basis, in a dollar for dollar manner, i.e., if a $1,000 depreciation deduction is taken on a horse, the basis of that horse is reduced by $1,000.

   b. Basis can be increased in certain situations. For example, the cost of a trip to acquire a horse is supposed to be added to the basis of the horse. For example, if $2,000 is spent on airfare, lodging and meals on a trip to California by an owner and a trainer for the purpose of buying a three year old colt, and the owner buys the three year old colt for $28,000, the basis of that colt will not be merely the $28,000 purchase price, as would usually be the case, but would be increased by the cost of the acquisition trip, that is, by $2,000, to $30,000.

C. When is Profit or Loss Taxed

Usually, profits are taxed in the year of sale, even if the payment is received in deferred payments, unless installment sales rules apply. (See discussion below at Section D.)

D. Installment Sales

An installment sale is defined as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The definition includes sales where only a single payment is made, if the payment is to be made after the year of sale.

1. If an installment method is used, then only the percentage of payments which equals the percentage of profit is taxed in that year. For example, if a horse is purchased for $15,000, then sold on a four-year contract for $20,000 during the following week, with one payment of $5,000 each year, the percentage of profits is 25% ($5,000 profit/$20,000 contract price). If the installment method is elected, then 25% of each $5,000 payment, i.e., $1,250, is taxed as profit in the year that each payment is received.

2. Exception -- Installment sale treatment does not apply to depreciable horses to the extent of depreciation recapture (see Section E.7 below). Depreciation recapture must be taken into account as ordinary income in the year of sale.

3. However, a horse business owner may want to have all of the profit taxed in the year of sale, even if the sale is an installment sale. An example of this might be where the year of sale is in a year following profit year, and if all of the profit from that sale is taken into account during the year of sale, a second profit year will result (the value of two consecutive profit years is that a rebuttable presumption is created in the next succeeding five years that the business is engaged in for profit. See also, generally, Horse Owners and Breeders Tax Handbook, Section 1.04.)

E. Long Term Capital Gain

1. Generally. The sale or exchange of a "capital asset" will usually result in a capital gain or loss.

2. Rates. Long term capital gain rates are 10%, 20%, or in some cases 28% In contrast, the ordinary income tax rates can go up to 39.6%, and effectively, because of the phaseout of certain deductions and exemptions, higher, in excess of 40%.

3. Brief Recent History. Prior to 1997, there were two capital gains rates -- one for long term capital gains (from the sale of assets held more than one year) and one for short-term capital gain (from the sale of assets held one year or less). For investors whose regular tax bracket was higher than 28%, the tax on long term capital gains was a flat 28%. For short-term gain and for investors in the 28% bracket and below, the tax was the same as their regular tax rate.

The 1997 Taxpayer Relief Act cut the tax on long-term capital gains, but did so in a complex, and typically government awkward way. The 1997 Act set the long-term capital gain rate at 20% for taxpayers in the 28% or higher tax bracket. For taxpayers in the 15% bracket, the long-term capital gains rate became 10%. Although it cut the long-term rate, the 1997 Act changed the definition of long term capital gains. The new rates applied only to assets held more than 18 months. Gains on assets held between 12 months and 18 months were called "mid-term gains" and the old 28% rate continued to apply.

4. Horses. Horses are technically not capital assets, but rather are "Section 1231" assets, so-called for Internal Revenue Code Section 1231, which describes assets used in a trade or business. Gains on Section 1231 assets are taxed like long-term capital gains. However, the holding period rules described above do not apply to horses, because Internal Revenue Code Section 1231(b)(3) defines the horses which are eligible for long term capital gains treatment as:

> ". . . horses, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by the taxpayer for draft, breeding, dairy or sporting purposes, and held by him **for 24 months or more** from the date of acquisition" [emphasis added].

Thus, because the 24 month holding period is a part of the definition of horse as Section 1231 asset, the shorter holding periods of 12 or 18 months do not apply to horses.

5. Reportable Long Term Capital Gains. Whether or not long term capital gains treatment is available is somewhat complicated. In order to determine whether or not capital gain treatment will be available in a given year, first, short term capital gains must be netted against short term capital losses. Then, long term capital gains must be netted against long term capital losses. Then, the net short term capital gain [or loss] must be netted against the net long term capital gain [or loss] and then, gains on sales of Section 1231 assets must be netted against losses on Section 1231 assets. Then, the net on Section 1231 transactions must be netted with the net of the long and short term capital gains, and then, the tax on the net of all capital gains and 1231 transactions, the "adjusted net capital gain" is taxable at the rate of 10% if the taxpayer's tax rate is otherwise 15%, or 20% if the taxpayer's tax rate is otherwise greater than 15%.

Of course, there are some exceptions, the capital gains rate on collectibles, which are defined as works of art, antiques, gems, stamps, and certain coins is 28%. The long term capital gain rate on real estate gains which represent gains on depreciation which have been taken on a straight line basis is 25%.

Finally, the net capital gain is included in the calculation of adjusted gross income for the purpose of the 2% floor on miscellaneous itemized deductions, the phaseout of itemized deductions, and the phaseout of certain personal exemptions. Ah, the simplicity of tax legislation.

6. ?1231 Property Qualifications. To qualify as a Section 1231 asset, an asset (including a horse) cannot be held as inventory, or held primarily for sale, but must be depreciable property, held in connection with a trade or business for more than twelve months, or, for horses or cattle held for draft, breeding, dairy or sport purposes, the holding period is 24 months.

7. Depreciation Recapture. When a capital asset, or a ?1231 asset has been depreciated, then is later sold with circumstances which would make the gain eligible to be taxed as long term capital gain, an amount of the gain equal to the total amount of depreciation previously taken will be "recaptured", i.e., treated as ordinary income for tax purposes. The rationale is that the previously taken depreciation deductions saved taxes at the ordinary income rate.

For example, if a three-year old show horse was purchased, and shown for 26 months, with depreciation of $1,072 taken in Year One, and $1,913 in Year Two, then sold after being held for sporting purposes in a horse breeding, showing and sales business for 26 months for $20,000, the tax treatment would be as follows:

Sales Price	$20,000	
Less Basis =	7,015	(10,000 - 1,072 - 1,913)
Gain	$12,985	
Recapture of Depreciation	$ 2,985	(1,072 + 1,913)
	$10,000	Eligible for long term capital gains rate of 20% or 10%

The $2,985 which is "recaptured" is taxed as ordinary income, which might be, for example, 39.6%.

F. Like-Kind Exchanges

1. Generally. Internal Revenue Code Section 1031 provides an exception to the general rule requiring recognition of gain or loss on the sale or exchange of property. It provides for non-recognition of gain or loss on the exchange of property for other property of like-kind. There are requirements concerning the timing of such exchanges, and also both the property transferred and the property received must meet certain requirements concerning use. The basic requirements are:

(a) There must be an exchange;

(b) The properties exchanged must be of "like kind"; and

(c) The property transferred and the property received must be held for productive use in a trade or business or for investment.

2. What is "like-kind" for horses?

(a) The horses must not be held primarily for sale.

(b) The horses must be the same sex. A stallion for a stallion. A mare for a mare. A gelding for a gelding. What about a stallion for a stallion share? The answer is not clear. Assuming that the stallion syndicate is not a partnership, it should be "yes".

(c) Must horses be of the same breed? The answer is not clear. A racing Quarter Horse gelding for a racing Arabian gelding should work. However, a racing Paint gelding for a Paso Fino show horse gelding would be more dubious, due to the different nature of use of the two animals. This latter transaction still should be within the realm of "maybe". An American Quarter Horse reining horse for an Arabian reining horse? The two horses have the same sex and the same use. Probably. What about a 3-year old Thoroughbred racing filly for a 10-year old Thoroughbred broodmare? Again, the answer is not clear, but since the two animals are the same sex, capable of breeding, and the same breed, this transaction should work as a like-kind exchange.

(d) Must the exchange be of the same number? What about one Morgan show mare for two Morgan show mares? Again, the answer is not crystal clear, but probably.

(e) Partnership interests -- tax free interests of partnership interests in different partnerships are expressly forbidden by the Internal Revenue

Code.

(f) Stallion shares for stallion shares? Maybe, it depends on whether the two syndicates are alike. Some stallion syndicates are partnerships and some are not.

3. Like-Kind Exchanges Involving Cash or Other Property.

If a horse owner trades property for like-kind property and cash or non-like-kind property, any gain on the trade is taxable to the extent of the cash and/or the fair market value of the like-kind property received. Such cash or non-like-kind property is called "boot" by tax types. If there is a loss on a trade involving like-kind property and boot, the loss is not deductible at the time of the exchange, but is deferred until the property received in the trade is sold or otherwise disposed of.

4. Basis.

When no cash or other non-like-kind property is involved in a like-kind exchange, just one horse for another horse, or one horse for two or more like-kind horses, the basis of the property received in the exchange will be the same as the property traded away. However, when an exchange of like-kind property involves cash or other property which is not like-kind, the basis rules become substantially more complicated. See Horse Owners and Breeders Tax Handbook, Section 8.06(a) and Treasury Regulations Section 1.1031(d)-1(b), (d).

5. Deferred Exchanges.

In a deferred exchange agreement, if the complex and stringently applied regulations are followed, taxes can be avoided on a sale of a horse, as long as the horse sold is replaced by a horse or horses (up to four) of the same sex.

(a) An independent qualified intermediary must hold the sale proceeds until a replacement horse can be found, and then must pay over the monies from the sale of the old horse to pay for part or all of the replacement horse(s).

(b) The replacement horse(s) must be identified within 45 days of the sale.

(c) The transaction must close within six months of the original sale.

III. Depreciation

Depreciation is the recovery of the cost of business assets over a period of years. Originally, the period over which the costs were recovered was based on the estimated useful life of the asset. The deductions were the basis of the asset divided into equal, annual amounts over the estimated useful life of the asset. This system was, and is, known as ?straight-line? depreciation, and it can still be used. However, a system which allowed bigger deductions in early years was enacted under President Reagan, called the Accelerated Cost Recovery System, or ACRS (pronounced like ?ACRES? among tax types). The ACRS system was later scaled back and made less beneficial to business owners under a system called the Modified Accelerated Cost Recovery System, or MACRS (pronounced like ?MAKERS? among the tax types). Depreciable assets in the horse business include horses, barns, fences, well, trucks, horse trailers, and grain storage bins, among other things.

A. MACRS Rates ? Property used in farming

The 150% declining balance method is used in calculating depreciation deductions for property used in farming (the 200% declining balance method is used for property not used in farming). Property is classified in 3 year, 5 year, 7 year, 10 year, 15 year and 20 year classes.

1. Horses

Horses which are used in a trade or business are classified as either three year or seven year property for MACRS purposes. The deduction schedules are as follows:

(a) 3 year property ? which are racehorses over the age of 24 months plus 1 day, or breeding animals over the age of 144 months plus 1 day, are depreciated as follows:

Year	
1	25.00% of the horse?s basis
2	37.00% of the horse?s basis
3	25.00% of the horse?s basis
4	12.50% of the horse?s basis

(b) 7 year property ? horses used in a trade or business which are not 3 year property, are depreciated as follows:

Year	
1	10.715% of the horse?s basis

2	19.134% of the horse?s basis
3	15.033% of the horse?s basis
4	12.248% of the horse?s basis
5	12.248% of the horse?s basis
6	12.248% of the horse?s basis
7	12.248% of the horse?s basis
8	6.126% of the horse?s basis

2. Conventions

Doubtless, the reader has astutely noticed that the ?3 year property? MACRS depreciation schedule above shows depreciation over four years, and the ?7 year property? MACRS depreciation schedule shows that eight years are needed for full depreciation. The reason for this seemingly Orwellian government-speak approach is the use of ?CONVENTIONS? concerning when the asset is placed into service. The numbers shown above use the ?Half Year? convention, which assumes that all property placed in service during the year is placed in service on July 1 of the year, therefore only one-half (1/2) of the MACRS deduction that would otherwise be available is allowable in year one. The presence of the 4th year for 3 year property, and the 8th year for 3 year property is to allow the deduction for the half year which was not allowed in year one.

(a) Half Year ? This is used for most assets where the business has a 12 month tax year (that is, the business is in business all year long). It is generally used regardless of when the asset is placed in service.

(1) Exception to the Half Year Convention.

If 40% or more of the assets placed in service during a year are placed in service during the last quarter of the year, the Half Year convention cannot be used, but rather the Mid-Quarter convention must be used.

(b) Mid-Quarter Convention ? When 40% or more of the cost of property placed into service during the year is placed into service during the last quarter, then property placed in service during the year is separated in 4 groups. The four groups are property placed into service during the 1st, 2nd, 3rd, and 4th quarters. The property placed into service is assumed to be placed into service during the midpoint of each quarter, and adjustments are made as follows:

1st quarter -- 7/8 x the otherwise allowable depreciation deduction for the full year

2nd quarter ? 5/8 x the otherwise allowable depreciation deduction for the full year

3rd quarter ? 3/8 x the otherwise allowable depreciation deduction for the full year

4th quarter ? 1/8 x the otherwise allowable depreciation deduction for the full year.

(c) Mid Month Convention - Applies to residential and non-residential real estate, similarly to the Mid-Quarter convention, but using each month rather than each quarter is a relevant period.

3. Other Horse Business Assets

(a) Autos and Light Trucks ? 5 year property when used in farming business are depreciated under MACRS:

Year

1	15.% of the basis of the asset
2	25.50% of the basis of the asset
3	17.85% of the basis of the asset
4	16.66% of the basis of the asset
5	8.33% of the basis of the asset

(assumes Half-Year convention)

(1) There are special restrictions on amounts deductible for automobiles, contained in (IRC ? 2807(a) and Rev. Proc. 96-25.

(b) Farm Equipment and Machinery ? 7 years property

(see schedule above for horses)

(c) Barns, Stables, and Farm Buildings ? 20 year property

Year

1	3.75% of the basis of the property
2	7.219% of the basis of the property

3	6.677% of the basis of the property
4	6.177% of the basis of the property
5	5.713% of the basis of the property
6	5.285% of the basis of the property
7	4.888% of the basis of the property
8	4.522% of the basis of the property
9	4.462% of the basis of the property
10	4.461% of the basis of the property
11-20	4.462% of the basis of the property
21	2.231% of the basis of the property

B. When Deductions Begin

To commence, the property must be ?placed in service.?

1. Horses

(a) Racehorses ? when placed in training

(b) Showhorses ? when placed in training, or when shown

(c) Breeding horses ? when

(1) Mares ? when brought to farm to be bred; or if in foal when purchased

(2) Stallions ? when stallion services offered, or breeding takes place.

C. Horses used outside of the U.S.

Horses used predominantly outside the United States are not depreciated under the MACRS system. Instead, they are subject to the ?Alternative Depreciation System (referred to as ?ADR? by the tax types). The ADR system uses the conventions (see Sections 2a and b above) but uses ?Straight line" depreciation with a class life, or 12 years if there is no specified class life. Some ADR class lives are:

Broodmares, all ages - 10 years
Breeding Stallions - 10 years
Racehorses - No life
Showhorses - No life

D. Change of Use

When a horse is purchased as a racehorse, but the horse?s use is changed to show or breeding, although there are not specific Treasury Regulations, respected secondary authority (Horse Owners & Breeders Tax Handbook) indicates that based on prior law, the proper treatment is that the MACRS deductions must be changed. See the discussion in the Horse Owners and Breeders Tax Handbook ?5.03(g) for the details of the calculation for a change in use.

E. Short Tax Years

If a horse business has a tax year of less than 12 months, such as when it is starting out, the conventions still apply, as discussed above, but the deductions available are prorated by the number of months that the business operates.

IV. Deductibility of Breeding, Training and Show Expenses.

A. Generally.

Internal Revenue Code Section 162 provides that a taxpayer can take a deduction for all "ordinary and necessary" expenses paid or incurred in carrying on a trade or business.

1. Trade or Business. One of the prerequisites to deductibility of expenses is that the taxpayer be engaged in a trade or business. A trade or business has been defined as an activity pursued full time, in good faith, and with regularity, for the production of income or livelihood, and is not merely a hobby. The "full time" part of this definition is not required, as a practical matter, but amount of time spent does have an impact on the passive activity loss rules.

2. "Ordinary and Necessary". The term "ordinary and necessary" really means "helpful and appropriate" to the taxpayer's trade or business. The term "necessary" has been interpreted to mean "appropriate and helpful" as opposed to required, or obligatory. An expenditure is necessary if it is appropriate and helps develop and maintain the taxpayer's business. The expense need not be essential to the business, but it must be reasonable to expect business benefits to result from the expense. "Ordinary" does not mean that the expense must be habitual or normal in the sense that the taxpayer must incur that expense frequently. Rather, ordinary means "normal, usual or customary". The terms refers to expenses that are normally or customarily incurred in response to a certain circumstance. Thus, an expense may be ordinary although it happens only once in a taxpayer's lifetime. The essence of the inquiry is whether the expense is one that has or could occur in connection with businesses similar to the business claiming the deduction.

3. Not Capital Expenditures. Expenditures of a capital nature are generally not deductible as ordinary and necessary business expense (except as permitted under Section 179, see Section E below.) A capital expenditure is generally defined as an amount paid for the acquisition, improvement or restoration of the property having a useful life substantially beyond 12 months. Examples of capital expenditures include:

(a) land and buildings;

(b) additions, alterations and improvements to buildings;

(c) automobiles, vans and trucks;

(d) farm equipment and machinery;

(e) fees connected with the acquisition of property (but not breeding fees);

(f) fences;

(g) horses and other livestock;

(h) major overhauls of machinery, equipment, cars, trucks and tractors;

(i) wells;

(j) reforestation.

B. Breeding Fees.

Farmers have been permitted to deduct breeding fees, even though breeding fees might arguably be considered part of the cost of creating an asset with a useful life of more than 12 months. The IRS audit manual, following a 1971 technical advice memorandum, states that:

> "Deductions for stud fees and training expenses incurred by taxpayers in the business of breeding, raising, and racing horses should not be disallowed as costs of acquiring property within the meaning of Regs. 1.263(a)-(2). Consistent treatment of stud fees and training expenses by taxpayers as allowable expenses of raising livestock under Regs. 1.162-12 should be accepted."

1. Embryo Transplants.

In 1980, the IRS issued a ruling that the owner of a registered cattle breeding herd could deduct as a business expense the cost of an embryo transplant. This IRS ruling should also apply to horse embryos transplants. It should be noted that the ability to expense an embryo transplant applies to farmers, i.e., individuals engaged in the farm business. It should also be noted that cases involving contract situations in which the farmer who would end up with the calf (or by analogy, the foal), in which the lessee (buyer) was guaranteed a live offspring, without risk of loss, the lessee (buyer) was not permitted to deduct this expense. Bearing the risk of loss is a critical factor.

2. Mares Purchased in Foal. Breeding fees for mares which are in foal at the time of purchase generally are not deductible, assuming that the fee has already been paid. Rather, such expenditures become part of the basis of the property acquired. However, in situations where the obligation to pay the stud fee is contingent upon a live foal being born, and the fee has not yet been paid, may result in a deductible expense for the payer.

C. Training Fees.

1. Cash Method. Training costs paid by a cash method taxpayer are deductible in the year in which they are paid as ordinary and necessary business expenses. This principle applies to both racehorses, and show horses. Note, again, this treatment applies to individuals engaged in the business of breeding, raising and showing (or racing) horses.

2. Accrual Method. For corporations, partnership, tax shelters, and any other taxpayers required to use the accrual method, training expenses incurred prior to the time a horse begins showing (or racing) should be capitalized. However, after the horse has begun to show (or race), the expenses would be deductible.

D. Other Deductible Expenses.

1. Labor.

(a) Wages,

(1) including FICA and FUTA taxes.

(2) including fair market value of property in lieu of wages.

(b) Including wages paid to children, if the wages paid are reasonable for the services rendered, and there is a bona fide employment relationship.

(c) Labor for repairs is deductible, but if the repairs create a benefit which lasts more than 12 months, then the labor for these repairs would have to be capitalized.

(d) Wages for building structures or other capital assets must be capitalized and added to the basis of those assets.

2. Interest

3. Fertilizer and lime

4. Taxes, including state and local taxes, federal excise taxes, and most other taxes, except federal income taxes. If the tax applies to both business and personal property, such as property tax on a farm which includes the horse business owner's principal residence, an allocation must be made of the personal portion (for the residence) and the farm.

5. Self-employment Health Care Insurance - In 1999 through 2001, 60% of medical insurance for self-employed individuals, their spouses and dependents can be deducted. In 2002, the percentage will be 70%. In 2003 and thereafter, the deductibility will increase to 100%.

6. Rent

7. Broodmare rent (lease payments)

8. Dues -- to organizations such as the American Horse Council, and breed associations.

9. Feed

10. Travel

(a) Internal Revenue Code Section 162 permits the taxpayer to deduct all ordinary and necessary expenses incurred while carrying on any trade or business. Deductible expenses include "traveling expenses", including amounts expended for meals and lodging, other than amounts that are lavish or extravagant under the circumstances, while away from home in pursuit of the trade or business. Internal Revenue Code Section 212 would permit a similar deduction for ordinary and necessary expenses paid or incurred in the production or collection of income. Deductible travel expenses include air, rail and bus transportation, operating and maintaining an automobile, taxi fares and other costs of transportation between an airport or station and hotel, or from one place of business to another, baggage charges and transportation costs for sample and display materials, meals and lodging while the taxpayer is away from home, cleaning and laundry expense, telephone and telegraph expenses, tips that are considered incident to any of the above-listed expenses, and other similar expenses related to qualifying travel.

If a trip is primarily for business, and the taxpayer extends the stay for personal reasons or makes side trips or engages in other activities, he may deduct only the expenses which would have been incurred in the trip had been totally for business. However, no allocation is required for transportation cost to and from the business destination.

11. Business meals.

E. ?179 Expenses. ?179 permits a taxpayer to expense, that is, currently deduct up to $19,000 (for 1999) in cost of qualifying personal property used in a trade or business which would otherwise have had to be depreciated. The amount which can be expensed under this provision rises to $20,000 in 2000, $24,000 in 2001 and $25,000 in 2003 and thereafter . It can be used on all - or part of a purchase price. It can be used on horse purchases.

1. Limits.

(a) This deduction is reduced, dollar for dollar, to the extent qualifying personal property placed in service during the year exceeds $200,000.

(b) The ?179 election deduction can apply only to income from a trade or business which is actively operated by the taxpayer. This means that if the horse business owner is an employee in his or her other job, has no trade or business which is profitable, and the horse business is losing money, a ?179 expense cannot be used to increase a loss. If the horse business owner has a loss year in the horse business, but his or her other pursuit is a trade or business reporting on a Schedule C, and the other trade or business is profitable, the ?179 expense election can be used to offset other trade or business income. However, even if the ?179 election deduction is not currently usable, if it is made, the deduction can be carried forward.

2. Possible Increase. The tax bill that passed both houses of Congress in 1999, but was vetoed by President Clinton would have raised the ?179 expense election amount to $30,000. It would favor horse businesses if this legislation passes this year.

F. Hobbyists. Feed, stabling, veterinary services, transportation, labor and other similar items common to raising, racing and showing horses are deductible by a cash method taxpayer as a farm business expense in the year paid. However, for someone who raises and shows horses only as a hobby, these costs would be deductible only to the extent of income produced by the horse activity, or none, deductible at all.

V. Employment Status of Workers -- The Trainer; Barn Help

A. Generally

Whether a particular worker is an "employee" or "independent contractor", has profound consequences for both the business owner and the worker, although the correct status is not always clear in every situation.

If the worker is an independent contractor, then the worker needs merely to be paid, and if more than $600 is paid during the year, then a Form 1099 needs to be issued at the end of the year.

On the other hand, if the worker is an employee, then the employer is obligated to withhold federal income tax, to withhold the employee's portion of the FICA (social security) taxes, pay the employer's portion of the FICA, withhold the employee's portion of the FUTA (federal unemployment tax) and pay the employer's share of the FUTA. Additionally, the employer will be responsible for the payment of state taxes, as necessary, including workers compensation insurance.

Frequently, both the worker and the employer prefer the independent contractor status. However, if audited, and found to have misclassified the worker, the employer could be liable for withholding taxes which had not been withheld, FICA and FUTA taxes, penalties and interest. Such findings upon an audit can be severe. The problem is magnified when it is realized that in the event the tax and penalties are not paid, the IRS will vigorously pursue collection, and these taxes are not generally dischargeable in bankruptcy. Even for corporations or LLCs, all individuals held to be "responsible persons" (generally, those who have the authority to designate which creditors are paid and which creditors are not paid), the IRS will pursue these individuals for payment, despite the existence of the entities, even if the entity is no longer in business or has gone bankrupt.

B. Independent Contractor versus Employee - The Test.

The Internal Revenue Service uses the 20 common law factors, listed in Revenue Ruling 87-41, and also Section 530 of the Revenue Act of 1978. (A copy of Revenue Ruling 87-41 is attached to this outline.)

Most generally, the right to control the manner in which the work (as opposed to merely the result) is done is generally the determinative factor.

A contract between an independent contractor and a farm does not necessarily completely control the determination of whether a particular worker is an independent contractor or an employee, but it can be very helpful.

C. What About Trainers? -- A trainer can be either an independent contractor or an employee, depending on the circumstances.

1. Public trainers. Public trainers who have their own training facility, who hold themselves out as available to the public as a horse trainer, with multiple customers, who send out bills to their customers, will usually be independent contractors.

2. Farm trainers. Horse trainers who are employed by a single farm will almost always be classified as employees.

3. The barn help. The barn help will usually be classified as employees.

4. The Farrier. Most farriers would be independent contractors, since they have multiple customers, own their own tools and trucks. Generally, farriers decide when they will come to your farm (in some cases, only slightly influenced by the begging and pleading of the farm owner).

D. Developments in the Law.

1. Small Business Job Protection Act of 1996.

The Small Business Job Protection Act of 1996 ("SBJPA") provides substantial relief to employers in the area of the safe harbor provisions for establishing independent contractor status under Section 530 of the Revenue Act of 1978 ("Section 530").

2. Background of Section 530.

Generally, Section 530 established an independent contractor safe harbor provision which provided immunity from reclassification by the IRS for employment tax purposes, subject to the following conditions:

(a) The employer has consistently treated the worker and similarly situated workers as independent contractors since 1978 [or inception of the business];

(b) The employer has complied with the requirements for issuance of Form 1099 concerning the compensation paid to the worker during the time periods in issue; and

(c) The employer classified the worker as an independent contractor on a "reasonable basis".

For purposes of Section 530, "reasonable basis" can be established by:

(1) reasonable reliance on published rulings or judicial precedent;

(2) reasonable reliance on a past IRS audit of the taxpayer;

(3) reasonable reliance on a longstanding recognized practice of a significant segment of the industry in which the taxpayer is situated; or

(4) "in some other manner".

3. <u>Changes Made by SBJPA</u>

The SBJPA made the following changes to Section 530 practice:

(a) There had been disputes between the IRS and Taxpayers based on the IRS insistence that Section 530 was not available until the IRS had first made determination of the workers status under common law test. The SBJPA codified the line of Tax Court cases rejecting this practice by the IRS.

(b) The SBJPA made it more difficult for a taxpayer to use a prior audit as the basis for a "reasonable basis". It accomplished this by requiring that for audits commencing after December 31, 1996, there can be no reliance to establish reasonable basis under Section 530 unless the taxpayer can show that the audit included examination of the employment tax area;

(c) The SBJPA required the IRS, when conducting an audit, to provide a written description of Section 530 and its safe harbor provisions.

(d) The concept of what was necessary to establish "industry practice" had been widely disputed between the IRS and the private bar. The SBJPA made two major changes, both of which were favorable to the taxpayer.

(1) The SBJPA established that a "significant segment" was to be no more that twenty-five percent of an industry, however, the SBJPA also made it clear that the safe harbor percentage represented a ceiling, and that a lower percentage might be appropriate in a given instance.

(2) The SBJPA established that the definition of "long standing" is ten years, although the SBJPA also provides that a shorter time may be appropriate based on the particular facts and circumstances of the case.

4. The SBJPA modified the burden of proof in Section 530 cases by shifting the burden of proof to the IRS with respect to the worker classification as soon as the taxpayer has established a prima facie case that it was reasonable to classify a worker as an independent contractor for Section 530 purposes. The exception to this shift in the burden of proof is the issue of whether a taxpayer has demonstrated a reasonable basis in "some other manner". Additionally, in order to qualify for the burden of proof shift, the taxpayer must show that he/she/it fully cooperated with reasonable requests by the IRS for information relevant to the issue.

5. Very importantly, the SBJPA made it clear that a taxpayer eligible for Section 530 protection who converts the covered workers to an employee status does not lose Section 530 protection for those workers for pre-conversion periods.

6. The Taxpayer Relief Act of 1997

The Taxpayer Relief Act of 1997 ("TRA '97") was not principally aimed at employment taxes. Nonetheless, there was one very significant change accomplished by TRA '97. Namely, the Tax Court was given jurisdiction to determine a worker's status. The Tax Court now has jurisdiction to resolve a controversy between a taxpayer and the IRS involving (1) whether one or more individuals performing services for the taxpayer are employees of the taxpayer, and/or (2) whether the taxpayer is eligible for relief under Section 530.

Prior to TRA '97, in order to contest a worker classification, it was necessary to pay one quarter's FICA and FUTA, and thereafter commence an action in District Court for a refund following the IRS rejecting the claim for a refund. In Tax Court, a tax can be challenged before it is paid.

If the Tax Court is utilized as a forum for resolution of a worker classification issue, the IRS will be prohibited from assessing or collecting the tax in dispute while the matter is pending in the Tax Court.