

STRAIGHT TALK FOR HORSE BUSINESS OWNERS: MAINTAINING AN ADVANTAGE IN IRS DISPUTES



Compiled from the legal reports of Richard W. Craigo and B. Paul Husband

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INTRODUCTION

The Internal Revenue Service can be a formidable opponent. By far the most common challenges against horse business owners involve two main Internal Revenue Code (IRC) provisions:

"Hobby Loss" - (IRC Section 183) challenges whether or not an owner engaged in the horse operation primarily for profit.

"Passive Activity Loss" - (IRC Section 469) challenges whether or not an owner "materially participated" in the horse business.

The purpose of this publication is educational, to help you gain a basic understanding of these potential challenges. It clearly outlines several preventive and recommended actions, but it is not specific legal advice to any particular individual or enterprise. Laws, including tax laws, change over time and individual fact patterns have a material effect on the best course to take. Therefore, this booklet should not be used as a substitute for competent, professional advice from a C.P.A. and/or tax attorney.



CHAPTER 1: PREVENTIVE PLANNING

As an ounce of prevention is worth a pound of cure, careful planning before entering a horse business may reduce the owner's exposure to an IRS dispute. Keeping good records is one step that an owner can take that will be helpful.

The principal planning techniques, when trying to minimize exposure to "hobby loss" and "passive loss" challenges, include the following:

“As an ounce of prevention is worth a pound of cure, careful planning before entering a horse business may reduce the owner's exposure to an IRS dispute.”

1. A Separate Checking Account

This is elementary planning. If an owner wants the IRS to believe that the horse operation is a profit motivated business, then funds of that enterprise should not be commingled with personal funds. Having said that, a lack of such a separate checking account is not fatal, provided income and expenses can be accurately tracked.

2. A Business Plan

The IRS will always want to see a written business plan but their existence is rare. The business plan need not be excessively long and complicated. A clear, basic plan outlining the goals and methods by which the horse business was operated will suffice. Business plans including rough annual estimates of income and expense will put that owner far ahead of the pack. The plan should be revised periodically, especially to show any modifications in the business operations, goals and activities. Modifications to a business plan done for the purpose of reducing losses and making a profit are powerful proof of a profit motive.

3. Books and Records

A bookkeeping or accounting system set up by a professional accountant is generally a strong indication that the owner is treating the horse business as profit-motivated.

4. Consult with Experts and Engage in Self-Education

Keep specific records of any consulting sessions held with industry professionals. Self-education such as attending seminars, joining industry organizations, and subscribing to and reading industry books and periodicals is also advantageous.



5. Keep a Time Log

"Material participation" is the principal factor to be proven in "passive activity loss" challenges. Numbers of hours spent is also an important factor in "hobby loss" challenges. While it is difficult to convince an owner to undertake such a tedious routine as logging hours, if kept contemporaneously it will be powerful evidence of time spent. Proof is key for a "passive activity loss" challenge, especially when the owner also has another business or profession.

6. Document Unforeseen Hardships

One of the best defenses, under the "hobby loss" rules, to a series of consecutive loss years is the proof of occurrence of one or more major unforeseen hardships, such as death or injuries to horses, infertility of a stallion, or industry-wide economic conditions. Hardships should be documented from the outset of the business, and if possible a photograph or something that described the hardship near the time it happened should be kept and presented if a "hobby loss" dispute arises.

7. Appraisals

If significant unrealized appreciation has taken place in the business, or increased values of the horses or the land on which the business was conducted has occurred, the owner may wish to create a record of the values from time to time showing that appreciation, in anticipation of explaining why the horse business was continued.

8. Maximize Gross Receipts

Courts often favor horse businesses that, despite continuing losses, generate substantial gross revenues, presumably based on reasoning that a horse operation which has substantial gross receipts is more likely to be seeking profits.

9. Appearances of Pleasure or Recreation

It is always best to keep business and purely personal pleasure activities involving the horses and property completely separate. With the racing breeds, the absence of riding the operation's horses is already a positive factor. And for farm owners, the absence of recreational riding by the principals and family members are positive factors. Of course, some show horse businesses are operated with family members showing the horses. While this brings greater IRS scrutiny, it is by no means fatal if the business purposes for such participation are clearly outlined from the onset.



10. Consider the Use of a Pass-Through Entity

Use of entities such as LLCs or S corporations to operate a horse business offer limited liability to the owners, which is desirable in a business which includes risk of injury or death, as the horse business does. It also may lend an aura of business intent, since other profit-motivated businesses often use these limited liability business vehicles.

11. Retain Prior Tax Returns

The outcome of a potential "hobby loss" dispute may depend in large part on an assessment of the progress of the activity from its outset. An owner who cannot produce the details regarding all facts affecting the business since inception may be at a disadvantage. Therefore, important records and information pertaining to the business should be retained from the outset.

12. Grouping Check

The owner and advisors should consider if there is a most advantageous "grouping" of business activities for "hobby loss" and "passive loss" purposes and file the tax returns accordingly.

Grouping for purposes of defeating a "passive loss" challenge can be important for several reasons, including since one of the chief goals is to prove 500 or at least 100 hours devoted to the horse activity in any given year. Treasury Regulation ("Treas. Reg.") 1.469(c)(1) provides that multiple trades or businesses may be treated as a single activity if they constitute an "appropriate economic unit" based on "all facts and circumstances," for example, breeding thoroughbred horses and racing them.

The five factors to which the IRS will give most weight in such a determination are:

1. Similarities or differences in the types of businesses
2. Extent of common control
3. Extent of common ownership
4. Geographic location
5. Interdependence of the activities

It would be a rare horse operation which could not have its various functions or divisions consolidated into one activity under those guidelines.



CHAPTER 2: HANDLING AN ACTUAL IRS CHALLENGE TO A HORSE BUSINESS

There are three levels of review afforded to taxpayers examined by the IRS including the audit level, the Appeals Office level, and the Tax Court level, where an IRS District Counsel represents the IRS.

The Audit Level

It is here that the initial IRS examination is made and that the initial and perhaps final determinations are made. This is most often handled by the owner's accountant who will be familiar with requirements and audit techniques. Once a problem arises, for example when the Revenue Agent indicates that he or she is leaning toward a "hobby loss" or "passive loss" determination, it may help the owner to bring in an attorney for advice on whether there is any reasonable chance of changing the position of the Revenue Agent. Under current IRS practice, all evidence that an owner may want to present to the Appeals Office must first be submitted to the Examination Division.

The Appeal

A "30-Day Letter" is essentially a write-up by the Revenue Agent of the case against the owner. It enables presentation of the owner's side of the case in a written "Protest Letter," to be filed within 30 days and requesting a hearing with the IRS Appeals Office. This is a voluntary procedure, but since the only alternative is to go directly into the trial phase, the appeal should almost always be elected. Also, below certain dollar limits, a "Protest Letter" need not be filed but even in those cases we recommend such filing.

The Protest Letter may be the most important document in the case. It is the first contact with the Appeals Officer and should fully set forth the case in the most convincing light, including all applicable law relative to the issues, prepared with the knowledge that the Appeals Office is where the majority of cases are either dismissed or satisfactorily settled.

The second most important contact is the initial conference with the Appeals Officer. Generally, Appeals Officers have heavy caseloads and in appropriate cases, they are willing to dismiss or settle cases which do not offer good prospects for the IRS. It is generally not in an owner's best interest to be personally present at an appeals hearing. A well prepared representative should have all of the facts at hand to present to the Appeals Officer as well as being ready to respond to questions regarding unfavorable facts.



While Appeals Officers are generally sophisticated, they deal in all areas of tax law and cannot be expected to have an expertise in horse cases, much less within any particular breed. So both the Protest Letter and the initial conference should be seen as opportunities to educate the Appeals Officer about the particular horse operation. In the event that the Appeals Officer asks for additional information and it should be supplied in a timely and professional manner.

1. Hobby-Loss Disputes on Appeal

In both the examination division (audit) and appeals division (starting with the protest letter), the nine regulatory factors of Treas. Reg. 1.183-2(b)(1) through (9), should be used as a framework and address each, setting forth the favorable factors which are met, and the qualifying reasons for those in the gray area or which have not been met. Always remember that the owner's intent is at issue, and anything that can show that the owner is attempting to reach the profit goal will help. Six of the nine important regulatory factors to be emphasized are businesslike operation, time devoted, expectation of appreciation in asset values, the history of loss years, occasional profits, and pleasure or recreation aspects:

"...it is the intent of the owner that is at issue, and anything that can show that the owner is attempting to reach the profit goal will help."

Businesslike Operation

If there is no written business plan, as is often the case and the business plan is held mentally by the owner, the owner's representative should set forth in detail the content of the plan and the facts that prove such plan was implemented. For example, implementation of a plan of "selective breeding" for racing, showing, or sale should be relatively easy to demonstrate in actual practice. If the operation is not very large, it may help to prepare a chart showing each horse utilized in the operation and its ultimate disposition or status at the end of the last year at issue, and highlighting any unforeseen hardships suffered (see discussion of "Losses" below). If the books and records are adequate or computerized, examples should be presented. Also cover all favorable facts such as a separate bank account, if any, insurance coverage of horses and other business assets, and the reputations of the professionals engaged, including trainers, farm personnel, and accountants. Finally, any showing of a change in business plan by the owner in an attempt to turn losses around is a favorable fact.

Time Devoted

If a log has been kept, this will be relatively easy to establish. Make a detailed presentation of hours expended, and when possible consider using affidavits or declarations from trainers or farm representatives or other third parties supporting at least the time claimed in those areas.



Unrealized Appreciation in Value

The only reason a "hobby loss" case is usually before the Appeals Officer is because it involves substantial "losses" as reported for tax purposes over a prolonged period, some or all of which may not be actual "losses" at all when unrealized appreciation is factored in. For instance, if the horse operation involves breeding, there may be a high level of unrealized appreciation in horse values, since the tax laws allow the owner, a "farmer," to currently deduct all costs of producing, raising, and training a homebred foal. Further, operations that include farm ownership may involve even more dramatic instances of unrealized real property appreciation.

Explaining Loss Years

This is a most important factor because, as noted, cases simply don't reach the Appeals Office unless there have been a substantial number of consecutive loss years reported on the owner's tax returns. And they must be explained, with more concrete reasons than simply "bad luck." Some of the more prevalent reasons recognized by the IRS for losses in any given tax year, include:

- *Unrealized appreciation*, as stated above, can result in distorted loss figures.
- *The potential for large gains* if the business involves stakes-quality horses or high-quality show horses.
- *Operations still in the "start-up" stage*. This is recognized by both the regulations and case law. Cases have often recognized periods from 5-10 years as a "start-up" stage where profits are not to be reasonably expected.
- *Unforeseen hardships* are also recognized in both the regulations and case law. That is why we earlier recommended keeping a record of all such hardships both internal to the operation and external such as poor market conditions.

*"...an opportunity to
"earn a substantial
ultimate profit"
from a "highly
speculative venture"
is "ordinarily
sufficient" to
indicate that the
activity is engaged in
for profit..."*

Occasional Profits

The representative should always call the Appeals Officer's attention to the statement in Treas. Reg. 1-183-2(b) (7) that an opportunity to "earn a substantial ultimate profit" from a "highly speculative venture" is "ordinarily sufficient" to indicate that the activity is engaged in for profit even though only losses or small profits have occurred. If the owner's representative has done his or her job, the Appeals Officer will know that there is no activity more "speculative" than a horse business. In the field of horse racing, for example, one success is often all it takes.



Personal Pleasure or Recreation

As previously noted, there are sound defenses to claims of personal pleasure in attending race tracks or horse shows, even if there are some pleasure or recreational elements.

2. Passive Activity Loss Disputes on Appeal

Here, the Protest Letter and initial conference will zero in on the one true issue - proof of participation in the horse business on a "regular, continuous, and substantial" basis.

To prove the owner is materially participating, there are seven "safe harbor" tests. The taxpayer must meet at least one test. For a horse operation, these will be the most important:

Passive Loss disputes require proof of participation in the horse business on a "regular, continuous, and substantial" basis.

1. The taxpayers (husband and wife where applicable) work 500 hours or more during the year in the activity.
2. The taxpayers do substantially all the work in the activity.
3. The taxpayers work more than 100 hours in the activity during the year and no one else works more than the taxpayers.
4. Based on all of the facts and circumstances, the taxpayers participate in the activity on a regular, continuous, and substantial basis for at least 100 hours during such year.

In proving material participation, it is generally recommended that a detailed chart of time spent, by date or approximate date, and presented by major category, be offered rather than a general prose summary. *Typical categories might include time spent:*

- at race tracks or horse shows both during training hours and in viewing actual competitions, including consultations with trainers;
- at farm facilities viewing potential stallions, brood mares, and offspring;
- in consultation with other experts, attending seminars, and reading books and periodicals;
- in relevant telephone conversations with trainers and other industry persons;
- studying for and making breeding decisions;
- in negotiating purchases or sales;
- at public auctions and reviewing auction catalogs;
- in administrative tasks such as keeping records, procuring insurance, paying bills;
- with accountants or attorneys;
- in travel connected with all of the foregoing



Documentation of time will need corroboration. The most common types are telephone records and credit card records, but those will rarely prove enough time spent. We recommend securing affidavits or declarations from third parties such as a trainer or farm personnel, supporting the owner's claims of a certain number of visits and approximate hours spent during those visits. This will serve the dual purpose of corroborating at least some of the time devoted and letting the Appeals Officer know that in the event of trial this will be the testimony of witnesses that the IRS will have to rebut.

The owner's representative should remember that a spouse's time devoted also "counts." A separate chart for the spouse is often helpful, and the spouse's presence on business occasions should be included as a part of the affidavits or declarations.

Finally, an owner who hires and supervises those responsible for taking care of the horses on a daily basis, along with making business decisions regarding the purchase, sale, and breeding of horses should qualify as participating on a "regular, continuous, and substantial" basis.

3. Finalizing the Appeal

After the "Protest Letter," the initial conference with the Appeals Officer, and for some cases, the submission of the supplemental documentation, there will come a time for settlement discussions. In some instances, the goal will be to settle the case for less than a trial would cost your owner-client. Under a new internal policy released in July and August of 2014, in cases that are not already pending in the U.S. Tax Court, submission of new evidence or new information to the Appeals Office is grounds to return the entire case to the Examination Division so the original revenue agent can consider the new information or evidence. The Appeals Officer has some discretion not to return a case to the Examination Division, but the clear intent of this new policy is to get taxpayers to show all of the information and evidence that they have to the examiner in the Examination Division.

There are ample opportunities and different reasons for negotiation and settlement even in the trial phase. So we would never recommend an unfair settlement at the Appeals Office stage. If there is no acceptable settlement offer at the Appeals level, the owner faces a choice: (1) file a petition with the U.S. Tax Court; or (2) pay the tax claimed and sue for a refund in the U.S. District Court. Some believe that the U.S. District Court is a more favorable forum for taxpayers, but an owner must first pay all of the taxes, plus penalties, plus interest claimed by the government before the owner can contest the matter in U.S. District Court. It is very rare for owners to choose this course.

To contest the IRS determination in the Tax Court, the owner's representative files the Tax Court Petition, the IRS answers it, and the case is assigned to a Tax Court Judge for trial. The owner's Petition is a straightforward pleading.



Preparation for Trial and Negotiating with the IRS Attorney

This is the final phase in the case. It will generally proceed on two parallel "tracks." The first is the sometimes laborious process of stipulating facts with exhibits where appropriate. The second parallel track is the ongoing negotiation between the IRS Attorney and the owner's counsel. The vast majority of Tax Court cases are settled before trial by negotiation - otherwise, the IRS and the Tax Court would be inundated. The goal for owner's counsel is to convince the IRS Attorney that this is a case the IRS Attorney does not want to try. The owner's counsel can reasonably expect that the government has other cases that are pressing, that the IRS Attorney would like to get rid of some, and that the IRS Attorney will constantly be evaluating the caseload for weak cases.



CHAPTER 3: SOME ADVANTAGES TO SEEK IN AN IRS DISPUTE

Recovery of Costs and Attorney Fees in General

IRC Sec. 7430 provides for the possibility of an owner recovering reasonable attorneys fees and costs from the IRS. This generally applies if the owner is the "prevailing party" and can establish that the position of the IRS was not "substantially justified," that they cooperated with the government during audit and appeal, that they kept records, and that certain net worth requirements are met.

The "Qualified Offer"

In the past, attorneys fees and costs were rarely recovered by owners because the courts generally accepted the IRS defense of "substantial justification" even when the owner was the "prevailing party." But a relatively new addition, IRC 7430(g), gives the owner an advantageous tool called a "Qualified Offer."

Upon issuance by the IRS of a "30-Day Letter", the owner can submit to the IRS a Qualified Offer to settle the case for a specified amount. This is recommended in virtually every case. The existence of the Qualified Offer can have a positive effect on the IRS Appeals Officer or the IRS Attorney. Since it does not work both ways, the taxpayer will never be liable for reimbursing the costs and attorney fees after an unsuccessful trial!

To have a chance of gaining this valuable advantage at trial, the owner's representative must be aware throughout the audit, appeal, and trial preparation, of the need for cooperation with the IRS and the need for establishing the adequacy of the owner's records, as well as other requirements of the law.

Shifting the Burden of Proof to the IRS

The taxpayer normally bears the burden of proof in tax cases. However, IRC 7491 was designed to shift that burden to the IRS in certain instances. The law is clear that the burden of proof should shift to the IRS upon the introduction of credible evidence by the taxpayer. Unfortunately, this law is virtually ignored by the Tax Court.



CONCLUSION

In several important respects, it is possible for an owner to obtain the "upper hand" in an IRS audit, appeal, or trial process relative to challenge of the owner's horse business on either a "hobby loss" at a "passive loss" basis.

To obtain the advantage, the owner should first utilize some preventive long-term steps to preclude an audit altogether, particularly the preparation at the outset of a written business plan and a separate bank account, the establishment and maintenance of books and records with the assistance of a professional accountant, consultations with industry experts, maintaining records of hardships encountered, and keeping a record of appreciation in the value of the operation's assets, particularly horses and farm land, if applicable. The potential "passive loss" challenge makes the proof of time devoted to the activity paramount, with a daily "log" being the ultimate planning tool.

During an actual challenge by the IRS at the audit level, the appeals level, and the trial preparation level, we have noted various techniques and strategies which may give the owner an advantage, including use of the "Qualified Offer".



ENDNOTES

Richard W. Craig and B. Paul Husband are both experienced equine tax attorneys. They wrote *Tax Planning For Horse Owners & Breeders* for the University of Kentucky School of Law Monograph Series. They have lectured together on numerous occasions and regularly cooperate on cases. Their combined experience has placed them among today's top equine tax attorneys in the United States.

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