AMERICAN HORSE COUNCIL FALL NATIONAL ISSUES FORUM

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KEENELAND RACETRACK

LEXINGTON, KENTUCKY

November 2, 2007

PASSIVE LOSSES FOR HORSE OWNERS

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A. Limitation on Passive Losses

The 1986 Tax Act added Section 469 to the Tax Code, providing that losses and credits from any business in which the horse owner does not materially participate are not allowed to offset salaries, active business income, or portfolio income such as interest, dividends or royalties. The limitation applies whether the individual directly owns an interest in the business as a sole proprietor, as a part owner in a business conducted in the form of a pass-through entity such as a partnership or S corporation, or as a part owner in a closely held C corporation or personal service corporation.

Losses and credits from this business activity (called a "passive activity") are deductible against "passive" income. Losses which are not currently allowed can be carried forward indefinitely and' used in subsequent years to offset passive income. Passive losses which are not allowed in full while a taxpayer owns an interest in the activity will be allowed in full when the entire interest in the activity is sold or otherwise liquidated This rule applies to passive losses incurred after 1986.

B. Material Participation

For an individual to materially participate in an activity, he must be involved in the operations of the activity on a basis which is regular, continuous, and substantial. To determine if this standard is satisfied, "all the facts and circumstances" of each situation must be examined.

The IRS regulations provide that an individual is deemed to have materially participated in a horse business or other activity during the tax year only if the individual satisfies at least one of several tests. The most pertinent of these tests for horse owners and breeders are:

1. The individual participates in the activity for more than 500 hours during the year.

2. The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year.

3. The individual participates in the activity for more than 100 hours during the taxable year, and the individual's participation is not less than that of any other individual (including individuals who are not owner of interests in the activity for such year).

4. The activity is a "significant participation activity" for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours. A significant participation activity is a business in which the individual participates for more than 100 hours during the tax year, but does not materially participate within the meaning of one of the other tests.

   (The purpose of this rule is to allow an individual who devotes more than 500 hours during the year to several activities, each of which is a significant activity of the individual, to be treated the same as someone who devotes an equivalent amount of time to one activity.)

5. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year. The regulations say that an individual's services performed in the management of the business shall not be taken into account in applying the facts and circumstances test if:

   (i) a paid manager participates in the business, or

   (ii) any other individual spends more time on management services than such individual (the individual being tested).

   While the regulations do not not set forth what facts and circumstances are taken into account, the regulations do state that an individual who does not participate for more than 100 hours during the tax year cannot, in any event, meet the facts and circumstances test. Further, even though an individual meets participation standards under another provision in the Tax Code, this is not taken into account for purposes of the passive loss limitations.

   In other words, if you do not spend more than 100 hours on the horse business during the year (which are counted as hours under the rules), there is no way you can be treated as materially participating in a business unless your participation is

substantially all of the work done by all people involved with the business, including farm managers, consultants, and any employees.

Participation - Generally, all work done in connection with a business in which you own an interest counts toward hours spent. You can also count your spouse's time, whether or not he/she is an owner and whether or not a joint return is filed. Work not customarily done by an owner or work done principally to meet the hourly test is not counted if done just to meet the test. Also not taken into account is work done in an individual's capacity as an investor, such as studying and reviewing financial statements and reports on operations of the business, preparing summaries or analyses of the finances or operations of the business for your own use, and monitoring the finances or operations of the business in a non-management capacity.

On the other hand, regular but seemingly routine activities, such as reading periodicals and attending races or shows to watch and evaluate your horse's performances, may very well qualify as material hours spent. Frequent discussions with a trainer, even if not immediately greeted with enthusiasm, are also in order and valuable. For their part, trainers should recognize the need for owners to document regular and meaningful participation.

With respect to farming activities such as the horse breeding and racing business , the legislative history takes a fairly broad view in its determination of whether an individual is a material participant in such activities. Specifically the Senate Finance Committee Report to the 1986 Tax Reform Act states that "[I]n the case of farming, the Committee anticipates that an individual who does not perform physical work relating to a farm, but who is treated as having self-employment income with respect to the farm under Section 1402, generally will be treated as materially participating." The Committee Report further states "[I]n determining material participation, the performance of management functions generally is treated no differently than rendering other services or performing physical work with respect to the activity." The Committee Report give as an example of qualifying management decisions in farming activities the following:

> "With respect to material participation in an agricultural activity, clarification is provided regarding the decision-making that, if bona fide and undertaken on a regular, continuous, and substantial basis, may be relevant to material participation. The types of decision- making that may be relevant in this regard include, without being limited to, decision- making regarding (1) crop rotation, selection, and pricing, (2) the incursion of embryo transplant or breeding expenses, (3) the purchase, sale, and leasing of capital items, such as cropland, animals, machinery, and equipment, (4) breeding and mating decisions, and (5) the selection of herd or crop managers who then act at the behest of the taxpayer, rather than as paid advisors directing the conduct of the taxpayer."

Records - According to the regulations, one can prove the requisite number of hours by any reasonable means, including appointment books, calendars, and narrative summaries. It is not

necessary to keep contemporaneous records or details of hours spent in connection with the business, but it is a good idea to develop a habit of consistent documentation.

Special rules permit persons who had materially participated in farming activities prior to retirement or disability to be treated as materially participating during retirement or disability. Similar rules permit the surviving spouse of a decedent who had materially participated in the farming activity to be treated as materially participating if the surviving spouse makes the management decisions of the activity (other than the daily operating decisions and other tasks.)

Many of the factors that are relevant to whether a horse related activity is engaged in for profit (for example, business plans, the owner' s knowledge of the business, and consultation with experts) are also relevant to whether the owner of that activity materially participates. However, the records also must show the extent of the owner's involvement in the daily operations of the business and management, which is not always required in showing a business motive where the reliance on an expert trainer or farm manager is often enough.

The "material participation" requirements are set forth in section 1.469-5T the regulations.

C. Definition of an Activity

The importance of knowing whether various similar activities conducted by an individual are one activity or separate activities can be very important in determining whether losses are classified as passive and therefore nondeductible against non-passive income. For example, if you own a racing stable in which you spend 60 hours a year and a breeding business in which you spend about 90 hours a year, can you treat the two as one activity and thus meet the 100 hour minimum requirement?

The new regulations state that, "one or more trade or business activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes"of the passive loss rules. Whether activities are treated as a single activity depends upon all the relevant facts and circumstances. A person may use any reasonable method of applying the relevant facts and circumstances in grouping activities according to the regulations. The most important factors are: (1) similarities and differences in types of business, (2) the extent of common control, (3) the extent of common ownership, (4) geographical location, and (5) interdependencies between activities (for example, the extent to which activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees or are accounted for with a single set of books and records).

The regulations also allow grouping of activities into one or more activities when the activities are operated through a partnership or an S corporation. First, the partnership or S corporation groups the activities using the guidelines previously discussed. Once a partnership or S corporation determines its activities, each partner or shareholder may group those activities with activities conducted directly by that partner or shareholder or with activities conducted through other

partnerships or S corporations in which that person owns an interest. Again, the shareholder or partner would use the guidelines previously discussed in making the grouping.

The grouping rules are less flexible for a limited partner or limited entrepreneur. A limited entrepreneur is a person who owns an interest in an enterprise which is not a limited partnership and that person does not actively participate in the management of that enterprise. A limited partner or limited entrepreneur can only group the activities of that limited partnership or enterprise with the activities of another business interest if the activities are the same type of business.

A rental activity can be grouped with a non-rental business only if the activities are an appropriate economic unit under the rules discussed above and (1) the rental activity is insubstantial in relation to the non-rental business or (2) the non-rental business is insubstantial in relation to the rental activity or (3) the ownership of the rental activity and the non-rental business is the same. This means it is possible to group a horse business with an apartment complex if the ownership is the same -- something that might be helpful toward meeting the "material participation" hourly requirements.

Once a person groups activities into a single activity following the guidelines of the regulations, the grouping must be used in each year thereafter unless a change of circumstances occurs.

The "activity" rules are set forth in section 1.469-4 of the regulations.

D. Limited Partners

The statute provides that a limited partner is normally treated as a passive investor (not a material participant) unless the regulations provide otherwise. Under the IRS regulations, a limited partner may be treated as an active participant if the limited partner (1) spends more than 500 hours during the year in the business, or (2) is treated as materially participating in the business either because he materially participated in the business in any five of the past ten years or because the business is a personal service activity in which he materially participated in three previous years.

If an individual is a general partner and a limited partner in the same business, that individual, in effect, will be treated as a general partner and therefore will be a material participant if he or she meets one of the tests discussed previously.

E. Passive Income

Income generated from the sale of property used in a passive activity is generally treated as a passive income if the activity is passive at the time of sale. This means that selling horses can generate passive income which can offset passive deductions. There is an exception for substantially appreciated property if the property appreciated while it was used in a nonpassive activity.

Income received after 1986 from an installment sale of a passive activity which occurred prior to 1987 will be treated as passive income if the activity would have been classified as passive when the installment sale occurred. For example, income from horses sold in 1986 on a five-year installment sale will be treated as passive income in each of the years the income is received assuming the activity was passive in 1986.

Income from one activity cannot be artificially characterized as passive income in order to be able to deduct passive losses from another activity. For example, an individual might want to treat the income from a successful "widget" business as passive by spending less than 500 hours a year on the business, even though the individual' s participation and services are significant in generating the income from that business. In that case, the regulations conclude that if an individual spends over 100 hours (but less than 500), income from that activity may be treated by the IRS as income from a non-passive activity.

F. Portfolio Income Not Passive

An individual's portfolio income cannot be reduced by passive losses regardless of whether the income is from a different activity in which the individual does not materially participate. Thus, it is important to know what is considered portfolio income. It is:

(1) gross income from interest, dividends, annuities, or royalties not derived from a business, less expenses (other than interest) allocable to this income; and

(2) gains or losses from sales or other dispositions of property which produces interest, dividends, annuities, or royalties from property held for investment.

Does income from the sale of farm land which was used or held for potential use in a horse business constitute portfolio income? If the land was used in the business, it would appear that income from a sale of farm land would not be portfolio income. This depends on the facts and circumstances. Since income from the sale of land which is not being used may be treated as portfolio income, it may be advisable to take steps prior to sale, such as subdividing the land, and making it clear that the land is being held primarily for sale (dealer sales).

G. Partnerships

Complying with the passive loss rules obviously is more difficult when you are operating in a partnership form. Each partner will have to demonstrate that he or she is materially participating in order for that partner to deduct any losses against income from sources which are not "passive". Some partners may satisfy the requirements and avoid the passive loss limitations and other partners may not. In order for all partners to avoid the passive loss limitations, every partner must play a very active role in operating the partnership, keeping in mind that a partner may be able to group various related partnership and S corporation interests in determining whether he or she has a significant number of hours.

H. S Corporations

The new rules apply individually to each shareholder of a Subchapter S corporation. Therefore, each shareholder has to materially participate in the business in order to deduct the losses against non-passive income, again keeping in mind that it may be possible to combine other interests in order to meet the required hours.

I. Closely Held Corporations

If more than 50% of the value of the outstanding stock of a corporation (which is not an S corporation) is owned by five or fewer individuals, the passive loss rules apply on a modified basis to that corporation. If the closely held corporation does not materially participate in an activity, losses from that activity may nevertheless be used to offset income from active business activities, but net passive losses cannot be used against portfolio income (interest, dividends and royalties). Thus, an individual cannot set up a regular C corporation to shelter interest and dividend income, but can use it to shelter other active business income with passive losses.

Attribution rules apply in determining the number of shareholders.

J. Personal Service Corporations

The modified passive loss limitation rule for closely held C corporations does not apply to personal service corporations. A personal service corporation is defined as a C corporation whose principal activity is the performance of personal services substantially performed by employee-owners. It does not apply to corporations where employee-owners together own less than 10 percent of the stock. Applying the full passive loss limitations to personal service corporations is designed to limit the ability of a group of lawyers or doctors to circumvent the passive loss limitations by running their outside passive business activities through their professional corporation.

K. Passive Losses Allowed in Later Years

A loss from a passive activity can be deducted against income generated by any other passive activity. The passive activity does not have to be the same type of business. For example, if an individual has passive income from a real estate tax shelter or another passive horse business, he or she can offset it with losses from a limited partnership engaged in horses or losses from any other horse business in which that person does not materially participate.

A loss from a passive horse business or other activity which is not deductible in one year carries over indefinitely and is deductible in subsequent tax years against passive income.

Passive losses from a particular activity which have been set aside in one or more previous years are fully deductible in the year when the individual's entire interest in that passive activity is sold or otherwise terminated. The disposition must be a transaction in which all gain or loss from the activity is recognized for tax purposes.

When there is a taxable sale of an entire interest in a passive activity, losses from the activity which have not been previously deducted are allowed in the following order:

(1) first, against income or gain (profit) from the passive activity for the year (including the gain from sale),

(2) next, against net income or gain from all passive activities that year, and (3) finally, against all other income or gain.

The rules for the treatment of disallowed losses are set forth in section 1.469-1T(f).