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SECTION 183 - - HOBBY LOSSES: AN OVERVIEW & UPDATE

BY:

Douglas P. Romaine, Esq.
STOLL KEENON OGDEN, PLLC
300 West Vine Street, Suite 2100
Lexington, KY 40507
(859) 231-3000
douglas.romaine@skofirm.com

I. Profit Intent.

A. General Principles

1. Rationale Behind Section 183.

Section 183 of the Internal Revenue Code serves to express the intention of Congress to disallow expenses generated from activities which are carried on primarily as sport, hobby or recreation. The determination of whether an activity is engaged in for profit is to be made by reference to the objective standards, taking into account all the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity or continued the activity with an hones and actual objective of making an economic profit independent of the tax considerations. Antonides v. Commissioner, 91 T.C. 686, 694 (1988).

2. Subjective Intent Determined by Objective Standard.

The goal must be to realize a profit on the entire operation, which presupposes sufficient net earnings to recoup earlier losses. King, T.C. Memo 1993-237. In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent. Engdahl v. Commissioner, 72 T.C. 659, 666 (1979).

3. "Not engaged in for profit" Defined.

The term "not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under

Section 162 or Section 212 (1) and (2). If an activity is not engaged in for a profit, the amount of deductions which the taxpayer may take against gross income will be limited to the amount of income produced by that activity. *Compare* Toth v Comr., 128 TC No 1 (01/18/2007) holding that Section 195(a) does not require the taxpayer's expenses for horse boarding and training activity to be capitalized as start up expenses. The taxpayer and IRS stipulated that the expenses were deductible under Section 212 as income producing expenses rather than trade or business expenses deductible under Section 162.

4. Presumption of Profit Motive: General Rule.

Section 183 (d) creates a presumption of a profit motive if the taxpayer can show that in three out of five consecutive years the activity in question produced more income than expenses.

5. Presumption of Profit Motive: Application to Equine Industry.

If the activity is one which consists in major part of breeding, training, showing or racing of horses, the requirements for receiving the benefits of the presumption are lessened and a showing of profit in two out of seven consecutive years will suffice to create the presumption that the activity was engaged in for profit. The regulations under Section 183 set out the presumption that the activity consists in major part of the breeding, training, showing or racing of horses if fifty percent of the expenses incurred during the preceding three tax years are attributable to the horse business.

6. Results of Meeting the Presumption.

Once the taxpayer has met the requirements of the presumption set up in Section 183(d), the burden of proof will be upon the Commissioner to show that the main objective of the taxpayer was one other than profit. Specifically, the Commissioner will need to show that the main objective of the taxpayer was the reduction of tax liability produced by the deductions created by the activity. If the taxpayer fails to meet the requirements of Section 183(d), no inference that the activities not engaged in for profit shall arise by reason of the provisions of Section 183. However, once the Commissioner has assessed a deficiency, the burden of proving that a profit motive was present is placed on the taxpayer. Baxter v. Commissioner, 816 F. 2d 493, 495 (9th Cir. 19).

7. Election.

(a) Delaying Determination of Profit Motive.

Section 183 permits the taxpayer to elect to receive the benefit of the presumption set out in Section 183(d) and to have the final

determination of whether the activity was engaged in for profit postponed until the close of the relevant period. Regarding activity which consists in major part of breeding, training, showing or racing of horses, the final determination of whether the taxpayer has met the requirements of the presumption would be postponed until the close of the sixth taxable year after the first taxable year in which the activity was first engaged in. For the purposes of setting the time period of consecutive years, a short taxable year will be considered a full taxable year.

(b) Extended Period for Assessing Deficiencies.

To protect the Commissioner's ability to assess a deficiency against the taxpayer who has made an election under Section 183 to receive the benefits of the presumption set out in Section 183(d), the Commissioner is given express authority to assess a deficiency against a taxpayer who has made the election for an additional two years following the close of the last taxable year to which the election relates, regardless of any other limitations imposed upon the Commissioner's ability to asses a deficiency against a taxpayer.

(c) Results of Failure to Meet Requirements.

The failure of the taxpayer to meet the requirements set out in the safe harbor provisions of Section 183(d), creates no inference that the activity is not engaged in for profit. The final determination of whether the activity is engaged in for profit shall be made pursuant to the facts and circumstances of each case, taking into account the relevant factors which the Code sets out in the regulations under Section 183.

8. Segregation of Separate Activities.

(a) General Principles.

A taxpayer may be involved in several undertakings which may constitute a single activity or a series of separate activities. 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 organization 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.

(b) Acceptance of Taxpayer Determination if Reasonable.

The Commissioner will accept the taxpayer's characterization of the activities as related or separate as long as his characterization does not appear artificial and can be reasonably supported by the facts and circumstances of the case. The regulations under Section 183 set out the presumption that the activity consists in major part of the breeding, training, showing, or racing of horses if fifty percent of the expenses incurred during the preceding three tax years are attributable to the horse business.

(c) Case law.

(i) Topping v. Comr., T.C. Memo 2007-92 (04/17/07) Tax Court allowed the taxpayer to aggregate her equestrian activity, which consistently generated a loss, with her profitable business of designing homes and barns for wealthy horse owners. As a result the hobby loss rules didn't apply and the equestrian activity deductions were allowed. The close organizational and economic relationship between the activities overcame the fact that the taxpayer reported the activity and business on separate Schedule Cs for the years at issue. The court stated that the success of the taxpayer's interior design business was far from incidental to her equestrian contacts and that the taxpayer's involvement in the equestrian world was the cornerstone of her relationship with her clients.

(ii) Compare the following in which no integration and interdependence were found so as to permit aggregation: DeMendoza v Comr., 1994-314 (real estate law firm/farming and polo activities); Wilkinson v. Comr., T. C. Memo 1996-39 (cosmetic plastic surgeon/polo horse ranch); and Zdun v. Comr., T. C. Memo 1998-296 (dentist/organic apple orchard).

(d) Similar Activities in Different Locations.

(i) The Tax Court ruled in Davis v. Commissioner of Internal Revenue, 29 T.C. 878 (1958), that farming operations in different geographic locations were separate activities even though all locations were engaged in farming.

(ii) In Stuckey v. Commissioner of Internal Revenue, T.C. Memo. 1982-537, the court held that the activity of grain farming in Iowa constituted a separate activity from horse breeding in Ohio.

9. Deductions.

If the activity is ruled to be one that is not engaged in for profit, Section 183 sets out the amount of deductions which may be taken for that activity. The deductions which may be taken are allocated among three tiers as set out in the regulations.

(a) Tier One.

Tier One involves deductions which are allowable regardless of whether the activity is determined to be engaged in for profit, such as real estate taxes. First tier deductions are deductible in their entirety, subject to the limitations which are set out in the other provisions of the Internal Revenue Code.

(b) Tier Two.

Second tier expenses are those out-of-pocket expense which are attributable to the activity which has been deemed not to be engaged in for profit. If the activity has produced income which exceeds the amount of the Tier One deductions, then the remaining income will first be allocated to Tier Two deductions, and if there is any income remaining after Tier Two deductions, then the remainder of the income will be allocated to the Tier Three deductions.

(c) Tier Three.

Third tier deductions are those expenses which affect, the basis of property, such as depreciation, partial losses with respect to property, partially worthless debts, amortization and amortizable bond premiums. As stated above, Tier Three deductions relate to the adjustment in the basis of property used in the activity. To determine the reduction in the basis of Tier Three property, the following formula is set out in Treas. Reg., Section 1.183-1(2). Take the amount of the basis adjustment which would have been allowed for the particular property had the activity been ruled as engaged in for profit and multiply by the basis adjustment fraction.

(i) Basis Adjustment Fraction.

(a) Numerator.

The numerator of this fraction is the total amount of income which is remaining after deductions are allocated to Tier One and Tier Two.

(b) Denominator.

The denominator is the total amount of deductions for all Tier Three property had the activity been ruled as engaged in for profit.

(ii) Actual Adjustment to Basis in Tier Three Property.

The basis in the Tier Three property will only be reduced by the amount of the deduction allowed to the taxpayer for that property.

(d) Further Limitations on Deductions: Sections 67 & 68.

The amount of deductions allowable for an activity which is deemed not to be engaged in for profit are further limited by Sections 67 and 68 of the Internal Revenue Code.

(i) Section 67.

Section 67 of the Internal Revenue Code states that no deduction shall be allowed unless the amount of the deduction exceeds two percent of the adjusted gross income of the taxpayer. However, Tier One deductions are unaffected by this provision. Thus, no deductions for Tier Two or Tier Three may be taken unless the amount of income which is leftover after Tier One deductions have been taken exceeds two percent of the adjusted gross income of the taxpayer.

(ii) Section 68.

Section 68 is a further restriction upon the deductions which may be taken by the taxpayer. If the adjusted gross income of the taxpayer exceeds $100,000.00 for the year in question or $50,000.00 for a married individual filing separately, the amount of the deduction shall be reduced by the lesser of three percent of adjusted gross income in excess of $100,000.00 or eighty percent of the itemized deductions that the taxpayer has for the year in question.

(e) Effect of Net Operating Loss.

A net operating loss deduction is not taken into account as a deduction for the purposes of this determination.

II. Objective Factors Used in Making Profit Motive Determination.

The regulations set out nine factors to be considered in making the determination of whether or not the activity is engaged in for profit. No single factor is considered to be

conclusive in making this determination, nor are these nine factors considered to be the only factors which will be considered in making the determination of whether the activity was engaged in for profit. Engdahl v. Commissioner, 72 T.C. 659, 666 (1979).

A. Manner in which the taxpayer carries on the activity.

The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicated that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

The term businesslike manner contemplates the use of cost accounting techniques that provide the taxpayer with information required to make informed business decisions. The purpose of maintaining business books and records is more than to memorialize for tax purposes the existence of the transactions and includes providing a means of periodically determining profitability and analyzing expenses. In the context of horse breeding activities, the courts have indicated that an absence of detailed monthly expense records for each animal may indicate a lack of profit motive.

Conversely the commingling of funds between personal and activity funds is not indicative of businesslike manner.

It is also good businesslike practice to prepare a written business plan which should be reviewed with competent business advisors and modified from time to time to reflect changes in operations and methods to improve profitability.

B. The expertise of the taxpayer or his advisors.

Preparation for the activity by extensive study of the accepted business, economic and scientific practices or consultation with those who are expert therein may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice but does not carry on the activity in accordance with such practices, lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity. Mere conversations with a CPA or financial advisor without advice regarding the economic aspects of carrying on a horse activity for profit are not sufficient.

C. The time and effort expended by the taxpayer in carrying on the activity.

The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

D. Expectation that assets used in the 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 profit from current operation 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 the appreciation of land will exceed expenses of operation.

A horse breeder may also include the increase in the value of his farmland used in relation to the activity in his attempt to prove a profit motive. However, under the Treasury Regulations Section 1.183-1(d)., "where land is purchased or held primarily with the intent to profit from the increase of its value, and where the taxpayer also engages in farming on such land, the farming and holding of the land will ordinarily be considered a single activity only if the income derived from farming exceed the deductions attributable to the farming activity which are not directly attributable to the holding of the land." If land appreciation of a horse farm is to be considered a positive factor in determining whether the farm is operated for a profit, the land must be used directly in connection with the horse operations and any increase in values should substantiated with competent appraisal.

Similarly any claimed appreciation in horse values should likewise be properly documented.

E. The success of the taxpayer in carrying on other similar or dissimilar activities.

The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the activity for profit even though the activity is presently unprofitable.

F. The taxpayer's history of income or losses with respect to the activity.

A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. For horse breeding activities, the courts have recognized that a 5 to 10 year start up period can be expected. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable

status, such continued losses, if not explained as due to customary business risks or reverses, ,ay be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, or other involuntary conversions or depressed market conditions, such losses would not be indicative that the activity is not engaged in for profit.

G. The amount of occasional profits, if any, which are earned.

The amount of profits in relation to the amount of losses incurred and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses or from an activity in which the taxpayer has made a large investment would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit, even though loses or only occasional small profits are actually generated.

H. The financial status of the taxpayer.

The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity, particularly if the losses from the activity generate substantial tax benefits, may indicate that the activity is not engaged in for profit, especially if there are personal or recreational elements involved.

I. Elements of personal pleasure or recreation.

The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return or which would be more likely to be profitable is not evidence the activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit.