Equestrian Activities and the Hobby Loss Rules

I. Effect of Hobby versus Business Distinction

Section 162 of the Internal Revenue Code (the "Code") generally allows taxpayers to deduct expenses incurred (a) in a trade or business or (b) for the production or collection of income or for the management, conservation or maintenance of property held for the production of income. Further, for the expenses to be deductible, the taxpayer must engage in or carry on an activity to which the expenses relate with an actual and honest objective of making a profit. The taxpayer additionally bears the burden of proof that he engaged in the activity with an actual and honest objective of realization of a discernable profit.

The Code thus permits a taxpayer to deduct, from unrelated income, losses from a horse-related business undertaken with the intention to realize a profit. However, if the horse-related activities are a hobby, rather than a business, Section 183 of the Code limits the deduction of hobby expenses to the extent of hobby income. The distinction between a horse-related business and an equestrian hobby is thus critical. Further, if a taxpayer claims equestrian activities as a business and the Internal Revenue Service (the "IRS") prevails in the recharacterization of the equestrian activities as a hobby, the IRS will recalculate the related tax liabilities for, at least, the three prior years and thus collect additional taxes as well as interest and, possibly, underpayment penalties.

The IRS is well aware that a significant number of improper deductions are claimed for hobby losses, and, in fact, a 2007 Treasury Department report estimated that over $2.8 billion in income tax revenue was lost in 2005 due to improper hobby loss deductions. It is important to note that equestrian activities are amongst the areas highlighted in internal IRS documents as areas susceptible to abuse and suggested for additional scrutiny.

II. Relevant Factors in Hobby versus Business Distinction

The distinction turns on intent—whether the taxpayer intended to realize a profit rather than whether a profit was, in fact, realized—but, if the taxpayer shows a long string of losses, it will be difficult to contend the taxpayer endured a significant record of losses, and, yet, engaged in the equestrian activities with a profit motivation and objective. The IRS examination of a taxpayer and his claims will involve application of standards set forth in the Treasury Regulations to the facts and circumstances of the specific taxpayer and, further, affords little weight to "form over substance" arrangements or to unsubstantiated claims by the taxpayer.

A. Treasury Regulations. The Treasury Regulations set forth nine factors that are to be considered in the determination of whether a venture is a hobby or a business.

1. 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 indicate that the activity is engaged in for profit. The taxpayer needs to demonstrate consistent efforts to maximize profitability through appropriate steps to increase revenues and reduce expenses. It is thus likely that the IRS examiner will inquire about a written business plan (and determine if the taxpayer followed the plan and, if the original plan was not successful, whether the taxpayer amended the plan to increase profitability), current financing for the business, whether the business carries insurance, and whether it advertises or maintains a yellow pages listing. It is important to note that the presence of sophisticated books and records will not suffice to prove a profit motive as the taxpayer must demonstrate reliance upon these records in order to operate the activity and make decisions or changes.

2. Expertise of the Taxpayer. Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive if the taxpayer carries on the activity in accordance with these practices (subscriptions to professional or business journals and membership in professional or trade

organizations can be helpful). However, if a taxpayer has preparation or procures expert advice, but does not carry on the activity in accordance with these practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques that may result in profits. In addition to the technical expertise necessary to operate the venture, expertise or consultation should also be obtained in the economic and commercial environments of the business.

The most recent version of the Audit Technique Guide used by IRS examiners to guide their taxpayer audits of hobby loss claims notes that the examiner needs to document specific instances whereby the taxpayer was advised by his experts to make changes and the taxpayer ignored the advice and the reasons that the taxpayer chose to ignore this advice and advises that, "if the taxpayer chooses not to implement the suggested changes and cannot provide just cause for doing so, then the taxpayer's use of advisors is questionable."

3. Time and Effort Expended by Taxpayer. The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not offer 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.

   The Audit Technique Guide notes that the examiner "should prepare an analysis that shows how much time is devoted to the activity as well as a breakdown of how that time is spent. For example, the examiner should designate how much is spent attending seminars, reading magazines and journals, or how much time is spent performing repairs and maintenance and so forth" and adds that "[t]ime and effort expended reading magazines, journals, and other periodicals are consistent with engaging in a hobby." The maintenance of a log book of time spent on the activities, although time consuming, thus may well be useful.

4. Expectation that Assets may Appreciate. The term profit encompasses appreciation in the value of assets, including land, used in the equestrian activities. 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 operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expense of operation. Appraisals and evidence that the taxpayer investigated appreciation of similar assets will be useful and, additionally, the taxpayer needs to be able to explain to an IRS examiner why the assets are expected to appreciate in value.

   However, if the operation of the activity and the holding of the assets are considered to be separate activities, the appreciation of the assets will not be considered for overall profit and the history of operational losses cannot be offset by the potential gain from asset appreciation. The Audit Technique Guide also suggests that the examiner inquire if the taxpayer intends to retire on the site (an area of concern, certainly, for many equestrians who wish to remain on their farms) and notes that taxpayers often purchase certain properties for future retirement. The Audit Technique Guide observes that, although the record of Tax Court cases is mixed with respect to taxpayers who expressed retirement purposes as an intention for land acquisition, the examiner should nonetheless address the issue since no single factor is determinative in the hobby versus business determination.

5. Success of the Taxpayer in other 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 present activity for profit, even though the activity is presently unprofitable. Of course, if the taxpayer can demonstrate that he was, in the past, able to turn an unprofitable venture into a

profitable business, the taxpayer will have some persuasive evidence in his favor. The Audit Technique Guide directs IRS examiners to focus on the profitability of activities other than the taxpayer's primary source of income and further directs the examiner to document any specific instances in which the taxpayer abandoned certain activities that proved to be unsuccessful. Therefore, if a business record indicates abandonment of prior unsuccessful ventures, taxpayer decisions consistent with a business motive, the taxpayer will be challenged to explain the continuation of an unsuccessful venture with hobby appeal.

6. History of Income or Losses. 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. 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 explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit. Further, circumstances that point to a more profitable future, or a trend toward profitability, may also favor the taxpayer subject to audit.

7. Occasional Profits. 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 losses or only occasional small profits are actually generated. It is important to be able to explain why prior irregular profits will become future consistent profits, and, therefore, if there are significant losses, the taxpayer is advised to underscore the speculative nature of the business and his expectation that he will recoup past losses out of future profits. The Audit Technique Guide suggests that the examiner consider the occasional profits generated by the activities and determine the source of the gross receipts in the event that the gross receipts were misreported on the tax return and thus resulted in the misstatement of the profitability of the activity.

8. 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. The IRS position is that, whereas lower-income taxpayers have a greater incentive to make activities profitable and to receive lesser tax subsidies from hobby deductions, higher-income taxpayers are more willing to spend greater resources on unprofitable activities and receive greater tax benefits (due to higher marginal rates) from deduction of hobby losses. The record indicates that many Tax Court cases involve taxpayers with other substantial sources of income who engaged in historically unprofitable activities without abandonment, and, in general, the record of success in Tax Court litigation for taxpayers with other substantial sources of income is less impressive than for taxpayers without similar financial resources.

9. 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 that an 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 if the activity is, in fact, engaged in for profit as evidenced by other factors. The Audit Technique Guide advises the examiner to consider whether the taxpayer would continue the activity even if the taxpayer "never made a profit" and treats the likelihood of continuation as an indication of a hobby.

However, the Audit Technique Guide is clear that no single factor controls, other factors may be considered, and the mere fact that the number of factor indicative of the lack of a profit objective exceeds the number indicating the presence of a profit objective (or vice versa) is not conclusive. The courts afford greater weight to objective facts than to the taxpayer's statement of his intent. Additionally, a profit objective in an earlier year does not automatically provide a taxpayer a blank check with regard to losses incurred in subsequent years.

B. Additional Factors. The IRS notes additional factors relevant to the determination whether an activity is, in fact, a business rather than a hobby.

1. Start-up Costs. The IRS recognizes that loses are common during the start-up period of many business ventures but, if the losses continue for a period of time that is longer than is customary for a similar operation, the IRS will interpret the losses as indicative of a hobby. The Tax Court decisions have acknowledged, for example, that racing and breeding businesses can take six to fifteen years to generate a profit due to the difficulties inherent in establishment of proper breeding stock and a business reputation. Further, if the taxpayer (especially a professional—or spouse—engaged in part-time equestrian activities) uses these losses to offset significant unrelated income, the IRS will be more suspicious of claims of taxpayer claims of a business motivation.

2. Nature of Losses. However, if the losses generated by the horse activities show a pattern of decline, it will be easier for the taxpayer to assert that the losses reflect bona fide start-up costs and that the venture is indeed motivated by prospects of an eventual profit. Further, losses that result from unforeseen or unfortunate events or circumstances are not indicative of the absence of a business motivation, but through documentation of all adverse circumstances is critical in the event of examination by the IRS.

3. Business Methods. It is also important for the taxpayer to maintain thorough records of efforts to bolster the profitability of the horse operations. The Treasury Regulations and case law underscores the importance of (a) maintenance of complete and accurate books and records (courts have held, in the context of animal-breeding activities, that the absence of detailed monthly expense records, maintained on an horse-specific basis, can be indicative of the absence of a profit objective), (b) the operation of the equestrian venture in a businesslike manner (the importance, for example, of a business plan, advertising, and functional, rather than luxurious, facilities), and (c) management of expenses and routine changes in operations to improve profitability (courts have held that small improvements over several years are not indicative of a businesslike operation).

C. Two of Seven Years Rule.

1. Presumption. Section183 of the Code includes a presumption that equestrian breeding, training, showing or racing activities that generate a profit for at least two of seven consecutive years are intended to be profit-making ventures. The IRS can, however, overcome the presumption with evidence that indicates the absence of a profit motivation, and, therefore, the presumption simply shifts the

burden to the IRS to demonstrate that the equestrian activities were a hobby rather than a business. Further, IRS examiners cannot use the failure to meet this test to create a presumption or permit an inference that the equestrian activities were not undertaken for business purposes, but, of course, the IRS can certainly argue, based on the facts and circumstances of the case, that the other relevant factors indicate a hobby rather than a business motivation.

2. Special Election. There is also a special election on Form 5213, which is intended to recognize the likelihood of losses during the start-up period, to permit suspension of the presumption until the close of the sixth tax year. The election generally can be filed within three years after the due date of the return (determined without regard to extensions) for the first year of the horse activities but not later than sixty days after the taxpayer receives written notice from the IRS that proposes to disallow the horse-related deductions. It is important to note that, as the presumption in Section183 of the Code is limited to the loss years that follow the profitable years, the election, if ultimately successful, extends the presumption to the loss years that precede the profit years. The election must be made within five years of the due date of the tax return for the year after the taxpayer initially engages in the horse business, so, if the taxpayer fails to timely make the election, he will not be able to use two profitable years to obtain the presumption for any prior loss years.

   The election is, in fact, rarely used until an examiner proposes to disallow equestrian activities as not engaged in for profit. The election generally results in the closure of the case to suspense until the end of the presumption period and, upon the filing of a sufficient number of the returns of the presumption period, the case file will be returned to the examiner for a final determination if the activity is engaged in for profit. However, the election to defer the determination extends the customary three-year statute of limitations for two years after the due date of the return for the final year in the seven-year period, though the extension is generally limited to activities to which the presumption applies and other items affected by the profit determination (including for example, self-employment taxes, deductions for health insurance premiums, alternative minimum tax, itemized deductions, personal exemption phase outs, and Roth IRA contributions). Further, as Form 5213 highlights the hobby issue, there is a concern it invites IRS examination.

D. Red Flags. The Audit Technique Guide indicates that, in their review of tax return for audit based on possible improper hobby losses, examiners will consider whether (1) there are activities with large expenses and little or no income, (2) losses are used to offset other income on the return, (3) whether the activity results in a large tax benefit to the taxpayer, and (4) the history of the activity shows that it is generating any profit in any year. The Audit Technique Guide also advises examiners to look for (5) large, unusual, and questionable items, (6) missing schedules, (7) inconsistencies between different years, and (8) audit potential and further advises auditors to obtain information about the taxpayer from searches of internal and external sources "such as Accurint, Google, Yahoo, and AltaVista…."

III. Equestrian Participation as Part of a Single Activity.

The Treasury Regulations further provide that, if a taxpayer engages in two or more separate activities, deductions and income from the separate activities are not aggregated either in determining whether a particular activity is engaged in for profit. Multiple undertakings may be treated as one activity if the undertakings are sufficiently interconnected, and in ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the IRS will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities, but, in the case of activities that can be construed as hobbies, the IRS will proceed with some modicum of suspicion, and the taxpayer's characterization will not be accepted if it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case.

Certain taxpayers who utilize their equestrian activities to promote their related businesses can thus, under limited circumstances, demonstrate that the equestrian activities are an integral and interconnected part of a single activity and are thus conducted for profit as a component of the single business. The Tax Court concluded, for example, in a 2007 case that the equestrian activities of an interior designer were necessary business activities and were thus deductible and noted that (a) she relied almost exclusively on her exposure and reputation as a rider as well as her involvement in a local equestrian organization to generate prospective clients for her interior design business, (b) virtually all of her clients depended on her knowledge and expertise of horses for design of horse barns and related houses, (c) her equestrian and design activities shared a close organizational and economic relationship, (d) her success as an equestrian competitor created goodwill that benefitted her design business, (e) she formed the two undertakings as a single integrated business and had an (albeit unwritten) plan for such business, (f) she used the same books, records and assets for both undertakings, (g) her decision not to advertise the design aspect through traditional methods was a strategic one based on her through understanding of attitudes about direct marketing, and (h) more than ninety percent of her clients, in fact, came from her equestrian contacts. The court concluded that her exposure and reputation as a professional equestrian materially benefitted her design activities and further noted that there was no evidence that her equestrian expenses were unnecessary or excessive. The court also acknowledged that, although her accountant reported the horse activities and design activities on separate Schedules C and observed that positions taken on tax returns constitute admissions against the taxpayer, a "plethora of evidence" confirmed that the two undertakings indeed represented a single activity and thus found that she overcame the otherwise fatal segregation of the two endeavors.

It appears that the most significant facts and circumstances in this determination are (a) the degree of organizational and economic interrelationship of undertakings, (b) the business purpose that 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 (c) the similarity of various undertakings. Therefore, in an effort to assert that equestrian activities are part of a single activity, it is important to (u) develop a written business plan that integrates the business activities, (v) maintain and consolidate the books and records of the business and equestrian activities, (w) engage a single accountant and manager for the business and equestrian activities, (x) share assets amongst the business and equestrian activities, (y) consolidate and report the business and equestrian activities in a single tax return, and (z) create goodwill through active participation in the equestrian activities. These guidelines will, if the facts support the consolidation of the business and equestrian activities as a single venture, help to demonstrate the organizational and economic relationships between the activities.

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