How to get a tax break if you raise horses

BY Robert M. Swaim

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Several years ago I had a client who entered into the business of breeding horses for the purpose of sale at a profit. The IRS audited his return and declared his horse farm to be a "hobby" rather than a business and disallowed his farm losses. The IRS argued that my client being a wealthy lawyer, was not engaged in the horse farm business as it was not his primary occupation, and that he was merely a "gentleman farmer" engaging in a "hobby" that gave him great personal pleasure. The greatest evidence that it was a hobby, said the auditor, was the fact that it had not turned a profit in recent years. I took strong issue with the government's position and appealed the auditor's decision. My client is a lawyer who makes his home on his horse farm in Georgia and does indeed earn his living as a lawyer. The client employs a hired help at the stables and regularly consults with veterinarians, at considerable expense. Financial books and records of the horse operation are maintained apart from their other financial activities by the client and his wife. There is a separate checking account just for the horse operation. He devotes 20-25 hours a week to the work and business affairs of his stables. He is actively engaged in care and maintenance of the horses, barns and stables. My client attends to his stables on a daily basis and devotes his weekends almost exclusively to the care of the horses and stables. Tax losses in prior year audits had never been questioned or disallowed. Expenses incurred in the operation of the stables include the ordinary and necessary expenses of: veterinarian services; services of professional trainer; feed; repair and maintenance of stables; insurance; property taxes; and transportation for the horses.

We successfully argued that in the matter of losses deducted on the federal income tax returns pertaining to the operation of a horse farm, that he was in compliance with statutory law and case law. We forcefully and vigorously argued that he met all the tests and criteria laid down by the federal courts in the several circuits of the United States with regard to being "engaged in trade or business for gain or profit" and not engaged in a "hobby." Specifically:

(a) Client lived in close proximity to his stables.
(b) He personally worked on the upkeep and maintenance of the stables.

(c) He employed professional horsemen and a veterinarian.
(d) Books of account are maintained on the horse operations.
(e) During the one year that he made profit he reported this profit to the government and paid the appropriate tax.

My client was in compliance with all relevant internal revenue code sections and income tax regulations in all material respects, to wit:

***Losses were the result of the excess of "ordinary and necessary" expenses over revenues.**

***Expenses were incurred in the conduct of business engaged in for profit.**

***Expenses represent actual cash outlays or expenses incurred during the tax year**

The operation of a stable and breeding farm is in essence a risky business frequently generating consecutive loss years, and has given rise to considerable tax litigation over the years.

While horse breeding is indeed a hobby for some, it can nevertheless constitute a business for other taxpayers. The existence of substantial financial risk in the conduct of such business does not necessarily convert it into a hobby any more than in the case of any other adventurous business such as oil drilling or stock trading. All of these businesses involve a substantial risk factor and frequently occasion periods of continued losses.

In Farish v. Commissioner of Internal Revenue. 103 f2d 65 (Texas, 1939)4, the court held that, as in the case of other activities, the determination of whether a breeding stable is a business or a hobby is the intention to derive income therefrom, the expectation of a profit. The court went on to say that the intention of the taxpayer at the outset is the dominant factor in determining whether he engaged in the venture for profit or merely for pleasure. The court ruled in favor of the taxpayer and allowed the loss deduction. In that case the taxpayer, a wealthy Texas oilman, operated a ranch for breeding polo ponies. He sought the advice and services of paid professional horse trainers and breeders. He was engaged in the breeding, training and sale of polo ponies. The fact that the taxpayer was an avid polo player, a man of wealth, and not dependent on the ranch for his livelihood, did not negate the fact that he was engaged in the horse business for gain and profit.

The court said "It is not at all improbable that men in the oil business, having ample capital, would engage in the enterprises here involved with the hope and expectation of ultimately making a fair return on the investment."

With regard to years of continuous losses the court allowed that "One who plants a fruit orchard must wait a number of years before the trees produce fruit in sufficient quantities to show profit, but the expense of cultivation goes on every year before that."

A venture once started, as a business does not become a hobby because of the fact that losses have been sustained. While the profit motive continues, it is immaterial whether the expectation of profit is reasonable so long as it is bona fide.

The courts have consistently refused to substitute their own predictions or those of the Commissioner, as to the likelihood of profit for those of the person operating the stable. Quite simply, the taxpayer knows better than the court or the IRS whether a profit is to be expected.

My client satisfied the presumption of profit in accordance with statutory law and case law.

The tax court held, in Morken v. COMMISSIONER OF INTERNAL REVENUE, TC Memo 1986-535, "A taxpayer engages in the breeding of horses in a businesslike manner if he researches and plans horse purchases, advertises, consults trainers or breeders, and becomes knowledgeable about the horse raising and breeding industry and its profitability."

It was held in Wilson v. Eisner, 282 F2d 38 (1922), that the mere fact that the venture has shown continuous losses is not alone sufficient to warrant the conclusion that the stable is not operated for profit. Although my client showed losses for 6 out of 7 of the total years of operation, the government cannot automatically presume that he is not engaged in business for profit under this ruling of the court.

In pursuance of that appeal we relied on the definition of "business" as handed down by the Supreme Court in Flint v. Stone Tracy Co., 220 U.S. 107: "Business is that which occupies the time, attention, and labor of men for the purpose of livelihood or profit." Clearly my clients were engaged in business under this definition. My client checked his horses and stables every morning and spent his weekends tending to maintenance, care, and upkeep of the animals and the stables.

In the case of Widener v. COMMISSIONER OF INTERNAL REVENUE, 33 F2d 833 (1929), the facts are identical to the situation my client was in. In ruling for the taxpayer, the court said: "We can see no difference between the plaintiff's position and that of the ordinary ranchman, who raises horses for the market, to be sold for trucking or draying purposes. If it be a fact, as it is earnestly urged by the government, that the taxpayer was a sportsman in the sense that he is fond of racing horses, it cannot change the character of this undertaking. Success in business is largely obtained by pleasurable interest therein."

This shoots down the IRS argument, and they always make it, that if an activity is fun then it must be a hobby and not a business, therefore all losses are denied.

Another case that closely parallels that of my client was Commissioner of Internal Revenue v. Field, 67 F2d 876 (1933), where the court made several points relevant to my client's plight, specifically:

***The taxpayer need not be dependent on the horse operations as his primary source of income.**

***There is substantial evidence that enterprises were conducted as a business for profit and with an expectation of ultimate profit. If the right to deduct losses under statute required that profit appear to the court to be possible, that requirement would be quite general and would be applicable to any enterprise, whether it was farming, manufacturing, or promotion of any character. We may not in this way foredoom any business venture··· It is a matter of intention and good faith.**

In the Field case the court outlined factual situations that led them to hold for the taxpayer. With regard to evidence of intent to engage in "business for profit" the court took note of the following items which are very similar to my client's situation:

(1) Books of account were kept
(2) The taxpayer obtained the guidance and services of expert horsemen
(3) He acquired thoroughbreds for the purpose of carrying out his business
(4) Records of all receipts and expenditures in connection with breeding were kept in good order and verified by a competent accountant when the tax return was prepared

The federal courts across the U.S. have consistently reiterated several key points in horse breeding cases over the past 75 years. Among the items cited by the courts, when ruling favorably toward the taxpayer, that would indicate engagement in trade or business for profit, are the following:

(a) developing an expertise in the horse business
(b) hiring and/or consulting with professionals such as breeders, trainers, jockeys, and veterinarians.
(c) Personally tending to horses and stables
(d) living in close proximity to the stables
(e) attending, often and continuously, races or shows or sales of horses
(f) advertising horses for sale or stud service
(g) the breeding establishment does not look like a show place and is not incidental to the taxpayer's social life.

All of these items surfaced in Clark v. COMMISSIONER OF INTERNAL REVENUE, 24 B.T.A. 1235 (1935), in that case the court found for the taxpayer

citing the factual circumstances, described above, as evidence that the taxpayer was engaged in the horse business for profit, despite heavy and continuous losses. The court said: " The breeding and training of horses is a highly speculative business and at all times during the period when losses were being sustained there was a reasonable ground for expectation that a profit might ultimately be realized. This case lent credible and substantial legal authority to the position we took on appeal. All of the facts in the cited cases very similar:

(1) Taxpayer was wealthy
(2) Taxpayer was not dependent on horse operations for his livelihood.
(3) Taxpayer kept books of account
(4) Taxpayer did have revenues from sales of horses, occasionally showing profit
(5) In the years where they had profit they paid their income tax due on it
(6) There were always substantial and continuous losses

Finally, we look to Amory v. COMMISSIONER OF INTERNAL REVENUE, 22 B.T.A. 1398 (1931). The court said that a financially hazardous undertaking may be classified as a business under the revenue law… and this is true though the business may have sustained substantial losses for several years."

The courts look to the actions and behavior of the taxpayer in determining whether the intent was to carry on a bona fide business for profit. In the Amory case the court said in support of the taxpayer's position: "In the conduct of the stable petitioner gave such personal attention to the same as is usually given to business enterprises. She required her manager and trainer to keep accurate accounts of operations and expenses, and was personally consulted by them in all phases of the same. The attention and attitude of petitioner toward the racing stable was marked by every indicia of business interest."

If you have a farming activity and have not been taking deductions on your income tax return it might be wise to review your position. If you have been taking the deductions you would be wise to tailor your activity to meet the criteria laid out by the courts as cited in this article.

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