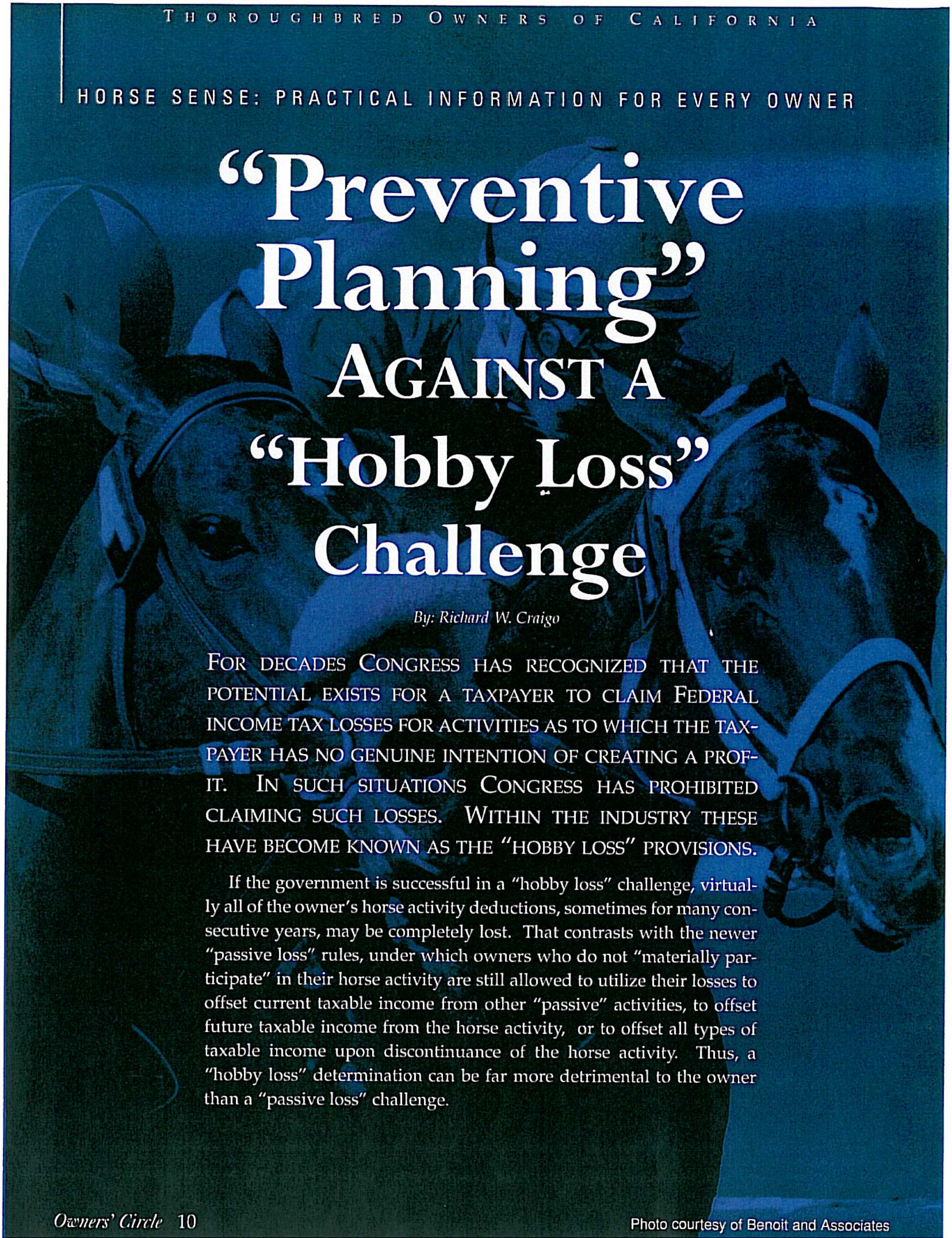

"Preventive Planning" Against a "Hobby Loss" Challenge

By: Richard W. Craigo

For decades Congress has recognized that the potential exists for a taxpayer to claim Federal income tax losses for activities as to which the taxpayer has no genuine intention of creating a profit. In such situations Congress has prohibited claiming such losses. Within the industry these have become known as the "hobby loss" provisions.

If the government is successful in a "hobby loss" challenge, virtually all of the owner's horse activity deductions, sometimes for many consecutive years, may be completely lost. That contrasts with the newer "passive loss" rules, under which owners who do not "materially participate" in their horse activity are still allowed to utilize their losses to offset current taxable income from other "passive" activities, to offset future taxable income from the horse activity, or to offset all types of taxable income upon discontinuance of the horse activity. Thus, a "hobby loss" determination can be far more detrimental to the owner than a "passive loss" challenge.

Photo courtesy of Benoit and Associates

Equine Business - Prime Target

Activities involving horses have always been a primary subject of hobby loss challenges and resulting court decisions. The determination to be made is simple enough - whether the horse owner's activity was "engaged in for profit." The burden of proof is, by statute, on the owner. The owner will carry this burden only by presenting objective facts as opposed to self-serving statements as to his or her subjective intent.

Any California Thoroughbred owner with 5 to 10 years of consecutive losses (slightly longer if a breeding operation is involved) is at risk of a government challenge, both Federal and state. A number of recent I.R.S. successes in the U.S. Tax Court indicate that the best way to avoid a "hobby loss" challenge is "preventive planning." Indeed, of the last 19 published "hobby loss" decisions dealing with horses (since 1992), the horse owners lost 15 of those cases.

Written Business Plan- a Helpful Tool

But a reading of those adverse decisions leads one to the conclusion that an "ounce of prevention" would truly have been worth a "pound of cure." I am convinced that there are several basic planning steps which are a "must" for the owner. Separate financial and business books and records and a separate bank account are the most elementary requirements. Engagement of a certified public accountant to set up the financial record keeping system will also be a positive factor, as will maintaining both the financial and the business records on a horse-by-horse basis. But those recent adverse cases indicate another factor which may carry the day for the owner. That is to maintain a written business plan. Numerous decisions have emphasized the presence or absence of a business plan. The courts have never required that such a plan be in writing, but any owner who can present such a written plan to a government auditor will be far ahead of other potential targets.

A written business plan need not be voluminous. A presentation of 5-10 pages should be adequate for most operations. If the first written plan comes after several years of operations it should provide a brief history of the operation but, most importantly, tell where the operation is going and how it expects to get there. And it should be updated regularly, with special emphasis on modifications to the business plan.

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Show Attempts to Modify Unprofitable Operations

The critical event is not whether the owner has experienced losses over many consecutive years, but whether the owner attempts to modify the operation even if unsuccessful. Maintenance of a written business plan which specifies those changes in the direction of the operation should be a very valuable tool. Here are some other specific ideas on "preventive planning":

- Ideally, the owner should prepare an annual budget of expenses, whether or not it is included in the written business plan.
- Maintain a log or history of the time and effort devoted to the equine activity.
- Maintain records of all the hardships experienced in the operation, and of all advice obtained from industry experts, especially regarding financial matters and industry economic trends.
- Engage in self-education, such as subscribing to and reading trade periodicals, attending seminars, and being active in trade organizations. Record this time.
- And the best preventive planning technique is the creation of a cash - basis profit year to break a long string of consecutive loss years (see your accountant).

Good Records and a Business Plan Guard Against Government Attack

The government appears to be attacking the horse owner's profit intention more frequently than ever. Thoroughbred owners have the advantage of being able to demonstrate profit potential through both purse earnings and appreciation in value, unlike the show horse breeds. But even Thoroughbred owners begin to be at risk after 5-10 years of consecutive losses. One excellent way to guard against a government attack is to have good financial and business records on a horse-by-horse basis, including a separate bank account and the engagement of a certified public accountant. But recent case law appears to indicate that an almost equally important element may be a formal written business plan, complete with budgets and recording all modifications made to the direction of the operation, at least if an owner has experienced a substantial number of consecutive loss years. This writer believes that the presence of such financial and business records and a formal written business plan will go far toward making an owner immune from a successful government challenge.

Mr. Craigo is a horse owner, breeder, and an attorney practicing equine law in Los Angeles. He has handled over 70 "hobby loss" disputes and has frequently lectured on this topic before the American Horse Council and the University of Kentucky Equine Law Symposium, as well as authoring numerous articles on the subject.