Thoroughbred Owners of California (TOC) Tax Seminar

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Accounting & Tax Considerations for
Thoroughbred Business Operations

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Federal Tax Reform as of December 20, 2017
Equine Industry Focus

Federal tax reform is upon us and, while most provisions in the current bill are effective for calendar years beginning in 2018, there may be some year-end planning items that horse and farm owners should consider prior to December 31, 2017.

As I am writing this article, both the Senate and the House have passed (and re-passed) the current bill and it is widely expected to be signed into law by the President today. While Dean Dorton has previously provided general information regarding what is included in this bill, this article addresses selected items that are specific to horse and farm owners. Unless otherwise noted, the bill is effective for years beginning after December 31, 2017 (so, 2018 for calendar year filers). Most of these provisions apply for a period of time and then revert back to current treatment, but this article focuses on when these items become effective versus the time period for which they are effective.

Depreciation Provisions

Under current law, bonus depreciation (50%) may be claimed on new tangible property purchased and placed in service. The current bill increases the amount eligible to be immediately expensed to 100% of the purchase price and expands the definition of new to include the taxpayer's first use of the property. So, if I purchase a broodmare, I may now expense 100% of her purchase price, as long as I had not previously owned her. Yearlings, racing prospects, farm equipment and office equipment, land improvements, and barns, to name a few, continue to qualify for this write-off as long as they have not been owned previously by the purchaser. This provision is effective for assets purchased after September 27, 2017.

Increased Section 179 depreciation of $1,000,000 on up to $2,500,000 of qualifying purchases is included with this bill. The bill also expands the definition of qualified property to include HVACs. As a reminder, in order to claim Section 179, there needs to be a net business profit. This is calculated first at the pass-through entity level and then again at the individual level.

Those in the farming business have been required to use 150% declining balance versus the standard 200% declining balance for federal depreciation. This bill removes the requirement to use 150% declining balance so 200% declining balance may be used going forward, which will accelerate depreciation deductions in the first few years. In addition, farm equipment that is currently seven-year life property becomes five-year life property so may be written off over a shorter period of time.

The three-year recovery period for depreciation on yearlings is not included in this bill. So, while the three-year recovery period still applies to racehorses when placed in service after the two-year anniversary of the foaling date, yearlings revert back to a seven-year recovery period. This is effective for years beginning after December 31, 2016, so make sure to update 2017 federal depreciation for this.

Federal Income Tax Rate Provisions

The top income tax rate for individuals will be 37% (versus 39.6% currently). For those who conduct horse operations via partnerships, S corporations, or sole proprietorships, there is a new 20% deduction available against qualified business income but there are many limitations and hurdles to meet in order to qualify for this deduction. This 20% deduction does not reduce an individual's adjusted gross income but is a reduction from taxable income. Trusts and estates may also qualify for this deduction.

This 20% deduction is limited to the greater of 50% of the allocable portion of wages paid by the business or the sum of 25% of allocable wages plus 2.5% of the allocable unadjusted basis of all qualified property immediately after acquisition. Non-corporate taxpayers with taxable income of less than $157,500 ($315,000 if married filing jointly) are not subject to the W-2 wage limitation when calculating this 20% deduction. For those that exceed this threshold, there may be a potential to qualify for this deduction even if wages are not paid by the entity but depreciable property (like buildings, horses, equipment, et cetera) is held in a trade or business or for the production of income. This portion of the calculation is confusing in the current bill so the above is a bit of an over-simplification.

This 20% deduction generally does not apply to specified service businesses (like accountants or where the principal asset is the reputation or skill of one or more of its employees or owners), but the service business limitation does not apply in the case of a taxpayer whose taxable income does not exceed the applicable thresholds above. As such, bloodstock agents, sales agents, trainers, and vets may fall under the service business limitations.
If you conduct your horse activities via a C corporation, the corporate income tax rate will decrease to 21% and the alternative minimum tax will be eliminated, both of which are good news.

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Business Operational Provisions

Business interest expense will continue to be fully deductible for the bulk of industry participants. If average annual gross receipts for the three prior years exceed $25,000,000, then interest expense is limited to 30% of a business' taxable income, with the excess carrying over to subsequent years. Farming businesses may elect not to be subject to the business interest limitation but would then be required to use Alternative Depreciation System (ADS) (straight-line and longer life) to depreciate property.

Like-kind exchanges of horses, vehicles, and farm equipment are eliminated. Like-kind exchange treatment is only available for real estate going forward, so this will reduce the opportunity for horse and farm owners to defer gain recognition on assets other than real estate for which the proceeds are re-invested in like property.

Meals provided to employees for the convenience of the employer (typically done during peak sale or breeding season hours) are currently 100% deductible but will become 50% deductible. Entertainment expenses will no longer be deductible.

Net Federal Income Tax Losses Generated by Active Businesses

Lastly, this next provision affects active business owners so will affect more than just the equine industry but may have a detrimental effect for those horse and farm owners that generate business losses which are offset by non-business income such as investment income. Under current law, excess farming losses are only limited if the farm receives a subsidy, which does not apply to many horse farm owners. Under this bill, a new section limits any excess business loss generated by an individual to ($250,000) (or ($500,000) if married filing jointly). This threshold applies after the active participation rules are applied and includes any trade or business, not just farming.

Business activities may be netted on an individual's income tax return to determine if the loss threshold has been exceeded. Any excess business loss beyond the above threshold becomes a net operating loss that rolls forward into the subsequent year. Given the accelerated deductions available to horse owners in years prior to the potential to generate income, quite often net taxable losses will be reported, especially in start-up years. This provision has the effect of at least a one-year deferral for these excess business losses and may negatively impact those who fund business operations with assets that generate investment income.

So, while this bill is primarily effective post-2017, what are some items that should be considered prior to December 31, 2017?

- Consider accelerating expenses into 2017 for active businesses owned by individuals. There should be a non-tax reason for doing so (for example, discount available, accessibility to certain stallions solely as a result of prepayment, et cetera).
- Calculate the 2017 versus 2018 income tax impact of accelerating income for individuals into 2017 and paying the related state and local taxes (since the deduction for state and local taxes is limited to $10,000 after 2017) by year-end.
- Determine if 2017 state, local, real estate, and/or sales tax should be paid by individuals not in Alternative Minimum Tax (AMT) prior to December 31, 2017. Note that there is no deduction allowed in 2017 for the prepayment of 2018 taxes.
- If the horse or farm owner makes contributions to charity in exchange for preferred seating at athletic events (like the University of Kentucky's K Fund), consider paying now. Currently, a charitable deduction for 80% of the amount contributed is allowed but this will be eliminated in future years.

This proposed bill certainly does not accomplish income tax simplification (and some have indicated that this will keep us tax accountants in business for quite some time) and creates many gray areas subject to interpretation without the existence of additional regulations. We are doing our best to interpret this bill as we understand it but know that we plan to send updates as additional clarifications are released in 2018.

Should you have any questions regarding federal tax reform and its potential impact on your 2017 or 2018 equine operations, please do not hesitate to contact us.

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The matters discussed in these materials provide general information only. You should consult with an advisor about your specific situation before undertaking action based on such general information.

Select a Business Entity

No single business entity fits all horse ownership situations. Individual tax, liability exposure, and estate planning considerations should impact the choice of entity type.

The **sole proprietorship** is the simplest form of ownership. No separate entity needs to be formed, and the tax results affect only the owner's personal tax return. To avoid unfavorable factors in a hobby loss issue, the owner should have separate business accounts, should maintain good accounting records for the business, and should prepare financial statements. A potential problem with this form of entity is that the owner has not limited his or her exposure to liabilities.

A **general partnership** is much like a sole proprietorship, just with more than one owner. Tax results "pass through" to the partners' returns, and, as with the sole proprietorship, the partners assume unlimited liability exposure.

In a **limited partnership** the tax results to the partners are much like those in a general partnership, but limited partners generally are unable to deduct tax losses beyond their capital investments. Further, limited partners are almost sure to have their tax losses treated as passive activity losses, potentially limiting their use. If limited partners become too involved in managing the partnership's business, they may unintentionally become subject to unlimited liability exposure, as general partners are. States may also impose an entity-level tax on LPs.

In an **S Corporation,** owners limit their liability exposure, and tax results "pass through" to the owners. Tax losses are available to owners only to the extent of their invested equity capital and direct loans to the S Corporation. Further, having certain entities as shareholders disqualifies a corporation from S Corporation status (although this has been liberalized), and many states impose franchise and license fees on corporations.

A **C Corporation** often is not a suitable entity for horse owners, because tax losses do not "pass through" to the owners, and C corporations are more restricted in their use of cash basis tax accounting (which means foal production costs must be capitalized). C Corporations are frequently used for non-US persons.

Limited liability companies (LLCs) are commonly used by horse owners. They combine the liability protection of corporations with the "pass through" tax characteristic of partnerships. Most states allow single-member LLCs. States may also impose an entity-level tax on LLCs.

A **Co-Ownership** is also commonly used by horse, owners, and the co-owners could be individuals or entities, with some of the same important considerations set forth in these materials. Co-Ownerships are often referred to as syndicates, and are found in both racing and breeding ventures.

Choose an Accounting Method

Generally, the cash method of accounting is allowable as well as preferable for tax purposes (because it is simpler and can be more effective in controlling the timing of income and deductions).

If the cash method is allowed, most expenses (other than farm improvements, etc.) can be expensed in the year paid.

> **Example**: Assume a mare owner enters into a contract on December 15, 2017 to breed to a stallion in the 2018 breeding season and the contract requires the fee to be paid upon signing. The fee should be deductible in 2017, whether or not the contract guarantees a live foal. This 2017 expenditure is not generally expected to produce related income until the resulting 2019 foal is sold as a weanling in 2019, as a yearling in 2020 or begins racing as a 2-year old in 2021.

The accrual method of accounting must be used in some cases:

- a "family corporation" (other than an S corporation) with more than $25 million annual gross receipts. Certain related corporations must be included in computing the $25 million test.
- a C Corporation, other than a "family corporation," which has gross receipts over $1 million.
- a partnership with a C Corporation as a partner.
- a "tax shelter," which is defined as follows:
  - a partnership or S corporation if units in the entity were offered for sale in an offering required to be registered; or
  - a partnership or S corporation if more than 35% of losses are allocated to limited partners or limited entrepreneurs (generally, someone who doesn't actively participate in management of the enterprise or who doesn't actively participate in the equine business).

If the accrual method of accounting is required to be used, costs of producing foals and of caring for them until they reach a productive age are required to be capitalized.

- Not usually a big issue for racing ventures, but may suggest placing the horse in service when placed in training to avoid capitalization of costs until the horse races.
- Potentially big issue for breeding ventures.
- Will result in more depreciation recapture.
- Accounting is more time-consuming.

Special Equine Tax and Accounting Issues

Producing a foal

- Most frequently, the owner of a mare will pay a stud fee for the right to breed to a stallion.
- Breedings typically occur in the first part of the year.
- Fees are typically due in the fall – when it can be determined that the mare is definitely in foal – or when the foal stands and nurses in the spring.
- Most stud fees come with a live foal guarantee. The terms of the guarantee can vary, but the most common is "stand and nurse." If a live foal is not produced, the stallion owner will return the fee.
- The payment of the stud fee and the return of the fee if a live foal is not produced almost always occur in different tax years.
- Mare owners may pay a fee to a bloodstock agent for researching pedigrees and recommending a mating.
- Mares come to the stallions to which they are to be bred.

- The costs of producing a foal to sell other than the stud fee – including board, veterinary care, and the use of the mare for a year – may average roughly $25K to $45K, depending on when the foal is sold.
- Stud fees range from $5K to $300K+ for the very top stallions.
- Horses produced from top-tier mares and stallions, while the most costly, are, on average, the most profitable as well.

Purchasing a horse

- Commissions and sales tax should be capitalized.
- When a mare is purchased in foal, a reasonable amount of the cost should be allocated to the foal (typically, minimum of 1 or 2 times stud fee).

Placing a horse in service

- Establish a consistent policy for when horses are placed in service.
  - Racing – either when the horse begins training or when it begins racing.
  - Breeding – when it is available for breeding.

Selling a horse

- Many horses are sold at public auction.
- The auction house and the selling agent or consignor will charge a commission on the sale. These commissions may be charged even if the horse is not sold because the reserve was not attained (RNA).
- The nature of the sales proceeds – capital gain or ordinary income – will depend on the use of the horse by the seller.
  - Breeders who routinely sell off their stock and pinhookers have ordinary income or loss from the sale because these animals are inventory-type assets.
  - Breeders and other owners who held the horse with the intention or actual use of the horse in racing or breeding will have income from the sale of an asset used in their business:
    - Depreciation will be recaptured at ordinary tax rates.
    - Gains on horses owned for two years or less will be taxed at ordinary rates.
    - Overall gains from horses owned for more than two years will be taxed as long-term capital gains.
    - Overall losses reduce ordinary income.

Example: Assume an owner sells two horses during a tax year: (1) a mare which was purchased three years ago for $100,000 and has a tax basis of $50,000 (sold for $200,000); and (2) a three-year old homebred filly (sold for $75,000). The results would be as follows:

	Mare	Filly
Total gain	$150,000	$75,000
Depreciation recapture (ordinary income)	$ 50,000	$ 0
Remaining gain (capital gain)	$100,000	$75,000

Tax Incentives Available to Horse Owners

Depreciation (Applicable pre-Federal tax reform)

- Depreciation begins when the horse is placed in service. The method is 150% declining balance if both racing and breeding activities are conducted (200% declining balance may be used if racing only). The life depends on the actual age of the horse (based on foaling date) when placed in service.
- Racehorses more than 2 years old when placed in service – 3 year life (Note that the 3 year life also applied to all racehorses placed in service 1/1/09 - 12/31/2016 but this has not yet been renewed for 2017 as of the date of this webinar). It is in the extenders bill so stay tuned!
- Any horse other than a race horse which is more than 12 years old at the time it is placed in service – 3 year life.
- All other horses – 7 year life.
- When you transfer a horse from racing to breeding, you need to change the depreciation life based on the un-depreciated basis in the animal.

Depreciation Percentages (Mid-Year Convention/150% Declining Balance)		
	Racehorse less than 2 years old and Breeding Stock 12 years old or less	Racehorse 2 years old or more and Breeding Stock more than 12 years old
Year 1	10.71%	25.00%
Year 2	19.13%	37.50%
Year 3	15.03%	25.00%
Year 4	12.25%	12.50%
Year 5	12.25%	
Year 6	12.25%	
Year 7	12.25%	
Year 8	6.13%	

Bonus depreciation (Applicable pre-Federal tax reform)

Additional depreciation may be available on purchases of qualifying new assets. This "bonus" depreciation is 50% of the value of the asset placed in service through 2017, then 40% in 2018 and 30% in 2019. The bonus depreciation provisions apply to large and small businesses – there are no sized-based limits, and the deduction is allowed whether or not the business has taxable income.

To be eligible for bonus depreciation, the horse generally must be "new" – i.e., not used in a business before. Meeting the **original use** requirement to qualify for bonus depreciation is an issue for many horse purchases. Our interpretations of the rules, as they would be applied to horses, are as follows:

- A horse acquired for breeding would qualify only if it had been neither bred nor raced previously (final Regs issued by the IRS specifically address this).
- A horse acquired for racing would seem to qualify only if it had not raced before. If the acquirer's practice is to treat a racehorse as placed-in-service when it enters training, an acquisition of a horse already in training, even though unraced, may not qualify. If the acquirer's practice is to treat a racehorse as placed-in-service when it first races, an acquisition of an unraced horse in training should qualify.

Example: John purchases a yearling for $100,000 on September 10, 2017 and places the horse into service at the time of training. John's depreciation for 2017 is:

$100,000 purchase price * 50% =	$50,000
($100,000 - $50,000 bonus depreciation) * 10.71% mid-year convention =	$5,355
Total depreciation for 2017	$55,355

Depreciation for subsequent years would be as follows:

2018	$9,565	($50,000 * 19.13%)
2019	$7,515	($50,000 * 15.03%)
2020-2023	$6,125	($50,000 * 12.25%)
2024	$3,065	($50,000 * 6.13%)

If the horse were ineligible for bonus depreciation, depreciation expense would be as follows:

2017	$10,710	($100,000 * 10.71%)
2018	$19,130	($100,000 * 19.13%)
2019	$15,030	($100,000 * 15.03%)
2020-2023	$12,250	($100,000 * 12.25%)
2024	$6,130	($100,000 * 6.13%)

Section 179 expensing election (Applicable pre-Federal tax reform)

The Protecting Americans from Tax Hikes (PATH) Act signed on December 18, 2015 permanently extends the increased annual deduction to $500,000 and increased the phase-out starting point for qualifying property additions to $2,000,000, subject to annual inflation adjustments. For 2017, the annual deduction is $510,000 on up to $2,030,000 of qualifying purchases.

As before, the deduction remains available only to the extent of the taxpayer's net business income. The deductible amount is not impacted by when during the year the property is placed in service – late year qualifying additions receive full benefit. Because the original use requirement does not apply to this deduction, horses need not be previously unused to qualify.

Like-kind exchanges (Applicable pre-Federal tax reform)

- You can defer gain on the disposition of a horse by using a like-kind exchange (also called a 1031 exchange).
  - The horse must be one that you used in your trade or business – not an inventory type asset.
  - You must use an outright trade or involve a qualified intermediary – do NOT touch the money.
  - Horses must be of the same sex (prefer same use as well – e.g., racing stock for racing stock).
  - Horses used predominantly outside of the US are not of like-kind to horses used predominantly within the US.

Involuntary conversions

- The death of a horse may result in an involuntary conversion for tax purposes.
  - If the horse was insured, the proceeds may be treated as proceeds from an involuntary conversion.
  - You have 2 years from the end of the year that insurance proceeds are received to replace the horse.
  - To qualify, the replacement horse must be similar or related in service or use – racehorse for racehorse (prefer same sex); mare for mare; stallion for stallion.

Plan with Awareness of the Hobby Loss Rules

In order to deduct expenses directly against the income from an activity, the activity must be engaged in for profit. Activities that do not meet this test are referred to as "hobbies." When an activity is found to be a hobby, the gross income is included on your tax return and the expenses are deducted only as miscellaneous itemized deductions. These types of deductions are only allowable to the extent that they exceed 2% of your adjusted gross income for regular tax purposes. They are not allowed at all for purposes of the AMT – with the result that they are usually permanently lost.

IRS regulations list nine factors for determining whether or not an activity constitutes a hobby or a business. No single factor is determinative, but the single most important factor based on case rulings is maintenance of good books and records, followed by development, evaluation, and adjustment of a business plan showing profit potential.

If you make a profit in 2 out of 7 years from your horse business, then you are presumed to have a profit motive. For most businesses, the rule is 3 out of 5 years. The 7-year period always begins with a profit year and contains at least one other profit year. For example, if you have profit in 2011 and 2014, the presumption is good through 2017. There are special elective rules with regard to application of this presumption to new horse activities. These rules result in an extension of the statute of limitations and therefore are not generally recommended.

What should you do?

- **Do** maintain separate financial accounts for your thoroughbred activity. A separate checking account is a must. Adjust assets to fair value on your statements. If you are leveraging your thoroughbred activities, your banker will require these statements as well.
- **Do** develop a business plan based on industry-specific financial and economic data. Evaluate the plan at least annually. Make and document adjustments as appropriate. If projections were not obtained, document the reasons therefore – e.g., unexpected losses due to extraordinary or reasonably unanticipated events – accidents, disease, declining markets, breeding problems. Also document the changes you've made to the plan and why.
- **Don't** lose more over multiple years than you could ever hope to regain.
- **Do** consult with knowledgeable people in the industry (other owners, bloodstock agents, and trainers), and document their suggestions. **Don't** then ignore their suggestions.
- **Don't** overlook the "home run" (SEATTLE SLEW, purchased for $17.5K and later syndicated for $12 million) possibility, e.g., Forbes.com historically provides a listing of the yearling purchase prices for Derby winners. The 2003 Derby winner Funny Cide was purchased for $22K as a yearling; War Emblem for $20K; Mine That Bird for $9.5K. California Chrome was the result of a $10K stud fee. Several others had yearling purchase prices of under $20K. Multiple Grade 1 winner Beholder was purchased as a yearling for $180K. Fusaichi Pegasus, the 2000 Derby winner, on the other hand, was purchased for $4M.
- **Do** understand the two out of seven year rule. **Don't** assume there is no potential for a hobby loss issue if you show net taxable income in at least two out of seven consecutive years. **Don't** assume tax losses are disallowed if you fail to show net taxable income in at least two out of seven consecutive years.
- **Don't** get quoted in the media describing how "it's an expensive hobby, but the fun is worth it."

The 9 factors listed in IRS Regulations for evaluating whether your thoroughbred activity is a business or a hobby

(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. 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.

(2) The expertise of the taxpayer or his advisors. 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 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, a 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.

(3) 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.

(4) Expectation that assets used in 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 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 expenses of operation. See, however, paragraph (d) of §1.183-1 for definition of an activity in this connection.

(5) 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 present activity for profit, even though the activity is presently unprofitable.

(6) 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. 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.

(7) 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 losses or only occasional small profits are actually generated.

(8) 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.

(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 whether or not listed in this paragraph.

Plan with Awareness of the Passive Activity Rules

These provisions of the 1986 Tax Reform Act were designed to severely limit (and have been most effective in severely limiting) the use of "tax shelters." Basically, the rules prevent a taxpayer who is passive (not a "material participant") in a business activity from currently deducting a loss from the activity, except such losses can be used to offset current income from other passive activities. Losses deferred under these rules can be used in the future to (1) offset net passive activity income; or (2) when the activity is disposed of completely, to offset any type of income.

When a person has sufficient amounts of passive activity income from other activities, passive activity losses do not present a problem.

> **Example**: X has $100,000 of passive activity income from real estate rentals; X can currently deduct up to $100,000 of passive activity losses.

When a person does not have sufficient income from other passive activities, the objective usually is to avoid passive activity status by being a "material participant" in the activity – i.e., involved on a regular, continuous, and substantial basis. Regulations provide 7 tests for an individual to prove that they are a material participant in a business.

(1) The individual participates in the activity for more than 500 hours during such 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 such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

(4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year for more than 100 hours during the year. Note that for this test, management activities will not count unless there is no compensated manager and no one else has more management time than the individual.

What time is included? There are no clear rules, but:

- Activities of spouses are combined.
- Time spent actually caring for animals should count – e.g., mucking the stalls, feeding, etc.
- Time spent in recreational activities, even if connected with the horse activity, is likely to be challenged. The activity must have a business purpose.
- Work done in your capacity as an investor – such as reviewing financial statements and operational reports – will not count unless you are directly involved in day-to-day management or operations.
- Attending races when your horse is running should qualify.
- Conferring with your trainer or the farm where you board breeding stock about your horses should qualify.
- Conferring with vets and other advisors regarding treatments for your horses should qualify.
- Conferring with agents, other owners, or other consultants about the business should qualify.
- Selecting horses to buy and sell should qualify.
- Determining where and when to race your horses should qualify.
- Attending sales where you are a prospective purchaser or seller and/or negotiating related deals should qualify.
- Evaluating potential matings if you are a breeder or conducting other blood-line analyses for current or prospective horses should qualify.
- Accounting for the activity may qualify.
- Doing your professional reading and attending seminars should qualify. There is a wealth of information – statistical and otherwise – on this business and to succeed, you must avail yourself of it.
- Making decisions regarding insurance should qualify.
- Travel time to conduct qualifying activities should qualify.
- Also consider time observing, studying, and tracking results of siblings and half-siblings of your bloodstock – the business is very blood-line oriented and these results can impact the value of your animals.

IRS may contest some of these items, but you should track them anyway.

> **Note:** Be sure to document your involvement in detail if you intend to meet the "material participation" test. At a minimum, identify services performed and hours spent. Daily time sheets are not required, but can prove extremely valuable in event of an audit.

> **Caution:** IRS currently has an audit program specifically focused on passive activities and agents are frequently required to address the issue as part of other audits.

> **Caution:** Please consult your tax advisor regarding combining multiple equine activities for purposes of meeting this test.

Remember that the passive activity rules potentially defer the use of losses; they do not disallow them.

General Equine Operational and Other Tax Considerations

State sales and use tax

- Sales tax rules vary by state. For example - In California, sales of breeding stock are exempt from state-level sales tax (localities may impose tax) and the sale of racing stock that will be shipped out of state is exempt. Racehorses are generally subject.
- Use tax may be due. California is very diligent about collecting this tax.
- A link to Dean Dorton's multi-state equine sales and use tax guide (co-authored) may be found on our website here:

Racing

- Racing proceeds are held at the track until a disbursement is requested.
- Proceeds may be used to cover other expenses at the track, including starting fees, jockey fees, and even clubhouse expenses. These should be separately accounted for – you can't just work off of the checking information.
- Where horses are owned by more than one person, proceeds and expenses need to be divided among the various persons. Proceeds should be reported 100% by the person whose tax number was used and then backed out on the return to ensure that IRS can match 1099s. That person should also send 1099s to the co-owners.
- It is not uncommon for owners and trainers to provide bonuses to other employees when a horse wins. Often these are in cash and can be difficult to catch for reporting purposes.
- When a horse is "claimed" in a claiming race, the proceeds are from the sale of the horse, rather than racing proceeds. When a horse is entered in a claiming race, it is for sale for the amount of the claiming race. Buyers put their money down prior to the start of the race. Once the horses leave the gate, they belong to the person who has claimed them – risk of loss and liability transfers at that time.
- Consider multi-state issues.

The boarding business

- Farms often board mares for breeding and other horses for sale.
- When they do, they provide owners with detailed reports on the horse, its medical treatments, and accountings/invoices. Often these go to multiple owners.
    - Boarding farms often use Horse Farm Manager software to track items charged separately to each horse, such as vet bills, medications, transportation, tack, farrier fees, and other items and to invoice each co-owner separately.
- Farms charge different amounts per day for boarding mares, mares in foal, foals, weanlings, sales prep, etc.

- Boarding operations often do not break even on a profit center basis. They are a loss-leader for consignment, sales prep, and bloodstock consultancy and help to cover payments on the land.

Co-ownership, foal shares, and other horse deals

- People often co-own horses.
  - Requires a separate accounting for each owner of income and expenses relating to the horse.
- Additionally, a person may acquire an interest in a horse without a cash outlay.
  - In a foal share, an owner of a mare and an owner of a breeding right in a stallion will agree to share the income and expenses of the resulting foal.
  - Trainers, syndicators, and others may receive shares in a syndicated stallion in exchange for services performed.
- Keeping an up-to-date list of horses, the percentage owned, and the status of the horse can be time-consuming, but is imperative. List separately: Mares, Foals, Weanlings, Yearlings, 2-Year-Olds in Training, Race Horses, Stallions, Stallion Shares
  - For industry purposes, all horse age one year on January 1. Thus a foal born on December 31, 2017 would be a yearling on January 1, 2018. This would put the horse at a huge racing disadvantage against other horses that were born much earlier in the year. For this reason, horse owners make significant efforts get their mares in foal early in the year.
  - For tax depreciation purposes, you look to the actual foaling date of the horse to determine its age.

Develop Good Accounting Practices

- Develop a chart of accounts and financial statements formats that fit the type of operation you are conducting – breeding, racing, etc.
- Conduct horse business and personal transactions from different bank accounts and have a separate accounting system for your horse business.

Develop a multi-year financial projection:

Based on your plans relative to the segment(s) of the business in which you intend to be active, develop a detailed, multi-year financial projection.

Recognize that it is more difficult to confidently project the financial results of thoroughbred horse ownership than it is most other types of business. Developments, both positive and negative, beyond the control of the owner can substantially impact financial results.

If the financial results are so uncertain, why prepare a business plan? In addition to a standard reason for planning – to provide a framework for better-decision making, a well-developed plan can help establish, if necessary, that you are conducting your horse operation in a business-like manner and with the intent of making a profit. Note, however, that a documented plan which does not reflect an expectation of an economic profit may be harmful in the context of a "hobby loss" issue.

For a racing operation:

- Determine the number of horses at different ages projected for the stable.
- Estimate the cost of the horses you plan to purchase, initially and later.
- Estimate the purses your horses will produce. Statistics are available for average purses per starter. Your estimates should reflect the appropriate level of the business in which you plan to compete.
- Estimate the selling prices of horses being sold from the stable. This, too, is difficult, as many of these sales are private, and helpful statistics are scarce.

- Estimate trainers' fees and other costs of maintaining your horse in training – using daily board rates and estimated vet expenses – may average roughly $40K-$50K in direct annual costs.
- Determine whether you will purchase mortality insurance coverage on your stable and, if you will, estimate the cost.
- Estimate other costs of operating the stable, such as trainer and jockey fees on purses, travel and entertainment, nominations, entry fees, professional fees, and other insurance coverage.

For a breeding operation:

- Determine the number of mares you intend to own over time.
- Project increases from subsequent purchases and retirement of fillies and decreases from death, disability, or sales.
- Estimate the cost of the mares you plan to purchase (and later, the price of any mares your plan indicates you may sell).
- Determine whether you plan to access stallions by purchasing seasons, shares, or a combination or both.
- Based on the quality levels you intend for your mares, estimate the cost of appropriate seasons and shares.
- Estimate the cost of caring for your mares (board, veterinary, etc.) using daily board rates and estimated vet expenses.
- Determine whether you will insure your breeding stock. Options include full mortality coverage, specified perils coverage, and self-insurance. Depending on your choice, estimate the cost.
- Estimate the size of your marketable foal crops, recognizing that not all of your mares will produce live, marketable offspring. You probably should estimate that 70-75% of your maximum potential income from selling your foals will be realized. ***Note:*** Remember to adjust your breeding fee expense for the portion of matings which is not projected to produce live foals.
- Estimate the value of your foal crops when you anticipate selling them (normally, as yearlings or as weanlings). To help in doing this, you can obtain statistics on particular stallions, if you know which ones you plan to breed to, or you can project a multiple of estimated breeding fees (probably 3 to 4 times, potentially more in a rising market).
- Provide for sales commissions – normally, 5% for the auction company and 5% for your agent/consignor.
- Estimate the cost of caring for your foals, beginning when they are weaned (about September of their foaling year) and ending when they are projected to be sold.
- Estimate other expenses relative to the scope and nature of your planned operations. These would include travel and entertainment, professional fees, and nominations.

Multi-state issues

- Racing in multiple states creates potential income tax issues. At a minimum, allocate and keep track of losses. Be aware of minimum taxes and registration requirements – even if you show losses.
- Racing or breeding in multiple states can create use tax issues.
- Property taxes – Certain states (CA, FL, and KY) impose a tangible property tax for business property in the state on January 1 of the year.

Reporting

- Get W-9s from all independent contractors for 1099 reporting and, most importantly, issue all required Forms 1099.
- Consider possible withholding requirements on payments to non-US persons for services performed in the US.
- If services are performed by a non-US person outside of the US, obtain the appropriate withholding exemption form.

Record-keeping

For any investment or business venture, you are required to keep good records to prove your related expenditures and the investment or business purpose thereof. If you consider your thoroughbred activity to be a true business and believe that you are a material participant in the activity, then you should be copious in your record-keeping.

No matter how familiar you are with your activities today, your memories will have faded by the time IRS gets around to auditing you. Say, for example, that you were in the equine business in 2014. IRS may begin an audit of that return as late as 2018 (or later if they assert substantial understatement) and they may not complete the audit for another several years – say 2020 – how well do you remember today what you were doing in 2014? Do you even have access to your paper or electronic records from 2014?

When you compile your tax information, consider preparing a brief narrative of what you accomplished in your horse business during the year – where your horses were, who won, who lost, who was born, who your advisors were, what went as expected, what you plan to change for the coming year, and how much time you spent on various activities.

The matters discussed above provide general information only. You should consult with an advisor about your specific situation before undertaking action based on such general information.