A Leg Up on Your Taxes

By Eric S. Adler, CPA

The year 2009 was *"un-be-lieve-able"* for the California Thoroughbred owner. The drama on and off the track contributed to the emotional and economic rollercoaster that is the racing industry. This article is not about Zenyatta's conquests, however, but more about the economic changes that affected the Thoroughbred owner during 2009.

Any tax article directed at the Thoroughbred owner must mention the importance of understanding the Sec. 183 "hobby loss" rules and the classification of passive-vs.-active income. The significance of understanding these guidelines before doing your tax planning cannot be overstated. The topics discussed below cover a few important changes to Federal and California law that may affect your tax planning and the filing of your 2009 tax return. It is best to consult a professional before considering any of the steps below.

American Recovery and Reinvestment Act of 2009 (ARRA)

The American Recovery and Reinvestment Act of 2009 (ARRA), signed by Congress during 2009, set out new guidelines for depreciation and also extended other popular tax incentives.

ARRA altered the recovery period for racehorses. Any racehorse (without regard to the age of the horse) placed in service after 2008 is treated as three-year property for General Depreciation System (GDS) recovery purposes. Whenever the recovery period is shortened, most owners benefit as this results in a faster recovery of cost.

The law extended bonus depreciation through 2009, which is the special 50% depreciation allowance, and increased limits on the Sec. 179 deduction. Typically, businesses recover capital investments through annual depreciation deductions spread over many years. Both of these provisions encouraged these investments by enabling businesses to write them off more quickly.

Section 179

The Sec. 179 deduction enables small businesses to deduct up to $250,000 of the cost of machinery, equipment, vehicles, furniture and other qualifying property (racehorses qualify) placed in service during 2009. This limit is reduced by the amount to which the cost of Sec. 179 property placed in service in the tax year exceeds $800,000. This special phase-out provision effectively targets the Sec. 179 deduction to small businesses and may eliminate it for many larger businesses.

Sec. 179 has a few important requirements with regard to Thoroughbred owners. The Thoroughbred must be acquired for business use and through purchase. It is also important to note that the Sec. 179 deduction must be used to offset taxable income and cannot be used to otherwise create a tax loss. California does not have the same limits with regard to Sec. 179.

Example: During 2009, EA Stables purchases a horse at a two-year-olds in training sale for $650,000. Assuming the stable has a taxable income of at least $250,000, exclusive of the Sec. 179 deduction, an immediate deduction of $250,000 would be available using Sec. 179. Then using bonus depreciation another deduction of $200,000 would be available. The benefit of an additional $450,000 would be recognized as a tax deduction in the current year. The asset would then be depreciable based on $200,000 of value. If the stable operates with a tax loss, Sec. 179 would not be available. However an immediate deduction of $325,000 would be available using bonus depreciation. The asset would then be depreciable based on $325,000 of value.

Bonus Depreciation

The bonus depreciation provision generally enables businesses to deduct half the cost of qualifying property in the year it is placed in service. One may be able to take an additional first year special depreciation allowance for certain qualifying property .The allowance is an additional deduction of 50% of the property's depreciable basis (after any Sec. 179 deduction and before figuring one's regular depreciation deduction).

Qualified property must also meet various tests with the following being important to the Thoroughbred owner: One must have acquired the racehorse after December 31, 2007 and before January 1, 2010. Qualified property must be placed in service before January 1, 2010, and the property must be "new;" therefore, a claimed horse will not qualify.

Property that does not qualify for the special depreciation allowance includes the following: horses placed in service and disposed of in the same tax year, property converted from business use to personal use in the same tax year it is acquired, and property converted from personal use to business use in the same or following tax year.

Federal Net Operating Loss (NOL) Carryback

One other important change that was enacted during 2009 was the Federal Net Operating Loss (NOL) carryback provision.

This allows businesses to elect to carryback an NOL from 2009 for three, four, or five years, in contrast to previous years in which the NOL was only allowed to be carried back two years. However, there are a few restrictions on the NOL carryback provision. The NOL carried back to the fifth year is limited to 50% of the available taxable income for that year. Any remaining NOL can fully offset taxable income in the remaining four carryback years. Determinations need to be made to carryback properly in order to result in optimum tax savings.

California NOL Suspended

Due to the economic woes in California, the state government suspended carryovers of NOLs in 2008 and 2009 except for small businesses, which are defined in California as taxpayers with net business income of less than $500,000 for the taxable year. NOLs for taxable years after 2007 will have a carryover period of 20 years (rather than the 10 years previously in effect) and the NOL carryovers suspended in 2008 and 2009 will have 10 years added to their carryover periods.

Beginning in 2011 carryback provisions are as follows:

Two Year Carryback
50% Allowed for 2011 Losses
75% Allowed for 2012 Losses
100% Allowed for 2013 Losses

California Estimated Taxes

The state of California has changed the estimated income tax payments for individuals and businesses for 2010. These new provisions will accelerate the payments by increasing the total percentage of the first two installments to 70%, rather than the prior 60%, of the required annual estimated tax. The installments will now be as follows for each of the four quarters: 30%-40%-0%-30%.

Planning for 2010

Beginning in 2011, tax rates prior to 2001 come back into effect, unless Congress takes action. The top income tax rate increases from its present 35% to 39.6%.

The tax rate for long-term capital gains and qualified dividends is scheduled to expire during 2010. In 2011, the maximum long-term capital gains tax rate increases to 20% from 15%.

With rates increasing in 2011, reverse tax planning for 2010 may be advisable. Income is accelerated and deductions are deferred; a strategy like this would enable the taxpayer to save if tax rates increase. If a racehorse at auction would command a sale price considerably more than its purchase price, it may be more beneficial to sell and recognize the gain in 2010. The opposite approach would be taken if the asset is going to be sold, but for a considerable loss; then it may be more beneficial to race the horse through year-end and sell for a loss in 2011.

With tax laws ever changing, proper planning can help ensure that the Thoroughbred owner is always a winner.

I look forward to seeing you at the track.

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