It's almost that time of year again…

Preparing for a HOBBY LOSS CHALLENGE

By Richard W. Craigo

Reasonable horse owners tend to agree that this is not the easiest business to be in if your sole objective is to make a profit. Nonetheless, according to Section 183 of the Internal Revenue Code, if a horse activity is not "engaged in for profit," then net losses from that activity are not allowed to offset other income. Known as the "hobby loss" provision, it requires the owner to demonstrate an "actual and honest object of making a profit." The reality is that any owner is open to a hobby loss challenge – either by the IRS or the State of California. Thus, the best defense is to be prepared; and, thorough advance preparation includes the following:

Establish a separate checking account for the activity. This is a must.

Engage a professional accountant and set up separate business and financial books and records, preferably accounting on a horse-by-horse basis. Also, be businesslike, in general, utilizing insurance and advertising, where appropriate.

Retain tax returns and records from the beginning of the horse activity. Prepare a written business plan. The plan should include annual budgets, although case law recognizes that, regarding Thoroughbreds, accurate projections of income are difficult to achieve.

Maintain a list of experts that have been consulted before and during the activity.

Keep a comprehensive time record. This includes any time spent on activities relating to the business – such as time spent at racetracks during both training hours and the racing program, visiting farms, attending seminars and auctions, maintaining business books and records, consulting with trainers and other professionals, etc.

Keep a list of the hardships that occur occasionally – such as injuries, deaths, illnesses, and abortions or barrenness of mares.

Obtain periodic appraisals where horses have appreciated in value.

If a series of loss years is experienced, consider revising the business plan or method of operation.

Maximize gross receipts. Courts tend to believe that substantial receipts from racing or sales are consistent with a profit motive, even though overall losses persist.

Minimize the appearance of utilizing the activity for pleasure or recreation. Virtually all adverse court decisions find elements of personal pleasure or recreation. While some agents claim that attendance at racetracks is recreational, we disagree. A prudent business person will want to see owned horses compete, view the competition, and possibly view purchase prospects.

By far the best way to prevent a hobby loss challenge is to assure that cash basis profits are realized at least occasionally. But there is no requirement, as some owners mistakenly believe, that profits must be realized in two out of every seven years. The most effective way to establish a profit year is through a sale of horses at a gain. And the entire gain on the sale of a horse may be reported in the year of sale, even if some of the cash is not received until a later year.

For many years government agencies have targeted horse operations for special scrutiny under the "hobby loss" statute. The horse owners who will be spared such challenges – or who will prevail when challenged – are those who have done sufficient planning to set them apart from that majority of horse owners who do not make the effort to accomplish such preventive measures until it's too late.

Richard W. Craigo is a Los Angeles attorney certified as a tax specialist by the California Bar Association. Specializing in equine law since 1979, he has represented owners, breeders, trainers, veterinarians and bloodstock agents in business transactions, administrative law practice, and litigation and tax matters. He has represented horse owners in more than 120 hobby loss and passive loss disputes with the IRS and state taxing authorities.