ACCOUNTING, OPERATIONAL, AND TAX CONSIDERATIONS FOR THOROUGHBRED BUSINESS OPERATIONS

THOROUGHBRED OWNERS OF CALIFORNIA (TOC) TAX SEMINAR
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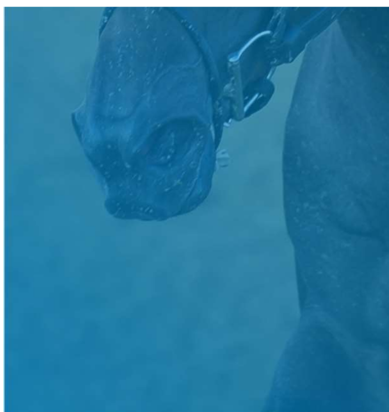

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SELECT A BUSINESS ENTITY

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 **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.

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.

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, 2021 to breed to a stallion in the 2022 breeding season and the contract requires the fee to be paid upon signing. The fee should be deductible in 2021, whether or not the contract guarantees a live foal. This 2021 expenditure is not generally expected to produce related income until the resulting 2023 foal is sold as a weanling in 2023, as a yearling in 2024 or begins racing as a 2-year-old in 2025.

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

- 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).
- a C Corporation which has gross receipts over $26 million in 2021.
- a partnership with a C Corporation as a partner which has gross receipts over $26 million in 2021.

The gross receipts noted above are based on an average of the 3 years prior to the current year. Certain related corporations must be included in computing total gross receipts. Special rules apply if the entity has not been in existence for the full 3 years. These gross receipts thresholds are adjusted annually for inflation.

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

TAX INCENTIVES AVAILABLE TO HORSE OWNERS

FEDERAL DEPRECIATION

In general, horses, cattle and other farm assets may be eligible to be depreciated once purchased and placed in service. Horse and farm owners may now use the 200%, versus 150%, declining balance for qualifying assets based on Federal tax law as of the date of this publication. If the 150% declining balance is preferred, an election may be made to utilize this; however, once made, this election is irrevocable.

Some examples of depreciable lives for common equine assets:

- 3 years: Yearlings placed in service through 12/31/2021, racehorses, any horse other than a racehorse (i.e., breeding stock) which is more than 12 years old
- 5 years: NEW (but not used) farm equipment, cattle
- 7 years: Any horse other than a racehorse which is 12 years old or less, farm equipment not eligible for 5-year life, fencing, racing prospects 2 years old or less (yearlings) placed in service after 12/31/2021
- 15 years: land improvements such as roads
- 20 years: barns

It is important to note that the depreciable life for horses depends on the actual age of the horse (based on foaling date versus the January 1 industry standard) when placed in service. Inventory items, such as weanlings or weanling to yearling pinhooks, are not eligible to be depreciated.

For tax purposes, there are tables which list the annual percentage of the purchase price which may be depreciated. Note that the recovery period is 1 year longer than the depreciable life listed above, as half year depreciation is claimed in the initial and final year. There are special rules that require the use of the mid-quarter versus half-year tables if greater than 40% of qualifying assets are acquired in the final quarter of the year.

When a horse is transferred from racing to breeding, the depreciation life needs to be changed based on the un-depreciated basis in the animal.

For reference, below are the 3-year and 7-year depreciation tables used for horse purchases (Mid-year convention / 200% declining balance):

Depreciation Percentages (Mid-Year Convention/200% Declining Balance)		
	Racehorse 2 years old or less and Breeding Stock 12 years old or less	**Racehorse more than 2 years old and Breeding Stock more than 12 years old**
Year 1	**14.29%**	**33.33%**
Year 2	**24.49%**	**44.45%**
Year 3	**17.49%**	**14.81%**
Year 4	**12.49%**	**7.41%**
Year 5	**8.93%**	
Year 6	**8.92%**	
Year 7	**8.93%**	
Year 8	**4.46%**	

Assets used predominantly outside of the US and electing farm businesses for purposes of the business interest limitation (not covered in this publication) are required to use the alternative depreciation system (ADS) for certain assets which are also not eligible for the Federal bonus depreciation covered below.

The provisions discussed next merely impact the timing of the Federal depreciation deduction by accelerating the deduction on qualifying property.

FEDERAL BONUS DEPRECIATION

Federal bonus depreciation has been significantly expanded, increasing the deduction in the first year and the type of qualifying property which is eligible for this first year deduction. Through 12/31/2022, 100% of the purchase price may be depreciated when the horse or other qualifying asset is placed in service. In order to qualify, the property must not have been previously owned by the purchaser, must not have been acquired from a related party or via gift or inheritance, and must be predominately used in the United States. After 2022, the bonus depreciation percentage decreases by 20% each year (so, 80% in 2023, 60% in 2024, 40% in 2025, 20% in 2026 and zero thereafter).

Examples of potentially qualifying property are yearlings, racehorses, breeding stock, equipment, fencing, land improvements, and barns.

Bonus depreciation applies to large and small businesses – there are no sized-based limits and the deduction is allowed whether or not the business has taxable income. It is also not prorated based on the time of year that assets are placed in service.

An annual election out of this bonus depreciation is available on an asset class-by-class basis. It may be preferable to depreciate the purchase price over a period of time to better align the depreciation deduction with the potential for income.

FEDERAL SECTION 179 EXPENSING ELECTION

The annual limit for Section 179 expensing is $1,080,000 but this starts to phase-out dollar-for-dollar if qualifying property additions exceed $2,700,000 in 2022 (adjusted annually for inflation). Like bonus depreciation above, the deductible amount is not impacted by when during the year the property is placed in service – late year qualifying additions receive full benefit. Property previously-owned may also qualify for this deduction. However, this deduction is available only to the extent of the taxpayer's net business income.

20% QUALIFIED BUSINESS INCOME DEDUCTION FOR NON-C CORPORATIONS

For those who conduct horse operations via partnerships, S corporations or sole proprietorships, there is a 20% deduction available against qualified business income effective for calendar years 2018 through 2025. Since most horse owners operate as sole proprietors or via pass-through entities, this deduction may be valuable to those with profitable businesses while requiring those with business losses to reduce this deduction. Individuals, trusts and estates may qualify for this deduction, which is calculated at the owner versus pass-through entity level. K1s issued to pass-

through entity members will provide the information necessary for the owner to calculate this deduction.

Qualified business income is the net income or loss generated from each of a taxpayer's US businesses but does not include investment income such as interest, dividends and capital gains. It also does not include wages earned by an employee or guaranteed payments paid to a partner by a partnership.

If the owner's taxable income is less than the below thresholds, this deduction is the lesser of 20% of qualified business income or 20% of taxable income excluding net capital gains.

However, if the owner's 2021 taxable income exceeds $164,900 ($329,800 if married filing jointly) (amounts are annually indexed for inflation), then two additional limitations apply.

The first limitation is based on allocated wages and/or allocated qualifying depreciable assets (the greater of 50% of allocable qualifying 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). The second limitation further defines a qualified business to include any trade or business other than a specified service business. There are specific fields that are listed as specified service businesses but the two designations that may impact certain equine industry participants are athletics and consulting. Jockeys, vets, and certain consulting arrangements which provide advice on things like horse purchases and sales may be classified as specified service businesses and not be eligible for this deduction (but only if taxable income exceeds the thresholds noted above).

Businesses that meet certain criteria may be aggregated either at the pass-through entity or individual taxpayer level in order to maximize this 20% deduction.

The mechanics of this 20% deduction, some of which are not mentioned above, are complex and beyond the scope of this summary; nonetheless, equine industry participants should be aware of how their horse and farm activities may impact this overall potential 20% qualified business deduction.

CAUTION REGARDING THE EXCESS BUSINESS LOSS LIMITATION FOR INDIVIDUALS, TRUSTS, AND ESTATES – 2021 THROUGH 2026

Many industry participants who utilize the Federal tax incentives noted above will report taxable business losses. While not equine-specific, net business losses are subject to an annual limitation through 2026, adjusted annually for inflation, with the excess treated as a net operating loss carry-forward. In 2021, total net business losses - both equine and non-equine - are limited to $262K ($524K if filing a joint tax return). If net business losses exceed this limit, this results in a deferral of the excess loss subject to the net operating loss carry-forward rules (eligible to offset up to 80% of taxable income in subsequent years). Industry participants should be aware of this annual limitation which may impact the timing of the Federal tax benefit associated with the business deductions discussed above.

STATE INTERACTION WITH FEDERAL TAX INCENTIVES NOTED ABOVE

States may or may not follow the Federal tax laws regarding the above tax incentives and many states have decoupled from the more favorable provisions. Check with specific states to determine if the above may apply or if separate state depreciation calculations and adjustments to taxable income are required for state tax filings.

LIKE-KIND EXCHANGES

Like-kind exchanges of horses, vehicles and farm equipment are no longer eligible for tax free treatment. You can defer gain on the disposition of real property, such as farms or commercial or residential real estate, by using a like-kind exchange (also called a 1031 exchange) if the proceeds are reinvested in qualified property. US real property is not like kind to non-US real property.

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

GENERAL EQUINE OPERATIONAL AND OTHER TAX CONSIDERATIONS

STATE SALES AND USE TAX

- Sales tax rules vary by state. For example, many states exempt the sale of breeding stock (localities may impose tax) while racehorses are generally subject. Specific exemptions may apply on a state-by-state basis so it is important to review the laws in each respective state in which horses are purchased, used and sold.
- Use tax may be due for the use of a horse in a particular state.
- A link to Dean Dorton's multi-state equine sales and use tax guide may be found on our website here or via QR code below:

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, 2021 would be a yearling on January 1, 2022. 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.

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. The expenses are deducted only as miscellaneous itemized deductions, which have been eliminated through calendar year 2025. As such, the deduction for these hobby expenses is 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 2015 and 2016, the presumption is good through 2021. 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 (considering 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.

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 2017. IRS may begin an audit of that return as late as 2021 (or later if they assert substantial understatement) and they may not complete the audit for another several years – say 2023 – how well do you remember today what you were doing in 2017? Do you even have access to your paper or electronic records from 2017?

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.