



TRAINERS VS. THE IRS

QUALIFYING LOSSES AS BUSINESS DEDUCTIONS

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As a Thoroughbred trainer, you are running an equine-related business. But the IRS may decide you are merely enjoying an expensive hobby. If that happens, the agency will deny your business expense deductions and boost your tax bill. What guidelines should you follow to ensure that your activities are not miscategorized, and when is the law on your side?

► A costly question

Here is a riddle for you: When is a business not a business? Before you answer, I should tell you that the Internal Revenue Service (IRS) is asking, not me. And with that, as is often the case when a tax collector asks a question, the wrong answer could prove costly. So, when is a business not a business? When the IRS says it is a hobby.

The question itself is valid. The United States Federal Tax Code taxes business income, among other things. In doing so, it allows any taxpayer who owns and runs a business to deduct all “ordinary and necessary expenses paid” during a tax year for “carrying on a trade or business.” However, the code also makes it clear that carrying on a trade or business means engaging in an activity to earn a profit, not because it is fun or enjoyable.

What does the IRS call engaging in an activity on a regular basis for the sheer pleasure of doing it? The same thing the rest of us do. “A hobby.”

Before Congress rewrote the federal tax code in 2018, some taxpayers might have been able to deduct certain hobby expenses. But they would have had to make money from the hobby, reported income and made sure their expenses qualified as miscellaneous itemized deductions under IRS rules. How many deductions does the current tax code allow for hobby-related expenses? Basically, none.

► From pleasure to profit

Meanwhile, American popular culture bombards us with career advice, urging us to pursue our passion and follow our dreams. No wonder so many of us grow up fantasizing about wildly successful careers spent doing something we love. The budding guitarist dreams of becoming a rock star. The talented young artist, of selling paintings in Paris for millions. And the young man or woman with talent and skill for horses, of riding to victory in the Triple Crown. While dreams like these are longshots, they might come true. More realistically, they may lead to other careers. The grown-up guitarist teaches music lessons, for instance, while the artist works as a freelance children’s book illustrator, and the young horseman becomes a Thoroughbred trainer.

In each of these cases, the individual would be running a business that began as a hobby. Doing so might be their full time career, or a “side hustle”

that supplements income from another job or business. These individuals may enjoy what they do a great deal. But once they start doing it to make money, their operating expenses are tax deductible. In other words, they are required to pay taxes only on their net profits (business income minus business expenses), not on the business’ gross profits (business income before the deduction of business expenses).

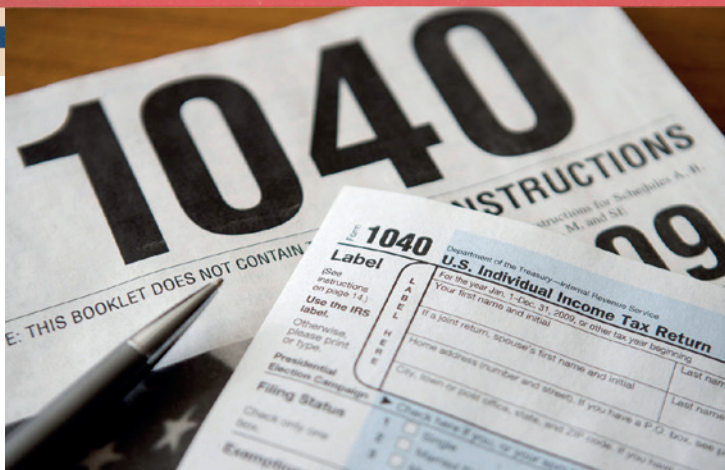
This means that items like the music teacher’s new amplifier, the illustrator’s new watercolor brushes and the trainer’s new tack may all be deducted, so long as the items are used for business purposes. The same applies to all other legitimate business expenses—from cellphones to facilities. And as the owner of any Thoroughbred-related business knows, expenses can add up quickly, especially when a business is starting up or expanding.

► The tax collector’s call

Unfortunately, taxpayers sometimes believe they are running a business, only to have the IRS decide they are simply spending a lot of money on a hobby. When this happens, the IRS typically rejects the taxpayer’s deductions for business expenses and invokes any number of what the agency sees as remedies. These range from insisting that an individual pay higher taxes in a single year to auditing up to six years of tax returns and demanding the payment of additional back taxes, plus interest payments and monetary penalties.

And woe unto the would-be wily tax cheat who clearly knows he is not really running a business and deliberately attempts to scam the IRS by claiming hobby costs as business expenses. Similarly honest mistakes on your taxes can be expensive. But in addition to being expensive, deliberate fraud can land the taxpayer in criminal court, and eventually prison.

If the IRS deems a taxpayer’s activities a hobby instead of a business, and the taxpayer disagrees with the agency’s determination, the taxpayer may gather their business records and other evidence and appeal to the IRS. If that fails, he or she may challenge the IRS in Tax Court. These situations can get complicated and expensive. Consider the landmark case of *Merrill C. Roberts v. the Commissioner of Internal Revenue*, in which a Thoroughbred operator challenged the IRS with dramatic results. >



< **► Case in point**

Merrill Roberts is a successful entrepreneur who owns and operates businesses in the Indianapolis, Ind. area. Roberts proved skilled at making money in businesses in which turning a profit can be difficult, including restaurants and nightclubs. He had sold most of his businesses and largely relegated himself to consulting roles by the late 1990s, when he accepted an invitation to a Thoroughbred association dinner. A dinner created to draw new participants into the racing industry.

Merrill Roberts caught the horse racing bug, big time. Within a couple of years, he owned a dozen horses, including a breeding stallion. He stabled them on his own property and employed various trainers. He passed the test to become a licensed trainer himself in 2002. Roberts also joined industry associations, eventually accepting leadership positions in two such organizations. And he lobbied for slot machines at Indiana racetracks—the proceeds of which help increase racing purses.

Immersed in his new activities, Roberts expanded his equine endeavors. He purchased 180 acres in rural Indiana and built an impressive new training facility. In addition to breeding, racing and boarding horses, Roberts grew hay on the property and leased some of the land to local farmers. His horses may not have set the world on fire, but his stable included some solid competitors.

► An expensive turn of events

Although Merrill Roberts' horse operations created significant gross revenue, his annual expenses were high. After making a small profit in his first year, he lost money for several more. The IRS audited Roberts' tax returns for 2005–2008, and determined that during those tax years, his horse racing activities were a hobby and not a business. This meant that, for those years, the IRS refused to accept Roberts' expenses for Thoroughbred activities as business deductions. Having dismissed his deductions, the IRS presented Roberts with a bill totaling over \$1 million for back taxes, penalties and interest. But like many successful entrepreneurs, Merrill Roberts is no shrinking violet, and took the IRS to Tax Court. The case went to trial in 2014.

In determining whether Roberts' horse operations constituted a business under IRS rules, the Tax Court noted several points in his favor. First, Merrill Roberts *conducted his activities in a businesslike manner*. Second, he relied on solid accounting methods, including the services of certified public accountants (CPAs). Third, he *invested large amounts of time* in horse-related activities, routinely working eight-to-twelve-hour days. Fourth, Roberts *relied upon industry experts*, including respected trainers and bloodstock agents. Fifth, he also *gained expertise himself*, learning to be a trainer and passing a state licensing test that the Tax Court itself found "rigorous." Sixth, he *purchased property and invested in suitable facilities* for the conduct of his equine activities; and seventh, Roberts reasonably believed *his property would appreciate in value*, adding credence to his claims of a profit-driven model.

In addition to these factors, the Court noted that Merrill Roberts had a *proven record of success* in other business ventures. The Tax Court also noted that, although Roberts

was wealthy, he did not appear to be so wealthy that he could view the funds spent on his horse operations dismissively. However, the Tax Court also noted that Roberts had received some income from real estate transactions and rental properties in certain years, which *could have reduced the need* for the horse operations to be profitable. And the court considered indications that *Roberts enjoyed* his Thoroughbred activities.

► Decisions, decisions

At this point, you have probably decided that the IRS was clearly wrong about Merrill Roberts' equine efforts, and the Tax Court quickly ruled in his favor. But remember, there is rarely an open-and-shut case. The Tax Court also recognized that in 2005 and 2006, Merrill Roberts attended races and on-track training sessions, indicating he *enjoyed the social and recreational side* of Thoroughbred activities. Even though, in 2007, Roberts had delegated those duties to an assistant trainer and spent more time at his own facilities.

The Tax Court ultimately ruled that, because Merrill Roberts received income from other business and because he *enjoyed the social and recreational aspects* of his horse operations, Roberts' equine endeavors functioned as a hobby during the 2005 and 2006 tax years, but as a business during the 2007 and 2008 tax years. One could view this as a partial victory for Roberts, or a convoluted, illogical decision. Roberts saw it as the latter and took the case to the Seventh Circuit Court of Appeals.

In April 2015, the Court of Appeals issued its decision. The ruling restated the many facts in Roberts' favor as recognized by the Tax Court. It also noted that legitimate businesses could expect to lose money for a period of years due to start-up costs. It touched on the fact that horse racing is a business in which making a profit may prove difficult and pointed to Merrill Roberts' various efforts to do so.

► Appealing results

The Appeals Court then detailed the flaws and contradictions in the Tax Court's ruling. It noted that the IRS had not challenged the business vs. hobby status of Roberts' Thoroughbred activities during the years prior to 2005. This meant that, in the eyes of the IRS, Merrill Roberts' equine activities had somehow transformed from businesses to hobbies and back to businesses in less than a decade. The Seventh Circuit judges found this absurd, especially since it eliminated start-up and expansion costs as business expenses.

The appellate judges stated that a business-like activity could not be labeled a hobby simply because the owner had other businesses that produced a profit, regardless of how much the owner enjoyed the activity in question. Indeed, the concept of enjoyment was at the heart of the Court of Appeals decision. The Court of Appeals stated: "...obviously many businessmen derive pleasure, self-esteem, and other non monetary 'goods' from their businesses, and horse racing is just the kind of business that would generate such 'goods' for participants such as the owners and trainers (Roberts is both) of the horses..." The court dismissed the idea that enjoying aspects of an activity could be used to determine whether that activity was a business or hobby.

The Federal Court of Appeals held that it could not be too hard on the Tax Court for its convoluted decision, because the Tax Court had been required to follow regulations that were "goofy."



The Federal Court of Appeals proceeded to deconstruct the IRS' longstanding "enjoyment" standard. It pointed out that "fun doesn't convert a business to a hobby"; "a hobby is not a career"; and that "a person deciding whether to take up a hobby is not contemplating a career change." It added that "profit goes with businesses, not hobbies" and quoted a 1972 court decision that states: "suffering has never been made a prerequisite for deductibility."

Based on these factors and others, the court ruled in Merrill Roberts' favor. His Thoroughbred business had always been a business. His deductions were allowed. He owed no additional taxes, penalties or interest for the years in question. It was a vindication that set new standards for the business/hobby determination.

► 9 things you must know

So, how do you ensure the IRS regards your equine activities as a business and not a hobby? First, know that there are currently nine key factors the IRS expects you to consider before you report any activity as a business. Second, know that the agency uses these same nine factors to determine whether an activity is a business or a hobby. Third, know that the IRS may come to a determination by applying a single factor, all nine factors, or any combination of the factors to a particular situation.

Here are the nine factors the IRS currently uses, and expects you to use, when determining if an activity is a business or a hobby:

- 1.) Whether the activity is carried out in a businesslike manner and the taxpayer maintains complete and accurate books and records.
- 2.) Whether the time and effort the taxpayer puts into the activity show they intend to make it profitable.
- 3.) Whether the taxpayer depends on income from the activity for their livelihood.
- 4.) Whether any losses are due to circumstances beyond the taxpayer's control or are normal for the start-up phase of their type of business.
- 5.) Whether the taxpayer changes methods of operation to improve profitability.
- 6.) Whether the taxpayer and their advisors have the knowledge needed to carry out the activity as a successful business.
- 7.) Whether the taxpayer was successful in making a profit in similar activities in the past.
- 8.) Whether the activity makes a profit in some years and how much profit it makes.
- 9.) Whether the taxpayers can expect to make a future profit from the appreciation of the assets used in the activity.

► Details may vary

These nine factors are referred to as the "Facts and Circumstances Test." If you have been in the business for several years, you may have noticed that some of these factors have changed since 2015, as a result, in part, of the Roberts case.

Some of the nine factors, including the number of profitable years within a certain timeframe, may vary based on the industry or type of business. Consider item number eight, regarding profitability over time. According to the IRS, activities should show a profit in at least two out of five consecutive tax years to be considered a business. But when "an activity consists in



major part of the breeding, training, showing or racing of horses," it should show a profit in at least two of seven consecutive tax years to be classified as a business and not a hobby. The longer timeframe is an acknowledgement of the challenges involved in making a profit in horse-related businesses.

► Be a pro, work with pros

Knowing and following the "Facts and Circumstances Test" will help you stay out of trouble with the IRS. What's more, this test will assist you in operating your business in a professional manner. These factors may even assist in expanding your business and increase your profits.

Many horse-related businesses are relatively complex from a tax standpoint. I recommend that a CPA and/or attorney with equine knowledge and experience be consulted. These professionals may also assist with decisions such as whether you should incorporate, and what type of business entity is best suited to your business model.

The IRS will continue to keep an eye on activities where professionals and hobbyists may overlap, particularly when those activities involve large expenses that might be reported as business deductions. **T**