BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82A-1867-GO
WIELAND H. AND JENNIE COLLINS)

Appearances:

For Appellants: Richard W. Craigo
Attorney at Law

For Respondent: Grace Lawson
Counsel

OPINION

This appeal is made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Wieland H. and Jennie Collins against proposed assessments of additional personal income tax in the amounts of $1,506.45, $445.70, $1,729.17, and $4,833.94 for the years 1975, 1976, 1977, and 1978, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

The sole issue presented in this appeal is whether appellants' operation of a horse farm constitutes an activity "not engaged in for profit" within the meaning of section 17233, subdivision (a), so as to limit the amount of the allowable deductions associated with such activity.

In 1956, appellants purchased three Thoroughbred brood mares for a total price of $4,000. Shortly thereafter, in 1957, appellants purchased a 14-acre horse farm located in Rancho Santa Fe for approximately $40,000 for use in their Thoroughbred operation and as their personal residence.[2/] Appellants state that from the beginning their plan was to earn a profit in their Thoroughbred operation by the judicious breeding and racing of their horses and by building up the quality and quantity of their horses, while also defraying the costs of the farm real estate as it appreciated in value. (App. Reply Br., Ex. C.) While the record is not entirely clear, it appears that the total number of horses in the operation had, at one time, increased to 32, but that during the years at issue had been reduced to 16. (Tr. at 11.) This number included one stallion and five broodmares, together with various foals, yearlings, and racing horses. (Tr. at 14.) Appellants entered their horses in from 10 to 25 races per year and state that they have entered approximately 450 races during the time of their operations. No data has been presented with respect to purses, if any, won by appellants' horses during the years at issue, but from 1961 through 1983, appellants sold or had claimed 53 horses for a total compensation of $121,165, Nevertheless, appellants' horse operations generated losses for over 20 straight years including the years at *issue.*

Upon audit, respondent concluded that appellants had failed to establish that they were engaged in the horse operations for a profit rather than as a hobby. Accordingly, respondent allowed certain deductions like real property taxes, which would have been deductible whether or not the horse operations were engaged in for profit (Rev. & Tax. Code, § 17233, subd. (b)), but disallowed the remaining expenses associated with the horse operations. Appellants protested, but respondent

2/ This residence is a three-bedroom, 1250 square-foot house which is 60 years old. Appellants have made this house their residence since 1957. (App. Reply Br., Ex. E at 3.)

affirmed the proposed assessments, and this appeal followed.

Section 17233 provides, in relevant part, that if an activity is "not engaged in for profit," only those deductions allowable regardless of a profit objective (e.g., taxes or interest) may be allowed. Accordingly, the disputed deductions with respect to the horse operations are allowable only if appellants had an actual and honest profit objective for engaging in those activities. (Appeal of Paul J. and Rosemary Henneberry, Cal. St. Bd. of Equal., May 21, 1980; Appeal of F. Seth and Lee J. Brown, Cal. St. Bd. of Equal., Aug. 16, 1979.) The taxpayer's expectation of profit need not be a reasonable one, but there must be a good faith objective of making a profit. (Allen v. Commissioner, 72 T.C. 28 (1979).) Of course, whether the activities were engaged in primarily for such profit-seeking motive is a question of fact upon which the taxpayer has the burden of proof. (Appeal of Guy E. and Dorothy Hatfield, Cal. St. Bd. of Equal., Aug. 1, 1980; Appeal of Clifford R. and Jean G. Barbee, Cal. St. Bd. of Equal., Dec. 15, 1976.) The regulations[3/] prov-ide a list of factors relevant in determining whether a taxpayer has the requisite profit motive. While all facts and circumstances with respect to the activity are to be taken into account, no one factor is determinative in making this determination. (Treas. Reg. § 1.183-2(b).) Among the factors which normally should be taken into consideration are the following: (1) manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) an expectation that assets used in the activity may appreciate in value: (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned: (8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation. After carefully reviewing the facts and circumstances involved here and considering the relevant cases in light of the applicable regulations, we are convinced

3/ As section 17233 conforms to Internal Revenue Code section 183 and since there are now no regulations of the Franchise Tax Board in this area, the regulations under section 183 of the Internal Revenue Code govern the interpretation of section 17233. (Cal. Admin. Code, tit. 18, reg. 19253.)

that appellants possessed the requisite profit motive with respect to the subject activity so that the disputed deductions are allowable.

Appellants contend that they operated the horse farm in a businesslike manner. They state that they maintained complete, accurate and separate books, records, and bank accounts and retained the services of a certified public accountant in this regard. In addition, appellants note that they adopted methods (e.g., reduction of transportation, training, and feeds costs) and abandoned unprofitable procedures (e.g., boarding the horses of others). Respondent appears to concede that the horse farm was, at least nominally, run in a businesslike manner, but argues that "where the hobby is a relatively expensive one ... it is only reasonable for one engaged in such a hobby to attempt to make the operation economical." (Resp. Br. at 9.) Moreover, noting that "the keeping of books and records may represent nothing more than a conscious attention to detail" (Golanty v. Commissioner, 72 T.C. 411, 430 (1979)), respondent argues that the records were not used to cut expenses, increase profits, or evaluate the overall. performance of the operation. However; appellants indicate that their discontinuance of boarding horses was done because they determined that to continue was uneconomical. Additionally, appellants changed their training procedures in order to reduce costs. (App. Reply Br., Ex. C at 2.) Certainly, the knowledge which they gained from their records would have been useful in and would have contributed to these decisions. Moreover, the fact that appellants have kept and maintained separate checking and bank accounts for the horse farm indicates that they intended to segregate that activity from their personal activities. (See Engdahl v. Commissioner, 72 T.C. 659, 667 (1979).) In addition, seeking and retaining the assistance of an accountant has been found to be "strong indication of the presence of a profit-making motive." (Farris v. Commissioner, ¶ 72,165 T.C.M. (P-H), at 72-862 (1972).) Based on the record presented us, we must find that appellants operated the horse farm in a businesslike manner.

Appellants also allege that they have expended extensive time to study the Thoroughbred industry and to consult with those who are experts in that industry. Appellants are members of the California Thoroughbred Breeders Association and Jennie has attended almost all the public Thoroughbred auctions in southern California in addition to veterinary seminars. Appellants subscribe

to various periodicals (e.g., "Blood-Horse" and "Thoroughbred of California") as well as regularly reading the "Daily Racing Form" and have accumulated a library about Thoroughbred industry practices. In addition, appellants have had informal and continuous consultations with veterinarians, trainers, and other horse breeders who are knowledgeable. For example, appellants have consulted with numerous experts in the industry including the successful trainers Hal King, Riley Cofer, and Ross Bringson, veterinarian Dan Evans, and Eugene Cummings, a manager of one of the largest Thoroughbred establishments in California. (App. Reply Br., Ex. C at 3.) In addition, appellants have benefited from associating with knowledgeable owners such as Rex Ellsworth, Flavious Lomax, and Dorothy Morton. (App. Reply to Resp. Supp. Memo. at 6 and 7.) (See Engdahl v. Commissioner, supra 72 T.C. at 668; compare Golanty v. Commissioner, supra, 72 T.C. at 432.) Appellants argue that these actions demonstrate an intent to develop a high level of expertise in the area which, in turn, indicates an intent to engage in the horse business for profit. In spite of these pursuits, respondent argues that, primarily in light of the consecutive years of losses, appellants actions "are characteristic of one engaged in a loved, although expensive hobby as opposed to an objectively run business." (Resp. Br. at 9.) However, based upon the record before us, it appears Jennie, who did much of the veterinarian and breeding tasks, has as significant an expertise as have many taxpayers who have been found to have acquired sufficient training to indicate possession of a profit motive. (Sanderson v. Commissioner, ¶ 62,284 T.C.M. (P-H) (1964), involving a practicing surgeon and his wife; Pennington v. Commissioner, ¶ 67,111 T.C.M. (P-H) (1967), involving the owner of a merchant patrol service and his wife; Appley v. Commissioner, ¶ 79,433 T.C.M. (P-H) (1979), involving a taxpayer described as one of the country's foremost experts in the field of management and organization.) Accordingly, again based upon the record presented us, we must find that appellants' expertise with respect to breeding and racing horses, indicates that the activity was engaged in for profit.

Another factor of great importance in determining the intent of appellants is the time and effort they expended in carrying on the activity. Jennie has testified that she devoted about six hours a day, seven days a week to running the horse operations. She stated she helped to breed the horses, deliver the foals, and administer medical attention to the horses. Wieland has testified that he spent two to four hours a day, seven

days a week, working on the farm. (Tr. at 11.) Respondent discounts the significance of the amount of time spent on the horses by stating that those involved in a hobby "are usually more than willing to perform the various tasks required by their hobby." (Resp. Br. at 8.) However, it seems clear that "activities such as 'mucking out' stalls, breeding horses, delivering foals, attending to sick or injured horses and grooming horses do not have the same recreational attraction as attending a horse show." (Patrick, Business Versus Hobby: Determination of Whether a Horse Activity is Engaged in for Profit, 70 Ky. L. J. 971 at 980 (1983).) Appellants' long hours did not have substantial personal or recreational aspects and, accordingly, indicate an intention to make a profit. (Cf. Keelty v. Commissioner, ¶ 84,173 T.C.M. (P-H) (1984), where the taxpayer rarely did any farming work, but instead boated in the summer and hunted in the winter.)

The most contested factor presented in this appeal is whether appellants had an expectation that assets used in the horse operations might appreciate in value. Appellants note that Treasury Regulation section 1.183-2(b)(4) provides that "[t]he term 'profit' encompasses appreciation in the value of assets, such as land, used in the activity." As indicated above, appellants purchased the subject ranch in 1957 for approximately $40,000. In these proceedings, appellants have produced a detailed independent appraisal which indicates the value of the ranch to be $980,000 in 1984. In addition, appellants state that the number of horses which they owned had increased from 3 to 16 during the years on appeal and that these 16 horses have a substantial fair market value. Aggregation of the increase in value of these assets with the operation of the horses, appellants argue, establishes their intent to make a profit in this activity. Respondent, however, argues that the increase in the "value of appellants' real property should not be considered in determining the existence or nonexistence of a profit motive." (Resp. Br. at 10.)

Respondent relies upon Treasury Regulation section 1.183-1(d)(1) which provides in relevant part:

> If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183. Where land is purchased

> or held primarily with the intent to profit from increase in its value, and the taxpayer also engaged in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land .... (Emphasis added.)

Arguing that in no year before this board had appellants' gross revenues from the horse operation exceeded the expenses directly attributable to the horses, respondent concludes that the holding of the land and the horse operations cannot be aggregated. However, since the holding of the land was only a collateral purpose and not the primary purpose of the horse operation, we do not feel that this regulation operates to prevent appellants from considering the appreciation of the land as an asset used in connection with the horse operations. (Ellis v. Commissioner, ¶ 84,050 T.C.M. (P-H) at 84-188 fn. 6 (1984), which held the above regulation did not operate to prevent aggregation of the horse operations and land appreciation because the holding of the land for appreciation was secondary to the central purpose of using the

4/ The record indicates the following gross revenues and expenses for the horse operations. (See Resp. Br., Ex. C.)

	1975	1976	1977	1978
Gross Revenue	$13,584	$ 1,287	$ 800	$ 7,000
Total Expenses	26,381	19,104	21,965	30,597
(Loss)	($12,797)	($17,817)	($21,165)	($23,597)

While the record does not break down the expenses between those directly attributable to the horses and those to the holding of the land, Exhibit A attached to appellants' reply brief indicates that expenses directly attributable to the horses exceeded gross revenues in each year.

land for taxpayers' quarter horse activities.)[5] Accordingly, after aggregating the appreciation of the land, we find that expectation of an overall profit was warranted.[6]

The most troublesome aspect of this appeal, both for this board and for respondent, centers upon appellants' history of losses with respect to the horse operations. Indeed, the record indicates that from its inception in 1956 through 1979, appellants' horse operations generated consecutive years of losses.[7] Only in 1980 (subsequent to the years under appeal), after the creative intervention of an accomplished tax advisor, did appellants' horse operations show a profit. Respondent argues that like the taxpayer in Boddy v. Commissioner, ¶ 84,156 T.C.M. (P-H), at 84-554 (1984) I "it strains credibility to believe that after experiencing 18 years of straight losses totaling $387,479.76, petitioner had an actual and honest profit objective in carrying on his horse breeding operation." However, as previously indicated, this one factor is not determinative. (McKinney v. Commissioner, ¶ 81,181 T.C.M. (P-H) (1981).) Moreover, the taxpayer in Boddy raised Arabian horses, which unlike the racing Thoroughbreds at issue here, are not ordinarily capable of generating substantial and quick profits. Indeed, many of the cases which have found periods of losses to be indicative of hobbies have involved activities which require moderate but steady yearly gains for success. (See, e.g., Keelty v. Commissioner, supra,

5/ Contrary to respondent's contentions, based on the record before us, we cannot find that appellants were real estate professionals whose primary purpose in purchasing the subject ranch was land speculation.

6/ Because of this finding, we do not have to speculate upon the value of appellants' horses.

7/ While the record is not complete, the yearly losses for which data is available are as follows:

Year	Loss	Year	Loss
1969	$10,099	1975	12,797
1970	7,727	1976	17,817
1971	9,490	1977	21,165
1972	8,675	1978	23,597
1973	21,380	1979	21,185
1974	16,050		

involving a grain and cattle operation; Mahr v. Commissioner, ¶ 82,297 T.C.M. (P-H) (1982), involving dog breeding; Swigert v. Commissioner, ¶ 82,500 T.C.M. (P-H) (1982), involving yacht chartering; Blake v. Commissioner, ¶ 81,579 T.C.M. (P-H) (1981), involving yacht chartering: Power v. Commissioner, ¶ 83,552 T.C.M. (P-H) (1983), involving an orchard and Morgan horse operation: Appeal of Virginia R. Withington, Cal. St. Bd. of Equal., May 4, 1983, involving the raising of dogs.) Pointing to the phenomenal success of such Thoroughbreds as Secretariat and John Henry, and the possible amount of racing and breeding gains, appellants argue that their Thoroughbred horse operations had the potential for substantial profits. Indeed, Treasury Regulation section 1.183-2(b)(7) provides, in relevant part:

> [A]n 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.

Based upon the record as a whole and based upon the tremendous profit potential in Thoroughbred horses, we do not believe that appellants' horse farm compiled a record of losses so serious as to indicate that appellants' ultimate goal was not to achieve a profit. (See Stuckey v. Commissioner, ¶ 82,537 T.C.M. (P-H) (1982); Faulconer, Sr. v. Commissioner, 55 A.F.T.R.2d (P-H) ¶ 85-302 (1984), involving Thoroughbred horse operations in which in spite of having had 20 years of consecutive losses, the Fourth Circuit Court found it to be an activity engaged in for profit.)

Moreover, while respondent contends that appellants had substantial income from sources other than the horse activity indicating that such activity is not engaged in for profit, we cannot agree. During the years at issue, appellants' tax returns indicated the following entries:

	1975	1976	1977	1978
Royalty and rent income	$30,961	$31,142	$32,126	$41,757
Interest income	40,910	20,300	1,200	29,128
Partnership income	6,930	7,336	2,328	1,051
Capital gains				133,502

Although this indicates that appellants were not destitute, their average income from other sources was not so great as to warrant an inference that continued losses from the horse operation was a matter appellants could cavalierly dismiss. (See McKinney v. Commissioner, supra, involving two taxpayers who both were apparently successful attorneys.) Clearly, the after-tax cost of this activity represented a significant amount to appellants. (Lemmen v. Commissioner, 77 T.C. 1326 (1981).) Lastly, as we indicated above, the horse activity did not have substantial recreational and personal aspects which would indicate a hobby. (Cf. Keelty v. Commissioner, supra.)

Accordingly, based upon the record before us, we must find that appellants' horse operations were an activity engaged in for profit and, as a consequence, we must reverse respondent's action.

Appeal of Wieland H. and Jennie Collins

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Wieland H. and Jennie Collins against proposed assessments of additional personal income tax in the amounts of **$1,506.45,** $445.70, **$1,729.17, and $4,833.94** for the years 1975, 1976, 1977, and 1978, be and the same is hereby reversed.

Done at Sacramento, California, this 4th day of March , 1985, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. **Collis,** Mr. **Dronenburg** and Mr. Harvey present.

_____, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code section **7.9**