Breeding Farms and Racing Stables--Hobby or Business?

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Notes

BREEDING FARMS AND RACING STABLES—HOBBY OR BUSINESS?

Section 162 of the Internal Revenue Code of 1954 allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Section 165 allows an individual to deduct any loss sustained during the taxable year and not compensated for by insurance or otherwise, if the loss is incurred in a trade or business.

In Flint v. Stone Tracey Company¹ the Supreme Court defined "business" as "that which occupies the time, attention, and labor of men for the purpose of livelihood or profit." In Wilson v. Eisner² the court decided that breeding farms and racing stables may constitute a trade or business and allowed the taxpayer to deduct his expenses and losses. Since the determination of Wilson v. Eisner in 1922 numerous other cases have been decided by the courts and the Board of Tax Appeals involving the question of whether horse breeding and racing activities constitute a trade or business. In a few cases such activities have been held not to constitute a trade or business.³ In other cases, which are much more numerous, the decision has been to the contrary.⁴

Whether or not a breeding farm or a racing stable is a trade or business turns upon the intention of the taxpayer.⁵ If the operation is entered into and carried on for profit, it is a trade or business; if it is entered into and carried on merely for the personal pleasure derived without expectation of profit, it is a hobby.⁶

The test used to determine the profit motive is both subjective and objective. The taxpayer must enter into and carry on his breeding farm or racing stable in good faith for the purpose of making a profit,

² 282 Fed. 38 (1922).
⁵ Deering v. Blair, 23 F.2d 975 (1928).
and his expectation of profit must be a reasonable one.\textsuperscript{7} In one case the decision was adverse to the taxpayer because the court felt that:

\begin{quote}
\noindent in view of the consistent record of expenses exceeding income over all the years, we are of the opinion that it would have been mere chance for the petitioner to have made any money. Where the making of income under such circumstances depends upon remote chances, where all experience has demonstrated that there would be none over expenses, we are of the opinion that the evidence does not disclose that the petitioner was engaged in the business of training and racing horses for profit.\textsuperscript{8}
\end{quote}

Each case must be tested on its own facts and the profit motive must be determined from all the evidence respecting the character of the taxpayer, the conditions under which he established the activity, his conduct of its operations, its losses and gains, and the opinion of the taxpayer, if that can be determined, as to its promise of financial return.\textsuperscript{9}

\subsection*{Character of Taxpayer}

In \textit{Shaw v. Commissioner}\textsuperscript{10} the taxpayer was engaged in harness racing and had experienced consecutive losses from 1918 to 1925. In its opinion the court stated that “when we consider the fact that he was a close man in money matters . . . that decedent was not a man with social aspirations . . . and during the later year in which losses were incurred the petitioner was bitterly disappointed, but expressed the belief that conditions would change and a profit be realized, we must conclude that the continuation of operations was with a view of retrieving the losses incurred.” The service and the courts therefore pay close attention to whether or not the taxpayer is noted for being a lavish spender, or uses his stable or farm for entertaining, social diversion, or exhibition. If so, his operation is likely to be considered a hobby.\textsuperscript{11}

The fact that the taxpayer is wealthy enough to pursue a hazardous occupation in which he has suffered discouraging losses does not establish the essential nature of the occupation.\textsuperscript{12} The courts have, however, been more sympathetic to taxpayers of limited means, and more scrutinious of those with extraordinarily large incomes.

\textsuperscript{9} James Clark and John H. O'Brien, Executors of the Estate of David Shaw v. Comm., 24 BTA 1235 (1931).
\textsuperscript{10} Ibid.
\textsuperscript{11} 18 The Journal of Taxation 176.
\textsuperscript{12} Comm. v. Widener, 33 F.2d 833 (1929).
ESTABLISHMENT OF THE ACTIVITY

The conditions which surround the establishment of a breeding farm or racing stable weigh heavily in the determination of the taxpayer's intent. In many cases where the taxpayer has been successful, he has been able to show that his decision to enter into breeding or racing was made only after he had given the matter careful study, and had obtained competent advice from others in the industry.13

The case of McVitty v. Commissioner 14 illustrates the appreciation the courts have for thorough study on the part of the taxpayer.

In or about 1913 plaintiff undertook a complete and detailed study of thoroughbred bloodlines, seeking to determine the blood strains of thoroughbred horses best suited for polo mounts. It was his theory that the most tractable thoroughbreds would make the best polo ponies. Plaintiff has continued his study since 1913 and has acquired a substantial library on this subject, comprising more than 1100 volumes of research works. In proving his theory McVitty acquired the tractable strains of thoroughbred horses, both in the United States and England, in order to secure and produce the desired qualities of intelligence, tractability, endurance and speed in his polo ponies. He became a recognized authority on polo ponies and wrote articles thereon which were published in various magazines. . . . Though misfortune assailed him and prevented the realization of his dreams, it cannot detract from plaintiff's determined and business-like efforts to succeed.

The courts have also been favorably impressed by evidence that the taxpayer has sought the advice of others engaged in breeding or racing before going into business.15

CONDUCT OF OPERATIONS

The burden of proof is on the taxpayer to show that he intended to and hoped to earn a profit.16 Evidence that his stable or breeding farm was conducted in a business like way will aid the taxpayer in sustaining this burden.

In Wilson v. Eisner 17 the court held for the taxpayer after determining that:

All the essentials of business were present in the enterprise undertaken by the plaintiff. He had a place of business, a large farm of 500 acres, cultivated feed for the horses, and had a force of men to care for them and the farm. He did not reside there. He received income from the business by way of prizes at fairs, purses at race tracks, and sales of his stock. He kept records showing a record of his business trans-

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actions. The farm was in charge of his personal business agent. He spent considerable time watching his horses at the race tracks and also in shows. He gave personal attention to the enterprise. The years 1909, 1916, 1919 and 1920 showed a profit, and he gave the benefit of this to the government by paying taxes therefore.

Other business characteristics, proof of which have aided the taxpayer, are attempts to reduce expenses wherever possible, advertising in various trade magazines, and liquidation of the breeding farm or racing stable after the activity has proven itself to be unprofitable.

LOSSES AND GAINS

The courts have long held that the mere fact that losses have been incurred over a number of years is not of itself determinative.

If the taxpayer operates a farm with the intention of making a profit and not merely "as a place of pleasure, exhibition, and social diversion, the fact that losses may be sustained from the operations of the farm does not change the character of the enterprise from one operated for profit to one not operated for profit.22

This rule was vividly illustrated in a memorandum decision where the evidence disclosed that the taxpayer had suffered losses of $606,000 over a sixteen-year period. The court nevertheless decided that his operation was a business.23

While consistent losses are not conclusive, they are evidence to be considered in determining the taxpayer's intent. The courts have been more willing to overlook such losses where they have occurred in the formative years of a racing stable or breeding farm, and have recognized that it takes time to build up a profitable operation. In Farish v. Commissioner the taxpayer was compared to one who plants a fruit orchard and must wait a number of years before the trees produce fruit in sufficient quantities to show profit, although the expenses of cultivation goes on every year before that.

The courts have also been more sympathetic to the taxpayer where his losses have been partially or wholly caused by various misfortunes beyond his control, such as "horses not coming up to expectations or

19 Blake v. Comm., 38 BTA 1457 (1938).
22 Field v. Comm., 26 BTA 116 (1932).
26 Ibid.
going wrong, lame, bowing tendons, mares proving barren, mares losing foals, and horses breaking legs and having to be destroyed.\textsuperscript{27} Depressions,\textsuperscript{28} wartime conditions, and sudden changes in market demand\textsuperscript{29} have also received the cognizance of the courts.

Less emphasis has also been placed on losses where the taxpayer could show that he has accumulated a valuable collection of horses or has land which has steadily increased in value,\textsuperscript{30} the sale of which would completely or substantially off-set his losses.

Evidence of profit in some years receives the attention of the courts just as does evidence of losses in others.\textsuperscript{31} Proof of such profit tends to clothe the venture with a business-like appearance and aids the taxpayer in sustaining the burden of proving his intent.

**OPINION OF TAXPAYER**

Since determination of whether the taxpayer's expenses or losses were incurred in a hobby or a business depends upon the intention of the taxpayer, the personal testimony of the taxpayer is given considerable weight. Failure of the taxpayer to testify seems to be given greater weight. In *Fisher v. Commissioner*\textsuperscript{32} the taxpayer failed to testify and the court made the following statement:

> In all of the cases cited it was found that the stable had been created with the expectation of making profits. For example, in the *Field* case, the court points out that the taxpayer testified that he established his stables "with a serious and businesslike desire to make his operation profitable" and that "it was his intention to give up the enterprise if it was not successful in making money." We have no such evidence here. We know nothing of petitioner's object in embarking upon the hazardous enterprise of breeding and training horses for the racetrack.

While the taxpayer must demonstrate that he intended to and hoped to earn a profit, the business character of the venture is not destroyed by the fact that he derives pleasure from dealing with horses.

If it be a fact, as is earnestly urged by the defendant, that the plaintiff was a sportsman in the sense that he is fond of racing horses, it cannot change the character of this undertaking. Success in business is largely obtained by pleasurable interest therein. Professional baseball playing has become a business, as well as an amusement for the public. And so with numerous other business enterprises, such as the theatre, circus, and the motion picture industry.\textsuperscript{33}

\textsuperscript{28}Larine B. Roth, 9 P-H Tax Ct. Mem. 50 (1936); Buschbaum v. Comm., 36 BTA 21 (1937).
\textsuperscript{29}Edward Q. McVitty, 8 P-H Tax Ct. Mem. 891 (1939).
\textsuperscript{30}Blake v. Comm., 38 BTA 1457 (1938).
\textsuperscript{31}Shaw v. Comm., 24 BTA 1235 (1931).
\textsuperscript{32}Fisher v. Comm., 29 BTA 1041 (1934).
It must be proven, however, that the dominant motive of the taxpayer was to earn a profit.

In summary, an analysis of the previously cited cases discloses that the operation of horses breeding farms and racing stables may constitute a trade or business; that the question of whether or not such operations constitute a trade or business depends upon whether the activities are for the purpose or with the intention of making a profit, provided the expectation of profit is reasonable; that the question of intention is a question to be determined in each case upon the particular facts presented; that the taxpayer's intention or purpose of making a profit as disclosed by his own testimony and by other evidence, is sufficient to establish the business character of the enterprise, provided the expectation of profit is reasonable; and that the fact that losses are incurred year after year does not necessarily indicate that the prospect of profit is not reasonable or that the taxpayer's intention is not to make a profit. .."

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