STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions of **PAUL AND LESLIE WESTON** for Redetermination of Deficiencies or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 2001, 2002 and 2003.	:	DETERMINATION DTA NOS. 820706 AND 820707

Petitioners, Paul and Leslie Weston, 3225 Swamp College Road, Trumansburg, New York 14886, filed petitions for redetermination of deficiencies or for refund of personal income tax under Article 22 of the Tax Law for the years 2001, 2002 and 2003.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, 130 West Main Street, Rochester, New York, on June 7, 2006 at 9:30 A.M., with all briefs to be submitted by September 22, 2006, which date began the six-month period for the issuance of this determination. Petitioners appeared by Bruce M. Poushter, Esq. The Division of Taxation appeared by Mark F. Volk, Esq. (Kevin R. Law, Esq., of counsel).

ISSUE

Whether petitioners' horse breeding business was an activity engaged in for profit within the meaning of section 183 of the Internal Revenue Code.

FINDINGS OF FACT

1. Petitioner Dr. Leslie Weston was raised on a small farm in Western, New York. As a result of her involvement in the 4-H Club, she had experience in producing, showing and

competing with livestock from an early age. She received a bachelor's degree from Cornell University, and master's and doctorate degrees from the College of Agriculture and Life Sciences of Michigan State University. She was employed for 12 years in the Department of Agriculture and Life Sciences at the University of Kentucky as an assistant professor and later an associate tenured professor. In 1998, Dr. Weston was hired by Cornell University to continue research with extension in teaching in its College of Agriculture and Life Sciences, where she remains employed to the present.

Petitioner Dr. Paul Weston has been employed by Cornell University since 1998 as a researcher with extension in teaching. He also received his bachelor's degree from Cornell University and master's and doctorate degrees from Michigan State University. He was employed by Kentucky State University as a researcher and extension in teaching associate until 1998.

2. In 1993, petitioners began the management and breeding of Appaloosa horses on their farm in Kentucky. Between 1993 and 1997, petitioners filed a Profit or Loss from Business Statement, Schedule C, with their Federal income tax return, indicating as the principal business "Dog and Horse Breeding." In 1994, petitioners purchased their first Appaloosa horse. Petitioners consulted with a certified public accountant with experience in the equine industry in setting up their business and establishing their books and records. They continue to the present to utilize the accounting system established by the CPA, which includes a general ledger and journals of revenues and expenditures, and which follows Federal guidelines as to the expenses claimed in operating a horse farm.

3. Petitioners decided to relocate to New York State to further their professional careers. They also were of the opinion that New York offered a more cost effective opportunity to own a

small horse farm. In general, Kentucky consisted of larger horse farms requiring large investments, while in New York smaller farms were a consistent portion of the equine business. They reviewed the cost of land in New York with consideration given to the proximity to Cornell University's Veterinary School and its reproductive facilities. They also felt that New York offered a large market of nonprofessional and youth riders who would be interested in purchasing horses. In the fall of 1998, petitioners purchased a farm in New York and commenced the following year with the renovation, update and upgrade of the house and facilities. They also brought an Appaloosa mare and foal to the farm.

4. Petitioners' interest in Appaloosa horses was based on the stamina and personality of the breed, and the interest which nonprofessionals and youth riders had shown in color breeds like the Appaloosa for showing, competing and pleasure riding.

5. In 1998, petitioners contacted Ray Burchett, a leading judge and exhibitor of Appaloosa horses. After their move to New York, they began working with him in terms of managing and training the horses and the sale of their own breeding stock.

6. Petitioners' initial business plan was to breed pleasure horses at a high level for the equine industry. They wished to create a high end, upper level show horse with a small group of quality mares. After a period of time they would eventually introduce their own stallion to the breed and offer it for public stud as well.

7. Petitioners planned to have three sources of income: the sale of young offspring directly off of the farm; the sale of trained offspring coupled with the purchase and resale of horses deemed profitable; and the standing of stallions as public studs, offering them for a fee for breeding purposes.

During the initial five years of operation in New York, the primary expenses of the farm, besides costs involved in the renovation of the house and barn, consisted of the purchase of a mare and getting the offspring out showing with successful show records to create recognition for the farm. According to petitioners, top trainers will generally not buy Appaloosa horses unless they have a proven genetic background and a successful status in competition.

Presently, the farm has six brood mares which produced four foals during the year 2006. The farm employs artificial insemination procedures obtained through Cornell University. Petitioners stand two of their own stallions at stud. In addition, they lease, breed, manage and stand at stud a third stallion, which at the present time would be too expensive to purchase.

The current focus of the farm is on a breeding program. The program is an effort to reduce training expenses, increase sales off the farm and increase the recognition of stallions and offspring. Petitioners have expanded attendance at show competitions outside those strictly for Appaloosa horses. In addition, petitioners presently attend all-breed futurities with larger prize money.

8. Since the 2000 through 2001 period, the sale price of an Appaloosa horse has declined dramatically. The high point occurred in the 1980s, with the sale price generally in decline for the last two decades. The major market now for buying and investing in Appaloosa horses is provided by youth and nonprofessionals. Currently, the average price for an Appaloosa horse is between $12,000.00 and $18,000.00, with an investment of $15,000.00 in training costs necessary to attain this price range.

Petitioners most recent business plan is to sell offspring directly off the farm for a sale price between $5,000.00 and $10,000.00, with little investment of training expenses. As previously noted, petitioners' brood mares produce four to five offspring per year. Petitioners

also plan to obtain a slightly older stock of yearlings and two-year olds, incur little training expenses and then sell them for moderate prices. Recently, petitioners sold a yearling for $3,000.00, which had a cost basis estimate of approximately $2,000.00.

9. The house purchased by petitioners in 1998 was originally built in 1820. They invested in the restoration of the house and the outlying properties. Petitioners restored pasturage and purchased an additional 15 acres in order to have 22 working acres for the farm. They put in an outdoor riding area and refenced a large portion of the acreage.

The barn on the property was built in 1840 and was used mainly for the storage of grain. Petitioners restored and renovated the barn, adding stalls for the horses and an exercise area.

10. In order to fund the purchase, renovation and operation of the farm, petitioners used the profits earned from the sale of their Kentucky farm and also withdrew funds from their retirement accounts in 1999, 2000 and 2001. Petitioners withdrew $102,000.00 in 1999, $47,000.00 in 2000 and $7,500.00 in 2001. The house and barn were purchased for $190,000.00, and with the renovations and appreciation in value, are worth approximately $370,000.00 today. Such value does not include the value of the land.

11. Both petitioners and their daughter ride the horses on the farm for pleasure. However, petitioners' primary focus is on the producing and marketing of the offspring, while their daughter spends time riding competitively. Dr. Leslie Weston devotes approximately 20 hours per week to the workings of the farm, while her husband and daughter each devote approximately 10 hours per week. In a week involving a competition or show, petitioners will spend more time in preparation and attendance.

The daily activities and responsibilities of the farm are shared by petitioners and their daughter. At least two hours a day are dedicated to the management, feeding and maintenance of

the mares. Petitioners maintain a video camera system for each stall to allow for the surveillance of the mares in foal. The stallions and young stock are worked daily, including riding, exercising and feeding. All horses require veterinary and farrier care. Time is also spent on the management of the pastures, website development, marketing, advertisements and telephone and e-mail contact with potential buyers.

As Dr. Leslie Weston testified at hearing with regard to the effort put into the farm operation, "[w]e spend a considerable amount of time - there is really no spare time - managing [the farm]. It could be a full-time business, but with the three of us involved in this, my husband, my daughter and myself, we can split the time involved in maintenance, and all of us enjoy it. We love it. We only do it because we are dedicated to it . . . ."

12. Horse shows are one of the best forms of advertising for Appaloosa horses. Horse shows are competitions which typically occur from Friday through Sunday. Prior to transporting the horses to the show, they are bathed, clipped and trimmed. For many months leading up to the show, the horses are exercised, trained and conditioned. They must be a particular weight and hair coat, and be in physiological condition to compete. In preparation for competition, horses have to be trained and acclimated to cart traffic, people, children, dogs, loud speakers and tractors. They have to be trained to haul on a trailer and unload.

13. In addition to exhibiting at horse shows, petitioners advertised their horses for sale and for breeding in horse show programs, newspapers, a horsemen's magazine and their web site.

Petitioners employ two full-time trainers and a breeding agent from Burchett Show Horses of Harrisburg, Pennsylvania. Burchett Show Horses was chosen because of its ability to successfully show horses and its reputation in the industry. Petitioners also employ equine

reproductive and general practice veterinarians at Cornell University and the New Bolton Clinic at the University of Pennsylvania.

Petitioners are members of six Appaloosa regional associations, and support these associations by serving on the boards of directors. Dr. Paul Weston is president of the Empire Appaloosa Association while Dr. Leslie Weston serves as its treasurer.

14. Petitioners' gross income, expenses and operating losses from 1993 through 1997 (with the exception of the year 1995, of which there was no information in the record) were as follows:

Year	Gross Income	Expenses	Profit or (loss)
1993	$2,334.00	$14,476.00	($12,142.00)
1994	594.00	22,314.00	(21,720.00)
1995	------	------	------
1996	364.00	19,983.00	(19,619.00)
1997	455.00	19,624.00	(19,169.00)

15. For the years 1998, 1999 and 2000, petitioners claimed Schedule C losses of $24,031.00, $56,447.00 and $66,296.00, respectively. For the years 2004 and 2005, petitioners claimed Schedule C losses of $58,431.00 and $74,737.00.

16. For the years at issue, petitioners filed profit or loss from business statements, Federal schedules C, indicating their principal business as "Dog and Horse Breeding" and their business name as "Cayuga Ridge Farm." Petitioners' gross income, expenses and operating losses as they appear on their returns were as follows:

Year	Gross Income	Expenses	Profit or (loss)
2001	$21,428.00	$92,189.00	($70,761.00)
2002	9,364.00	94,400.00	(85,036.00)
2003	13,470.00	107,546.00	(94,076.00)

17. Between September 2003 and September 2004, petitioners sold five horses for a total of $37,500.00. Show earnings amounted to $4,650.00.

18. On May 21, 2004, the Division of Taxation ("Division") issued to petitioners two statements of proposed audit changes for the years 2001 and 2002. On August 23, 2004, the Division issued to petitioners a Statement of Proposed Audit Changes for the year 2003. The statements explained that the Division was disallowing the claimed Schedule C losses for the years at issue because it had been determined that petitioners were not carrying on their business activity for profit. The statements further explained that a negligence penalty of 5% was being imposed pursuant to Tax Law § 685(b)(1) and, in addition, an amount equal to 50% of any interest due on a deficiency attributable to negligence, pursuant to Tax Law § 685(b)(2).

19. On July 16, 2004, the Division issued to petitioners a Notice of Deficiency of personal income tax for the year 2002 in the amount of $6,487.34, plus penalty and interest. On August 16, 2004, the Division issued to petitioners a Notice of Deficiency of personal income tax for the year 2001 in the amount of $5,642.49, plus penalty and interest. On October 18, 2004, the Division issued to petitioners a Notice of Deficiency of personal income tax for the year 2003 in the amount of $1,000.02, plus penalty and interest.

CONCLUSIONS OF LAW

A. Tax Law § 689(e) places on petitioners the burden to refute the Division's disallowance of the business loss deductions and to establish that they are entitled to the

expenses claimed (***see***, ***Matter of Schneier***, Tax Appeals Tribunal, November 9, 1989). The starting point for determining New York State personal income tax liability is a taxpayer's Federal adjusted gross income (Tax Law § 612[a]; 20 NYCRR 112.1). Since the New York State Tax Law is patterned after the Internal Revenue Code, Federal law is determinative of the substantive question presented in this matter (***see, Hunt v. State Tax Commn.,*** 65 NY2d 13, 16-17, 489 NYS2d 451, 453; ***Matter of Rizzo***, Tax Appeals Tribunal, June 3, 1993, ***confirmed Rizzo v. Tax Appeals Tribunal***, 210 AD2d 748, 621 NYS2d 115).

B. The issue to be addressed is whether petitioners' activities as horse breeders were engaged in for profit within the meaning of Internal Revenue Code § 183, which provides, generally, that where an activity is "not engaged in for profit," deductions attributable to such activity are allowable only to the extent of income from such activity. Resolution of this issue turns on whether petitioners had an actual and honest (but not necessarily reasonable) objective of making a profit (***see, Dreicer v. Commissioner***, 78 TC 642, 645, ***affd*** 702 F2d 1205; ***Hulter v. Commissioner***, 91 TC 371). Such an objective is properly determined based on a review of the surrounding facts and circumstances and in consideration of the nine factors set forth in Treas Reg § 1.183-2(b) (***see, Hoag v. Commissioner***, 66 TCM 326, 328). In resolving the factual question, greater weight is given to the objective facts than to the taxpayer's statements of intention (***Thomas v. Commissioner***, 84 TC 1244, 1269, ***affd*** 792 F2d 1256).

C. The nine factors listed in the regulations to help determine whether a taxpayer has engaged in an activity for profit are as follows: (1) the 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) 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 (Treas Reg § 1.183-2[b]). The factors listed above are intended as guidelines and are nonexclusive. Accordingly, no single factor or combination of factors is conclusive in indicating a profit objective (***see***, ***Ranciato v. Commissioner***, 52 F3d 23; ***Yancy v. Commissioner*** 48 TCM 872, 874).

D. Although no one factor is determinative of the taxpayer's intention to make a profit, a record of substantial losses over many years and the unlikelihood of achieving a profitable operation are important factors bearing on the taxpayer's true intention (***Golanty v. Commissioner***, 72 TC 411, 426, ***affd*** 647 F2d 170). The presence of losses in the early years of a business, particularly one like the petitioners' involving the breeding of horses, is not necessarily inconsistent with an intention to achieve a later profitable level of operation, bearing in mind, however, that the ultimate aim must be to realize a profit on the entire operation, which presupposes not only future net earnings but also sufficient net earnings to recoup the losses which have been sustained in the formative years (***Bessenyey v. Commissioner***, 45 TC 261, 274).

E. The first factor considers whether the taxpayer engaged in the activity in a businesslike manner (Treas Reg § 1.183-2[b][1]). In determining whether the taxpayer conducted the activity in a businesslike manner, the courts have considered whether accurate books were kept, whether the activity was conducted in a manner similar to other comparable businesses and whether changes were attempted in order to make a profit (***Dodge v. Commissioner***, 75 TCM 1914).

Although petitioners' horse-breeding operation had some of the indications of a business, such indications, standing alone, are insufficient to establish that the operation was a business carried on for profit. Petitioners contacted a certified public accountant familiar with the horse breeding business to obtain assistance in setting up the books and records for their operation to properly record their income and expenses. They also consulted with a leading expert in the area of Appaloosa horses to seek his guidance in terms of managing, training and the sale of their own breeding stock. Petitioners also advertised in various trade newspapers and magazines and competed in horse shows as a way to become recognized in the field of the breeding of Appaloosa horses. However, there was no showing that books and records were kept for the purpose of cutting expenses, increasing profits and evaluating the overall performance of the operation. Petitioners did not establish that the books and records were used to improve the operation of the business. Although petitioners adjusted their business plans, there was no showing that the changes in the business plans would result in the horse farm being operated at a profit, or that profits would in fact result in the future from the changes.

The economics of petitioners' operation showed that they could not make a profit from their horse breeding activity. During the years 1993 through 1997 (there is no information in the record relating to the year 1995), when petitioners operated their horse farm in Kentucky, the business operation incurred total losses of $72,650.00, or an average of $18,162.00 per year. For the three years preceding the years at issue, 1998, 1999 and 2000, when petitioners began operation in New York State, the horse farm incurred losses totaling $146,774.00, or an average yearly loss of $48,925.00. Petitioners' business operation incurred losses of $249,873.00 during the years at issue, 2001, 2002 and 2003, resulting in average losses of $83,291.00 per year. For the years 2004 and 2005, losses from the horse farm operation were $133,168.00, an average of

$66,584.00 per year. Total losses incurred by petitioners' horse farm operation since its inception in 1993 through the year 2005 were $602,465.00, without taking into consideration losses that may have been incurred in 1995. The market price for Appaloosa horses has been declining since the 1980s, and has more recently collapsed. Even under the best case scenario where petitioners are able to sell their four or five foals produced each year for $5,000.00 to $10,000.00 each, and a few yearlings at a profit of $1,000.00 each (***see***, Finding of Fact "8"), such income would be insufficient to overcome the expenses incurred to produce such stock. During the years at issue, petitioners incurred expenses of $294,135.00, for an average per year expense amount of $98,045.00, which far exceeds any potential income amount. Petitioners have not shown that their business plan would lead to profits in the future, or be sufficient to recoup the over $600,000.00 in losses already incurred. Petitioners' horse-breeding operation does not appear to have the potential to be a money-making proposition with the possibility of both achieving future profits and recouping past losses.

F. The second factor is the expertise of petitioners. Preparation for an activity by extensive study of its accepted business, economic and scientific practices may indicate a profit motive (Treas Reg § 1.183-2[b][2]). The focus is on learning applicable techniques and skills in an effort to generate an overall profit from the activity (***Golanty v. Commissioner***, ***supra***).

Petitioners offered no evidence to establish that any skills developed in operating the horse farm would be helpful in making the business profitable. It is unquestioned that petitioners improved, extended and refined their skills in caring for horses, but no explanation was offered to explain how their new and improved skills would lead to a profitable horse-breeding business.

G. The third factor is the time and effort expended by the taxpayer. The fact that a taxpayer devotes much of his personal time to an activity may indicate an intention to derive a

profit, particularly if there are no substantial personal or recreational aspects to the activity (Treas Reg § 1.183-2[b][3]).

Petitioners did devote a substantial amount of time to the horse-breeding activity. However, as Dr. Leslie Weston's testimony indicated (***see***, Finding of Fact "11"), there were substantial personal and recreational aspects to the activity. In addition, neither petitioner gave up his or her regular job as a professor to pursue making a living from the horse-breeding operation. As much as the horse-breeding activity involved a substantial amount of time, it appears that it was a pleasurable sideline, and not a source of livelihood.

H. The fourth factor is the expectation that assets used in the activity may appreciate in value (Treas Reg § 1.183-2[b][4]). Petitioners argue that their land has appreciated in value, although without distinction between appreciation caused by an increase in values in the area and appreciation caused by the improvements made to the land. Petitioners contend that the increase in the value of the land should be considered in determining whether their horse-breeding activity was profitable.

Treasury Regulation § 1.183-1(d)(1), provides as follows:

> 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 engages 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 (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land).

Applying the above-cited regulation to the present matter, it is noted that there is no evidence in the record which establishes that the horse-breeding activity reduced the cost of carrying the land for its appreciation in value. In fact, even excluding the items attributable to the land, the horse-breeding operation incurred substantial losses since the purchase of the land. Under these circumstances, the holding of petitioners' land is to be considered a separate activity from the horse-breeding activity and is not to be considered in determining the profitability of the farm operation.

I. The fifth factor is petitioners' success in carrying on other similar or dissimilar activities. The regulations suggest that a taxpayer who was able to convert an unprofitable enterprise to a profitable one in the past may be able to do the same thing with the current activity (Treas Reg § 1.183-2[b][5]). Although petitioners have had success in their professional careers, there is nothing in the record which establishes any success achieved in business generally, or in breeding farm animals specifically.

J. The sixth factor is the taxpayer's history of income and losses with respect to the activity (Treas Reg § 1.183-2[b][6]). During the years that petitioners have operated the horse-breeding operation, they have incurred losses of $602,465.00, an average of $50,205.00 per year. The losses have generally increased over time, with losses in the years 2001 through 2005 reaching $383,041.00, an average of $76,608.00 per year. In addition, there is nothing in the record which supports a conclusion that the horse-breeding activity has any possibility of making a profit in the future, or the potential to recoup the losses which have meanwhile been sustained in the intervening years (***Golanty v. Commissioner***, ***supra***).

K. The seventh factor is the amount of occasional profits earned from the activity. A substantial profit, though only occasional, would generally indicate that an activity is engaged in

for profit (Treas Reg § 1.183-2[b][7]). Petitioners earned no profits during the 13 years of operating their horse-breeding activity.

L. The eighth factor is the financial status of the taxpayer. Substantial income from other sources, particularly when the losses from the activity at issue generate tax benefits, may indicate that the activity is not engaged in for profit, especially when personal or recreational aspects are present (Treas Reg § 1.183-2[b][8]). Petitioners' tax returns indicate that both have had success in their careers, and that the losses claimed from the horse-breeding activity, if allowed, would provide them with significant tax benefits, reducing the after-tax cost of carrying on this activity.

M. The final factor is whether petitioners derived pleasure or recreation from the activity (Treas Reg § 1.183-2[b][9]). It has been established by petitioners that the operation of a horse-breeding farm involves much hard work, including cleaning and brushing the horses, trimming their hooves, watering and feeding the horses, extensive training of the horses, maintaining the pastures and transporting the horses to shows. It has also been established that petitioners thoroughly enjoyed operating the farm, attending the shows and training the horses. As Dr. Leslie Weston stated, "all of us enjoy it. We love it. We only do it because we're dedicated to it." Although the maintenance of horses demands a large amount of laborious and unpleasant work, it is clear that petitioners were partially motivated by personal reasons in engaging in the horse-breeding activities (***Yates v. Commissioner***, 72 TCM 1193; ***Bischoff v. Commissioner***, 69 TCM 1741). Petitioners and their daughter enjoyed the activities involving horses, and it is the enjoyment they received which appears to have motivated them to continue with the operation of the horse-breeding farm, despite the many years of labor and losses.

N. Based upon all the facts and circumstances presented herein, it is determined that petitioners' horse-breeding operation was an "activity not engaged in for profit" within the meaning of Internal Revenue Code § 183(a), as they did not have a bona fide expectation of profit. Therefore, the losses incurred by petitioners during the years 2001, 2002 and 2003 are not deductible.

O. The petitions of Paul and Leslie Weston are denied, and the notices of deficiency, dated July 16, 2004, August 16, 2004 and October 18, 2004, are sustained.

DATED: Troy, New York
March 8, 2007

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE