

1 Louis A. Ambrose, Tax Counsel IV  
2 State Board of Equalization, Appeals Division  
3 450 N Street, MIC: 85  
4 PO Box 942879  
5 Sacramento, CA 95814  
6 Tel: (916) 445-5580  
7 Fax: (916) 324-2618

8 Attorney for the Appeals Division

9 **BOARD OF EQUALIZATION**  
10 **STATE OF CALIFORNIA**

11 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
12 **ROBERT J. MOLINARO AND** ) **PERSONAL INCOME TAX APPEAL**  
13 **CAROL E. MOLINARO<sup>1</sup>** ) Case No. 715378  
14 )  
15 )  
16 )  
17 )

18 Deficiency

<u>Year</u>	<u>Amount</u>
2005	\$81,297
2006	\$71,597

19 Representing the Parties:

20 For Appellants: Richard W. Craigo, Esq.  
Joseph A. Vinatieri, Esq.

21 For Franchise Tax Board: Cheryl L. Akin, Tax Counsel

22  
23 **QUESTION:** Whether appellants have shown that respondent erred by disallowing claimed losses  
24 based on respondent's determination that appellants did not operate a business that  
25 generated the losses with the primary purpose of making a profit.

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27  
28 <sup>1</sup> Appellants reside in Pleasanton, Alameda County.

1 HEARING SUMMARY

2 Background

3 Appellants manage and hold a 99 percent indirect ownership interest through their trust in  
4 Walnut View Farms, Inc. (Walnut View), a subchapter S corporation incorporated in California in 2002,  
5 which is engaged in thoroughbred horse breeding, racing and training activities. Appellants' son holds a  
6 1 percent interest in Walnut View and has been a paid horse trainer for Walnut View since 1986. Prior to  
7 the incorporation of Walnut View in 2002, appellants engaged in these activities since the 1970s.  
8 (App. Op. Br., pp. 3-4; Resp. Op. Br., p. 2.)

9 For tax years 2005 and 2006, appellants timely filed joint California income tax returns  
10 reporting taxable income of \$2,862,142 for 2005 and \$2,894,588 for 2006. On each return, appellants  
11 reported pass-through items from approximately 20 entities, including Walnut View. Appellants claimed  
12 nonpassive loss deductions of \$789,294 for tax year 2005 and \$690,649 for tax year 2006. Respondent  
13 audited appellants' 2005 and 2006 tax year returns and disallowed the claimed loss deductions for  
14 Walnut View because respondent determined that appellants did not engage in the thoroughbred horse  
15 activities with the primary purpose of making a profit. On December 6, 2010, respondent issued to  
16 appellants Notices of Proposed Assessment (NPAs) for tax years 2005 and 2006 proposing disallowance  
17 of the losses for those years and additional assessments of tax of \$81,297 for tax year 2005 and \$71,597  
18 for tax year 2006. Appellants filed timely protests of the NPAs which respondent denied and issued  
19 Notices of Action (NOAs) affirming the NPAs on January 11, 2013. Appellants filed this timely appeal.  
20 (Resp. Op. Br., pp. 3-4.)

21 Contentions

22 Appellants' Contentions

23 Appellants describe their "thoroughbred racing involvement" in two "phases"; "Phase I"  
24 was from 1973 through September of 1994" and "Phase II was from October of 1994 through tax year  
25 2006". Appellants state that during Phase I, their business plan was "to acquire a small number of  
26 thoroughbred race horses and race horse prospects" and "attempt to develop one or more into successful  
27 race horses that would create profits . . ." Appellants state that during Phase I, 17 horses were purchased  
28 at a total cost of \$137,715 and the highest price paid for one horse was \$21,300 in 1983. Appellants

1 further state that in 1978 they purchased a 20-acre farm site in Pleasanton for about \$170,000, with  
2 about \$40,000 of existing improvements to which they added about \$20,000 in improvements over the  
3 following five years. On that site, they housed their breeding horses and offspring and their race horses  
4 recuperating away from the track. In 1986, appellants' son, Kent Molinaro, was licensed by the state as a  
5 professional thoroughbred horse trainer and has worked for appellants and Walnut View since that time.  
6 In 1989, appellants sold their farm for a profit of over \$4 million and after deducting total losses of less  
7 than \$600,000, resulted in an "overall profit of the Phase I operation" of over \$3.4 million. (App. Op.  
8 Br., pp. 3-4.)

9 Appellants state that in 1994, Kent Molinaro advised appellants to "maximize their  
10 chances of producing profits" by purchasing substantially more race horses and race horse prospects of  
11 higher quality to develop them into successful race horses to win the "lucrative purses available in  
12 California" and "develop one or more into successful race horses that could be sold or syndicated for the  
13 multi-million prices" often paid for such horses. Under this "business plan modification", appellants  
14 state that they and Walnut View purchased 84 horses between 1994 and 2006, the Phase II period, at a  
15 total cost of \$2,002,262. Appellants state that 34 of the 84 horses each cost more than \$21,300, which  
16 was the highest price paid for any horse during Phase I, and one of those horses cost \$216,500.  
17 Appellants state that Kent Molinaro trained horses for outside parties and, after incorporation of  
18 Walnut View, the outside training became a part of Walnut View's business. (App. Op. Br., pp. 5-6.)

19 Appellants state that in 1995, appellants reported a profit of \$54,670 and "1996 was a  
20 'break-even' year cash-flow wise, when depreciation is not included." Appellants further state that the  
21 business did not make a profit in the following ten years due to "the devastating level of unforeseen  
22 hardships" which appellants describe as follows:

- 23 • In 2004, a breeding mare was euthanized.
- 24 • An "unraced 2-year old" was purchased in 2003, but was injured before racing and given away  
25 in 2005.
- 26 • Appellant purchased three horses in 2001, 2003 and 2004 which raced until May 6, 2005,  
27 June 19, 2004 and September 10, 2005, respectively, when they suffered career-ending injuries  
28 and were given away.

- 1       • A horse purchased in 2004 raced until December 11, 2005, when it broke down and was given  
2 away.  
3       • A “homebred” horse of 2002, raced until November 16, 2006, when it suffered a career-ending  
4 injury and was given away.

5               Appellants state that they purchased a horse in 1996 for \$75,000 which earned \$515,000  
6 and was retired as a stallion prospect with his first foals arriving in 2006, but he later died from a  
7 heart attack. Appellants further state that: Walnut View maintained a separate bank account and  
8 complete books and records, Walnut View paid wages of \$236,611.68 and \$293,185.02 in 2005 and  
9 2006, respectively, to 17 employees, 36 of the 84 horses were eligible for the Breeders’ Cup Series of  
10 championship races, and appellants’ 1999 federal return was audited by the Internal Revenue Service  
11 (IRS) and a refund determination letter was issued. (App. Op. Br., pp. 6-8.)

12               Appellants list the following “[f]acts relative to both ‘Phase I’ and ‘Phase II’”:

- 13       • Neither appellants nor Walnut View purchased another farm after the 1989 sale of the farm site.  
14       • Appellants and Walnut View engaged in “limited breeding activities to obtain race horse  
15 prospects.”  
16       • By 2005, appellants each had 33 years of experience in the thoroughbred horse industry.  
17       • Walnut View and appellants were members of the Thoroughbred Owners of California and the  
18 California Thoroughbred Breeders’ Association, appellant-husband read *The Daily Racing Form*  
19 several days each month and the *California Thoroughbred* each month.  
20       • Appellants discussed the business with industry experts and with their professional trainers,  
21 including Kent Molinaro who is well-respected in the industry for his career success and his  
22 “claims” acumen.  
23       • During Phase II, appellants owned or controlled several other businesses and in those other  
24 businesses and in the thoroughbred horse business appellant-husband had a “hands-on  
25 management style” and worked 60 to 80 hours each week without written business plans,  
26 budgets or income forecasts, written personnel evaluations or engagement of paid outside  
27 business advisors.  
28       • Kent Molinaro states in a declaration that appellants’ Phase II operation was conducted in

1 essentially the same manner as other Thoroughbred operations he was familiar with.

- 2 • During 2005 and 2006, appellant-husband visited the Pleasanton Race Track facility an average  
3 of three mornings per week for about two hours to watch Walnut View's horses in training and  
4 to discuss them with Kent Molinaro. Appellants also visited active race tracks when their horses  
5 were racing and off-track simulcast facilities to view such races.
- 6 • Appellants made all business decisions concerning which horses to sell or purchase, which races  
7 their horses would compete in, when to employ a trainer (and discussions with those trainers),  
8 when to engage horse boarding farms, when to retire a horse, which stallions to breed with their  
9 mares, and numerous administrative tasks.
- 10 • Appellant-husband spent 20 to 40 hours per week and appellant-wife spent over 10 hours per  
11 week in the thoroughbred operation during Phase II and "always conducted a vigorous program  
12 of evaluating their horses, quickly 'culling' (discarding through sale or donation) those horses  
13 that had suffered career-ending injuries or did not meet their criteria for profitability" as  
14 confirmed by respondent's auditor. (App. Op. Br., pp. 9-11.)

15 Appellants state that the issue here is whether pursuant to R&TC section 17201,  
16 Walnut View operated its business in 2005 and 2006 for the primary purpose of making a profit.  
17 Appellants cite case law and enumerate the nine nonexclusive factors of Treasury Regulation section  
18 1.183-2(b) which the courts apply to determine whether claimed business losses are deductible.  
19 Appellants argue that the facts in *Appeal of Wieland and Jennie Collins*, 86-SBE-047, decided by this  
20 Board on March 4, 1986 (*Collins*),<sup>2</sup> are similar to the facts presented here. Appellants state that the  
21 appeal involved a thoroughbred horse breeding and racing operation of comparable size, complete and  
22 accurate separate books and records, separate bank accounts, engagement of certified public  
23 accountants, several consecutive years of losses<sup>3</sup>, farms that were purchased and used primarily as horse  
24 farms and which appreciated substantially in value, and taxpayers who spent substantial hours per week  
25 working in the business and had many years of industry experience. Appellants state that this Board  
26

27 <sup>2</sup> State Board of Equalization cases (designated "SBE") can be viewed on this Board's website ([www.boe.ca.gov](http://www.boe.ca.gov)).

28 <sup>3</sup> Appellants state the taxpayers in *Collins* had losses over 19 years, but that they had losses for nine years.

1 noted in *Collins* that, in view of the tremendous profit potential of thoroughbred horses, consecutive  
2 losses for over 20 years did not necessarily indicate a lack of profit motive. Appellants also state that the  
3 Board also noted that the taxpayers in *Collins* modified their operation whereas appellants contend that  
4 they completely revised their operation. (App. Op. Br., pp. 11-13.)

5 Appellants apply the nine nonexclusive factors of Treasury Regulation section 1.183-2(b)  
6 as follows:

- 7 1. Businesslike operation: Walnut View kept books and records in a businesslike manner and kept  
8 detailed ledgers to track monthly expenses, maintained a separate bank account and engaged  
9 certified public accountants, engaged a professional trainer and professional breeding and  
10 boarding farms and was highly efficient in culling horses. Appellants further note that they had  
11 no written business plan because none of their other businesses had written business plans and a  
12 written plan is not required so long as an unwritten plan is confirmed by the taxpayer's actions.  
13 Appellants also assert that Walnut View did not prepare written budgets because none of  
14 appellants' other businesses had written budgets and they are not required or useful. Appellants  
15 cite *Trafficante v. Comm'r*, T.C. Memo 1990-353, which involved a thoroughbred horse racing  
16 operation that had 10 consecutive years of losses in which they assert the court held that a profit  
17 and loss statement was not useful due to the speculative nature of the business.

18 Appellants also quote a portion of the relevant provision, Treas. Reg. sec. 1.183-2(b)(1),  
19 which states that "a change of operating methods, adoption of new techniques or abandonment of  
20 unprofitable methods in a manner consistent with an intent to improve profitability may indicate  
21 a profit motive." Appellants maintain that the major change in the business plan implemented in  
22 Phase II indicated a profit motive and coupled with the other factors listed above this factor  
23 weighs in appellants' favor. (App. Op. Br., pp. 14-16.)

- 24 2. Expertise of Taxpayers or Advisors

25 Appellants meet this factor as they had a combined experience of 66 years in this industry  
26 and, as experts, they never needed to hire paid outside consultants. (App. Op. Br., p. 16.)

- 27 3. Time and Effort Expended

28 Appellants meet this factor because they devoted 30 to 50 hours per week to this activity

1 and engaged a professional trainer and professional breeding and boarding farms. (App. Op. Br.,  
2 p. 16.)

3 4. Expectation of Appreciation in Value

4 Given the high quality of the horses acquired during Phase II, appellants state that they  
5 reasonably expected one or more of their horses to compete successfully and thereby appreciate  
6 in value. Appellants state that one of their successful horses came close to fetching “a seven-  
7 figure price” and they assert that Thoroughbred horses are “in a class by themselves” when  
8 considering the potential for appreciation. Appellants cite a case in which the court found that the  
9 taxpayer operated a “for profit” Thoroughbred operation despite 21 years of consecutive losses  
10 and observed that the taxpayer’s failure to obtain an extremely successful horse was mere chance  
11 because horse racing is a “risky business”.

12 Appellants also maintain that the \$4 million profit from the sale of the farm site met the  
13 definition of “profit” as provided by subparagraph (b)(4) of Treas. Reg. sec. 1.183-2. Appellants  
14 further maintain that pursuant to Treas. Reg. sec. 1.183-1(d), the holding of the land and the  
15 Thoroughbred horse operation was a single activity for purposes of determining expected  
16 appreciation of value in assets under Treas. Reg. sec. 1.183-2(b)(4). Appellants cite *Engdahl v.*  
17 *Comm’r* (1979) 72 T.C. 659 and other tax court cases in support of this argument and assert that  
18 their position is consistent with the Board’s reasoning in *Collins*. (App. Op. Br., pp. 16-20.)

19 5. Success in Other Businesses

20 Appellants provide a schedule of their other businesses during 2005 and 2006 and they  
21 describe them as “capital intensive enterprises operated in the same businesslike way.” (App. Op.  
22 Br., p. 20.)

23 6. History of Income and Losses

24 Appellants quote Treas. Reg. sec 1.183-2(b)(6) which provides in part that “a series of  
25 losses during the start-up stage of an activity may not necessarily be an indication that an activity  
26 is not engaged in for profit.” Appellants assert that Phase II, which commenced in 1994, should  
27 be considered a “start-up stage” of appellant’s business operations. Appellants further state that  
28 1995 was a profitable year and in 1996 the business broke even while in 1989 appellants made

1 \$4 million profit. Appellants state that the business operated at a loss in the subsequent 10 years  
2 but appellants assert that courts have held that 10 years and longer is considered the “start-up  
3 stage”.

4 Appellants further assert that even if the years from 1995 to 2006 are not considered  
5 “start-up stage” the losses resulted largely from “the remarkable number of unforeseen  
6 hardships” described above. Appellants state that the foregoing regulation also provides that  
7 losses that are due to “unforeseen or fortuitous circumstances which are beyond the control of  
8 the taxpayer, such as . . . other involuntary conversions . . . would not be an indication that the  
9 activity is not engaged in for profit.” Appellants state that during the three year period of  
10 2004-2006 Walnut View suffered seven serious involuntary conversions as described above  
11 which was devastating to an operation with only 20 to 30 horses. Appellants compare their  
12 involuntary conversions and losses with those of *Dishal v. Comm’r*, T.C. Memo 1998-397 in  
13 which taxpayers with an operation about the same size as appellants’ suffered 12 involuntary  
14 conversions during 19 consecutive years of losses.

15 Appellants cite *Faulconer v. Comm’r* (1984) 748 F.2d 890 (*Faulconer*) in support of their  
16 contention that the courts have also considered the existence of gross receipts as an indication  
17 that an activity was engaged in for profit. Appellants state that their business operations  
18 excluding horse sales generated gross receipts of \$2,643,151 during Phase II, an average of  
19 \$220,262 per year. Appellants assert that none of the cases involving the application of IRC  
20 section 183 decided since 1979 had “even remotely comparable gross receipts.” Appellants  
21 conclude that for any or all of the foregoing reasons, this factor favors them. (App. Op. Br.,  
22 pp. 20-23.)

#### 23 7. Amount of Occasional Profits

24 Appellants state that under this factor an opportunity to earn a substantial ultimate profit  
25 in a highly speculative venture is ordinarily sufficient to indicate profit motive regardless of past  
26 losses or profits. Appellants contend that thoroughbred horse racing is such a highly speculative  
27 venture and it presents the opportunity to earn a substantial ultimate profit as evidenced by the  
28 fact that thoroughbred horses “often become worth millions or tens of millions of dollars.”

1 Appellants assert that the high-quality horses and race horse prospects purchased during Phase II  
2 had a potential to earn such a substantial ultimate profit. (App. Op. Br., p. 23.)

3 8. Financial Status

4 Under this factor, the taxpayer's substantial income from sources other than the  
5 loss activity may indicate the activity is not engaged in for profit particularly if the losses from  
6 the activity generate substantial tax benefits. Appellants maintain that courts have held that  
7 "regardless of substantial outside income, a level of commitment exists above which finding a  
8 'hobby' is not rational." As evidence of such a level of commitment, appellants note that the  
9 NPAs show that they devoted 20 percent of their taxable income to the horse operation for the  
10 years at issue. Appellants cite *Engdahl, supra* in which, appellants assert, the court found that the  
11 taxpayer devoted approximately 20 percent of his income to his horse activity and held that it  
12 was unlikely that the taxpayer would engage in an activity costing thousands of dollars without a  
13 profit motive. Appellants contend that the court's reasoning is "even more applicable" for  
14 appellants' investment of millions of dollars. Appellants also cite two cases in which the  
15 taxpayers "committed 5.5% and 10.2% of after-tax cash" and 6.2% and 4.1% of gross income".  
16 Appellants state that the courts found those low percentages to be compatible with a hobby  
17 whereas appellants contend that their 20 percent commitment involving millions of dollars  
18 weighs against a finding of a lack of profit motive. (App. Op. Br., pp. 23-25.)

19 9. Elements of Personal Pleasure or Recreation

20 Appellants state that this factor favors them because during Phase II, neither they nor  
21 Walnut View owned a farm or any pleasure horses and they did not ride any horses. Appellants  
22 state that the audit report stated there are no facts "that shed light on this factor" but made the  
23 unconvincing assumption that appellants have "some sort of affinity" for horses. Appellants  
24 further state that the protest hearing officer suggested that the element of personal pleasure was  
25 subsidizing their son's activity as a licensed professional horse trainer. Appellants assert that this  
26 conclusion is erroneous as their son was 42-years-old in 2006, had been a licensed professional  
27 trainer for 20 years and he had been engaged by third parties for seven years prior to the  
28 incorporation of Walnut View. Finally, appellants contend that even if respondent could show an

1 element of personal pleasure or recreation, the U.S. Tax Court held in *Jackson v. Comm.* (1972)  
2 59 T.C. 312, 317, that an activity does not become a hobby merely because the owner finds it  
3 pleasurable. (App. Op. Br., pp. 25-26.)

4 Respondent's Opening Brief

5 Respondent contends that appellants did not operate their Thoroughbred horse operation  
6 in 2005 and 2006 with the "primary, actual or good faith purpose" of making a profit within the meaning  
7 of IRC section 183. Respondent states that IRC section 183 may generally deduct ordinary and  
8 necessary business expenses attributable to for profit activities but may not deduct losses attributable to  
9 any activity not engaged in for profit. Respondent asserts that the taxpayer bears the burden of showing,  
10 primarily based on objective facts, that he or she had a reasonable good faith expectation of profit.  
11 Respondent enumerates the nine objective factors of Treas. Reg. sec. 1.183-2(b) and states that no single  
12 factor is determinative but all facts and circumstances, including those not listed, should be considered.  
13 Thus, according to respondent, the issue in this appeal is "whether the way in which appellants  
14 conducted Walnut [View] demonstrates that profit-making was their primary and predominant purpose  
15 and objective in 2005 and 2006." (Resp. Op. Br., pp. 5-7.)

16 Respondent contends that appellants did not conduct the operation in a businesslike  
17 manner for the following reasons:

- 18 1. Respondent contends that the most important factor is whether appellants made changes in  
19 operating methods or adopted new techniques to control losses, reduce expenses and generate  
20 income with an intent to improve profitability. With respect to appellants' argument that they  
21 demonstrated "profound adaptive behavior" by purchasing a greater number of high-quality  
22 horses, respondent asserts that the tax court specifically found in *Filios v. Comm'r*, T.C. Memo  
23 1999-92, that such measures do not constitute "profit-motivated operational changes".  
24 Respondent further asserts that appellants' decision in 1994 to spend more despite a history of  
25 losses does not indicate an intent to reduce costs or improve profitability.

26 Contrary to appellants' contention that operating costs are irrelevant to a profit-making  
27 purpose in the Thoroughbred horse racing and breeding industry, respondent cites the  
28 Thoroughbred Owners of California handbook which states that "cost management" is a "crucial

1 exercise” which should be “undertaken thoughtfully and monitored regularly.” Respondent  
2 contends that appellants did not conduct formal evaluations or make any significant operational  
3 changes despite losses from 1997 through 2006. Finally, respondent asserts that even if the  
4 Phase II purchases did constitute a material change, appellants have not made the required  
5 showing that the change had a material impact on the operation’s profitability as they have not  
6 substantiated the \$50,000 profit in 1995 or the alleged break-even year in 1996.

7 2. Respondent contends that a taxpayer must have a business plan for success, even if not in  
8 writing, that states “more than just generalized goals”. Respondent contends that appellants never  
9 had a legitimate unwritten business plan and provided conflicting information about their alleged  
10 business plans at protest, where they stated the activity had five successive unwritten plans and  
11 on appeal where they stated the activity had two unwritten plans. Moreover, respondent contends  
12 that appellants’ Phase I plan to train less expensive horses into strong competitors and Phase II  
13 plan to focus on higher-priced horses are not “mere statements of the operation” rather than  
14 actual business plans. Specifically, respondent asserts that appellants did not engage in financial  
15 projections and, regardless of appellants’ assertion that they are not suitable for horse operations,  
16 the Tax Court has looked to market overviews, budgets and financial projections as indicative of  
17 a business plan. Respondent further asserts that even if this Board finds that financial projections  
18 are unnecessary, the generalized goal of breeding successful high-quality horses is inadequate,  
19 particularly in view of appellants’ long history of losses.

20 3. Respondent contends that it is well-settled that the mere ability to substantiate expenses does not  
21 establish that books and records were maintained in a businesslike manner. Respondent cites  
22 *Golanty v. Comm’r* (1979) 72 T.C. 411 and *Abbeene v. Comm’r*, T.C. Memo 1998-330, as cases  
23 holding that a taxpayer must show that books and records were kept for the purpose of cutting  
24 expenses, increasing profits and evaluating the overall performance of the operation. Respondent  
25 contends that appellants have not shown that they reviewed the books and records at the end of  
26 each year to improve the operation after years of losses nor have the alleged or shown that they  
27 took any steps demonstrating “business-like financial management or planning.”

28 Respondent asserts that appellants’ description of the number of employees and payroll amounts

1 does not demonstrate that the operation was conducted in a “businesslike manner” which  
2 contemplates the “use of cost accounting techniques that provide the taxpayer with information  
3 required to make informed business decisions.”

- 4 4. Respondent states that a taxpayer engaged in horse breeding and sales activity is generally  
5 required to show “substantial forms of advertising” the activity. While appellants state that they  
6 did not advertise because none of their horses was a successful thoroughbred race horse,  
7 respondent contends that appellants were “remiss in failing to competitively solicit buyers at  
8 more modest prices.” Respondent further contends that appellants’ “refusal to find buyers for  
9 what they considered to be average or inferior horses” through advertising is inconsistent with a  
10 profit-driven enterprise.
- 11 5. Contrary to appellants’ assertion, respondent contends their operation was not managed in a  
12 manner substantially similar to that of other Thoroughbred horse operations. Respondent states  
13 that the Thoroughbred Breeders and Owners Association (TOBA) recommends such operations  
14 begin with a written business plan setting forth objectives, a timetable, projected expenditures  
15 and revenues, the location and scope of the activity, and the projected term of the activity and  
16 that the plan be updated with changing conditions. Respondent also quotes TOBA’s advice  
17 regarding the documentation of day-to-day activities and asserts that appellants did not follow  
18 any of the foregoing guidelines. Thus, respondent concludes that although the operation had the  
19 “trappings of a business” during 2005 and 2006, those are insufficient to demonstrate that it was  
20 conducted in a businesslike manner. (Resp. Op. Br., pp. 7-12.)

21 Respondent contends that appellants’ explanation that they never needed to engage an  
22 outside consultant is illogical because the operation had losses of millions of dollars while most  
23 of their other businesses generated significant income. Respondent asserts that appellants’ failure  
24 to recognize a need for and to seek professional business advice indicates their lack of concern  
25 with the operation’s profitability. Although appellants state they consulted with experts aside  
26 from their son, respondent states that they do not describe the advice sought or received and they  
27 do not describe how they implemented the advice. With respect to appellants’ assertion that they  
28 are experts in this industry, respondent contends that “experience in conducting a tremendously

1 unprofitable operation does not provide expertise in the economic aspects of that operation.” For  
2 those reasons, respondent contends that this factor favors respondent. (Resp. Op. Br., pp. 12-13.)  
3 6. Respondent contends that the time spent on the operation by Walnut View’s employees does not  
4 indicate a profit objective because appellants as Walnut View’s managers did not spend adequate  
5 time or effort on creating a profitable operation. According to respondent, appellants did not  
6 keep a log of their time spent and provided conflicting time estimates ranging from appellant-  
7 husband spending 10 hours per week during the audit, to 15 hours and occasionally 40 during  
8 protest, to approximately 20 hours at a later stage of the protest, and then an average of 20 to 40  
9 hours per week not including travel time on appeal. Respondent states that during audit  
10 appellant-wife estimated she spent 3 to 5 hours per week but on appeal she estimates 10 hours  
11 per week.

12 Respondent asserts that this Board and the Tax Court interpret “the time/effort factor” as  
13 favoring taxpayers who perform “dawn-to-dusk labor associated with horse operations” as  
14 opposed to those who engage in more recreational aspects such as attending races. Respondent  
15 states that appellants lived in Pleasanton during the years on appeal which is approximately  
16 130 miles from Fresno where Walnut View’s horses were boarded. Respondent contends that  
17 appellants were not involved in the day-to-day manual labor of Walnut View and appellant-  
18 husband’s activities, such as reading horse publications, attending races and discussing horses  
19 with his son, is in large part as consistent with a hobby as with a business. Respondent also states  
20 that the Tax Court has found that spending 30 hours per week on an activity does not necessarily  
21 establish a profit motive.

22 Respondent states that appellant-husband conservatively estimates the time he spends on  
23 the other businesses at 40 to 60 hours per week and he actively managed all of his controlled  
24 businesses. Respondent states that appellants receive significant wage compensation from  
25 several of the businesses. Even though appellants engaged professionals to perform Walnut  
26 View’s daily operations, respondent concludes that the time spent on their other businesses  
27 detracted from the time that could have devoted to Walnut View to improve profitability. For  
28 those reasons, respondent asserts that this factor is neutral. (Resp. Op. Br., pp. 12-16.)

1 7. Respondent states that appellants have misapplied the factor requiring consideration of the  
2 taxpayer's "expectation that assets used in the activity may appreciate in value" by their  
3 discussion of the irrelevant sale of land in 1989. Respondent contends that this factor focuses on  
4 whether appellants expected the assets Walnut View held in 2005 and 2006 would appreciate and  
5 thereby offset the history of losses. Respondent notes that the cases cited by appellants involved  
6 the unrealized appreciation of land those taxpayers owned during the years on appeal as opposed  
7 to land that appellants owned 16 years prior to the first year on appeal.

8 With respect to appellants' statement that during 2005 and 2006 they expected Walnut  
9 View to realize a substantial profit from appreciation of one outstanding horse, respondent  
10 asserts that such a belief is not indicative of a profit motive if it is not adequately supported and  
11 appellants have provided no such evidence. Respondent further notes that appellants state that  
12 they conducted no advertising because none of their horses met the criterion for a successful race  
13 horse. On that basis, respondent concludes that appellants did not have a reasonable belief of  
14 substantial profit from appreciation of a horse. Respondent asserts that the Tax Court has held  
15 that the "possibility of a speculative profit . . . is insufficient to outweigh the absence of profits"  
16 for a period of years. Respondent contends that Walnut View's operating expenses would have  
17 far exceeded revenue even if its horses had placed first in every race entered in 2005 and 2006.  
18 Thus, respondent concludes this factor favors respondent due the absence of a good-faith  
19 expectation. (Resp. Op. Br., pp. 16-18.)

20 8. Respondent states that a taxpayer's success in converting similar business activities from  
21 unprofitable to profitable activities may show that the taxpayer has a profit objective but,  
22 respondent asserts, appellants have not engaged in activities similar to the horse racing and  
23 breeding operation. Respondent further asserts that at protest appellants conceded that their other  
24 business activities were dissimilar but on appeal they make the "dubious" argument that all their  
25 business activities are similar because they were all capital intensive and were operated in the  
26 same way.

27 Respondent states that even if one accepts that the business activities were similar,  
28 appellants have not explained why appellants' waste management operations are highly

1 profitable while the horse racing and breeding activity is not. Because appellant-husband is  
2 acknowledged as an experienced businessman, respondent contends that it is not credible that his  
3 primary purpose in operating the horse operation was to make a profit. Thus, respondent  
4 concludes that this factor favors respondent.

- 5 9. Respondent states that a history of substantial losses may indicate the taxpayer did not operate a  
6 business activity for profit. Respondent maintains that appellants' horse activity had such a  
7 history and contends that this factor strongly favors respondent for the following reasons:

8 Start-up Stage: Respondent contends that in *Dodds v. Comm.*, T.C. Memo 2013-76, the Tax  
9 Court rejected an argument similar to appellants' argument that Phase II commenced a start-up  
10 stage because it constituted "a new and different activity". In that case, the court held that when  
11 a horse breeder who bred "grade" horses switched to breeding "world-caliber" horses, he was not  
12 entitled to a new start-up stage because he altered the goal of the breeding activity. Respondent  
13 contends that appellants' operation did not "become a new entity for tax or other purposes" in  
14 1994 even if they have a new business plan and, moreover, appellants stated during protest that  
15 the operation had five business plans rather than two so their claim of a second start-up appears  
16 arbitrary. Respondent further contends that appellants' argument is contradictory in that  
17 appellants argue that the losses prior to 1994 should not be considered but also maintain that  
18 their 1989 profit should be considered. Finally, respondent maintains that regardless of the length  
19 of the start-up stage, it is well-established that that the magnitude of an activity's cumulative  
20 losses should not make an overall profit impossible.

21 Unforeseen Hardship: Respondent contends that appellants have not supported their claim that  
22 the losses from 1997 to 2006 were due to several "devastating" unforeseen events. Respondent  
23 asserts that appellants have stated that, between 2004 and 2006, Walnut View involuntarily  
24 converted seven of its horses due to career-ending casualties, but appellants have not shown that  
25 the operation would have made a profit if those casualties had not occurred. In addition, those  
26 involuntary conversions do not explain the losses from 1997 through 2003 or from 2006 to the  
27 present and, as appellants admit, such injuries are not uncommon for thoroughbred race horses.

28 Gross Receipts: Respondent contends that *Faulconer, supra*, cited by appellants is not analogous

1 because the horse ranch in that case realized a net profit in two of the seven years in issue and,  
2 thereby, triggered the presumption under IRC section 183(d) that the ranch was operated for  
3 profit. Respondent states that the presumption does not apply here and that by 2005 Walnut View  
4 was incurring a level of expenses that was greatly in excess of income. (Resp. Op. Br., pp.  
5 19-21.)

6 Respondent notes that appellants claim the horse operation had two profitable years in  
7 1989 and 1995 but contends that the profit in 1989 is not attributable to the horse operation and that  
8 appellants have not substantiated the 1995 profit. Respondent states that the claimed 1989 profit resulted  
9 from a like-kind exchange of a parcel of land on which appellants claim they stabled their breeding and  
10 lay-up horses and that appellants deferred most of the \$4 million gain from the sale and recognized only  
11 \$631,108. Respondent also states that appellants argue that their holding of the land and the horse  
12 operation should be considered a “single activity” to allow consideration of the \$4 million gain in  
13 determining the horse operation’s profit for 1989. (Resp. Op. Br., p. 22.)

14 Respondent contends that appellants misapply the single activity test under Treas. Reg.  
15 sec. 1.183-1(d)(1) which requires an examination of all facts and circumstances and provides that, when  
16 a taxpayer purchases land with the primary intent of profiting from appreciation, the holding of the land  
17 and farming are considered a single activity only if the farming activity is profitable. Respondent asserts  
18 that appellants erroneously interpret this provision to mean that whenever a taxpayer purchases land  
19 with a different primary intent, the holding of the land and the farming activity constitute a single  
20 activity regardless of whether the activity is profitable. Respondent contends that the language does not  
21 support appellants’ interpretation but rather requires consideration of the facts and circumstances which,  
22 in respondents’ view, “call for a disaggregation” of the holding of the land and the horse operation for  
23 the following four reasons:

- 24 1. The holding of land was incidental to (and not integral to) appellants’ horse operation as  
25 evidenced by the fact that since selling that land appellants have stabled their horses on land  
26 owned by third parties.
- 27 2. Appellants were “significantly involved” during the years on appeal in several business ventures  
28 holding real properties for investment purposes so it should not be presumed that the land was

1 held for purposes of the horse operations.

2 3. The appreciation of the land was not due apparently to appellants' horse operations but rather to  
3 unrelated conditions of the real estate market as the land was sold to developers who subdivided  
4 it and built residential units.

5 4. Over \$3.3 million of the gain from the sale was reinvested in like-kind property and, therefore,  
6 did not provide funds for the improvement and benefit of appellants' horse operation. (Resp. Op.  
7 Br., pp. 22-24.)

8 Respondent further asserts that "[a]ppellants' attempt to offset the roughly \$600,000 in  
9 losses . . . by paper gain of \$3.3 million" is not an effective means of determining the "commercial  
10 viability and soundness" of the horse operation which was subsidized by appellants' other ventures.  
11 Respondent contends that "an objective inquiry would recognize" that appellants could not have  
12 maintained the horse operations activity for over 40 years if it had been appellants' sole business  
13 activity. Respondent further contends that the horse operations activity never had its own funds and was  
14 supported by a "continuous infusion of capital from appellants' other profitable enterprises". Because  
15 the holding of the land and the horse operations were separate activities in 1989, respondent concludes  
16 that it appears the horse operations sustained a \$43,000 loss that year. Even if the Board finds that they  
17 constituted a single activity, respondent contends that appellants have not shown that they were  
18 operating the business with the "predominant purpose" of making a profit in 2005 and 2006. (Resp. Op.  
19 Br., pp. 24-25.)

20 Respondent contends that appellants have not proven the business made a profit in 1995  
21 and broke even in 1996, and that even if they did prove that it made a profit, a finding of profit motive  
22 for the years on appeal would be disfavored because the profit was earned 10 years prior to the first year  
23 on appeal and was very small in relation to losses exceeding \$3 million from 1999 through 2006.  
24 Respondent notes that the horse operations, even assuming appellants are correct, sustained losses for  
25 21 years from 1973 to 1994 and 16 years from 1997 to 2012. In the face of such losses, respondent  
26 contends that by 2005 and 2006 prudent business people would have significantly altered operating  
27 methods and practices or abandoned unprofitable ventures. In view of the foregoing, respondent  
28 contends that this factor strongly favors respondent. (Resp. Op. Br., pp. 25-26.)

1 Respondent contends that this Board is required to consider appellants' significant  
2 income from their other businesses which may indicate that appellants did not conduct the horse  
3 operations for profits, especially if the losses generated large tax benefits. Respondent states that for  
4 each year on appeal appellants reported over \$3 million of nonpassive and wage income from over a  
5 dozen pass-through entities and took deductions of over \$600,000 for Walnut View's losses, which  
6 reduced appellants' taxable income by about 21.6% in 2005 and 23.9% in 2006. Contrary to appellants'  
7 claims that this favor weighs in their favor because they made significant financial investment in  
8 Walnut View, respondent asserts that the Tax Court has observed that "[a] taxpayer with substantial  
9 income unrelated to the activity can more readily afford a hobby." Respondent also states that the  
10 Tax Court has noted that a taxpayer's substantial income enabled the taxpayer to engage in a pursuit  
11 primarily for personal reasons with the government subsidizing a portion of the activity's costs, even  
12 though the tax savings were less than 100 percent of the loss. For those reasons, respondent states that  
13 this factor favors respondent. (Resp. Op. Br., pp. 26-27.)

14 Respondent contends that its auditor did not recommend allowing the losses due to the  
15 absence of a recreational or pleasure motive. Respondent asserts that in cases involving similar facts the  
16 Tax Court has found that continued engagement in the business activity despite sustained losses is  
17 evidence of a pleasure motive even if there is no clear evidence of such a motive. Respondent further  
18 contends that appellants' engagement in the horse operation for decades with losses indicates that they  
19 were not motivated by profit, "but by the promise of personal gratification." Respondent states that this  
20 factor is neutral. (Resp. Op. Br., pp. 27-28.)

21 Respondent contends that the *Appeal of Collins, supra*, cited by appellants, is easily  
22 distinguishable as follows: The *Collins* taxpayers analyzed costs and expenses and made material  
23 operational changes while appellants did not perform any sort of economic analysis. The *Collins*  
24 taxpayers were entitled to consider the value of the land during the years on appeal in their expectation  
25 of asset appreciation whereas appellants' gain from the like-kind exchange in 1989 was not relevant to  
26 asset appreciation in 2005 and 2006. The *Collins* taxpayers "heavily invested personal time and effort"  
27 in performing manual labor. And, the *Collins* taxpayers did not have substantial income from sources  
28 other than their horse activity. (Resp. Op. Br., pp. 28-29.)

1           Appellants' Reply Brief

2           In their reply brief, appellants first state that the tax returns for years 1989, 1995 and  
3 1996, which are attached as exhibits, substantiate that the horse operation earned a profit in 1989 and  
4 1995 and broke even in 1996 which, appellants contend, show that appellant generated overall profits of  
5 almost \$3 million. They also claim that respondent never audited or assessed taxes for any of the years  
6 1973 through 2004, and that the IRS only audited appellants' 1999 return but issued a no change  
7 determination. (App. Reply Br., pp. 3-4, exhs. 1 and 2.)

8           Appellants contend that there is no evidence to support respondent's argument that the  
9 land was purchased with the primary intent to profit from appreciation and the facts show that appellants  
10 added \$20,000 in improvements and used it in their horse operation for 11 years. Unless a property is  
11 held primarily for appreciation, appellants quote Treas. Reg. sec. 1.183-1(d) as providing that  
12 "[g]enerally, the Commissioner will accept the characterization by the taxpayer of several undertakings  
13 either as a single activity or as a separate activity." Appellants also state that they "are not attempting to  
14 justify the 2005-2006 losses" by claiming the gain on the land sale but are trying to counter respondent's  
15 claim that there were 40 years of losses when there was almost a \$3 million profit during the period  
16 from 1973 through 1998. (App. Reply Br., pp. 4-5.)

17           Appellants respond to respondent's discussion of the nine regulatory factors as follows:

18           Change in Operating Methods: Beginning in late 1994, appellants made profound changes in the  
19 quality and quantity of their race horses and race horse prospects. Whereas from 1973 to late  
20 1994, their horse purchases totaled less than \$150,000 but, from late 1994 through 2006, such  
21 purchases totaled over \$2 million. Respondent concludes that only cost reductions are significant  
22 but changes to increase revenue are equally important.

23           Respondent cites *Filios v. Comm'r* (1st Cir. 2000) 224 F.3d 16, affg. T.C. Memo  
24 1999-92 (*Filios*) and claims that the court "ignored a similar increase in the number of horses  
25 and in the use of improved bloodlines." Appellants distinguish *Filios* noting that case involved  
26 37 consecutive loss years totaling over \$6.6 million and the court noted but minimized the fact  
27 that many years earlier the taxpayer had increased his horse holdings by an undetermined  
28 number. Appellants also contend that improvement of bloodlines was minimal here because

1 appellants bred very few race horse prospects. Finally, appellants assert that respondent fails to  
2 state that the Circuit Court of Appeals, in its decision affirming the Tax Court, stated that it did  
3 not agree with the Tax Court that the changes were *de minimis* but held that the taxpayer failed to  
4 meet the burden of proof. Appellants question respondent's citation of a footnote in a Tax Court  
5 case for the proposition that appellants are required to show that the changes in late 1994 had a  
6 material impact on profitability. As evidence, appellants refer to Kent Molinaro's Declaration,  
7 attached as an exhibit to the opening brief, in which he recommends appellants "substantially  
8 increase both the quantity and quality of their race horse prospects" to "optimize [their] chances  
9 for profit." (App. Reply Br., pp. 5-7; App. Op. Br., exh. C.)

10 Business Plan: Appellants state that they and Walnut View have always had a business plan of  
11 developing and racing horses for profit and they revised the business plan in 1994 as described  
12 above. Appellants maintain that appellants' unwritten business plan met "virtually all" of the  
13 suggestions from the trade publication excerpt cited by respondent as follows: they defined the  
14 type of business form as a corporation, identified goals of primarily purchasing horses and also  
15 breeding horses to race with the ultimate goal of creating profits through winning purses and  
16 developing one or more horses which could be sold for millions of dollars, specified a consultant  
17 and his credentials by engaging Kent Molinaro, showed their means of acquiring equine assets  
18 by purchasing over 80 Thoroughbreds and breeding another 19 horses between 1994 and 2006,  
19 established a regional location in California, carried appropriate insurance by purchasing general  
20 liability insurance and, as is common practice, selectively insuring against mortality for very  
21 important horses, and articulating the terms of the existence of the enterprise by stating that they  
22 intend to pursue their profit objective based on the "current market's high potential for  
23 appreciation in value". Appellants also state that their business plan did not implement the  
24 suggestion "project expenditures and revenues" because as they explained on page 14 of their  
25 opening brief, that is a "near impossibility with Thoroughbreds". (App. Reply Br., pp. 8-9.)  
26 Books and Records: Appellants argue that financial projections and economic forecasts are not  
27 feasible as appellants in their opening brief describe the reasoning in *Faulconer* and *Trafficante*.  
28 Appellants further argue that respondent does not understand that their business plan was "to

1 purchase and successfully race Thoroughbreds and thereafter sell those of high enough quality.”  
2 Appellants also assert that respondent’s citation of *Keating v. Comm.*, T.C. Memo 2007-309, is  
3 inappropriate as that case involved the breeding and sale of show horses and the court held that  
4 the taxpayer’s modifications were “relatively insignificant” whereas appellants increased their  
5 horse purchases from \$150,000 over the first 22 years to over \$2 million in the next 12 years.  
6 (App. Reply Br., pp. 9-10.)

7 Advertising: Appellants present the “two basic plans” for a Thoroughbred operation for profit as  
8 (1) a large group of participants acquire young Thoroughbreds and develop them for sale at  
9 public auction and (2) a large group of participants acquire or breed horses for the purpose of  
10 racing them. The “profit centers” for the latter group are the lucrative purses and the sales of  
11 successful horses. Appellants state that their and Walnut View’s business plan has always been  
12 racing so there was no reason to advertise because they only disposed of involuntarily “claimed”  
13 or injured horses. (App. Reply Br., pp. 10-12.)

14 Operating Like Successful Horse Businesses: Appellants assert that unlike the taxpayer in *Filos*,  
15 *supra*, cited by respondent, they have provided evidence in the form of Kent Molinaro’s  
16 declaration that appellants operation is conducted in the same manner as successful horse  
17 businesses. (App. Reply Br., p. 12.)

18 Appellants further describe as “four other businesslike aspects” the formation of  
19 Walnut View, an S corporation, to operate their horse activity, Walnut View’s employment of  
20 17 people, the eligibility of 36 of appellants’ horses for the Breeders’ Cup Championship races, and  
21 Walnut View’s “especially efficient” program of “culling” unneeded or unproductive horses. Appellants  
22 also describe two other changes to their business plan as training horses for outside owners and  
23 purchasing “Profound Secret” in 1996 for \$75,000. (App. Reply Br., pp. 12-13.)

24 Appellants repeat their arguments that they were experts and they consulted with experts  
25 in the Thoroughbred horse industry and they dispute respondent’s argument that they failed to engage an  
26 “outside consultant or manager” as respondent “impermissibly substituting its own business judgment.”  
27 Appellants assert that respondent has conceded that the time devoted to the horse operation by  
28 Walnut View’s “competent employees” was “significant” and appellants have established by their

1 declarations that appellant-husband spent 20 to 40 hours per week and appellant-wife spent 10 hours per  
2 week. Appellants contend that this time commitment is adequate under the cases cited by appellants in  
3 their opening brief and there is no requirement that appellants' engage in "day-to-day manual labor".  
4 (App. Reply Br., pp. 13-15.)

5 Appellant assert that Thoroughbred horses have "an incredible potential for appreciation  
6 in value" which explains appellants' decision in late 1994 to increase the quality of their horse race  
7 prospects. In this regard, appellants note that respondent cites cases in which the taxpayers held over  
8 20 consecutive loss years whereas appellants had only eight "start-up stage" loss years. Appellants  
9 contend that case law cited in their opening brief refutes respondent's assertion that their other  
10 businesses were dissimilar to the horse operation and they contend that the horse activity generated a  
11 profit of almost \$3 million in the first 26 years of operation. Furthermore, appellant-husband states in his  
12 declaration that he operated all of his businesses without written business plans, formal written budgets  
13 or forecasts, or written key personnel evaluations, and never engaged paid outside consultants. (App.  
14 Reply Br., pp. 16-17.)

15 Appellants dispute respondent's comparison of their horse operation with the operation in  
16 *Dodds, supra* in which the taxpayer upgraded the quality of his breeding of "Morgan horses" but he  
17 failed to turn a profit in 17 years and the court found he also failed "to produce any significant income."  
18 Appellants contrast their own history of generating gross operating revenues of \$2,643,151 during the  
19 period from 1995 through 2006 and they argue a more apposite case is *Shane v. Comm.*, T.C. Memo  
20 1995-504, in which a Thoroughbred operation that modified its business plan was recognized as being  
21 entitled to a start-up status. Appellants further argue that they have described their "unforeseen  
22 hardships" in detail and respondent has not cited any authority to support its position that appellants are  
23 required to show that the horse operation would have been successful if the casualties had not occurred.  
24 In this regard, appellants maintain that actual profit has never been a requirement for finding a profit  
25 motive and showing how the loss of race horse affects profits is just as impossible as forecasting income  
26 in a Thoroughbred horse operation. (App. Reply Br., pp. 17-18.)

27 Appellants take issue with respondent's citation of cases involving operating revenues in  
28 the thousands of dollars with appellants' operation with generated \$2,643,151 from 1995 through 2006.

1 Appellants further argue that *Faulconer, supra* supports their position in that the court found that  
2 receipts averaging over \$80,000 per year (while appellants' receipts were three times that amount) were  
3 not compatible with a personal pleasure motive. Appellants assert that their occasional profits in 1989  
4 and 1995 are important facts but they argue that they have met the test under to Treas. Reg. sec.  
5 1.183-2(b)(7) which provides that, "the opportunity to earn substantial ultimate profit in a highly  
6 speculative venture, is ordinarily sufficient to indicate that the activity is engaged in for profit . . .".  
7 Appellants point to three articles they provided with their opening brief regarding thoroughbred horses  
8 valued in the millions of dollars. (App. Reply Br., pp. 19-20.)

9 Appellants point to the court's conclusion in *Engdahl, supra* that "it would be unlikely  
10 that the taxpayers would embark on an enterprise costing 'thousands of dollars' without a profit motive"  
11 as supportive of appellants' position that their investment of over a million dollars indicates a profit  
12 motive. Appellants also note that the source of capital for Walnut View was their "personal service  
13 income" and that the court in *Appley v. Comm.*, T.C. Memo 1979-433 held that the taxpayer "would not  
14 be likely to squander personal service income in a hobby of such magnitude." Appellants state that  
15 respondent finds no personal pleasure or recreation element and determines this factor to be neutral.  
16 However, appellants contend that the applicable case is *Nickerson v. Comm.* (7th Cir. 1983) 700 F.2d  
17 402, in which the court held that there are only two primary reasons for an economic venture – pleasure  
18 or profit – which, under these facts, means that the primary purpose was profit. Finally, appellants repeat  
19 their contention that *Appeal of Collins, supra* is applicable here. (App. Reply Br., pp. 20-22.)

#### 20 Respondent's Reply Brief

21 Respondent states that, based on the tax year 1995 return, it acknowledges that  
22 appellants' horse operation had a net profit of \$49,138 for that tax year but respondent rejects  
23 appellants' argument that the 1989 land sale generated profit for the horse operation. Respondent repeats  
24 its argument that appellants misread Treas. Reg. sec. 1.183-1(d)(1) which requires an examination of all  
25 facts and circumstances to determine the existence a single activity. Further, respondent argues that  
26 appellants erroneously assert that respondent is required to show that appellants held the land with the  
27 primary intent to profit from it. Rather, respondent contends that it followed the regulation by  
28 conducting such an examination but appellants do not address those arguments in their reply brief.

1 Moreover, respondent contends that appellants have failed to meet their burden of showing a single  
2 activity and respondent repeats its reason for not considering the land holding and horse operation a  
3 single activity. (Resp. Reply Br., pp. 3-7.)

4 Respondent questions appellants' position that the land was integral to their horse  
5 operation when they failed to use at least a portion of the sale proceeds to purchase new property to  
6 conduct their operation. Rather than acquiring such property, respondent states that they acquired rental  
7 properties and land parcels not used in the horse operation which, respondent concludes, suggested they  
8 held the subject land for investment or appreciation purposes. Respondent also notes that appellants  
9 claim that the 1989 land sale had no bearing on the 2005 and 2006 losses and so it should not be  
10 considered by this Board. Furthermore, respondent rejects appellants' "artificial" characterization of a  
11 single activity and, thus, concludes that appellants had a loss rather than a profit in 1989. Even if this  
12 Board finds a single activity, respondent contends that such a finding does not establish appellants were  
13 conducting that activity with the predominant purpose of making a profit in 2005 and 2006. (Resp.  
14 Reply Br., pp. 7-8.)

15 Respondent repeats its arguments that appellants did not carry on the activity in a  
16 businesslike manner for the following reasons:

- 17 • They made no profit-motivated changes despite decades of losses but only expanded an activity  
18 which was unprofitable for 23 years. The facts in *Filios, supra* are similar in that, with the  
19 exception of 1995, appellants have sustained losses totaling over \$7.2 million for 40 consecutive  
20 years. In *Filios* the court also determined, contrary to appellants' claim, that the taxpayer  
21 increased his herd by 84 horses and, thus, the facts parallel appellants' "change" in the quantity  
22 and quality of their horses. Moreover, the Court of Appeals decision affirming the Tax Court  
23 establishes that even when a taxpayer effects more than minor changes in operations, the court  
24 may still find no profit motive. Finally, the declaration statements regarding the profit-making  
25 purpose of the 1994 changes are outweighed by the fact that losses have increased since 1994  
26 and appellants did not implement changes to reverse that trend over the 10 year period to 2005  
27 and beyond. (Resp. Reply Br., pp. 9-12.)
- 28 • Appellants had no business plan to make the activity profitable but mere statements of operation.

1 Appellants' description of their unwritten business plan which met "virtually all" of a trade  
2 publication's suggestions was "merely a statement of what the horse activity did or how it  
3 operated" as opposed to an actual business plan and there is no evidence they engaged in a  
4 strategic analysis of potential profitability. The unpredictability of a Thoroughbred horse  
5 operation does not exempt appellants from preparing a business plan or budget in an attempt to  
6 make the business profitable. In *Filios, supra* the courts found it significant that the taxpayer  
7 never conducted written business or economic studies, prepared a business plan or budget or  
8 hired consultants to make the activity profitable. Here, appellants' objective to train and breed  
9 certain horses was a goal and not a strategic plan which is insufficient to merit a finding that  
10 appellants developed a business plan under case law. (Resp. Reply Br., pp. 12-13.)

- 11 • Appellants' mere ability to substantiate expenses does not establish they kept books and records  
12 in a "businesslike manner" as they did not use the books and records to evaluate or to increase  
13 profitability. Appellants have not alleged or shown that they ever engaged in businesslike  
14 financial management or planning in the 40 years of their horse operations. Appellants' reliance  
15 on *Faulconer, supra* is misplaced because in that case the horse ranch realized a net profit in two  
16 out of seven years which triggered the legal presumption, not applicable here, that the activity  
17 was engaged in for profit. In addition, the court found the activity was carried on in a  
18 businesslike manner because the taxpayer sought expert advice in how to make the horse activity  
19 profitable and changed his operating methods accordingly. More on point is *Filios* in which the  
20 court found as significant that the taxpayer did not have "budgets, income statements, balance  
21 sheets, income projections or financial statements" other than those necessary to prepare tax  
22 returns. (Resp. Reply Br., pp. 13-15.)
- 23 • Appellants' refusal to sell their horses unless they could develop a superior race horse for a  
24 multi-million dollar price despite a long history of losses is not consistent with an intent to make  
25 a profit in tax years 2005 and 2006. (Resp. Reply Br., pp. 15-16.)
- 26 • Kent Molinaro's declaration statement that appellants' horse operation was conducted in a  
27 manner substantially similar to successful operations is vague, conclusory and lacks factual  
28 support. He does not specify whether other "successful" horse operations were profitable or

1 merely enjoyed success in horse racing and he does not describe the practices that made those  
2 operations successful and whether appellants followed the same practices. As the court found in  
3 *Filos*, appellants have not provided any evidence of how comparable profitable businesses  
4 worked and that they operated in a substantially similar manner. Appellants cite the corporate  
5 form, employees and culling practice as evidence the operation was conducted in a “businesslike  
6 manner” but such “trappings” of business are not sufficient to show a profit-making intent and  
7 they have not shown that the operation’s components, such as the number of employees, was the  
8 result of an informed cost-benefit analysis. Furthermore, a culling practice is as consistent with a  
9 horse racing hobby as it is a profit-making enterprise and in *Filos*, the court found the taxpayer’s  
10 activity to be a hobby even though the taxpayer gave away 124 horses that were not performing  
11 well. (Resp. Reply Br., pp. 16-17.)

12 Respondent contends that while appellants have shown they had expertise in breeding  
13 and training horses, they have not alleged or shown they sought or obtained expertise as to the economic  
14 aspects of a race horse operation. In *Filos*, the court found that the taxpayer who had been involved in  
15 horse racing for 37 years but failed to show that he had the requisite expertise or that he consulted with  
16 experts in the business of a horse racing activity. Respondent also asserts that appellants’ argument that  
17 they never paid outside consultants or managers for any of their other businesses is unconvincing  
18 because those other businesses were all profitable unlike the horse operation. (Resp. Reply Br., pp.  
19 17-18.)

20 Respondent agrees with appellants that there is no requirement that appellants have  
21 performed “day-to-day manual labor” but asserts that this Board and the Tax Court have interpreted the  
22 time/effort factor as favoring taxpayers who perform such labor associated with horse operations  
23 because those taxpayers are more likely trying to make a profit as opposed to taxpayers who engage in  
24 more recreational activities like attending races. Respondent contends that the time and effort appellant-  
25 husband spent on the horse operation was as consistent with a hobby as it was with a profit-making  
26 business and the Tax Court held in *Dodds, supra* that spending 30 hours per week on an activity does  
27 not necessarily establish a profit motive. Furthermore, respondent contends that appellants have not  
28 addressed respondent’s arguments that appellants gave conflicting testimony about and did not record

1 the time spent on the horse operation and that the time spent by appellants' on their other businesses  
2 detracted from time spent attempting to make the horse operation profitable. (Resp. Reply Br.,  
3 pp. 18-20.)

4 Respondent contends that appellants have not shown as required by Treas. Reg. sec.  
5 1.183-2(b)(4), that as of 2005 and 2006 any of their horses had appreciated to such an extent that  
6 appellants still hoped to realize a profit despite substantial current and prior losses. Moreover, appellants  
7 state they conducted no advertising because none of their horses met the criteria for a successful  
8 Thoroughbred race horse. Respondent further contends that appellants have also not shown they  
9 expected to earn a profit from racing in 2005 and 2006. Respondent asserts that the Tax Court in *Foster*  
10 *v. Comm.*, T.C. Memo 2012-207 and other cases has held that “[t]he possibility of speculative profit in a  
11 taxpayer’s horse activity is . . . insufficient to outweigh the absence of profits for a sustained period of  
12 years.” Despite appellants’ contention that their horse operation was in a “start-up stage” with only  
13 8 years of losses, respondent argues that it has been operating since 1973 with 40 years of losses totaling  
14 more than \$7.2 million. (Resp. Reply Br., pp. 20-21.)

15 Respondent contends that appellants’ other businesses were not similar to the horse  
16 operation but even if they were appellants have not explained why the waste management operations are  
17 highly profitable whereas the horse activity is not profitable after 40 years. Respondent asserts that  
18 appellants point to the 1989 like-kind exchange as evidence that the horse operation was profitable and  
19 ignore the \$6.9 million in losses since 1989. Respondent maintains that an “expert businessman” with  
20 the principal objective of making a profit would not continue to operate at a loss for 40 years. (Resp.  
21 Reply Br., pp. 22-23.)

22 Respondent contends that the horse operation has a history of substantial losses which  
23 may indicate it was not conducted for profit. Respondent contends that *Shane, supra* cited by appellants  
24 to support their position the horse operation was in a start-up stage is distinguishable because the  
25 taxpayer “completely changed the focus of his horse business” by shifting from sales to breeding. Here,  
26 respondent argues, appellants’ activity continued in its goal to develop one or more successful race  
27 horses to win purses and be sold for multi-million dollar prices. Respondent argues that *Dodd, supra* is  
28 applicable and appellants are not allowed to “reset the clock” because they expanded the scope of their

1 horse activity. Even if appellants are allowed to reset the clock, respondent contends that the start-up  
2 stage expired in 2004 and the horse activity continued to operate at a loss through 2012. (Resp. Reply  
3 Br., pp. 23-34.)

4 Respondent contends that the seven involuntary conversions does not account for  
5 17 years of losses between 1996 and 2012 and 21 years of losses between 1973 and 1994 and appellants  
6 have failed to show that the activity would have been profitable absent those events. In addition,  
7 Walnut View's gross receipts alone are not indicative of a profit motive and when one considers  
8 operating expenses the activity's losses increased from prior years by 2005. Furthermore, the small  
9 profit earned in 1995 when weighed against 40 years of losses totaling more than \$7.2 million does not  
10 justify an expectation of profits in 2005 and 2006. By 2005, a prudent business person either would have  
11 significantly altered operating methods and practices or abandoned the venture and appellants did  
12 neither. Respondent also states that though it stated that appellants did not ride the horses for pleasure it  
13 continues to maintain that there were elements of personal pleasure in appellants' horse racing activities.  
14 (Resp. Reply Br., pp. 25-26.)

15 Respondent repeats its argument that the Walnut View losses combined with appellants'  
16 high income and tax bracket generated considerable tax benefits for appellants that disfavor finding a  
17 profit motive. Respondent also contends that appellants derived personal enjoyment from being engaged  
18 in horse racing and breeding and attending races and auctions and likely derived pleasure from seeing  
19 their son, Kent Molinaro, pursue his passion as a trainer. Finally, respondent contends that the *Appeal of*  
20 *Collins* is distinguishable because the taxpayers analyzed costs and expenses and made material  
21 operational changes, considered the value of the farm land they held during the years on appeal, heavily  
22 invested personal time and effort in manual labor, and did not have substantial income from other  
23 activities. (Resp. Reply Br. 27-29.)

#### 24 Appellants' Supplemental Brief

25 Appellants argue that *Appeal of Collins, supra* is on point as it involved a similar size  
26 operation, business plan, farm value appreciation, complete records, several consecutive loss years,  
27 substantial time devoted, no substantial pleasure or recreational element, and tremendous profit  
28 potential. Appellants contend that they have shown that they made major business plan changes and

1 devoted substantial time and effort and respondent concedes they hired several competent professionals  
2 during 2005 and 2006. Appellants assert that respondent unfairly notes that 2007 through 2012 were loss  
3 years even though they are not at issue and that respondent did not mention that 1996 was a breakeven  
4 year. Appellants also repeat their contention that the 1989 land sale disproves respondent's contention  
5 that appellants' operation had 40 years of losses. Appellants also contend that the facts and  
6 circumstances prove that the holding of the land and the horse operation were a single activity. (App.  
7 Supp. Br., pp. 4-6.)

8 Appellants further contend that respondent makes four arguments to demonstrate that the  
9 land was not integral to the horse operation:

- 10 • Respondent uses "hindsight" to conclude that the land was not integral because they did not  
11 invest in another parcel to conduct their horse operation. Appellants contend that most  
12 Thoroughbred horse operations do not include farm ownership.
- 13 • Respondent cites no evidence to support the view that appellants' involvement in other real  
14 estate holdings indicates that the holding of the land was not part of the horse activity.
- 15 • The fact that the appreciation of the land value was not the result of the horse activity does not  
16 alter the use and improvement of the land as a horse farm for 11 years.
- 17 • Respondent cites no authority for its position that appellants' deferral of tax on the gain from the  
18 sale under IRC section 1031 renders the horse operation a separate activity for the prior 11 years.  
19 (App. Supp. Br., pp. 6-7.)

20 Appellants repeat their argument that the business plan was modified in 1994 to increase  
21 revenues rather than cut costs which created a profit in 1995 and a breakeven year in 1996. When  
22 considered in light of the net profit of \$3.4 million from 1973 through 1994, appellants argue that  
23 "[s]uch a brief period of losses is not unusual for a Thoroughbred racing operation, especially given the  
24 numerous unforeseen casualties . . .". Appellants assert that they had a business plan as described in  
25 their prior briefs. Appellants further assert that respondent substitutes its business judgment for  
26 appellants' by arguing that appellants' refusal to attempt the sale of average or inferior horses or  
27 otherwise modify their activities to increase revenues "until a multi-million dollar horse could be sold"  
28 showed a lack of concern for their continuous losses. Appellants maintain that they have always quickly

1 culled all horse that were unproductive or did not meet their criteria. (App. Supp. Br., pp. 8-10.)

2 Appellants take issue with respondent's statement that appellants admitted that none of  
3 their horses met the criterion of being a successful Thoroughbred race horse. Appellants argue that  
4 "Profound Secret" was successful but could not fetch the price appellants sought. Appellants also take  
5 issue with respondent's statement that Walnut View's operating expenses would have far exceeded  
6 revenues even if appellants' horses place first in every race entered in 2005 and 2006. Appellants argue  
7 that it makes no sense to enter horses in races in which they are not competitive and that, if those horses  
8 had won all of those races, they probably would have appreciated in value by thousands or even millions  
9 of dollars. (App. Supp. Br., pp. 10-11.)

10 Appellants maintain that their operating revenues of \$2,643,151 from 1995 through 2006  
11 do not indicate a hobby and are an affirmation of appellants' profit motive. Appellants assert that  
12 respondent cites no authority for its position in the opening brief that their engagement in an  
13 unprofitable activity is evidence of a pleasure motive. Appellants further assert that respondent "appears  
14 to include another position" in its reply brief but also "rather dismissively states that '. . . respondent  
15 need not identify the specific element of pleasure appellants gained from their horse activity.'" Finally,  
16 appellants summarize the arguments made in the prior briefs relating to the nine regulatory  
17 requirements. (App. Supp. Br., pp. 11-14.)

#### 18 Applicable Law

19 Whether a taxpayer may deduct expenses related to an activity depends on whether it is  
20 carried on for profit. IRC section 162(a) provides generally that there shall be allowed as a deduction all  
21 the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or  
22 business. IRC section 212(1) provides that, in the case of an individual, a deduction shall be allowed for  
23 all the ordinary and necessary expenses paid or incurred in the tax year in connection with the  
24 production or collection of income. R&TC section 17201 incorporates by reference IRC sections 162  
25 and 212, except as otherwise provided.

26 IRC section 183, to which California conforms pursuant to R&TC section 17201,  
27 provides that in the case of an activity engaged in by a taxpayer, if such activity is not engaged in for  
28 profit (i.e., a "hobby"), no deduction attributable to such activity shall be allowed except as provided.

1 “IRC [section] 183 is sometimes referred to as the ‘hobby loss rule.’” (IRS FS-2008-23 (June 2008), Is  
2 Your Hobby a For-Profit Endeavor?) For purposes of IRC section 183, “the term, ‘activity not engaged  
3 in for profit’ means any activity other than one with respect to which deductions are allowable for the  
4 taxable year under section 162 or under paragraph (1) or (2) of section 212.” (Int.Rev.Code, § 183(c);  
5 Treas. Regs. § 1.183-2(a).)

6 There is a general presumption that an activity is engaged in for profit “[i]f the gross  
7 income derived from [the] activity for 3 or more of the taxable years which ends with the taxable year  
8 exceeds the deductions attributable to such activity (determined without regard to whether or not such  
9 activity is engaged in for profit)[.]” (Int.Rev.Code, § 183(d).) Treas. Reg. sec. 1.183-2(a) provides,  
10 “Although a reasonable expectation of profit is not required, the facts and circumstances must indicate  
11 that the taxpayer entered into the activity, or continued the activity, with the objective of making a  
12 profit.” It further provides that “[t]he determination whether an activity is engaged in for profit is to be  
13 made by reference to objective standards, taking into account all of the facts and circumstances of each  
14 case” and “greater weight is given to objective facts than to the taxpayer’s mere statement of his  
15 intent.” (See *Landry v. Comm’r* (1986) 86 T.C. 1284, 1304; *Dreicer v. Comm’r* (1982) 78 T.C. 642,  
16 645 - 646, affd. (D.C. Cir. 1983) 702 F.2d 1205.)

17 Treas. Reg. sec. 1.183-2(b) provides a list of nine nonexclusive factors to be considered  
18 in determining whether an activity is engaged in for profit. No one factor alone is decisive. Such factors  
19 include: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or  
20 his advisors; (3) the time and effort used by the taxpayer in carrying on the activity; (4) the expectation  
21 that assets used in the activity may appreciate in value; (5) the taxpayer’s success in carrying on other  
22 similar or dissimilar activities; (6) the taxpayer’s history of income or loss with respect to the activity;  
23 (7) the amount of occasional profits, if any, which are earned; (8) the taxpayer’s financial status; and  
24 (9) whether elements of personal pleasure or recreation are involved. (See *Verrett v. Comm’r*, T.C.  
25 Memo 2012-223; IRS Publication 535, Business Expenses (2007), p. 5; IRS FS-2008-23 (June 2008), Is  
26 Your Hobby a For-Profit Endeavor?)

27 Pursuant to Treas. Reg. sec. 1.183-2(b)(4), “profit” includes “appreciation in the value of  
28 assets, such as land, used in the activity.” This provision explains that, in addition to deriving a profit

1 from the operation of the activity, a taxpayer may also intend an overall profit from appreciation in the  
2 value of land used in the activity because “income from the activity together with the appreciation of  
3 land will exceed expenses of operation.” Treas. Reg. sec. 1.183-1(d)(1) provides, in relevant part, that:

4 [i]n ascertaining the activity or activities of the taxpayer, all the facts and circumstances  
5 of the case must be taken into account. Generally, the most significant facts and  
6 circumstances in making this determination are the degree of organizational and  
7 economic interrelationship of various undertakings, [and] the business purpose which is  
8 (or might be) served by carrying on the various undertakings separately or together in a  
9 trade or business . . . Where land is purchased or held primarily with the intent to profit  
10 from increase in its value, and the taxpayer also engages in farming on such land, the  
11 farming and the holding of the land will ordinarily be considered a single activity only if  
12 the farming activity reduces the net cost of carrying the land for its appreciation in value.  
13 Thus, the farming and holding of the land will be considered a single activity only if the  
14 income derived from farming exceeds the deductions attributable to the farming activity  
15 which are not directly attributable to the holding of the land (that is, deductions other than  
16 those directly attributable to the holding of the land such as interest on a mortgage  
17 secured by the land, annual property taxes attributable to the land and improvements, and  
18 depreciation of improvements to the land).

*Engdahl v. Comm.* (1979) 72 T.C. 659.

14 In *Engdahl*, the taxpayers operated an American saddle-bred horse-breeding venture and  
15 the court found that they spent an average of 35 to 55 hours per week caring for the horses and  
16 maintaining the improvements on the ranch and did not use the horses or the ranch for personal pleasure.  
17 The taxpayers argued that they intended to make a profit to supplement their retirement income incurred  
18 an uninterrupted series of losses over several years and applied the losses against income from other  
19 sources. The IRS argued that the substantial income received from the taxpayer-husband’s orthodontic  
20 practice indicated that the activity was not engaged in for profit, especially since losses from the activity  
21 generated substantial tax benefits. The court rejected that inference and found that it was “unlikely that  
22 [the taxpayers] would embark on a hobby costing thousands of dollars and entailing much personal  
23 physical labor without a profit motive.”

24 *Faulconer v. Comm’r* (1984) 748 F.2d 890

25 In *Faulconer*, the court discussed the significance of gross receipts among the factors to  
26 be considered in determining whether the taxpayers’ horse activity was operated for profit. The court  
27 stated that “if gross receipts from a business are practically negligible in comparison with expenditures  
28 over a long period of time, there may be a compelling inference that a taxpayer’s real motives are those

1 of personal pleasure as distinct from a business venture.” However, the court found that the gross  
2 receipts for the activity averaged \$83,537.21 annually from 1970 to 1976 and, based on the testimony of  
3 an expert in the industry, that the earnings and expenses of the activity were comparable to those of  
4 another successful horse breeding and racing business. The court concluded that the evidence of  
5 business hardships, such as injuries to three of 10 horses available for racing in single year, the presence  
6 of substantial receipts and some net-profit years, and the similarity of the taxpayers’ operation to another  
7 horse farm that ultimately achieved great profitability, all tended to show that the taxpayers had a profit  
8 objective.

9 *Dodds v. Comm.*, T.C. Memo 2013-76

10 In the determination of whether an activity is performed in a businesslike manner, the  
11 court held that “perhaps the most important indication . . . is whether the taxpayer implements methods  
12 for controlling losses, including efforts to reduce expenses and generate income.” The court found that  
13 the taxpayer provided no evidence to show that he tried to reduce expenses, had abandoned specific  
14 unprofitable activities, or implemented any cost-cutting measures. The court also found that the  
15 taxpayer’s initial business plan “to breed grade horses” and subsequent plan “to breed world caliber  
16 foals that could become successful show horses” was not sufficient to find that he had an established  
17 business plan. In addition, although the taxpayer used profit and loss statements, the court found “scant  
18 evidence” that he used them “for the important purposes of cutting expenses, increasing profits, and  
19 evaluating the overall performance of the operation.”

20 *Foster v. Comm.*, T.C. Memo 2012-207

21 The taxpayers realized no profits in over more than 25 years of engaging in their horse  
22 activity. While acknowledging that horseracing, breeding, and training are highly speculative activities,  
23 the court found that the reasons cited by the taxpayers including the horse injuries and death did not  
24 account for such a long string of losses. The court held that “[w]hile a series of losses during the initial  
25 or startup stage of an activity may not necessarily indicate a lack of a profit motive, a record of large  
26 losses over many years is persuasive evidence that a taxpayer did not have such a motive.” Moreover,  
27 the court noted that the taxpayers did not show that their horse activity would have been profitable if  
28 events beyond their control had not occurred. Finally, the court held that the possibility of a speculative

1 profit in a taxpayer's horse activity is insufficient to outweigh the absence of profits for a sustained  
2 period of years.

3 *Filos v. Comm'r* (1st Cir. 2000) 224 F.3d 16

4 The Court of Appeals affirmed the Tax Court's ruling in favor of the IRS holding that the  
5 Tax Court's findings were supported by the record and led to the conclusion that the taxpayer's horse  
6 racing and breeding activity was not engaged in for profit. In its examination of some of the factors, the  
7 Court of Appeals noted that the taxpayer was far from realizing a profit during a 37-year period with  
8 total losses exceeding \$6 million. The Court of Appeals also noted that there was no error in the  
9 Tax Court's determinations that:

- 10 • The taxpayer failed to support his contention that a profit motive may be inferred from the  
11 speculative nature of the horse business "absent evidence showing what other horse operations  
12 did to become profitable."
- 13 • The taxpayer did not keep records that could be used for the purpose of cutting expenses,  
14 increasing profits, and evaluating the overall performance of the business on an ongoing basis  
15 which would indicate a profit motive.
- 16 • Although the taxpayer read horse publications, attended breeding seminars, and used  
17 professional trainers, veterinarians, horse farms, breeders, auctioneers, and jockeys, he did not  
18 prove that he possessed the requisite expertise regarding the business end of the activity, or that  
19 he relied on the advice of others who possessed that type of expertise.

20 While the Court of Appeals disagreed with the Tax Court's conclusion that changes to the  
21 methods of operation (increasing the size of the herd and making two changes to breeding practices)  
22 were *de minimis*, the Court held it was not necessary to consider that point because the weight of the  
23 evidence based on the other factors supported the Tax Court's ruling in favor of the IRS.

24 *Appeal of Wieland and Jennie Collins*, 86-SBE-047, March 4, 1986

25 In determining that the taxpayers' activity was operated for profit, the Board found that  
26 the taxpayers conducted the activity in a businesslike manner by maintaining complete, accurate and  
27 separate books, records, and bank accounts and by retaining the services of a certified public accountant,  
28 they abandoned unprofitable procedures, they consulted with experts, they did not have substantial

1 income from other sources and taxpayer-wife performed many of the veterinarian and breeding tasks  
2 and had a level of expertise that indicated a finding of a profit motive. Although the taxpayers' horse  
3 activity had losses for 20 consecutive years, this Board held that "[b]ased upon the record as a whole  
4 and based upon the tremendous profit potential in Thoroughbred horses, we do not believe that  
5 appellants' horse farm compiled a record of losses so serious as to indicate that appellants' ultimate goal  
6 was not to achieve a profit." In addition, the Board held that the taxpayers were entitled to include the  
7 appreciation in the value of the real property used in the operation during the years on appeal in  
8 considering whether appellants had an expectation of an increase in value of the assets used in the  
9 operation.

10 STAFF COMMENTS

11           The issue here is whether the losses from the Walnut View operation may be used to  
12 offset income from other sources or activities. In order to do so, appellants will need to establish that  
13 Walnut View was operated for profit.

14           To dispute respondent's contention that their horse activity sustained losses in all but one  
15 year over 40 years of operation, appellants argue that the activity realized a profit of almost \$3 million in  
16 the first 26 years of operation from the sale of the farm-site land in 1989. Respondent disputes the  
17 inclusion of these proceeds arguing that appellants' holding of this property and the horse operation  
18 were not a single activity as required by the regulation. In making a single activity determination,  
19 Treas. Reg. sec. 1.183-1(d)(1) provides that the most significant facts and circumstances "are the degree  
20 of organizational and economic interrelationship of various undertakings, [and] the business purpose  
21 which is (or might be) served by carrying on the various undertakings separately or together in a trade or  
22 business." Under Treas. Reg. sec. 1.183-2(b)(4), "the taxpayer may intend to derive a profit from the  
23 operation of the activity, and may also intend that, even if no profit from current operations is derived an  
24 overall profit will result when appreciation in the value of land used in the activity is realized since  
25 income from the activity together with the appreciation of land will exceed expenses of operation."  
26 Here, it appears the proceeds were invested in the purchase of other real property not used in appellants'  
27 horse activity. At the hearing, the parties should be prepared to discuss whether this is relevant to the  
28 analysis of whether appellants intended to derive an overall profit from a single activity that included the

1 holding of the land.

2 Appellants argue that they had expertise in running a horse operation through their  
3 combined 64 years of experience, membership in the Thoroughbred Owners of California and the  
4 California Thoroughbred Breeders' Association, discussions with industry experts and professional  
5 trainers and reading horse publications each month. However, the Court of Appeals found in *Filios*,  
6 *supra* that similar activities and attributes cited by the taxpayer did not demonstrate the "requisite  
7 expertise" in the horse racing and breeding business to satisfy this factor. At the hearing, appellants  
8 should be prepared to discuss *Filios* further and, if possible, may wish to provide other evidence that  
9 they possessed such expertise.

10 Appellants submit declarations from Kent Molinaro and appellant-husband as evidence  
11 that Walnut View was operated like other substantially similar for-profit activities, including successful  
12 horse businesses. However, those declarations provide no detail or description as to the manner in which  
13 those other horse businesses operated. Prior to or at the hearing, appellants may wish to present  
14 additional evidence to support this contention.<sup>4</sup>

15 Respondent argues that appellants' personal pleasure motive is evident because they  
16 derived enjoyment from engaging in horse racing and breeding and attending races and auctions and  
17 likely derived pleasure from seeing their son, Kent Molinaro, pursue his passion as a trainer. At the  
18 hearing, respondent should be prepared to discuss this argument further and address whether there is  
19 case authority in which a court has ascertained a personal pleasure or recreational motive on similar  
20 facts.

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27  
28 <sup>4</sup> Pursuant to California Code of Regulations, title 18, section 5523.6, if possible, any additional evidence should be provided at least 14 days prior to the oral hearing in order to facilitate an orderly and productive hearing. Evidence exhibits should be sent to: Khaaliq Abd' Allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.