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KEEPING PROPER RECORDS

Anyone who enters the horse business soon learns that maintaining breeding records and other information about horses' pedigrees is essential to understanding the business and to producing a quality animal. From an accounting standpoint, good, accurate records are just as important as are the pedigrees and breeding information relating to the horses.

First and foremost, a person needs to know how he/she is doing from an economic standpoint in the horse business. In order to ascertain this, adequate records must be maintained to be able to determine income, the source of it, and the cost of producing it.

It may sound simple to keep good accounting records, but, as the courts have held, it is just as important to maintain good accounting records to substantiate your tax position as it is to be able to show that you have had the proper advisers or expertise for your business to substantiate your tax picture.

It is very important to be able to isolate the sources of revenue for a horse operation. Of course, you need to keep good accounting records, which will reflect the various sources of income, the amount, the year in which the receipt was earned, the time it was received, whether payment was timely or late, and what you did with it once it was received.

A particularly good tool in keeping these records is bank deposit slips. First, establish a policy of depositing all receipts. Thus, there can never be a challenge that income was omitted from any source. Once this policy has been established, the second step is to make out the deposit ticket that the bank requires so that the bank knows whose funds it is handling to serve as one of your bookkeeping tools. It does no good to list on the deposit slip the number of the bank from which the deposit was received. It is important, however, to show who paid you the money and what it was for. This becomes particularly significant with a third-party payment; for example, an owner paying for an item that was billed to a trainer, or vice versa.

By having this information on the deposit slip, you can reconstruct these records even if they should be lost or destroyed. Banks maintain photocopies of all deposits and checks for several years. The length of time they keep these documents varies from a minimum of about three years to a maximum of about five years, but these periods of time are adequate for any tax examination that would come along. Thus, if you lose a deposit slip, a check, or if you cannot tell what the source of an income item was, you can obtain a copy of the microfilm of the deposit from the bank and identify the item since it is spelled out on the deposit slip.

The same thing can also be done with expenses and other disbursements if one of the appropriate types of checks is used. In the write-once system, or even in the computer check system, if you use what is known as a "center right" check, you can describe in the middle of the check, between the name of the payee and the amount, the purpose for which the check is issued. This then becomes part of the body of the check, and, like the deposit slip mentioned above, is photocopied by the bank and is recoverable from a microfilm of the canceled checks.

During the first year or two of operation, you will have to rely on someone to advise you regarding the individual costs that you incur in a horse operation. For a breeding operation, you will need advice on the appropriate stud fee that should be incurred based on the bloodlines and the records of your mares.

Similarly, if you own a stallion share, you must have some guidelines to determine the quality and type of mare to which your stallion should be bred. Thus, you need some knowledge not only of the pedigrees, but also of the value of the respective mares and stallions to prevent putting an excessively expensive stud fee in a cheap mare or a cheap stud fee into a well-bred mare, which could produce a yearling of high quality.

Once you have been in business for a year or two, you then have the necessary experience and can begin to establish goals for the expenditures you will incur in maintaining your operation in the third, fourth, fifth, and later years. While it is not practical to determine the exact amount of hay or straw required per animal, you can come up with reasonable annual estimates for utility bills, labor costs, blacksmith and veterinary costs, tack supplies, and other expenses. In selecting the categories to use in classifying expenses, start with the items listed on Form 1040, Schedule C, which is used for all individual tax returns. There are a number of other categories we normally use for horse operations, including: commissions, stall rent, jockey fees, entry fees, training expenses, blacksmith charges, pedigree information, hay, straw, tack, etc.

We always recommend the use of as many different accounts as you have expenses that you believe can be controlled. It is very easy to combine accounts to create a general category (i.e., utilities, resulting from combining water, electricity, telephone, natural gas, propane gas) and then to break down the consolidated account into its components.

Experience has taught us that accounts that contain large amounts of money seem to attract the attention of the tax authorities and can cause your return to be examined. Similarly, you will need income categories other than those on Schedule C. Common account titles used include racing income, stud fees, board collected, and breeders' awards.

Court decisions make it essential that you have a separate bank account and maintain separate records for your horse operation if you want to be able to show that you are running the operation as a business. To maintain your position as a horseman, you need to either run the business on your own and be able to prove it, or hire advisers who are experienced and show that you have corresponded with them and have maintained a working relationship with them in order to learn the business.

Attend seminars, such as the American Horse Council sessions, and other programs designed to assist you in learning both the breeding and the financial sides of the business. In maintaining records, do not depend entirely on canceled checks and deposit tickets. It is also essential to maintain detailed invoices and other records of expenses incurred in the operation.

The question that often arises is: How long should I keep these records? Since the normal statute of limitations is three years and the negligence statute of limitations (that is the omission of 25% or more of income or overstatement of deductions to the extent of 25% or more of income) extends to a six-year period, you should maintain all supporting records for no less than six years; i.e., the detailed records that should be maintained for that period.

Tax returns should be maintained indefinitely since they might prove very valuable in showing where you acquired income at favorable tax rates. Most people do not realize that after about five years the Internal Revenue Service destroys the return that was filed, and if you maintain your copy that shows the tax amount that will match their record of the taxes paid, you are in a very advantageous position. Maintain general ledgers and summary reports, such as financial statements, for a longer period of time, preferably at least ten years.

While this may seem like an excessive period of time and a lot of details to maintain, if you want to insure that you are allowed to take the proper deductions permitted under the Internal Revenue Code, you should be certain to maintain the records we have outlined above.

In conclusion, you need good financial records for tax purposes, but even more importantly, you need these records so that you can operate your horse business in a competitive and profitable fashion.

The following pages are a guideline for good accounting recordkeeping. Included are account numbers for horse expenses, summary sheets for income and expenses recording sheets for income and expenses. This information can be used with computer record keeping such as Quick Books and Quicken or a pure manual system