TAX > TIME

WITH A DRAG RACE CAR BUSINESS

by Robert Szabo

HOBBY OR BUSINESS: Is the racecar a hobby or a business? Most hobbies are done for fun. They are activities that are out of the ordinary income making activity. Many racers have a fulltime job in non-racing related fields. We race for fun. Some of us race for sanity. Some of us race for insanity. Anyhow, hobby expenses may not be deductible beyond hobby income.

I have a different attitude towards that for drag racing. This activity is so intense, from a cost and time commitment standpoint that, to me, it is beyond any reasonable definition of a hobby. It is a hobby to the wealthy few that make more money than they can spend.

DRAG RACING AS A BUSINESS: But to the rest of us, drag racing could be a business. It may not be your principal source of income. However, it can be your principle business activity. It can be run like a business with income that is declared and expenses that are deducted. The fact it is fun is immaterial to the free enterprise definition of a business.

My racing competitiveness was greater from operating my racecar activity as a business. With the profit motive, I made better decisions about (A) whether I could afford to turn up the power or (B) how far (and expensive) to travel for races. When I raced within my business budget, I always did better.

I believe the IRS will recognize your racecar business after only a reasonable racing effort done as a business. You do not have to be the final round winner. You do not have to be a famous driver from a Top Fuel team. You can compete in any level of performance and be a legitimate business.

ACCOUNTING TIP: If you choose to set up a racecar business, help from a tax professional will be vital. The tax rules are extensive and they are changing frequently. An experienced tax preparer, accountant or CPA can provide valuable assistance for your both business tax record keeping and return.

IHRA INFORMATION SUPPORT: IHRA can provide promotional information to help your business image. Those thousands of spectators (potential customers) in the DRM and web photos, contingency awards, race winnings and the other sponsorships that are present, all add to a legitimate business image. They demonstrate a racing income potential. Couple that with a reasonable sponsorship gathering effort (such as highlighted in my article in the first '06 issue of DRM, p. 42 & 43) and you are legitimately in the racecar business.

HOW DO YOU PAY FOR YOUR DRAG RACING? (a) With "after tax" dollars or (b) "before tax" dollars? With "before tax dollars," it could mean enough tax savings for an extra engine.

"AFTER TAX" DOLLAR BURDEN: (a) It is easy to pay for your racing activity with "after tax" dollars. If you earn enough money to pay your own way, you pay between 10% to over 40% of your earnings to the government. What is left after living expenses could be for racing. There is not really any tax accounting for how the money is spent that is left after taxes. Unfortunately it is not much money for the average income earner.

THE REAL COST OF RACING WITH "AFTER TAX" DOLLARS: So you want to buy a new race part for $1,000. If you make about $40,000 taxable income, typically you are in the 34.5% tax bracket 15% federal income tax (FIT), 4% state income tax (SIT), your 7.5% SS + Med, your employer's 7.5% SS + Med., 1/2% city tax). Because of this, you must EARN over $1,500. That much is necessary to pay over $500 of taxes to have $1,000 remaining to buy that race part. The current tax system charges you in several tax categories such as those listed in the previous example. Some are deductible (or credited) to other tax categories, and some are not. In the latter case, you actually pay taxes on other taxes that you have paid. For example, in all of the states that I have lived in, I paid state income tax on my federal tax payments. The actual SIT rate that we are paying is a lot higher than the SIT rate such as the 4% example previously noted. That is the case for most of the categories of taxes that you pay. This is another reason to look for a better way.

A BETTER WAY: (b) A fortunate perk for living in a free enterprise (such as the United Stated and many other countries) is that you can set up a business. If you operate a business, business expenditures are deductible. They are deductible from "before tax" earnings according to a set of business tax rules. Your business expenses are paid first out of your gross income. Your taxes are based only on what remains.

In a racecar business (such as a sole proprietorship), you only have to earn about $1,150 from your W2 income for a $1,000 fuel injection expense. Your FIT and SIT taxable income can be reduced by much of that $1,000 expense. You end up paying about $300 dollars less in FIT and SIT.

OBVIOUS GOAL: Operate the racing activity as a business. Pay for it with "before tax" dollars. Deduct that cost from your income and pay less FIT, SIT, ... on the remaining smaller amount.

A TAXING EXPERIENCE? I was involved with several sole proprietorship businesses as well as a C Corporation. Because of that experience, I became familiar with a lot of the US and state tax regulations (although I always sought assistance from tax professionals).

(1) The Sole Proprietorship is a common form of a business. Basically you fill out a simple form (Schedule C) showing the outcome from your income and expenses. That outcome is either a profit or loss. You transfer the profit or loss to your 1040 tax return. For a profit, it adds to the taxable income. For a loss, it subtracts from the taxable income. It was simple, easy to understand, and the least amount of time.

One CPA advised that a Sole Proprietorship is a reasonable business structure for gross incomes from zero to about $150,000 per year. Beyond that, a Corporation should be considered. In addition, a loss from a Sole Proprietorship business will not offset the SS & Med. taxes on your W2 income from other sources. Those taxes are based on your W2 income from your other sources before any racing business loss on your tax return.

(2) My C Corporation experience was for industrial business activities. These activities had greater liability and higher revenue than what I did with racing. Partnerships, S-Corporations, and LLC's are other methods. My CPA's and accountants reported that each of these business structures have different benefits and burdens. They all act for the same purpose however. They are tax-reporting methods to deduct legitimate business expenditures from legitimate business income. Some of them also have favorable liability protection for the owners and managers. If you are paid from your corporation, business expenses can reduce your Social Security and Medicare taxes. The amount totals about 15% that is significant.

In the Star Trek TV Series, the Ferengi (fictitious people with very large ears) were REQUIRED in their society to make a profit in everything that they did. In a sense, our free enterprise system operates the same. You fit in well if your business is profitable. However, our system can allow you a few years of losses to make that profit. That freedom lends itself well to forming a new car racing business. It provides tax deductions for much of the initial cost of a racecar, trailer, tow vehicle, tools, etc. as business expenses. In the beginning, those expenses often exceed the racing income that is typical of most business startups. If done correctly, those expenses can be deducted from other sources of income during the start-up years.

SOME OF THE RULES: (I) Two out of five years, you should show a profit. The profit from racing, either directly or from related racing sources, should be reasonable. You do have to be able to account for where your living costs are coming from if business costs take all of your income. Living cost examples would be past savings, investors, or loans.

(II) Whatever you do in a racing business, it has to make sense. More than one racer has told an old wives' tale: 'if you are paid only one dollar of income to your racing business, you can deduct all of your expenses.' If you try to do this, the accountants have said that does NOT look reasonable. Most likely you will get audited by the IRS, and your racing business disallowed.

Instead work smart to earn $2,000 of legitimate income, for example, and $12,000 of legitimate expense, the first or second year. That is better than $100 of income and $10,100 of expense. In both cases, you would show a loss of $10,000. But the latter does not make much sense. One accountant said that a minimum income of at least 10% of the expenses is an amount that he is comfortable with. Another accountant described a client with a 10 million dollar expense and a 9 million dollar income. Both figures were substantiated with proper documentation. The IRS allowed that one million dollar loss because both expenses and income were in a same range. With reference to the example of a $10,100 expense and a $100 income, she said that would be harder to defend in an IRS tax audit than the million-dollar loss of the other client.

(III) Another tip from that accounting world: reported figures such as $2,003 & $12,028 look better than $2,000 & $12,000. Report earnings and expense numbers that are not rounded off. Whole numbers look like estimates and less legitimate. This is an example of tax audit avoidance. Experienced accountants and CPA's often have a lot of information on bookkeeping rules such as this one. Recent tax preparation computer programs are equipped with tax audit ratings. They can be useful for your tax return preparation for better audit avoidance. In many cases, the location of a deduction is flexible. In one spot, it is an audit flag. In another, it is not. Experts can often coach you on audit flags.

(IV) You have to divide your expenses into (1) items to deduct the year they were paid for & used, and (2) items to depreciate, in some cases, over several years. The second rule applies to items that form assets to the business. Major expenses such as the racecar, engine, transmission, trailer, and tow vehicle are examples of items that are usually depreciated. Other items such as travel expenses, oil, fuel, broken drill bits, etc. fall into the first category.

(V) If you accidentally crash your racecar, it may all become fully deductible the year of the incident. The amount of full deduction is less any salvage value. Best to keep some photos and a list of salvage items. You do not want to go out and intentionally acquire a business loss. However when one accidentally occurs, it has a value that can reduce taxes. In the accounting world, business losses have a value just as business gains have a value. In ‘Corporate Row,’ most major corporations all have losses from liabilities. These form the value of that corporation that offsets income. They are often bought and sold as income reducing vehicles. Business losses can work for you also.

(VI) You have greater latitude for business loss if your racing activity is your primary source of income. Assume, for example, you have a non-racing related employment income (W2) of $24,000. Assume, over several years, you have a continuous racing loss of around $10,000 per year. You report that on a Sole Proprietorship Schedule C each year. That can look questionable. It would be more reasonable if you were in a racing job with an income of $24,000 with the same $10,000 of expenses. Excuse me, $10,034 of expenses.

In my first couple of years of deducting racing expenses, I had many expenses. Those deductions exceeded my racing income by a considerable amount. Each year, that was reported on a Schedule C Sole Proprietorship form. The outcome was transferred to my Federal 1040 as a loss. For a couple years, it remained a business loss. Then my racing activity qualified me for a full time position for an established racing business. After the 3rd year, the IRS audited me. That full time position qualified all of my previous losses, and I passed the audit with no problem.

(VII) That leads me to the next rule: operate your racing activity like a business. Have a reasonable plan. And try to stick to your plan.

One of the main line items on your plan is to generate income. With the IRS rules in mind, that should occur in an upward scale from year to year. It should exceed your expenses by the 4th year or at least any two out of five years. Keep in mind that often you may make your big racing purchases in the early years. With major purchases made, then you can settle down and reduce your spending. Then it is easier to make a profit during the later years without those big expenses.

EXAMPLE TO AVOID: Assume you have spent $35,000 for a bracket racecar for the first three years. You decide to trade-up to a Top Alcohol car or Pro Stocker the 4th year. That decision adds an expense of another $100,000. That does not make sense to your “bracket racecar business.” If you are using the bracket racing expense to offset non-racing income in prior years, you are facing the possibility of an IRS audit. It is likely the entire expense will be disallowed by that audit. If you choose to do this, you just cannot deduct it to save taxes from other sources of income that are paying the bill.

FAVORABLE DEPRECIATION RULES TODAY: The most recent tax regulations allow much of the depreciation expenses (item 2) to be deducted the year they were purchased and used. That is a reason that now is a good time, tax wise, to invest in a new business.

In previous years, depreciation expenditures (item 2) had to be deducted over several years. During the year that you bought an asset, you could only deduct part of it. Then only in subsequent years could you deduct the remainder.

SOME TAX TIDBITS: (a) A few hundred dollars of profit (income more than expenses) may be all that is incurred during one of those 2 years out of 5 years of a business. It is still an income and may qualify well enough for one of those 2 years of profit. (b) The vehicle tow mileage allowable deduction has been dramatically increased for ’05 and thereafter. After a few IHRA race jaunts and racecar fabricating trips, you can easily get a business mileage deduction of a couple thousand dollars from this category. (c) Be careful with home office deductions. Strict IRS rules apply to what is allowed and what is not. (d) Save all of your race business receipts for business deductions. Supplies such as light bulbs, hand towels, furniture fixtures, paint thinner, FAX machine, ink jet printer, paper, and many others add up fast.

(e) When your expenses are a lot higher than your income, the IRS may be less concerned about the source of income. Those perks that you received for showing your racecar at a show (free entry, free case of oil, etc.) can be classified as income against your expenses. These are especially valuable if you need income. With attention to detail, you can find many new sources of income as well as new sources of expenses. The more you make, the better you look even if it costs more. In one race, a local promoter paid me a couple thousand dollars to organize a racecar show. I paid out all of that money to the racers. However, I did get a 1099 payment statement from the promoter. That 1099 beefed up the income side of my business tax return even though the same amount was added to my expense side.

RESEARCH CREDIT! This is not for all, but it is an interesting and valuable benefit to some. If you can get involved with developing new products, you may qualify for a research tax credit. The rules of what activities can qualify are somewhat undefined. The activity has to be mostly a material advancement in technology for the US. Conventional racing endeavors do not quality. However, I believe many advances in racecars would qualify.

The best example is the advancement that is typical in highly financed Formula One racing. I believe the research and development (R & D) for most of those advances would qualify for a research credit. Many of those advancements are beyond aerospace such as “no neutral” manual transmission shifting and flexible composite wings by design. England is a technology center for Formula One development. A recent tech article stated that the English Government provides favorable tax treatment to British Formula One suppliers and teams that do R & D, which is probably most of them.

YOUR RESEARCH: In drag racing, I believe some of the work with the recent on-board data acquisition systems can lead to research & development (R & D) in the research credit category. Further advances in rev limiters and timing control are most likely candidates. Further ignition development, use of composites & super alloy metals, and the development of advanced machining & manufacturing methods are candidates. Race tire pre-treatment for better traction or longer life, advanced weight & space saving engine designs, and special fuel blends, are examples. And finally, advanced lubrication techniques and more efficient cooling systems are all examples in my opinion. Many activities that are technologically unique start out with an investment in research. Often they end up with a product that is sold for a profit. They are good candidates. In the past years, the research credit rule said that once you start selling the product, you would no longer take the research credit. In that case, develop another new product. Hence Capitalism.

HERE IS A BIG OPPORTUNITY: Your involvement with your racecar simply as a pilot vehicle for testing many new products could be a research credit expense for you. Both the researcher (manufacturer) and the subcontractor (test vehicle) can qualify for research credits. Just about everything that you see at the racetrack was tested on someone’s vehicle when it was first introduced. Most was R&D at one time or another. You may need to write a report or some type of documentation to confirm the advanced R & D nature. Find out if your supplier is taking a research credit. If he is, you probably can.

RESEARCH CREDIT HISTORY: One of the biggest qualifiers of a research credit expense is a history of taking the credit in prior years. To establish a history, start your research with a small project to qualify for the credit. It is not dollar for dollar. For example, in one case where a research credit was taken on a tax return, the researcher was able to deduct the research expenditure as a normal business expense. In addition, the rules at that time gave the researcher one dollar of research credit (tax reduction) for four dollars of research expenditures. An example of a reasonable starting research credit would be something that computes to less than $1,000 from less than a $4,000 research expense.

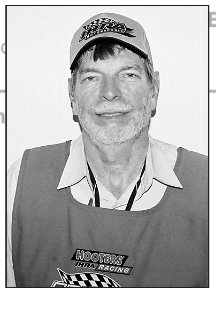
MY RESEARCH: Because of my racing involvement, I developed an adaptive traction & antilock braking control method. I have not taken it past the design concept. I have not taken a research credit for any expenses. However, I did review this project with one accountant familiar with the research tax credit. He said in his opinion that this was definitely an activity that would qualify. It is on my back burner as something that I want to do: an adaptive traction & braking control system with treatment of the expense as research credit.

LOOKING TO THE FUTURE: You can then gear your racing effort towards more qualified research expenditures. Your choice of racing activity in the advanced technology field could be reinforced by the tax advantages of this credit. There are rules that change from year to year. In addition, the credit is better allowed in some businesses rather than others. The IRS has rulings published on their web site that provide a lot of information. Few accountants are familiar with this avenue, but most accountants use tax accounting computer programs that have the research credit calculation feature.

YOUR BUSINESS IMAGE FROM RESEARCH: One final note: conforming to the rules to qualify for a research credit, then taking the credit can provide you with tax savings as well as an excellent business image.

THE SKILL SET OF A DRAG RACING BUSINESS PERSON: Many successful racecar people possess the skill set of a company president or CEO. My racing business was far more difficult than my non-racing businesses. I learned a lot more about tough business decisions from racing than from the industry.

YOUR BUSINESS OF DRAG RACING: After you have done all of this, now you are a racing business professional. You go to races to further your income producing efforts. You are keeping expense and income records. You are making good decisions according to a business plan. And you are racing. What a life!•



Bob Szabo is a racecar book author who is currently working on a new publication about racing with METHANOL. His current book “Fuel Injection Racing Secrets” is all about mechanical fuel injection that is used throughout IHRA drag racing. It is also supplier recommended. Bob is a lifetime student of technology and a drag racecar owner / driver. For book ordering information, check the DRM Yellow Pages for his Fuel Injection Racing Secrets listing under S’s (for Szabo) or look on the Internet at http://www.racecarbook.com or call (707) 446 2917.