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Taxation of Equine Sales and Exchanges

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Taxation of Equine Sales and Exchanges*

BY MARTIN J. MCMAHON, JR.**

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*** EDITOR'S NOTE: At the insistence of the Author, the citation format used in this Article differs from the citation format normally employed by the *Kentucky Law Journal*.

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INTRODUCTION

Thoroughbred horse breeding and racing is big business, involving big money. Furthermore, the industry has an important, relatively unique aspect other than the legal gambling associated with horse racing. Its major tangible product and productive asset, the horse, is subject to rapid and phenomenal appreciation. Spend

a Buck, winner of the 1985 Kentucky Derby, was purchased as a yearling in March of 1983 for \$12,500.¹ In late 1985, after a great racing season, an undivided one half interest in Spend a Buck sold for a reported \$7,000,000.² Devil's Bag, an early season favorite to win the 1984 Kentucky Derby, was syndicated for \$36,000,000 while still racing as a two year old in late 1983.³ As a yearling, he had been purchased for \$350,000.⁴ Triple Crown winner Seattle Slew, purchased for \$17,500 as a yearling in 1976, was syndicated for \$12,000,000 in 1978 with a single share selling for \$300,000.⁵ Following the victory of Seattle Slew's son, Swale, in the 1984 Kentucky Derby, a Seattle Slew share reportedly sold for \$3,000,000;⁶ and in November of that year a single breeding season sold for \$710,000.⁷ A lifetime breeding right to Alydar sold for \$1,995,000 in November of 1985.⁸

Fillies and mares, like the stallions above, can also sell for huge sums of money. The record price paid at auction for a horse in training for racing is \$4,500,000, which was paid for Estrapade, a five year old filly, in November of 1985.⁹ That same month Miss Oceana brought \$7,000,000 at the dispersal sale of the breeding stock of Newstead Farm Trust.¹⁰ That price was a new record; the previous record was \$6,000,000, paid for Princes Fame, in foal to Alydar.¹¹

Even unraced horses, if well bred, may bring extraordinary prices. At the Keeneland Select Yearling Sales in July 1985, a

¹ Mooney, *Conditioning Spend a Buck*, 219 THOROUGHBRED REC. 4242, 4242 (Aug. 31, 1985).

² Mooney, *Horse of the Year—Spend a Buck*, 220 THOROUGHBRED REC. 962, 963 (Feb. 15, 1986).

³ Heckerman, *The Big Buyers*, 219 THOROUGHBRED REC. 3322, 3328 (July 13, 1985).

⁴ *Id.*

⁵ *Id.*

⁶ Heckerman, *Lightning in a Bottle*, 218 THOROUGHBRED REC. 5820, 5824 (Nov. 7, 1984); *Record Review*, 219 THOROUGHBRED REC. 4549, 4549 (Sept. 14, 1985).

⁷ *Record Review*, 218 THOROUGHBRED REC. 6037, 6037 (Nov. 14, 1984).

⁸ *Record Review*, 219 THOROUGHBRED REC. 5892, 5893 (Nov. 16, 1985).

⁹ Capps, *Estrapade Sold at Keeneland*, 219 THOROUGHBRED REC. 5889, 5889 (Nov. 16, 1985).

¹⁰ Heckerman, *Newstead Farm Trust Dispersal*, 219 THOROUGHBRED REC. 5886, 5886-87 (Nov. 16, 1985).

¹¹ *Id.* at 5886.

yearling colt sired by Nijinsky II sold for \$13,100,000.¹² The average price paid for the 258 yearlings sold at that sale was \$537,384.¹³ From 1976, when the sale of a yearling for \$1,000,000 was first recorded, through July 1985, one hundred and fifteen yearlings sold for \$1,000,000 or more.¹⁴

Although these numbers are impressive, they are somewhat misleading. Only a very small percentage of thoroughbred horses ever attain the stratospheric prices described in the preceding paragraphs. Nevertheless, the value of many "ordinary" thoroughbreds is significant. At the November 1985 Keeneland September yearling sales, the largest yearling sale in the country, 1,861 yearlings sold for an average price of \$33,333.¹⁵ At the less prestigious Fasig-Tipton Kentucky yearling sale in October of that year, however, the average price for the 204 thoroughbred yearlings was only \$4,804.¹⁶ At numerous other sales around the country, similar average sales prices are recorded.¹⁷ Every day across the country many thoroughbred horses are entered in claiming races in which they may be claimed for \$10,000 or less.

The economic gains realized on the sale or exchange of thoroughbred horses can be significant. Thus, the taxes due on those gains may be correspondingly significant. Prior to the general rate reduction and the repeal of the preferential taxation of capital gains in the Tax Reform Act of 1986,¹⁸ the taxes imposed on gain from the sale of a horse were much greater if the horse was not classified as a capital asset or section 1231 property than they were if the horse was so classified. With the repeal of the capital gains preference, the tax dollars at stake based on the characterization of the horse are not as substantial. Nevertheless, the Internal Revenue Code of 1986 continues to make all of the technical

¹² Heckerman, *Keeneland Select Sale*, 219 THOROUGHBRED REC. 3620, 3620 (July 27, 1985).

¹³ *Id.* at 3621.

¹⁴ *Million Dollar Report*, 219 THOROUGHBRED REC. 3460, 3460 (July 20, 1985).

¹⁵ *Keeneland September Sale*, 219 THOROUGHBRED REC. 4643, 4644 (Sept. 21, 1985).

¹⁶ *Record Review*, 219 THOROUGHBRED REC. 5561, 5564 (Nov. 2, 1985).

¹⁷ *E.g.*, *A Tough Sale to Figure*, 219 THOROUGHBRED REC. 5872, 5872 (Nov. 16, 1985) (Fasig Tipton Kentucky Fall Mixed Sale); *Breeders Without Buyers*, 219 THOROUGHBRED REC. 5151, 5151 (Oct. 19, 1985) (Ocala Mixed Sales); *Record Review*, *supra* note 16, at 5561 (Fasig Tipton Belmont October Sale).

¹⁸ Pub. L. No. 99-514, §§ 301, 311, 100 Stat. 2085, 2217-19.

distinctions between capital assets, section 1231 property, and ordinary income property that were made under prior law.

This Article explores the characterization of gains realized on the sale or exchange of horses and examines the applicability of various provisions for deferring gain, such as installment sale reporting, like kind exchanges, and elective deferral of gain realized on the involuntary conversion of property. Although a few special provisions apply unique rules to horses, most issues within this topic arise because of the nature of the industry and the nature of horses. Because horses are reproducing animals and breeding is a large part of the industry, "a horse" is not simply "a horse": gender may make a difference. Furthermore, many owners are involved in all phases of the breeding and racing industry, and therefore determining the purpose for which a particular horse is held often is difficult. These factors give rise to many uncertainties in applying the general rules governing the characterization of gain and deferral of recognition-rules that may be more easily applied in other contexts.

This Article discusses tax treatment of operating expenses only to the extent that it impacts on determining the amount of gain or loss realized on a sale or exchange. Thus, problems such as the applicability of the "hobby loss" rules, partnership basis rules, the "at risk" rules, and passive loss rules limiting loss deductions to investors in horses are not discussed. Losses realized on a sale or exchange are not discussed extensively either. Because the cost of raising a horse generally is deductible and because purchased horses are subject to rapid depreciation under the Accelerated Cost Recovery System (ACRS),¹⁹ taxable gains on the sale or exchange of horses are encountered more frequently than losses. Even if a horse's sale price is much less than the purchase price, the transaction results in a gain for tax purposes unless the horse's value declines quite rapidly and the horse sells within a relatively short time after purchase.

¹⁹ See I.R.C. § 168. All citations to the Internal Revenue Code in this Article refer to both the Internal Revenue Code of 1954 and the Internal Revenue Code of 1986, except citations to §§ of the 1954 Code repealed by the Tax Reform Act of 1986 and §§ of the 1986 Code added by the Act.

I. RECOGNITION OF GAIN OR LOSS ON THE SALE OR EXCHANGE OF HORSES

For the purpose of computing federal income taxes, the seller must recognize and include in gross income gains realized on the sale of a horse.²⁰ A loss realized on the sale of a horse may be deducted if the horse was owned by a corporation, but if it was owned by an individual (including a partnership) the loss may be deducted only if the horse was held in connection with the taxpayer's trade or business or was acquired and sold in a transaction entered into for profit that was not connected with a trade or business.²¹ This latter condition allows the deduction of losses incurred with respect to horses acquired for investment purposes. Losses incurred with respect to horses that are held primarily for pleasure may not be deducted except to the extent allowed under section 183 of the Internal Revenue Code (I.R.C.).²²

Gain is the excess of the amount realized upon the disposition of the horse over its adjusted basis.²³ If the amount realized on disposition is less than the adjusted basis, the seller realizes a loss. Both "amount realized" and "adjusted basis" are terms of art that must be carefully defined.

A. *Determining the Amount Realized on a Sale or Exchange*

1. *Receipt of Cash or Property*

The amount realized on a sale or other disposition is the sum of the money received plus the fair market value of any other

²⁰ I.R.C. § 61(a)(2)-(3) (gross income includes business income and gains from dealings in property). *See also* Treas. Reg. § 1.61-4 (1972) (gross income of farmers).

²¹ I.R.C. § 165(a), (c)(1)-(2).

²² I.R.C. § 183 deals with so-called "hobby losses" and allows the deduction of expenses incurred in an activity that is not conducted for a profit only to the extent of the gross income derived from the activity. *See* I.R.C. § 183(b)(2). The application of I.R.C. § 183 to horse breeding, racing and showing has been considered elsewhere, and this Article does not explore the issue. For discussion of the application of I.R.C. § 183 to equine activities, see, e.g., Kersten, *How To Prove a Profit Motive in Horse Breeding*, 5 J. AGRIC. TAX & L. 331 (1984); Patrick, *Business Versus Hobby: Determination of Whether a Horse Activity is Engaged in for Profit*, 70 Ky. L.J. 971 (1981-82).

Although the owner of a pleasure horse may not deduct a loss on the sale of the horse, he may be able to claim a casualty loss on the death of the horse by accident, fire or other casualty. *See* I.R.C. § 165(c)(3), (h).

²³ I.R.C. § 1001(a) (computation of gain or loss).

property received by the seller.²⁴ In a cash sale this amount is easy to determine. In an exchange or deferred payment sale, however, the computation of the amount realized can be substantially more difficult.

If the taxpayer disposes of a horse by exchanging it for other property (including another horse), the amount realized is the fair market value of the property received in the exchange.²⁵ "Fair market value" is defined generally as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."²⁶ Fair market value of property received generally should be determined by a competent appraisal. If the property received cannot be valued, it is presumed to be of a value equal to the property surrendered in the exchange, assuming the surrendered property can be valued.²⁷

If the property received in exchange for a horse is another horse "of like kind," the gain realized on the exchange is not currently recognized.²⁸ Instead, the gain is deferred, and the horse received in the exchange takes a basis generally equal to the basis of the property surrendered. Part II of this Article discusses like kind exchanges of horses.²⁹

2. Sale for Deferred Payment

If the seller receives a promissory note from the horse's buyer, the amount realized depends on the interrelationship of several factors. The three most significant factors are the interest rate on the note, whether the seller elects not to report the recognition of income on the installment method under section 453, and whether the seller reports his taxes on the cash or the accrual method.³⁰

²⁴ I.R.C. § 1001(b); Treas. Reg. § 1.1001-1(a) (1984).

²⁵ See I.R.C. § 1001(b).

²⁶ Treas. Reg. § 20.2031-1(b) (1958). Although this definition appears in an estate tax regulation, it is generally accepted to apply for purposes of the income tax as well.

²⁷ See *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954).

²⁸ See I.R.C. § 1031.

²⁹ See notes 331-408 *infra* and accompanying text.

³⁰ Under the cash method of accounting "all items which constitute gross income (whether in the form of cash, property or services) are to be included for the taxable

If the seller does not elect out of the installment method of reporting and the note bears adequate interest as determined under sections 483 and 1272 through 1278,³¹ the stated principal amount of the promissory note, plus any cash and the fair market value

year in which actually or constructively received," and "[e]xpenditures are to be deducted for the taxable year in which actually made." Treas. Reg. § 1.446-1(c)(1)(i) (1984). Taxpayers using the accrual method of accounting include items in income "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.451-1(a) (1978). Accrual method taxpayers claim deductions in the "year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy," Treas. Reg. § 1.461-1(a)(2) (1967), subject to the economic performance limitations imposed on the deductions by I.R.C. § 461(h).

Most farmers elect to use the cash method of accounting. Simplicity is the primary advantage of this method, but it also may defer taxes because a farmer on the cash method of accounting is not required to maintain inventories of livestock (or crops) raised by him and may deduct as a current expense all of the expenses connected with the livestock. See Treas. Regs. §§ 1.61-4; 1.162-12(a) (1972); 1.47-(b)(a). Section 263A, enacted in the Tax Reform Act of 1986, requires the capitalization of the expenses of raising any livestock with a preproductive period in excess of two years. I.R.C. § 263A(d)(1)(A). This requirement does not apply, however, to certain farmers electing to recover the cost of all depreciable property placed in service in the farm business during the year under the alternative depreciation system of I.R.C. § 168(g)(2) rather than under ACRS. I.R.C. § 263A(d)(3), (e)(2). A farmer may elect to use inventories even if he is not required to do so. Treas. Reg. § 1.471-6(a) (1960). Even if the farmer uses the cash method and does not use inventories, the cost of purchased livestock may not be deducted, but must be capitalized, regardless of whether the livestock is held for resale, breeding or sporting purposes. See Treas. Regs. §§ 1.61-4(a)(2); 1.162-12(a); *Alexander v. Commissioner*, 22 T.C. 234, 238-241 (1954) (*acq.*). See also Hanisch, *Tax: Accounting and Inventory Valuation Methods for Farmers*, 22 WASHBURN L.J. 513 (1983); Vogel, *A Primer In The Taxation of Agricultural Transactions*, 3 TAX L.J. 61, 64-74 (1985).

Corporations engaged in farming, however, generally are limited to the accrual method. I.R.C. § 447(a). Farming syndicates using either the accrual or the cash method may not deduct feed and other supplies until they are actually consumed. I.R.C. § 464(a). This provision may apply to any breeding or racing syndicate interests which have been registered for sale with either the S.E.C. or any state agency administering a "blue sky" law. See I.R.C. § 464(c). See also Vogel *supra* at 88-92.

There is no single concise definition of "farm," "farming," or "farmer" for purposes of taxation. Different regulations and cases apply a variety of definitions. See Cox, *Farming and Ranching—Tax Accounting*, 413 T.M., A-1-A-2 (1980). Raising horses for breeding and racing, including the training of horses, fits within the parameters of the broad definition of farming. See I.R.C. § 464(e)(1); Treas. Reg. § 1.61-4(d); Priv. Ltr. Rul. 6302119340A (Feb. 11, 1963) ("The fact that the breeding activity is conducted on farms operated by others would not adversely affect the taxpayer's status as a farmer within the meaning of the 1954 Code and regulations thereunder provided she meets the other qualifications thereof as, for example, operation of the breeding activity for gain or profit.").

³¹ See text accompanying notes 277-90 *infra*.

of other property received is the amount realized on the sale.³² Even when the seller elects not to report on the installment method, if the seller is on the accrual method, the amount realized is not affected.³³ If, however, the seller is on the cash method and elects out of the installment method, the amount realized is the fair market value of the promissory note rather than the principal amount.³⁴ This is determined with reference to all of the relevant facts.³⁵ Treating the fair market value of the note as the amount realized does not reduce the amount of income ultimately recognized; it merely defers the recognition of the excess of the stated principal over the fair market value at the time of receipt. For years during which the capital gain preference was in effect, however, the price of this deferral was conversion of the deferred income into ordinary income.³⁶

If the promissory note does not bear adequate interest under section 483 and the Original Issue Discount Rules of sections 1272 through 1278, then the sales price is recomputed to reflect adequate interest. This reduces the amount realized to something less than the stated principal of the promissory note and converts potential capital gains to certain ordinary income. The problem of unstated interest is explored more thoroughly later in this Article.³⁷

B. *Computation of Basis*

1. *General Principles*

a. *Purchase Price Basis*

Gain and loss are computed with respect to the "adjusted basis" of the property sold.³⁸ Cost basis under section 1012 is

³² See Temp. Reg. § 15a.453-1(b)(2) (1984).

³³ See Temp. Reg. § 15a.453-1(d)(2)(i); *Castner v. Commissioner*, 30 T.C. 1061, 1069-71 (1958); *First Fed. Sav. and Loan Ass'n v. Commissioner*, 40 T.C. 474, 484-487 (1963).

³⁴ See Temp. Reg. § 15a.453-1(d)(2)(i); *Cowden v. Commissioner*, 289 F.2d 20, 24-25 (5th Cir. 1961); *Warren Jones Co. v. Commissioner*, 524 F.2d 788, 793-94 (9th Cir. 1975).

³⁵ See text accompanying notes 253-60 *infra*.

³⁶ See text accompanying notes 258-59 *infra*.

³⁷ See text accompanying notes 277-90 *infra*.

³⁸ See I.R.C. §§ 1001(a); 1011(a).

generally the starting point for the determining adjusted basis. The cost of purchasing a horse for breeding or sporting (racing) must be capitalized and the basis recovered through ACRS depreciation deductions.³⁹ The cost of horses purchased for resale may not be deducted until the year in which the animal is sold, even by a farmer who elects the cash method of reporting farm income.⁴⁰

The horse's cost is the amount of money paid for it, including, if the stated interest is adequate, the stated principal of a promissory note given in payment of the purchase price. If the interest on the promissory note is inadequate under the unstated interest rules of the I.R.C.,⁴¹ then the buyer's purchase price is reduced in the same manner as the amount realized was reduced for the seller of the horse.⁴² If the horse was acquired in exchange for other property (including another horse, other than in a like kind exchange subject to the rules of section 1031), the purchase price is the fair market value of the horse received in the exchange.⁴³ If the horse was acquired in a like kind exchange, its basis is generally equal to the basis of the horse surrendered in the exchange.⁴⁴

b. *Other Methods of Acquisition*

If the horse was acquired by a method other than purchase, the unadjusted basis must be determined under the relevant provision. For example, under section 1015, the basis of property acquired by gift generally is equal to the donor's basis.⁴⁵ Section

³⁹ Treas. Reg. § 1.162-12(a). See *Duggar v. Commissioner*, 71 T.C. 147, 154-55 (1978) (costs associated with weaning calves must be capitalized). Alternatively, the taxpayer may elect to include purchased livestock in inventory. Treas. Reg. § 1.162-12(a).

⁴⁰ Treas. Reg. § 1.61-4(a); *Alexander*, 22 T.C. at 239-41. See also Rev. Rul. 80-102, 1980-1 C.B. 108 (transportation costs involved in purchasing livestock are only deductible when livestock sold). See note 30 *supra* for a discussion of farm accounting methods.

⁴¹ I.R.C. §§ 483; § 1274.

⁴² See notes 277-90 *infra* and accompanying text.

⁴³ See *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954).

⁴⁴ I.R.C. § 1031(d). For a discussion of the rules for computing the basis of property received in a like kind exchange, see text accompanying notes 331-39, 357-61 *infra*; 2 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 44.2.5 (1981).

⁴⁵ I.R.C. § 1015(a). If the fair market value of the horse at the time of the gift was less than the donor's adjusted basis, the donee's basis for loss purposes is limited to the fair market value. *Id.* The donee's basis can be increased, subject to the above limitation, by a portion of the gift tax, if any, incurred by the donor as a result of the gift. *Id.* at (d).

1014 provides that the basis of property acquired by inheritance is the fair market value of the property on the date of the decedent's death.⁴⁶

The basis of a horse acquired by a partnership in exchange for a partnership interest is equal to the transferor's basis.⁴⁷ A horse acquired by a corporation in a transaction in which gain or loss was not recognized under section 351 likewise has a basis in the hands of the corporation equal to the transferor's basis.⁴⁸

c. *Horses Raised By Owner*

Prior to the enactment of section 263A in the Tax Reform Act of 1986, if a horse was raised by the owner, the horse in most instances had an unadjusted basis of zero. No purchase price was paid for a horse foaled by an owner's broodmare that was not in foal when purchased. The stud fee paid was currently deductible,⁴⁹ so it could not have been included in basis.⁵⁰ If, however, the owner of the mare elected to capitalize the stud fee, that amount was the unadjusted basis of the foal.⁵¹ The cost of feeding and boarding both the broodmare and the foal was deducted currently regardless of whether the taxpayer used the cash or accrual method,⁵² and those expenses likewise did not increase the basis of the foal. With respect to the foal, the owner could have elected not to deduct the expenses currently. If no current deduction was

⁴⁶ I.R.C. § 1014(a)(1).

⁴⁷ I.R.C. § 723.

⁴⁸ I.R.C. § 362. The corporation's basis is increased by any gain recognized to the transferor under I.R.C. § 356 or § 357 as a result of the transfer.

⁴⁹ See *Ellis v. Commissioner*, 47 T.C.M. (CCH) 991, 1002 (1984); Priv. Ltr. Rul. 6302119340 A (Feb. 11, 1963) (stud fees are deductible even though the fee is refundable if the mare does not produce a live foal). *But see* Rev. Rul. 79-176, 1979-1 C.B. 123; Rev. Rul. 78-411, 1978-2 C.B. 112 (both requiring capitalization of breeding and other fees where taxpayer did not have benefits and burdens of ownership of breeding stock and ownership at time expenses were incurred).

⁵⁰ See Treas. Reg. § 1.162-1(a); *Ellis*, 47 T.C.M. (CCH) at 1002 (disallowing addition to dead foal's basis of a portion of previously expensed feed for broodmare in computing loss deduction); *Bicha v. Commissioner*, 38 T.C.M. (CCH) 522 (1969) (vendor of cattle could not include in basis cost of grain previously expensed in raising cattle).

⁵¹ See *Welder v. United States*, 329 F. Supp. 739, 751-53 (S.D. Tex. 1971), *aff'd per curiam*, 461 F.2d 1269 (5th Cir. 1972) (holding that Treas. Reg. § 1.162-12 allows cash basis farmers the option of deducting or capitalizing such expenses).

⁵² See Treas. Reg. § 1.162-12(a); Rev. Rul. 74-527, 1974-2 C.B. 42, 43; *Ellis*, 47 T.C.M. (CCH) at 1002.

claimed, the feed and board expenses should have been capitalized into the horse's basis.⁵³

Section 263A, added by the Tax Reform Act of 1986, requires the comprehensive capitalization of the costs of producing inventory and the preproductive costs of producing property to be used in the taxpayer's trade or business.⁵⁴ This rule does not apply, however, to "any animal which is produced by the taxpayer in a farming business and which as a preproductive period of two years or less, if the taxpayer uses the cash receipts and disbursements method of reporting income."⁵⁵ The legislative history indicates that the preproductive period commences at the beginning of gestation and ends when the animal is ready to perform its intended function.⁵⁶ Thus, because the period between the beginning of gestation and the sale of a yearling exceeds two years, horse breeders apparently will be required to capitalize all breeding fees, as well as the cost of raising the foals until they are sold as yearlings.⁵⁷ Similarly, because a horse generally does not enter training for racing or begin breeding within two years of the beginning of gestation, breeding fees and other expenses incurred to raise a horse for use as breeding stock or in racing must also be capitalized.⁵⁸

In the case of horses held for breeding or racing rather than resale, a taxpayer other than a corporation, partnership, or tax shelter required to use the accrual method of accounting may elect not to capitalize these costs.⁵⁹ If such an election is made, however, the taxpayer must forgo the benefits of ACRS deductions for all property used by the taxpayer in the farming business that was placed in service in that year. Instead, the cost of all such property is recoverable under the less advantageous alternative depreciation system of section 168(g)(2).⁶⁰

⁵³ See *Welder*, 329 F. Supp. at 751-53; *Ellis*, 47 T.C.M. (CCH) 991, 996.

⁵⁴ Tax Reform Act of 1986, Pub. L. No. 99-514, § 803, 100 Stat. 2085, 2350-58.

⁵⁵ I.R.C. § 263A(d)(1).

⁵⁶ H.R. REP. No. 426, 99th Cong., 1st Sess. 628 (1985).

⁵⁷ See I.R.C. § 263A(e)(3)(A)(ii).

⁵⁸ See I.R.C. § 263A(e)(3)(A)(i).

⁵⁹ I.R.C. § 263A(d)(3).

⁶⁰ I.R.C. § 263A(e)(2). This rule also applies to the taxpayer if any related person, as defined in I.R.C. § 263A(e)(2)(B), has elected under I.R.C. § 263A(d)(3) not to capitalize preproductive period expenses.

In addition to requiring capitalization of stud fees and other cash expenses of raising horses, section 263A disallows a deduction for a portion of the interest expense incurred by the taxpayer during the preproduction period and requires the addition of that interest expense to the basis of the horse.⁶¹ This rule requires not only the capitalization of interest on debt directly attributable to production period expenses, but also the capitalization, under the avoided cost method, of interest on debt actually incurred for other purposes.⁶² Some portion of the depreciation on barns and equipment and other general expenses and overhead of the farming activity conducted by the taxpayer also is subject to capitalization under section 263A. Although the legislative history provides some guidance, specific rules have not yet been developed. In general, however, section 263A, at the very least, requires the capitalization of all expenses that are inventory costs under the principles of full absorption inventory accounting.⁶³

d. *Miscellaneous Additions to Basis*

The normal rules for capitalization of acquisition expenses are applicable to purchased horses. Therefore, expenses such as attorney's fees and broker's fees, payable by the purchaser in connection with the acquisition of a horse, must be capitalized as part of the horse's basis.⁶⁴ This rule also extends to expenses such as the transportation of a horse from the point of delivery by the seller to the buyer's farm or stable.⁶⁵ Similar expenses incurred with respect to the sale of the horse are added to basis in computing the gain realized on the sale, rather than deducted in computing taxable income.

2. *Purchase of Mare in Foal*

The purchase of a mare in foal raises the difficult question of whether the purchase price should be apportioned between the

⁶¹ I.R.C. § 263A(f).

⁶² I.R.C. § 263A(f)(2)(A)(ii). See S. REP. NO. 313, 99th Cong., 2d Sess. 144 (1986); H.R. REP. NO. 426, 99th Cong., 1st Sess. 626 (1985).

⁶³ The legislative history directs the Treasury to pattern the regulations under I.R.C. § 263A after those governing long-term contracts under Treas. Reg. § 1.451-3. S. REP. NO. 313, 99th Cong., 2d Sess. 141 (1986).

⁶⁴ See, e.g., *Briarcliff Inv. Co. v. Commissioner*, 30 B.T.A. 1269, 1270-71 (1934) (real estate commissions paid by purchaser must be capitalized).

⁶⁵ Rev. Rul. 72-113, 1972-1 C.B. 99.

mare and the foal. In *Gamble v. Commissioner*,⁶⁶ the Tax Court held that such an apportionment was proper, and the seller was permitted to allocate to the foal, which was sold when it was sixteen months old, a portion of the purchase price for the mare.⁶⁷ This case stands in apparent contrast to *Metz v. United States*,⁶⁸ in which the taxpayer successfully argued that no part of the amount realized upon the sale of a mare in foal should be allocated to the foal. The government's position was that a portion of the sales price was attributable to the foal, and that the gain attributable to that portion of the amount realized was ordinary income, not eligible for section 1231 treatment.⁶⁹ Upon instructions to the jury, a special verdict was returned finding that no part of the mare's purchase price was attributable to the unborn foal.⁷⁰ Thus, any apparent irreconcilability of these decisions is illusory. Opposite results were reached in these cases because the taxpayer in *Gamble* was able to persuade the trier of fact that he paid more for the mare in foal than he would have paid had she not been in foal. The taxpayer in *Metz*, however, was able to carry the burden of proof that no part of the purchase price was attributable to the unborn foal.

This issue is clearly a question of fact to be determined on a case by case basis. In order to allocate a portion of the purchase price to the foal, however, the enhanced price of the mare in foal must be attributable to the foal, not merely to the demonstration that the mare was fertile. In *Gamble* the court found that the taxpayer paid an increased price due to the prospect of obtaining the foal.⁷¹ The instructions to the jury in *Metz* stated that if the increased value of the mare was "attributable merely to the fact that the mare in foal was an indication that she was a breeding mare and would be bred again, and that was the interesting point

⁶⁶ 68 T.C. 800 (1977)(*acq.*).

⁶⁷ *Id.* at 820-21.

⁶⁸ 62-1 U.S.T.C. ¶ 9500 (E.D. Ky. 1962).

⁶⁹ *Id.* at 84,474-75. The mare was I.R.C. § 1231 property and the gain attributable to the mare would be eligible for conversion to long term capital gains. The foal on the other hand had an insufficient holding period to qualify for I.R.C. § 1231 treatment, if treated as separate property. See text accompanying notes 138-48 *infra* regarding the necessary holding period to obtain § 1231 treatment on the sale of a horse.

⁷⁰ See *id.* at 84,476-77.

⁷¹ 68 T.C. at 821.

that the buyer was concerned with," then the jury was to return a verdict that no portion of the price was attributable to the foal.⁷² Nevertheless, where a stud fee of any substance was paid and the buyer obtains foal insurance, some portion of the purchase price probably will be attributed to the foal. The stud fee and the amount of the foal insurance is highly probative evidence of the portion of the purchase price that should be allocated to the foal.⁷³

If the taxpayer may apportion the purchase price of a mare in foal between the mare and the foal, how is that apportionment to be made? *Gamble* again provides guidance. Although the actual amount apportioned to the foal will be based on all facts and circumstances, in *Gamble* the Tax Court placed the greatest weight on the amount of foal insurance obtained by the taxpayer, finding the fair market value of the foal to equal the amount of the insurance.⁷⁴ Although the stud fees for the stallion that sired the foal are relevant, they do not necessarily translate dollar for dollar into basis allocated to the foal. Furthermore, if the price of the mare in foal is less than the stud fees plus the fair market value of the mare were she not in foal, *Gamble* suggests that the "discount" should be equitably apportioned between the basis allocated to the mare and the basis allocated to the foal.⁷⁵ The Internal Revenue Service (IRS), however, recently has taken the position that the proper method of allocation is to subtract from the price of the mare in foal the amount that would have been her fair market value if she were not in foal.⁷⁶ Although this might be determined by an appraisal, all of the foregoing factors might nevertheless influence such an appraisal. Thus, in practice, the apportionment method remains unclear because even the IRS "formula" requires the use of an assumed fact that is contrary to reality.

The question of whether the apportionment of basis to the foal should be made at the time of purchase or at the time of birth may be relevant when a foal is stillborn, in computing a loss deduction or, if the owner had foal insurance, in computing gain

⁷² 62-1 U.S.T.C. at 84,475.

⁷³ See *Gamble*, 68 T.C. at 821.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ A.O.D. 1986-024.

realized. Under the *Gamble* logic, it should be permissible to allocate a portion of the mare's purchase price to the dead foal. This conclusion, however, is by no means certain. In *Greer v. United States*⁷⁷ the Sixth Circuit Court of Appeals held that the holding period of a foal does not begin until its birth for purposes of determining if it is section 1231 property at the time of its subsequent sale.⁷⁸ If the holding period does not begin until birth, it is difficult to see how any portion of the purchase price of the mare can be allocated to the foal prior to its birth.

Logic, however, is on the side of allocating the purchase price between the mare and the unborn foal immediately upon purchase. The mare will most likely be depreciable property in the purchaser's hands.⁷⁹ Immediate apportionment of the purchase price avoids numerous computational difficulties that arise by waiting until the foal's birth to apportion. If the apportionment is delayed, the mare's unadjusted basis for purposes of computing ACRS deductions very likely will be greater in the first year than in later years. As a result, cumulative ACRS deductions will be overstated; the sum of the aggregate ACRS deductions on the Mare and the basis allocated to the foal will exceed the purchase price of the mare in foal. Complex adjustments to the ACRS formula would be necessary to avoid this result.⁸⁰ Furthermore, equity also is on

⁷⁷ 408 F.2d 631 (6th Cir. 1969).

⁷⁸ *Id.* at 636-37.

⁷⁹ See note 89 *infra* and accompanying text.

⁸⁰ Under I.R.C. § 168 ACRS deductions are computed over the recovery period under the 200 percent declining balance method, switching to the straight line method in the first year in which the straight line method produces a larger deduction. Except as provided in I.R.C. § 168(e)(3) (treating any racehorse that is more than two years old when placed in service and any horse that is more than twelve years old when placed in service as 3 year property), horses are 7 year recovery property. For years prior to 1987, horses that were not assigned a 3 year recovery period were 5 year property. See Prop. Reg. § 1.168-3(c)(2) (1984).

The problem noted in the text can be demonstrated as follows using the ACRS system in effect before the Tax Reform Act of 1986. Assume that in 1986 the taxpayer purchases a five year old broodmare in foal for \$50,000; \$20,000 of which is allocated to the foal that will be born in 1987. If the allocation is deferred until the birth of the foal, the ACRS allowance for the broodmare in 1986 will be \$50,000 x .15, or \$7,500. See I.R.C. § 168(b)(1) as in effect prior to the Tax Reform Act of 1986. In 1987, after the foal is born, \$20,000 of basis would be allocated to the foal, reducing the unadjusted basis of the broodmare to \$30,000. Applying the percentages specified in I.R.C. § 168(b)(1) for years 2 through 5 to an unadjusted basis of \$30,000 results in additional

the side of an immediate apportionment. Failure to apportion part of the mare's purchase price to the foal prior to birth may result in an unjustifiable acceleration of the ACRS deductions on the mare because of her overstated unadjusted basis in the first year. Finally, if a portion of the purchase price is attributable to the foal, failing to allow any apportionment prior to the live birth of the foal unjustly denies the owner a deserved casualty loss (or overstates gain if the owner has foal insurance) upon the abortion or still birth of the foal.

3. *Adjustments to Basis*

The adjusted basis under section 1011, used in the computation of gain or loss on the sale or exchange of a horse, is the unadjusted basis, determined as discussed in the immediately preceding section, increased or decreased as provided in section 1016.

a. *Adjustments That Increase Basis*

All expenditures incurred with respect to a horse that are properly chargeable to a capital account should be capitalized as part of the horse's basis.⁸¹ One of numerous expenditures in this category⁸² is particularly significant with respect to horses. Expenses incurred in training a horse in preparation for a racing career are not currently deductible but must be capitalized as part of the horse's basis.⁸³ These expenditures are recovered through ACRS deductions when the horse begins its racing career. Only expenses actually incurred may be added to basis. If the taxpayer

cumulative ACRS deductions of \$25,500. Total ACRS deductions will be \$33,000, \$3,000 more than the portion of the purchase price allocable to the broodmare. The easiest solution would be to disallow the excess deductions in the last year, but would still result in an unjustifiable acceleration of the ACRS deductions.

⁸¹ I.R.C. § 1016(a) (1984).

⁸² See Treas. Reg. § 1.263(a)-2 (1960) (examples of expenditures).

⁸³ *Journal Box Serv. Corp. v. United States*, 9 A.F.T.R.2d (P-H) 798, 817 (S.D. Ind. 1962). For years after 1986, § 263A should compel this result. *But see* Internal Revenue Manual 45(11)1 (1976) ("Consistent treatment of stud fees and training expenses [of 'raising' horses] should be accepted."). Expenses of continuing training of a horse during its racing career are currently deductible. *Hill v. Commissioner*, 26 T.C.M. (CCH) 1287, 1288-89 (1967).

personally trains a horse, the fair market value of the taxpayer's services may not be added to the horse's basis.⁸⁴

Expenses to feed and care for horses held for sale, breeding or racing may be deducted currently rather than added to basis as long as the taxpayer is a "farmer" for purposes of the I.R.C.,⁸⁵ unless the taxpayer elects the inventory method of accounting for the cost of raising livestock.⁸⁶ This same rule applies to the cost of feeding and caring for a mare in foal, regardless of whether the mare was purchased in foal.⁸⁷

b. *Adjustments That Decrease Basis*

The most significant adjustment that decreases the horse's basis is the reduction of basis by the amount of the ACRS depreciation deductions allowable with respect to the horse.⁸⁸ ACRS deductions are allowed with respect to horses held for racing (also referred to as "sporting purposes" by the I.R.C.) and breeding, but ACRS deductions are not allowed on horses held as inventory,⁸⁹ stock in trade, or primarily for sale to customers in the ordinary course of business.⁹⁰

⁸⁴ *Miller v. Commissioner*, 34 T.C.M. (CCH) 37 (1975) (disallowing capitalization of imputed expense of value of owner's services in training standardbred for computing casualty loss deduction upon horse's death).

⁸⁵ See Treas. Reg. § 1.162-12(a); *Duggar*, 71 T.C. at 154-55.

⁸⁶ See Treas. Regs. §§ 1.61-4(a), 1.162-12(a).

⁸⁷ See Treas. Reg. § 1.162-12(a); *Ellis*, 47 T.C.M. (CCH) at 1002.

⁸⁸ See I.R.C. § 1016(a)(2); Treas. Reg. § 1.1016-3(a) (1986); *Sullivan v. Commissioner*, 17 T.C. 1420, 1425 (1952), *aff'd*, 210 F.2d 607 (5th Cir. 1954).

⁸⁹ Horses held for breeding and racing are clearly property used in a trade or business subject to an allowance for depreciation, see Treas. Reg. § 1.162-12(a), unless the taxpayer uses the accrual method of accounting and elects to inventory livestock used for breeding purposes as permitted under Treas. Regs. §§ 1.61-4(a) and 1.162-12(a). Inventoried livestock is not depreciable, Treas. Reg. § 1.167(a)-(6)(b) (1960), and, therefore, no ACRS deductions are allowable with respect to such livestock.

Under I.R.C. § 163(e)(3) (I.R.C. § 168(h)(1) for years prior to 1987) any racehorse that is more than two years old when placed in service and any horse that is more than twelve years old when placed in service are 3 year recovery property. All other horses are 5 year recovery property. Prop. Reg. § 1.168-3(c)(2) (1984). All other horses placed in service after 1986 are 7 year recovery property.

⁹⁰ See I. B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 23.2.1 (1981). *Cf. Riordan v. Commissioner*, 37 T.C.M. (CCH) 839, 841 (1978) (farmer who erroneously claimed depreciation deduction on livestock sold during the year was allowed to claim same amount as cost of goods sold when depreciation deduction was disallowed).

Another less common basis adjustment is the reduction required when a horse owner receives insurance proceeds due to the horse's disability to continue either a racing or breeding career. To the extent that such insurance proceeds are not reimbursement for otherwise deductible expenses (such as veterinarian expenses) and are excluded from gross income, the horse's basis must be reduced by the amount of insurance proceeds.⁹¹ If the insurance proceeds exceed the adjusted basis of the horse, the excess must be included in gross income,⁹² unless the event constitutes an involuntary conversion and the owner elects under I.R.C. section 1033 not to recognize the gain.⁹³ Basis is also reduced by the amount of any unreimbursed casualty loss deduction claimed in a horse.⁹⁴ To the extent that a loss is reimbursed by insurance, however, the loss deduction is disallowed.⁹⁵ The exclusion of the insurance proceeds from gross income nevertheless requires a concomitant reduction in the horse's basis.

C. Character of Gain or Loss

1. General Principles

The character of the gain or loss recognized upon the sale or exchange of a horse depends upon the purpose for which the taxpayer held the horse. The three primary purposes for holding a horse in the breeding and racing industry are resale, racing, and breeding.⁹⁶ In some instances, a horse may be held for an

⁹¹ See *C. G. Willis, Inc. v. Commissioner*, 41 T.C. 468, 474 (1964), *aff'd per curiam*, 342 F.2d 996 (3d Cir. 1965) (receipt of insurance proceeds attributable to partial destruction of ship by casualty).

⁹² See I.R.C. §§ 1033(a)(2), 1231(a)(3)(A); *Central Tablet Mfg. Co. v. United States*, 417 U.S. 673, 676 (1974) (gain on receipt of insurance proceeds in excess of basis of building destroyed by fire).

⁹³ See Part III *infra*.

⁹⁴ Cf. Rev. Rul. 71-161, 1971-1 C.B. 76, 77.

⁹⁵ I.R.C. § 165(a).

⁹⁶ A decreasing number of horses are held for draft purposes. Among the other uses of horses are rental for pleasure riding, see *Campbell v. Commissioner*, 20 T.C.M. (CCH) 825, 838 (1961); advertising, see, e.g., the Budwiser Clydesdales; and entertainment, see, e.g., Mr. Ed.

investment purpose that does not fit into the above categories,⁹⁷ but that generally will not be true. Horses held for resale virtually always will be categorized as stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business, and thus are excluded from the definition of capital asset.⁹⁸ Accordingly, all gain or loss recognized on the sale of such horses is taxed as ordinary income. A horse held for investment purposes is a capital asset.⁹⁹

For years prior to 1987, the gain recognized on the sale of a capital asset may have received the advantageous treatment accorded to long term capital gains if it had been held for more than six months. Any loss recognized, however, suffered the disadvantageous treatment accorded to capital losses.¹⁰⁰ The Tax Reform Act of 1986 repealed the preferential treatment of long term capital gains recognized after December 31, 1986.¹⁰¹ Even

⁹⁷ This would most likely be true with respect to pleasure horses and horses held for use in activities that are subject to the limitations in I.R.C. § 183. In such a case it is probable that an attempt to deduct a capital loss would be denied by the Commissioner even though it is clear that gains recognized on the sale of such horses must be included in taxable income.

⁹⁸ I.R.C. § 1221(1). See *Nowland v. Commissioner*, 15 T.C.M. (CCH) 368, 375-76 (1956), *aff'd per curiam*, 244 F.2d 450 (4th Cir. 1957); *Jewell v. Commissioner*, 25 T.C. 109, 109, 117-18 (1955). *But see Black v. Commissioner*, 35 T.C. 90, 96 (1960) (taxpayer held real estate "primarily for sale" and thus could not avail herself of nonrecognition under I.R.C. § 1031 on exchange of real estate, but gain was capital gain because property was not held "primarily for sale to customers in the ordinary course of business").

⁹⁹ See I.R.C. § 1222.

¹⁰⁰ For years prior to 1987, I.R.C. § 1202(a) allowed individuals a deduction equal to sixty percent of the excess of long term capital gains over all capital losses recognized for the year. In effect this reduced the rate of tax on 100% of the gain to 40% of the rate of tax applied to ordinary income. Corporations were allowed preferential rates on long term capital gains under I.R.C. § 1201. Both of these preferences were repealed by the Tax Reform Act of 1986.

I.R.C. § 1211(b) limits individual taxpayer's deduction for capital losses to capital gains plus an amount not to exceed \$3,000, determined by formula. Under I.R.C. § 1211(a) corporations may deduct capital losses only to the extent of capital gains. Disallowed losses are carried over under I.R.C. § 1212. These limitations on the deductibility of capital losses have been continued notwithstanding the repeal of the capital gains preference.

¹⁰¹ Pub. L. No. 99-514, §§ 301, 311, 100 Stat. 2085, 2217-19. For 1987 there is a limited capital gains preference for taxpayers in a marginal tax rate bracket above 28%. Section 1(j) limits the maximum rate of tax on net long term capital gains to 28%. This limitation is not effective, however, with respect to the 5% surtax imposed on certain taxpayers under I.R.C. § 1(g) for years after 1987.

though the preferential treatment of capital gains has been eliminated, section 1211 continues to limit to \$3,000 per year the amount of capital losses that may be deducted against ordinary income. Thus, the characterization of both gain and loss as ordinary or capital continues to be relevant, although of diminished significance.

Horses held for breeding and racing purposes are depreciable property used in a trade or business,¹⁰² and as such are excluded from the ambit of capital assets.¹⁰³ For the same reason that they are excluded from the definition of capital asset, however, such horses are "section 1231 property" if held for more than twenty four months.¹⁰⁴ Thus, the gains and losses recognized on the sale of horses used for breeding and racing may enter into the section 1231 hotchpot, with the resultant possibility that gains may be treated as long term capital gains and losses may be treated as ordinary losses, depending on whether the taxpayer recognized an overall gain or loss on the sale of section 1231 property during the year.¹⁰⁵ Section 1231 gains, however, are subject to a major limitation. Under section 1245 any gains realized on the sale are treated as ordinary income to the extent that the seller claimed ACRS (or depreciation) deductions with respect to the horse.¹⁰⁶ Only gains in excess of "depreciation

¹⁰² See I.R.C. § 1231(b)(3)(A). See also *Kirk v. Commissioner*, 47 T.C. 177, 187 (1966).

¹⁰³ I.R.C. § 1221(2); *Gamble v. Commissioner*, 68 T.C. 800, 810 (1977) (*acq.*).

¹⁰⁴ I.R.C. § 1231(b)(3)(A). This rule stands in stark contrast to the six month holding period that is generally required to attain the status of I.R.C. § 1231 property. For the possibility that a horse held for less than twenty four months may nevertheless be I.R.C. § 1231 property, see *Gamble*, 68 T.C. 800, discussed at notes 157-73 *infra*.

¹⁰⁵ A discussion of the mechanics of the operation of the I.R.C. § 1231 hotchpot is beyond the scope of this Article. For a detailed explanation, see 2 B. BITTKER, *supra* note 44, at ¶ 54.1-54.2 (1981).

¹⁰⁶ Treas. Reg. § 1.1245-3(a)(4), provides that I.R.C. § 1245 (1981) property "includes livestock . . . with respect to taxable years beginning after December 31, 1969. . . . [T]he term 'livestock' includes horses . . . irrespective of the . . . purpose for which they are held." The amount of gain subject to depreciation recapture is not limited to the depreciation previously claimed by the taxpayer if his basis is determined with reference to his transferor's basis. In such a case all of the depreciation claimed by the taxpayer and his transferor is taken into account in measuring the amount of the gain subject to recapture under § 1245. See Treas. Regs. §§ 1.1245-2(a)(4), -2(c)(2), -4(c)(1)-(2). See also Treas. Reg. § 1.1245-2(c)(4) (1965) regarding depreciation recapture on property acquired in an exchange subject to I.R.C. § 1031.

recapture" under section 1245 are treated as section 1231 gains.

Because different treatment is accorded gains and losses on a sale depending on the purpose for which the horse was held, it is crucial to determine whether a horse was held primarily for "sale to customers in the ordinary course of business" or for breeding or racing. On occasion, it may be necessary to determine if the horse was held for some other purpose, which may result in both gains and losses being treated as capital gains and losses. If the horse was held for use in the taxpayer's trade or business but not for resale, racing or breeding, the holding period prerequisite for section 1231 treatment is reduced to six months.¹⁰⁷ Unfortunately, due to the nature of the industry, categorizing the purpose for which a horse was held is frequently a difficult task.

2. *Distinguishing Horses Held Primarily for Sale to Customers From Horses Held for Breeding and Racing Purposes*

Whether a horse is held primarily for sale to customers in the ordinary course of business or for use in the taxpayer's trade or business is a question of fact.¹⁰⁸ A horse is not held primarily for sale to customers in the ordinary course of business, however, unless that purpose predominates over all other purposes.¹⁰⁹ This standard frequently helps taxpayers engaged in the breeding and racing industry to establish that a horse that has been sold was not held primarily for sale to customers in the ordinary course of business because frequently a single horse may be held for racing, breeding, or sale, based on whichever course of action appears at the time to be most profitable. Vendors of horses do not, however, have a blank check to claim that all of the horses that they have sold were held for multiple purposes and therefore

¹⁰⁷ See *Gamble*, 68 T.C. at 816-17.

¹⁰⁸ See, e.g., *Gotfredson v. Commissioner*, 217 F.2d 673 (6th Cir. 1954), cert. denied, 350 U.S. 846 (1955) (cattle); *McDonald v. Commissioner*, 214 F.2d 341, 342 (2d Cir. 1954) (cattle); *Jewell*, 25 T.C. at 115.

¹⁰⁹ See *Kirk*, 47 T.C. at 193. This principle is not unique to the horse industry; it is merely a specific application of the general principle applicable to all types of property announced by the Supreme Court in *Malat v. Riddell*, 383 U.S. 569, 572 (1966).

not held primarily for sale to customers in the ordinary course of business.

Many sellers are undeniably in the trade or business of breeding or buying horses for resale. Although there is authority for the proposition that each sale by a taxpayer generally in the business of selling horses must be separately examined to determine the purpose for which the horse was held,¹¹⁰ a taxpayer that maintains a farm breeding horses and customarily selling all of them as yearlings or weanlings probably will be found to hold all of his yearlings and weanlings primarily for sale to customers in the ordinary course of business.¹¹¹ This does not prevent the taxpayer, however, from establishing that other horses sold by him were held for either breeding or racing,¹¹² although it may be more difficult for such a taxpayer to carry the burden of proof than it would be for a taxpayer that did not generally sell horses in the ordinary course of business. Advertising horses for sale in the ordinary course of business through public media, trade journals or sales catalogues generally assures treatment of gains as profits realized from sales to customers in the ordinary course of business.¹¹³ Furthermore, even if the taxpayer can establish that the horse was held for breeding or racing purposes rather than for sale to customers in the ordinary course of

¹¹⁰ See *Jewell*, 25 T.C. at 117; Priv. Ltr. Rul. 6302119340A (Feb. 11, 1963).

¹¹¹ See *Nowland*, 15 T.C.M. (CCH) at 372 (taxpayer annually sold entire yearling crop at auction, buying back those he wished to keep by reserved bid or through a straw bidder). *But see* *Bradshaw v. United States*, 72-1 U.S.T.C. ¶ 9364 (E.D. Ky. 1971) (taxpayer who sold 85% of colts foaled on his farm was found by jury to have recognized § 1231 gain, not ordinary income, on the sale of certain horses).

¹¹² See *Jewell*, 25 T.C. at 117.

¹¹³ See *Clark v. Commissioner*, 27 T.C. 1006, 1007-10 (1957) (taxpayer extensively advertised cattle for sale, had substantial volume of sales, and was willing to sell any cattle on farm, not just selected head); *Nowland*, 15 T.C.M. (CCH) at 372 (taxpayer advertised horses in trade journals and sales catalogues). See also *Campbell*, 20 T.C.M. (CCH) at 838 (1961) (hackney horse held for sale to customers in the ordinary course of business despite the lack of advertising and that all sales were by word of mouth because the only manner in which taxpayer could earn a profit from breeding, training and showing hackney horses was by sale). *But see* *Estate of Collings v. United States*, 138 F. Supp. 837, 839, 841 (W.D. Ky. 1955) (broodmares sold by taxpayer were § 1231 property; although taxpayer advertised his stable generally and the amount of the horse's winnings advertisements did not offer particular horses for sale or state prices) and compare with *Kirk*, 47 T.C. at 193 (taxpayer's failure to advertise horses for sale at general auction was a factor in finding that they were not held for sale to customers).

business, any gain recognized is still ordinary income unless the horse was held for the twenty four month period necessary to qualify for section 1231 treatment.¹¹⁴

The amendment of section 1231(b)(3) in 1969, extended from twelve to twenty four months the holding period required for cattle and horses held for draft, breeding or dairy purposes to qualify as section 1231 assets, and added horses held for sporting purposes to the category of livestock subject to the extended holding period requirement.¹¹⁵ Prior to the amendment, a number of cases arose in which the issue was whether taxpayers who regularly culled animals from their breeding herds and racing stables realized section 1231 gain or loss on such sales or whether they realized ordinary gain or loss from the sale of livestock in the ordinary course of business. Horsemen who maintained established breeding and racing operations and cattlemen who maintained breeding operations generally were found to have realized section 1231 gain or loss.¹¹⁶ Most of those cases involved animals held for less than twenty four months. Therefore, the issue should arise less frequently under the current statute. Nevertheless, there may be instances in which these cases are important.

It is difficult to apply these cases to clearly determine the purpose for which a horse is held. This difficulty arises from the courts' conclusion that the actual use of the horses or cattle prior to sale was not determinative of the purpose for which the taxpayer held the animals. The taxpayer's motive was what was important; therefore, a horse that never was bred or raced nevertheless might be held for breeding or racing purposes.¹¹⁷

¹¹⁴ See I.R.C. § 1231(b)(3)(A); Treas. Reg. § 1.1231-2(a)(1)(i) (1986); *McCarthy v. Commissioner*, 22 T.C.M. (CCH) 129, 137 (1963) (sale of racehorse under pre-1969 version of I.R.C. § 1231(b)(3)); *Priv. Ltr. Rul. 7410240190A* (Oct. 24, 1974) (sale of racehorse under current I.R.C. § 1231(b)(3)).

¹¹⁵ Tax Reform Act of 1969, Pub. L. No. 91-172, § 212(b), 83 Stat. 487, 571 (1969).

¹¹⁶ See, e.g., *United States v. Bennett*, 186 F.2d 407, 410 (5th Cir. 1951); *Albright v. United States*, 173 F.2d 339, 344-45 (8th Cir. 1949)(cattle); *Kirk*, 47 T.C. at 187; *McCarthy*, 22 T.C.M. (CCH) at 137; *Fowler v. Commissioner*, 37 T.C. 1124, 1134 (1962); *Journal Box Serv. Corp. v. United States*, 9 A.F.T.R.2d (P-H) 798, 817 (S.D. Ind. 1962); *Jackson v. Commissioner*, 11 T.C.M. (CCH) 939, 940-41 (1952).

¹¹⁷ See, e.g., *McDonald v. Commissioner*, 214 F.2d at 343; *Kirk*, 47 T.C. at 192-93. See also Treas. Reg. § 1.1231-2(b).

Generally, the key factor in establishing that animals were held primarily for breeding or racing was the taxpayer's practice of holding the animals until he could determine whether they were desirable for that purpose. A consistent practice of selling only those animals that were, according to the taxpayer's standards, undesirable for either breeding or racing would result in treatment of the gains and losses as section 1231 losses.¹¹⁸ This would be true even if a particular animal was too young at the time of sale for actual use in the intended purpose as long as the animal already exhibited characteristics that rendered it undesirable for that purpose.¹¹⁹

In *Jewell v. Commissioner*,¹²⁰ a taxpayer who sold most, but not all, of the horses bred on his farm was found to be in the business of selling horses to customers in the ordinary course of business, even though he retained some horses to enhance the quality of his breeding stock. The court was influenced by the historical operation of the taxpayer's farm and by the fact that over a five year span he sold all but one of the colts foaled on the farm—most as yearlings. Although the court found that all of the horses foaled were to be added to the breeding herd if they were good enough, most of the horses that the taxpayer asserted were culls were found by the court to have been held primarily for sale to customers in the ordinary course of business.

In determining the purpose for which the horses were held, the *Jewell* court dealt very specifically with the factual circumstances surrounding the sale of each horse. Examining the particular defect asserted by the taxpayer to render each unfit for breeding or racing, the court concluded that those horses not sold within a reasonable time period after the defect first appeared were held primarily for sale to customers in the ordinary course of business.¹²¹ Although they originally might have been

¹¹⁸ See, e.g., *Kirk*, 47 T.C. at 192-93; *McCarthy*, 22 T.C.M. (CCH) at 137; *Jackson*, 11 T.C.M. (CCH) at 940-41.

¹¹⁹ See note 118 *supra*.

¹²⁰ 25 T.C. 109 (1955).

¹²¹ *Id.* at 115-18. Compare *McCarthy*, 22 T.C.M. (CCH) 129, in which the fact that the taxpayer retained some horses for a period of time after discovery of a characteristic that rendered the horse unfit for breeding or racing was not even considered

held for breeding purposes, continuing to hold them after it was apparent that they were not suitable for breeding effected a change in the purpose for which they were held. On the other hand, those horses that initially appeared to be desirable for breeding, but were sold shortly after the discovery of an undesirable trait, were found to have been held for use in breeding and the gains recognized from the sales of those horses were accorded section 1231 treatment.¹²²

In contrast to the taxpayer in *Jewell*, who raced only one horse (which was not one of those sold) during the tax years in question, taxpayers that actively train and race a very high percentage of their horses have been more successful in claiming all of the horses they sold were not held for sale to customers in the ordinary course of business.¹²³ Here again, however, courts generally examine the particular facts upon which the taxpayer bases his claim that the horse in question has been culled from a breeding or racing stable.¹²⁴ In *Kirk v. Commissioner*¹²⁵ the Tax Court closely examined both the training procedures followed by the taxpayer, a successful harness racing owner, and the defects asserted by the taxpayer causing the horse to be culled from his stable. Many of the horses sold during the years in question were raced by the taxpayer. Others were trained, but never raced. None were used for breeding purposes. All of the culled horses were sold at general auction as soon as feasible and without advertising.

The Tax Court rejected both of the Commissioner's arguments and concluded that the taxpayer was in the business of

by the court as a factor in determining whether the gains realized on the sale of culls were I.R.C. § 1231 gains or gains from the sale of horses held primarily for sale to customers in the ordinary course of business.

¹²² 25 T.C. at 117-18.

¹²³ See *Kirk*, 47 T.C. at 192-93; *McCarthy*, 22 T.C.M. (CCH) at 137; *Jackson*, 11 T.C.M. (CCH) at 940-41.

¹²⁴ See *Estate of Collings*, 138 F. Supp. at 841 (finding that broodmares sold by taxpayer in the business of breeding, training and selling saddle horses were property used in the taxpayer's trade or business, not property held primarily for sale to customers in the ordinary course of business); *Gamble*, 68 T.C. at 801-02 (culls from racing stable); *Kirk*, 47 T.C. at 193 (culls from racing stable); *Campbell*, 20 T.C.M. (CCH) at 857 (according different treatment by grouping to hackney horses and horses held for rental as riding horses); *Jackson*, 11 T.C.M. (CCH) at 940 (culls from racing stable).

¹²⁵ 47 T.C. 177 (1966).

racing horses. The Commissioner argued that the taxpayer's purpose in racing the horses was merely to increase their sale value and that the taxpayer was engaged not only in the business of racing horses, but also in the business of selling horses that were not suitable for use in racing.¹²⁶ The first argument was quickly rejected on the facts; the taxpayer was in the business of racing horses, not selling them. The second argument was rejected because the sales were "a necessary incident" to the taxpayer's principal business. The taxpayer sold only those horses that were not suitable for racing. The mere fact that he knew from the time the horses were foaled that many of them would not be suitable for racing did not mean that the horses that were sold were held primarily for sale to customers in the ordinary course of business.¹²⁷ His intent in holding the horses was deter-

¹²⁶ *Id.* at 192-93.

¹²⁷ It does not appear that the Commissioner argued or that the Tax Court ever considered the possibility that the sales of horses could have been ordinary income under the *Corn Products* doctrine. See *Corn Prod. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955), *reh'g denied*, 350 U.S. 943 (1956), which was applied to I.R.C. § 1231 property in *Hollywood Baseball Ass'n v. Commissioner*, 423 F.2d 494 (9th Cir.), *cert. denied*, 400 U.S. 848 (1970). In apparent reference to the *Corn Products* doctrine, the trial court in *Bradshaw v. United States*, 72-1 U.S.T.C. ¶ 9364 (E.D. Ky. 1971), in framing its instructions to the jury, took a somewhat different view of the significance of sales being "a necessary incident" of the conduct of the taxpayer's business than the *Kirk* court did. *Bradshaw* was engaged in the business of breeding, training and showing saddle horses. The court instructed the jury that even if it found that the horses in question were not held primarily for sale to customers in the ordinary course of business that it was to return a verdict for the government if it concluded that the sale of the horses was "an integral part of [the taxpayer's] business. By 'integral part of' it is meant that the sales were necessary for the conduct of his business." *Id.* at 84,260. Based on this instruction, the jury nevertheless returned a verdict for the taxpayer. *Id.* at 84,261.

In *Clark v. Commissioner*, 27 T.C. 1006, 1014 (1957), the Tax Court, attempting to draw the line between cattle held for sale to customers in the ordinary course of business and cattle held for breeding purposes, noted the admonition of the Supreme Court in *Corn Products* that the scope of capital assets was to be narrowly construed, but apparently had no thoughts of directly applying *Corn Products*.

The better view is that, given the congressional purpose behind I.R.C. § 1231 (whether or not one agrees with that policy), the *Corn Products* doctrine should not override I.R.C. § 1231. See *Deltide Fishing & Rental Tools, Inc. v. United States*, 279 F. Supp. 661, 665-66 (E.D. La. 1968). In *Guggenheim v. Commissioner*, 46 T.C. 559, 569-70 (1966), the Commissioner specifically argued that the *Corn Products* doctrine overrode I.R.C. § 1231 on the sale of syndicate shares in a stallion by the taxpayer, who prior to the syndication owned the entire interest in the stallion and used him for breeding purposes. The Tax Court quickly rejected the argument, concluding that the taxpayer was merely liquidating part of his interest in I.R.C. § 1231 property. *Id.* at

minative, and on the facts, the taxpayer did not decide to sell any particular horse until it was shown that the horse was not a desirable racehorse. Accordingly, all of the taxpayer's gains were treated as section 1231 gains.

In reaching its decision in *Kirk*, the Tax Court cited its earlier memorandum decision in *McCarthy v. Commissioner*¹²⁸ as a case "in which the facts were very similar."¹²⁹ Although this is generally true, there were some differences in both facts and approach. Unlike *Kirk*, yet like *Jewell*, the taxpayer in *McCarthy* continued to hold some of the horses in training for a period following discovery of a characteristic rendering them unfit for racing. Nevertheless, the Tax Court distinguished *Jewell* as a case dealing with a seller who, on all facts, was primarily engaged in raising horses for ultimate sale rather than for racing or breeding. *McCarthy*, on the other hand, did not continuously sell horses as yearlings. He kept the majority of his horses for more than a year, training them and selling only those horses that proved to be unfit or too slow for racing, while also showing a profit from his racing activities.¹³⁰ These facts indicated that the horses "were not trained and raced as part of a horse selling business but as a part of the integral, indivisible business of the [taxpayer] of owning, training, racing, and breeding racehorses."¹³¹ The court concluded, without a detailed examination of the circumstances surrounding the decision to sell each horse, that the gains realized on the sale of the horses held for more than six months were eligible for capital gains treatment under

570.

On the other hand, there is some authority for the proposition that property may simultaneously be I.R.C. § 1231 property and property held primarily for sale to customers in the ordinary course of business. See *International Shoe Mach. Corp. v. United States*, 491 F.2d 157, cert. denied, 419 U.S. 834 (1974). An argument that the gain on the sales of culls was ordinary income based on this precedent should also fail. The sale of horses determined to be unfit for racing or breeding is analogous to the sale of equipment at the end of its useful life to the taxpayer, a situation that concededly produces I.R.C. § 1231 gains, not ordinary income. See, e.g., *Philber Equip. Corp. v. Commissioner*, 237 F.2d 129 (3d Cir. 1956).

¹²⁸ 22 T.C.M. (CCH) 129 (1963).

¹²⁹ 47 T.C. at 109 n.5.

¹³⁰ *McCarthy*, 22 T.C.M. (CCH) at 133.

¹³¹ *Id.* at 137. See note 127 *supra*.

section 117(j) of the 1939 Code, the predecessor of section 1231.¹³²

The factors cited by the Tax Court in *McCarthy* for identifying horse owners that are not generally in the business of selling horses to customers in the ordinary course of business are clearly the mainstream criteria. The failure of the *McCarthy* court to examine individually the circumstances surrounding the sale of each horse, however, does not appear to be in the mainstream. Perhaps this reflects *sub silentio* reasoning in *McCarthy* that taxpayers who generally do not hold horses for sale to customers in the ordinary course of business do not do so with respect to specific horses, while it is much more likely that taxpayers who hold horses for sale to customers in the ordinary course of business might not hold a particular horse for that purpose.¹³³ It also may simply reflect the fact that in most cases the volume of horses sold by the taxpayer is sufficient to raise the possibility of dual businesses—one of breeding, training and racing horses and another of selling horses to customers in the ordinary course of business. Courts have examined closely the facts of each sale to determine whether the sales were part of a second business or merely incidents of the breeding, training and racing business. This appears to be the reason behind the detailed factual analysis in *Kirk*. Perhaps *McCarthy* may be reconciled as a case in which the factors discussed above established so clearly that the taxpayer was not in the business of selling horses to customers in the ordinary course of business that there was no need to examine further the circumstances of each sale.

If the taxpayer is not actively engaged in racing, it may be more difficult to establish that culls are not held primarily for

¹³² 22 T.C.M. (CCH) at 135-37.

¹³³ Compare *Kirk*, 47 T.C. at 191 ("The fact that petitioner [who was found to be engaged in the business of breeding, training and racing horses] knew in advance that a good number of the horses would never develop into good racehorses and that he would have to sell them does not mean that the horses sold were necessarily held primarily for sale.") with *Jewell*, 25 T.C. at 115-18 (taxpayer who kept only 1 out of 23 colts foaled during 5 year span, selling 19 as yearlings, was in the business of selling horses to customers in the ordinary course of business, but sales of certain colts and fillies bred for use as breeding stock but never used as such because of unsuitability were treated as sales of property held for use in the taxpayer's business).

sale to customers in the ordinary course of business.¹³⁴ This will be particularly true with respect to colts. Before a horse commences a breeding career, he generally must first prove his value on the track.¹³⁵ It is unlikely that a breeder would retain all of the colts foaled on his farm for use in breeding operations even aside from the need to first prove them on the track. Not only does a breeding operation require fewer stallions than it does broodmares, but retention of the colts for future use as stallions would lead to undesirable inbreeding.¹³⁶ Furthermore, unless the taxpayer is engaged in racing, his activities probably will not produce a profit other than through the sale of horses bred by him.¹³⁷ If the sale of horses is the only source of profit, then the gains would arise from property held for sale to customers in the ordinary course of business and therefore would be ordinary income. The taxpayer could demonstrate, however, as in *Jewell*, that a particular horse was held for use as breeding stock and thereby have those gains accorded section 1231 treatment.

3. *Special Problems in Qualifying for Section 1231 Treatment*

a. *Section 1231(b)(3) Twenty Four Month Holding Period Requirement For Horses Held For Breeding, Draft, Or Sporting Purposes*

As noted in the previous section, to be considered section 1231 property, a horse held for draft, breeding or sporting

¹³⁴ See Treas. Reg. § 1.1231-2(c)(1)(iii) ("A horse which has neither been raced at a public track nor trained for racing shall not, except in rare and unusual circumstances, be considered as held for racing purposes."); *Jewell*, 25 T.C. at 115-18 (1955). Cf. Treas. Reg. § 1.1231-2(b)(2), Example (2) (A taxpayer who is in the business of raising horses for sale to others for use as draft horses does not hold the horses for use as draft horses merely because he uses them on his farm as draft horses for the purpose of training them; his use of the horses for draft purposes is incidental to the sale of the horses.).

¹³⁵ See *Guggenheim*, 46 T.C. at 561; *Fowler*, 37 T.C. at 1127-29.

¹³⁶ See *Jewell*, 25 T.C. at 118 (that seller knew colts foaled on farm were related to fillies foaled on farm negated argument that colts were held for breeding). Cf. *Kirk*, 47 T.C. 177 (filly sold by taxpayer because she was product of accidental inbreeding).

¹³⁷ See *Campbell*, 20 T.C.M. (CCH) 825 (taxpayer who bred and showed hackney horses realized ordinary income from sales of horses because, although he won substantial prize money at shows, the only way in which the activity could show a profit was through the sale of horses whose value had been enhanced by good show records). *But see Hancock v. Commissioner*, 31 T.C. 752, 757-58 (1959) (taxpayer that maintained only a breeding herd and sold only culls was allowed I.R.C. § 1231 treatment on all cattle sold).

purposes (including racing) must be held for more than twenty four months.¹³⁸ A horse held for use in the taxpayer's trade or business other than for draft, breeding or sporting purposes, however, must be held for only six months in order to be section 1231 property.¹³⁹ The 24 month holding period requirement largely moots the question of whether horses that the taxpayer claims were culled from potential breeding stock or from the racing stable were in fact held for those uses rather than for sale to customers in the ordinary course of business. All gains and losses realized on the resale of horses within two years of purchase or on the sale of horses foaled by the taxpayer within two years of birth will be ordinary income or loss,¹⁴⁰ unless the taxpayer can show that the horse was held for a purpose other than breeding, sporting or sale to customers in the ordinary course of business. Thus, the number of instances in which the IRS and the courts must grapple with ambiguous facts to make fine distinctions, as illustrated in the cases discussed in the prior section, is significantly reduced.

The extended holding period provided in section 1231(b)(3) was enacted specifically because Congress recognized that the purpose for which young horses and cattle are held frequently may be ambiguous.¹⁴¹ The one year holding period requirement previously in force was considered to be an insufficient time period for the taxpayer to determine whether cattle were suitable for breeding stock and horses were suitable for racing or breeding stock or whether the animals were held for sale. Congress also was concerned that the shorter holding period, combined with the ability of investors to utilize farm accounting methods

¹³⁸ See I.R.C. § 1231(b)(3); Treas. Reg. § 1.1231-2.

¹³⁹ See *Gamble*, 68 T.C. at 820. See also *Campbell*, 20 T.C.M. (CCH) at 855-56; J. O'BYRNE & C. DAVENPORT, FARM INCOME TAX MANUAL, § 325 (6th ed. 1982).

¹⁴⁰ See Rev. Rul. 76-70, 1976-1 C.B. 225; Priv. Ltr. Rul. 7410240190A (Oct. 24, 1974). See also *Greer v. U.S.*, 408 F.2d 631, 636-37 (6th Cir. 1969) (casualty gain recognized on receipt of insurance proceeds paid upon death of five day old colt was ordinary income and did not go into I.R.C. § 1231 hotchpot); *McCarthy*, 22 T.C.M. (CCH) at 137 (gain on sale of racehorses held less than six months was ordinary income under pre-1969 version of I.R.C. § 1231(b)).

¹⁴¹ See S. REP. No. 552, 91st Cong., 1st Sess. 100-01 (1969), reprinted in 1969-3 C.B. 423, 488; H.R. REP. No. 413 (Part 1), 91st Cong., 1st Sess. 70 (1969), reprinted in 1969-3 C.B. 200, 244.

to currently deduct expenses,¹⁴² gave rise to a large number of transactions with the solely tax motivated purpose of converting ordinary income into capital gains. Extending the holding period necessary to obtain capital gains treatment through section 1231 solved both problems.

In extending the section 1231 holding period, Congress implicitly rejected the idea from earlier cases that the taxpayer's motive in holding the animal, rather than the taxpayer's actual use of the animal, determines whether it was held for breeding.¹⁴³ This is manifested in the legislative history.¹⁴⁴ The House version of the amendment would not have extended the one year holding period, but would have provided that the holding period would not begin until the animal reached the age at which it normally first would be used for breeding or racing purposes.¹⁴⁵ The Senate believed, however, that the flexible commencement date of the holding period would present administrative difficulties and, therefore, substituted the arbitrary twenty four month holding period.¹⁴⁶ Because cattle normally reach breeding age within two years of birth¹⁴⁷ and horses generally commence training for racing within two years,¹⁴⁸ the purpose of the Senate amendment evidently was no different than the purpose of the House version.

b. *Identifying Horses Held For Breeding Or Racing Purposes Under The Regulations*

The Treasury Regulations promulgated under section 1231(b)(3) evidence a tightening of the test for determining

¹⁴² See note 141 *supra*. For a brief discussion of the peculiarities of farm tax accounting methods giving rise to the problem, see note 30 *supra*.

¹⁴³ See cases cited in note 117 *supra*.

¹⁴⁴ See notes 145-46 *infra*.

¹⁴⁵ See H.R. REP. NO. 413 (Part 1), 91st Cong., 1st Sess. 70 (1969), reprinted in 1969-3 C.B. 200, 244.

¹⁴⁶ See S. REP. NO. 552, 91st Cong., 1st Sess. 100-01 (1969), reprinted in 1969-3 C.B. 423, 488; H.R. CONF. REP. NO. 782, 91st Cong., 1st Sess. 298 (1969), reprinted in 1969-3 C.B. 644, 656.

¹⁴⁷ See *McDonald*, 214 F.2d at 343-44; *Fox v. Commissioner*, 16 T.C. 854, 856 (1951), *aff'd*, 198 F.2d 719 (4th Cir. 1952).

¹⁴⁸ See *Gamble*, 68 T.C. at 802 (thoroughbreds); *Kirk*, 47 T.C. at 180 (standardbreds).

whether a horse is held for breeding or racing purposes.¹⁴⁹ Although the regulations provide that whether or not livestock is held for breeding or racing “depends upon all the facts and circumstances in each case,” they also state that the “purpose for which the animal is held is ordinarily shown by the taxpayer’s actual use of the animal.” Actual use is not necessary, however, to show that a horse was held for breeding or racing purposes if the “animal is disposed of within a reasonable time after its intended use for such purpose is prevented or made undesirable by reason of accident, disease, drought, unfitness of the animal for such purpose, or a similar factual circumstance.” Thus, the regulations allow some of the flexibility evidenced in prior case law. The regulations, however, do contain the admonishment that an animal is not held for breeding or racing purposes “merely because it is suitable for such purposes or merely because it is held by the taxpayer for sale to other persons for use by them for such purposes.”¹⁵⁰

The regulations go on to provide very specific rules to determine whether a horse is held for racing purposes.¹⁵¹ A horse that actually was raced at a public track is considered to be held for racing purposes, “except in rare and unusual circumstances.”¹⁵² Conversely, a horse that neither was raced at a public track nor trained for racing is not considered to be held for racing purposes “except in rare and unusual circumstances.”¹⁵³ No authority provides examples of “rare and unusual circumstances” in either context.

If a horse was not raced at a public track, but was trained to race, the horse may be found to be held for racing purposes if “other facts and circumstances in the particular case also indicate that the horse was held for this purpose.”¹⁵⁴ This vague standard is clarified by the further statement that if the taxpayer “maintains a written training record on all horses he keeps in training status, which shows that a particular horse does not

¹⁴⁹ Treas. Reg. § 1.1231-2.

¹⁵⁰ Treas. Reg. § 1.1231-2(b)(1).

¹⁵¹ Treas. Reg. § 1.1231-2(c).

¹⁵² Treas. Reg. § 1.1231-2(c)(1)(i).

¹⁵³ Treas. Reg. § 1.1231-2(c)(1)(iii).

¹⁵⁴ Treas. Reg. § 1.1231-2(c)(1)(ii).

meet objective standards (including, but not limited to, such considerations as failure to achieve predetermined standards of performance during training, or the existence of a physical or other defect) established by the taxpayer for determining the fitness and quality of horses to be retained in his racing stable, . . . [and] the taxpayer disposes of the horse within a reasonable time after he determined that it did not meet his objective standards for retention, the horse shall be considered as held for racing purposes."¹⁵⁵ These criteria strongly resemble the factual circumstances cited by the Tax Court in *Kirk* and other similar cases used to establish that the taxpayer was in the business of training and racing horses, not selling horses, and that the particular horse in question was held for use in racing.¹⁵⁶ Thus, the earlier cases continue to be important precedent under the subsequently applicable regulations, although the section 1231 holding period currently is longer.

A difficult continuing issue under the regulations involves the sale of a filly or maiden mare that has not been trained for racing and has been held for more than two years by a taxpayer generally in the business of breeding and selling horses. If the animal was not actually used for breeding, apparently the horse is not treated as section 1231 property unless the taxpayer establishes both that the particular horse was held for breeding purposes (rather than for sale to customers in the ordinary course of business) and that the horse was sold within a reasonable time after discovery that she was not suitable for breeding. This often may be a difficult or impossible burden to carry. The Tax Court's decision in *Gamble v. Commissioner*,¹⁵⁷ however, offers another possibility.

Gamble, who was found to be in the thoroughbred racing business and not in the business of selling thoroughbreds, purchased a mare in foal on December 20, 1969. The foal, a colt, was born on April 12, 1970. The foal neither was raced at a public track nor trained for racing, but it "was handled in a manner entirely consistent with a plan to train and race it when

¹⁵⁵ *Id.*

¹⁵⁶ See *Kirk*, 47 T.C. at 193; *McCarthy*, 22 T.C.M. (CCH) at 137; *Jackson*, 11 T.C.M. (CCH) at 940-41.

¹⁵⁷ 68 T.C. 800 (1977) (*acq.*).

it reached the proper age.”¹⁵⁸ In August 1971, as the colt approached the age at which training would normally begin, Gamble sold the colt at the Saratoga Yearling Sale. Gamble claimed that the colt was a capital asset. The Commissioner argued that the colt was property used in Gamble’s business subject to section 1231 and that the twenty four month holding period requirement was not met.

Based on the evidence, the court concluded that Gamble was “holding the colt in order to exploit it through whatever course of action might appear at the time to be most profitable, either through sale, or to race it himself, or in some other manner (e.g., by syndication).”¹⁵⁹ Because no single purpose predominated, the court reasoned that the colt was not held primarily for sale to customers within the meaning of section 1221(1). Despite Gamble’s argument that his failure to claim depreciation with respect to the colt established that it was a capital asset,¹⁶⁰ the court concluded that, because Gamble’s business “*encompassed* holding immature foals for possible future use as race horses,” the evidence established that the colt was “unmistakably

¹⁵⁸ *Id.* at 806.

¹⁵⁹ *Id.* at 812.

¹⁶⁰ *Id.* at 813. The taxpayer’s failure to depreciate the colt was consistent with treating the colt as I.R.C. § 1231 property. Immature animals held for future use in draft, breeding or dairy purposes are not considered to be placed in service until they reach maturity, “the age at which they can be worked, milked, or bred.” U.S. TREAS. DEPT., PUB. NO. 225, FARMER’S TAX GUIDE 16 (1981 ed.). See also Rev. Rul. 60-60, 1960-1 C.B. 190. But see *Rudolph Inv. Corp. v. Commissioner*, 31 T.C.M. (CCH) 573, 578 (1972) (taxpayer was allowed to depreciate yearling heifers, despite immaturity for breeding, because they became part of the breeding herd at that age). No depreciation may be claimed until the animal is placed in service. Treas. Reg. § 1.167(a)-10(b) (1960). See, e.g., *Piggly Wiggly Stores, Inc. v. Commissioner*, 84 T.C. 739 (1985) (supermarket equipment), *aff’d*, 803 F.2d 1572 (11th Cir. 1986). If breeding stock may not be depreciated prior to the year it reaches the age at which it may be bred, by analogy, no depreciation should be allowable with respect to a racehorse prior to the year in which it enters training. Nevertheless, property that will be subject to an allowance for depreciation after it is placed in service by the taxpayer is not excluded from the ambit of I.R.C. § 1231 because the taxpayer is unable to claim depreciation deductions on the property not yet placed in service. See *Alamo Broadcasting Co. v. Commissioner*, 15 T.C. 534 (1950). Therefore, it was entirely proper to claim no depreciation on the colt even if it was property subject to an allowance for depreciation held for use in the taxpayer’s business and not a capital asset. But see *Talbot & Fehrenbach, Thoroughbred Breeding—Tax Considerations*, 49 C.P.A. J. 11, 13 (July 1979) (table of useful lives of thoroughbred racehorses shows useful life for horse that is 1 year old when placed in service).

bly" depreciable property held in connection with Gamble's business described in sections 1221(2) and 1231(b).¹⁶¹ After finding the colt to be section 1231 property, rather than a capital asset, the court turned to the question of what holding period to apply, the six month holding period of section 1231(b)(1) or the twenty four month holding period of section 1231(b)(3).

At this juncture, the *Gamble* case takes a strange twist. Because the colt neither was raced nor trained for racing, the Commissioner agreed with Gamble's contention that section 1231(b)(3), with its twenty four month holding period, was inapplicable.¹⁶² That being so, Gamble argued that the horse was nevertheless section 1231 property meeting the section 1231(b)(1) six month holding period requirement. The government, however, argued that horses could be treated as section 1231 property only under subsection (b)(3) and that if subsection (b)(3) was inapplicable the horse could not qualify under subsection (b)(1). With what at first blush appears to be well reasoned logic, the Tax Court rejected the Commissioner's argument and allowed Gamble to treat the gain recognized as capital gain on the sale of a section 1231(b)(1) asset.

First, the court noted that subsection (b)(3) provides that the term "property used in the trade or business . . . includes"¹⁶³ horses held for draft, breeding and sporting purposes. Section 7701(b) specifically provides that the word "includes" does not exclude things other than the specified examples if they are independently within the meaning of the defined term. Prior to the 1969 amendment to subsection (b)(3), it was established that animals held for purposes other than those specified in subsection (b)(3) could qualify as section 1231 property under subsection (b)(1).¹⁶⁴ Furthermore, adopting the Commissioner's argument would not only exclude from section 1231 property horses held for breeding or racing that were not held for twenty four months, but would also exclude horses held for any purpose

¹⁶¹ 68 T.C. at 812 (emphasis in original).

¹⁶² *Id.* at 817.

¹⁶³ *Id.* at 818 (emphasis in original).

¹⁶⁴ *See, e.g.,* McDougal v. Commissioner, 62 T.C. 720 (1974)(*acq.*) (racehorses were I.R.C. § 1231 property under I.R.C. § 1231(b)(1) prior to addition of "sporting" purposes to subsection (b)(3) in 1969); *Fowler*, 37 T.C. 1124 (same).

not stated in subsection (b)(3), such as horses used for advertising, entertainment, or by riding stables, regardless of the holding period.¹⁶⁵ Finally, the court could not find adequate support in the legislative history of the 1969 amendment to conclude that Congress intended the amendment to restrict section 1231 treatment to horses that *both* had been held for twenty four months *and* held for one of the specified purposes. Although there was some language in the Senate Committee Report supporting the Commissioner's argument,¹⁶⁶ other language in that report and in the Conference Report indicated that the purpose was only to extend the holding period applicable to animals held for the specified purposes.¹⁶⁷ The general tenor of the legislative history, reciting the problems and abuses encountered with respect to the character of gain recognized on the sale of animals that were alleged to have been held for the specified purposes, supported this analysis.¹⁶⁸

It is difficult to fault this logic. But the result is unsettling, and there is language in the *Gamble* opinion that hints that the result may have disturbed the court. After reaching its conclusion, the court noted:

We recognize that the regulations as they now exist . . . might in some cases effectively shield from the 24-month holding period requirement horses which arguably should be subjected to it. However, that problem is not presented in this case, because the Government has taken the position that the chest-

¹⁶⁵ 68 T.C. at 814. See also *Campbell*, 20 T.C.M. (CCH) at 885-56 (pleasure-riding horses held for rental were I.R.C. § 1231 property).

¹⁶⁶ See S. REP. NO. 552, 91st Cong., 1st Sess. 100-01 (1969), reprinted in 1969-3 C.B. 423, 488, quoted in 68 T.C. at 818-19 n.16 ("Thus, cattle and horses are not to qualify for long-term capital gains treatment unless the animal is held by the taxpayer for at least two years for one of the specified purposes.").

¹⁶⁷ *Id.*, quoted in 68 T.C. at 819, n. 17 ("The committee amendments extend the present one-year holding period for cattle and horses, which are held for draft, breeding, dairy or sporting purposes, to two years." (emphasis added by Tax Court)); H.R. CONF. REP. NO. 782, 91st Cong., 1st Sess. 298 (1969), reprinted in 1969-3 C.B. 644, 656, quoted in *Gamble*, 68 T.C. at 819 n.17 ("The Senate amendment provides that in order for any gain on the sale of horses or cattle to result in capital gain where the animals are held for draft, dairy, breeding, or sporting purposes, the horses or cattle must have been held for at least two years." (emphasis added by Tax Court)).

¹⁶⁸ See 68 T.C. at 819. See also S. REP. NO. 552, 91st Cong., 1st Sess. 100-01 (1969), reprinted in 1969-3 C.B. 423, 488.

nut colt was property used in the petitioner's trade or business and that it was *not* held for sporting purposes.¹⁶⁹

The court was correct in noting the flaw in the regulations. Its assertion that the problem was not presented in *Gamble*, however, was correct only in the narrowest sense.

In fact, *Gamble* involved the exact fact pattern that the 1969 amendment was intended to reach. The legislative history of the amendment specifically states that the changes were necessary because of the problems encountered when "the purpose for which animals are held is ambiguous."¹⁷⁰ The remedy was to remove horses that might be held for racing in the future or might be held for sale from the ambit of section 1231. Yet *Gamble* was able to use his ambiguous purpose as a sword to gain section 1231 treatment. Moreover, the facts of the case reveal not only that the taxpayer sold either a colt or filly at about the age when training would begin in each of the preceding three years, but also that the colt in question was particularly well bred and desirable.¹⁷¹ Similar facts in other cases involving sales of greater numbers of animals annually have resulted in ordinary income treatment.¹⁷² How then, did the taxpayer prevail in *Gamble*?

The easy answer is that the Commissioner largely stipulated away his case. Because *Gamble* did maintain a number of horses that actively raced, his sales activities were not of the level generally necessary to find that he was holding animals for sale

¹⁶⁹ 68 T.C. at 820 (emphasis in original).

¹⁷⁰ S. REP. No. 552, 91st Cong., 1st Sess. 100-01 (1969), reprinted in 1969-3 C.B. 423, 488; H.R. REP. No. 413 (Part 1), 91st Cong., 1st Sess. 70 (1969), reprinted in 1969-3 C.B. 200, 244.

¹⁷¹ 68 T.C. at 801-09.

¹⁷² See *Rice v. United States*, 75-1 U.S.T.C. ¶ 9207 (D. Mont. 1975) (sale of high quality, undiseased heifers rather than inferior animals demonstrated a predetermined effort to hold well bred animals for sale rather than culling from breeding herd); *Bandes v. Commissioner*, 44 T.C.M. (CCH) 243 (1982) (over the course of several years taxpayer serially sold groups of 13 month old pregnant gilts; applying Treas. Reg. § 1.1231-2(b)(1), the court concluded that, contrary to taxpayer's testimony that he intended to hold the hogs for breeding, the facts established that he held the hogs for sale to customers in the ordinary course of business); *Kline v. Commissioner*, 15 T.C. 998 (1950) (taxpayer, who purchased cows in the fall, bred them and resold the cows in the spring after calving, realized ordinary income because he never intended to hold them for breeding beyond the first year).

to customers.¹⁷³ On the facts, that portion of the Commissioner's argument was unsound, and it should have been recognized as such. Similarly, the Commissioner's argument that to be section 1231 property a horse had to fall within subsection (b)(3) was very clearly destined to lose. Thus, the Commissioner lost by agreeing that the colt was not held for sporting purposes. In light of the regulations, however, the Commissioner's agreement on this point does not appear to be unreasonable. The colt was neither raced nor trained, and the regulations provide that in such a case a horse "shall not, except in rare and unusual circumstances, be considered as held for racing purposes." The regulations, therefore, led to a result contrary to the Congress's intent in enacting the 1969 amendments to section 1231(b)(3). Although holding "immature colts for possible future use as race horses" brings the animals within the meaning of property held for use in the taxpayer's business, it does not amount to a "sporting purpose." Consequently, unless the regulations are amended, the same result likely would be reached if another case similar to *Gamble* arises. It is doubtful that the *Gamble* facts present the "rare and unusual circumstances" necessary to find that a horse that neither was raced nor trained is held for racing purposes.

c. *Sale of Mares in Foal*

The sale of a mare in foal raises the question of whether the amount realized should be apportioned between the mare and the unborn foal. If the amount realized is so apportioned, only the gain attributable to the mare will be eligible for section 1231 treatment, assuming that the requirements of section 1231 are otherwise satisfied, because an embryonic foal cannot satisfy the holding period requirement of either section 1231(b)(3) or subsection (b)(1).¹⁷⁴

In *Metz v. United States*,¹⁷⁵ the Commissioner unsuccessfully argued that part of the amount realized upon the sale of a mare

¹⁷³ Compare *Jewell*, discussed at notes 120-22 *supra*, with *Kirk* and *McCarthy*, discussed at notes 123-33 *supra*.

¹⁷⁴ See *Greer*, 408 F.2d 631 (holding period of foal begins at birth).

¹⁷⁵ 62-1 U.S.T.C. ¶ 9500 (E.D. Ky. 1962).

in foal should be allocated to the foal and that the gain attributable to the foal, which would be the entire amount realized because the seller had no cost basis in the foal, should be taxed as ordinary income. The government contended that an amount equal to the stud fees paid with respect to each of two mares involved in the case should be treated as the amount realized on the sale of the unborn foal. This argument was based on the earlier Tax Court decision in *Gamble*,¹⁷⁶ which held that the buyer of a mare in foal was entitled to allocate a portion of the purchase price to the foal for purposes of computing the gain realized upon the subsequent sale of the foal. The court in *Gamble*, however, considered the stud fees as only one factor in determining the portion of the purchase price allocable to the foal.

The *Metz* court apparently accepted the government's theory that a portion of the amount realized could be attributable to the unborn foal. It submitted special interrogatories to the jury, asking first, whether the " 'purchase price was enhanced by reason of the fact that the mare was thought by the parties to the transaction to be then carrying an unborn foal, and that any part of such enhancement in price, if any, was due to a value attributed or attributable to the unborn foal,' " ¹⁷⁷ and second, if the answer to the first interrogatory was "yes," the percentage of the amount realized attributable to the foal.¹⁷⁸ Although on the evidence the jury answered the first interrogatory in the negative for both foals, if the jury had answered the first interrogatory in the affirmative, whatever portion of the amount realized was allocated by the jury to the foal presumably would have been held by the court to be ordinary income. Otherwise, there was no need to submit the issues to the jury.

Thus a careful comparison of *Gamble* and *Metz* leads to the conclusion that whether a portion of the amount realized on the sale of a mare in foal is properly attributable to the unborn foal is clearly a question of fact, to be determined on a case by case basis. The same considerations that govern the allocation of a

¹⁷⁶ 68 T.C. 800 (1977) (*acq.*).

¹⁷⁷ *Metz*, 62-1 U.S.T.C. at 84,475 (quoting the first interrogatory).

¹⁷⁸ *Id.*

portion of the purchase price to the buyer's basis in the foal should apply in determining whether the seller must allocate a portion of the amount realized to the unborn foal. To the extent that a portion of the amount realized is attributed to the foal, the seller generally realizes ordinary income of an equal amount, assuming that the stud fee was previously deducted. If, on the other hand, the seller elected to capitalize the stud fee or was required by section 263A to capitalize all the costs of raising the foal, including the stud fee, that would be his basis in the foal for computing ordinary gain or loss realized with reference to the allocable amount realized.¹⁷⁹ In the unusual instance that the seller can establish that he held the unborn foal neither for sale to customers in the ordinary course of business nor for future breeding or racing and if the mare was in foal for more than six months, the seller might have an argument, based on *Gamble*, that he was entitled to section 1231 treatment on the gain attributable to the foal. This is, however, a tenuous argument at best, and is contrary to the decision in *Greer v. United States*,¹⁸⁰ deciding that the holding period of a foal does not begin until its birth.

4. Sales of Syndicate Shares

a. Is a Syndicate Undivided Ownership or a Partnership?

Syndicated ownership of horses occurs in racing syndicates, broodmare syndicates, and stallion syndicates.¹⁸¹ Racing syndicates and broodmare syndicates should be treated as partnerships for federal income tax purposes,¹⁸² and the sale of a share in

¹⁷⁹ See notes 49-51 *supra* and accompanying text.

¹⁸⁰ 408 F.2d 631 (6th Cir. 1969) .

¹⁸¹ See generally Campbell, *Racing Syndicates as Securities*, 74 Ky. L.J. 691 (1985-86); Campbell, *Stallion Syndicates as Securities*, 70 Ky. L.J. 1131 (1981-82); Kropp, Flannagan & Kahle, *Choosing the Equine Business Form*, 70 Ky. L.J. 940, 945-58 (1981-82).

¹⁸² In determining whether the syndicate is a partnership, the standards developed under I.R.C. §§ 761 and 7701(a)(2) should be determinative, not the state law determination. See, e.g., *Commissioner v. Culbertson*, 337 U.S. 733 (1949) (ranching partnership); *Wheeler v. Commissioner*, 37 T.C.M. (CCH) 883 (1978) (real estate development partnership). *But see* M.H.S. Co., Inc. v. Commissioner, 35 T.C.M. (CCH) 733 (1976),

such a syndicate should be taxed under the rules governing the sale of partnership interests.¹⁸³ A stallion syndicate, however, may or may not be a partnership for income tax purposes, depending on its organization. The rules governing taxation of the sale of a share in a stallion syndicate differ depending on how the syndicate is organized.

Reduced to its most basic elements, a stallion syndicate entails multiple ownership of a stallion in which an ownership interest (commonly termed "share") entitles the owner to certain annual breeding rights (commonly termed "nominations" or "seasons") and obligates the owner to share in the stallion's maintenance expenses. In thoroughbred syndicates each share owner typically has the right to breed one mare to the stallion annually. The syndicate manager is responsible for the daily care of the stallion and the supervision of breeding activities. He maintains records of the syndicate's activities and bills the share owners for their proportionate share of the syndicate's expenses. In some syndicates the syndicate manager may be responsible for promoting the horse through advertising, obtaining insurance on the horse, assisting share owners in selling their breeding rights, or selling extra breeding rights on behalf of the syndicate and applying the proceeds against expenses or dividing the profits between the share owners.

A syndicate structured as merely an expense sharing arrangement should not be categorized as a partnership for federal income tax purposes.¹⁸⁴ It is merely the co-ownership of property used by each of the co-owners in his separate business and lacks

aff'd, 575 F.2d 1177 (6th Cir. 1978) (applying state law, but noting that same result is reached under federal law).

I.R.C. § 761(a) provides that "the term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation, trust or estate." Treas. Reg. § 1.761-1(a), in relevant part, provides that "[t]enants in common . . . may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof." In *McDougal v. Commissioner*, 62 T.C. 720 (1974) (*acq.*), the court found that co-owners of a horse held for racing and future use as a stud were partners. See text accompanying notes 186-87 *infra*. See also Trower, Davis & Geske, *Taxation of Equine Partnerships*, 70 Ky. L.J. 1021, 1038 n.51 (1981-82).

¹⁸³ See text accompanying notes 196-208 *infra*.

¹⁸⁴ See Treas. Reg. § 1.761-1(a).

the joint profit motive necessary for a partnership.¹⁸⁵ But if the syndicate actively carries on a business or a venture with the object of making and dividing profits among the syndicate members, a joint profit motive exists and the syndicate is a partnership for tax purposes.¹⁸⁶ Thus, if the syndicate manager is empowered to sell seasons on behalf of the syndicate and to apply the proceeds to reduce the expenses charged to the share owners or to divide the profits among the share owners, the syndicate should be treated as a partnership for federal income tax purposes. The sale of seasons by the syndicate, as opposed to sale of seasons by individual shareholders, should be viewed as the conduct of a business regardless of whether the proceeds are used solely to offset expenses or are divided among the share owners.¹⁸⁷

b. *Character of Gain on Nonpartnership Syndicate Shares*

If a stallion syndicate share is merely an undivided interest in the horse and not an interest in a partnership, gains and losses realized upon the sale of the share should be categorized as ordinary or section 1231 gains or losses by each individual share owner, using the same standards applicable to sales of wholly owned horses. Generally, this results in section 1231 treatment as long as the holding period requirement is met. Because each share owner characterizes the purpose for which he holds the share by looking at his own activities,¹⁸⁸ the holding period for section 1231 purposes normally commences when the share owner acquires his share, not when the syndicate acquired the stallion, if that occurred at an earlier date. Thus, section 1231 treatment

¹⁸⁵ See MCKEE, NELSON & WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 3.03[5] (1977, 1985).

¹⁸⁶ Treas. Reg. § 1.761-1(a). See MCKEE, NELSON & WHITMIRE, *supra* note 185; Trower, Davis & Geske, *supra* note 182, at 1038 n.51.

¹⁸⁷ See *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980) (electric utility companies jointly operating nuclear power plant and distributing power in kind rather than jointly selling power to third parties were nevertheless partners); *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (2d Cir. 1980) (co-owners of commercial building were partners).

¹⁸⁸ If the syndicate were classified as a partnership, the character of the gain on the horses would be determined with respect to the partnership's activities and purpose for holding the horse. I.R.C. § 702(b); Treas. Reg. § 1.702-1(b) (1985).

is not available until the share owner has held the share for more than twenty-four months.¹⁸⁹ The availability of section 1231 gains, of course, is limited by section 1245. If the share owner is not a partner, but an owner of an undivided interest in the stallion, he will have claimed ACRS deductions with respect to the stallion. These deductions result in gain realized upon the sale of the share being ordinary income under section 1245 to the extent of ACRS deductions previously claimed by the share owner.¹⁹⁰

The similarity of the rights of a syndicate share owner and the rights of a mere lifetime season owner led the Commissioner to assert in *Guggenheim v. Commissioner*¹⁹¹ that gain realized on the initial sale of syndicate shares by the promoter was ordinary income. The Commissioner argued that the purported sale of undivided interests in the stallion was, in substance, only the sale of lifetime seasons. Focusing on the rights acquired by the purchasers, rather than the rights surrendered by the promoter, the court concluded, however, that the purchasers indeed acquired undivided ownership interests in the stallion. Unlike an owner of a lifetime season, the share owners were required to contribute to the stallion's expenses, were entitled to share in any profits from the sale of excess seasons, had the right to vote on a successor syndicate manager, and had a right of first refusal to purchase the interest of any share owner who wished to sell his share. These rights, combined with the form of the transaction, were sufficient basis to respect its form.

Alternatively, the Commissioner argued that, even if the form of the transaction was respected, the seller could not treat the transaction as a sale of section 1231 property under *Commissioner v. P.G. Lake, Inc.*,¹⁹² *Corn Products Co. v. Commissioner*,¹⁹³ and *Commissioner v. Gillette Motor Co.*¹⁹⁴ All three of these cases were found to be inapplicable, however, and the

¹⁸⁹ I.R.C. § 1231(b)(3); Treas. Reg. § 1.1231-2.

¹⁹⁰ See text accompanying note 106 *supra*.

¹⁹¹ 46 T.C. 559 (1966). See also Priv. Ltr. Rul. 6302014720 (Aug. 9, 1966) (technical advice memorandum issued with respect to *Guggenheim* during audit).

¹⁹² 356 U.S. 260 (1958).

¹⁹³ 350 U.S. 46 (1955).

¹⁹⁴ 364 U.S. 130 (1960).

taxpayer was permitted to treat his gains as section 1231 gains. The taxpayer in *Guggenheim* clearly had transferred the investment risks associated with three-sevenths of the stallion to the purchasers of the fifteen shares. This readily distinguished the case from *P.G. Lake*, which the Tax Court concluded involved a disguised sale of future ordinary income because the purchasers of the oil rights in that case had not really acquired any substantial investment risks or benefits. The seller in *P.G. Lake* bore the same investment risks after the transaction that he bore before the transaction. The Commissioner's attempted application of *Gillette Motor Co.* was rejected for the same reasons.

Corn Products was found by the court to be inapposite because the Commissioner's application of the case was based on his already rejected argument that *Guggenheim* in substance sold breeding rights, not undivided shares in the stallion. The sale of undivided interests in the stallion was a partial liquidation of the taxpayer's interest in a horse held for breeding purposes, not a transaction to further the taxpayer's business of breeding horses.

Guggenheim, decided almost thirty years ago, is the last word from either the courts or the IRS on the character of gain realized on the sale of syndicate shares. It is reasonable to conclude that the issue is settled, at least as far as traditional syndication agreements are concerned. Care must be exercised in the application of *Guggenheim*, however, because the Tax Court opinion dealt only with the character of the gain realized by *Guggenheim* upon sale of the undivided shares of the stallion in the syndication. Careful analysis of the facts leads to the conclusion that the syndicate, once established, should have been treated as a partnership because the syndicate manager had the power to sell excess seasons and either apply the proceeds against syndicate expenses or divide them among the share owners. Thus, any subsequent sales of shares by either *Guggenheim*, the promoter, out of his twenty reserved shares, or by any of the purchasers of the fifteen shares originally sold by *Guggenheim*, should have been analyzed as a sale of a partnership interest. This leads to the question of whether the transaction actually at issue in *Guggenheim* should have been analyzed as the formation of a partnership rather than a sale of undivided interests in the

stallion. This issue is explored later in this Article.¹⁹⁵

c. *Sale of Shares in a Syndicate That is a Partnership*

If, under the standards discussed previously, a syndicate is treated as a partnership for federal income tax purposes, the rules determining the character of the gain or loss realized upon the sale of a syndicate share are quite different. Sales of interests in partnerships owning horses, whether the horses are held by the partnership for breeding, racing or sale to customers in the ordinary course of business, are governed by the same provisions of Subchapter K that govern the sale of interests in partnerships holding any other type of section 1231 assets or property held for sale to customers in the ordinary course of business. Although a thorough discussion of the mechanics of Subchapter K provisions relating to the sale of partnership interests is beyond the scope of this Article, a few basic principles should be considered.

Section 741 provides that gain or loss recognized on the sale of a partnership interest is treated as long or short term capital gain or loss.¹⁹⁶ Except as provided in section 751, the character of the underlying assets owned by the partnership does not affect the characterization of gain or loss realized on the sale of a partnership interest.¹⁹⁷ Thus, for example, the gain recognized on the sale of a partnership interest is capital gain even if the entire gain is attributable to appreciated assets owned by the partnership that would produce section 1231 gain upon sale. Section 751, however, stands as a guardian to prevent recognition of capital gains on the sale of the partnership interest if the partnership assets reflect significant ordinary income potential, including depreciation recapture under I.R.C. section 1245.¹⁹⁸ Therefore, because every syndicate will have claimed ACRS deductions on most, if not all, of the horses held, some portion

¹⁹⁵ See Part I.E. *infra*.

¹⁹⁶ See Treas. Reg. § 1.741-1 (1985).

¹⁹⁷ Prior to the enactment of I.R.C. § 751 (1954) the courts, on occasion, looked through the partnership to characterize gain on the sale of a partnership interest with reference to the underlying assets. This was the exception, however, rather than the rule. See MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 15.03.

¹⁹⁸ I.R.C. § 751(a)(1), (c); Treas. Reg. § 1.751-1(c)(4) (1985).

of the gain realized on the sale of a share in a syndicate, classified as a partnership, is treated as ordinary income. On the other hand, none of the gain or loss realized on the sale of a partnership is characterized as ordinary gain or loss under the *Corn Products*¹⁹⁹ doctrine or on the theory that the taxpayer is a dealer in partnership interests.²⁰⁰

In computing gain or loss on the sale of a partnership interest, the seller uses his basis determined under sections 705 and 742. This reflects prior contributions to and withdrawals from the partnership, as well as the cumulative effect of his allocable share of partnership income and losses.²⁰¹ In addition, a partner's basis includes his share of partnership liabilities, determined under Treasury Regulation 1.751-1(e). Consonantly, the amount realized on the sale of the interest includes not only the cash and fair market value of other property received but also the selling partner's share of the partnership liabilities.²⁰²

The greatest pitfall in properly characterizing the gain realized on the sale of a partnership interest lies in the application of section 751. This section overrides section 741 and characterizes the gain attributable to unrealized receivables and substantially appreciated inventory held by the partnership as ordinary income.²⁰³ Not only are the computations complex, but section 751 may require the recognition of ordinary gain even if the overall transaction resulted in a sale of the partnership interest at a loss.²⁰⁴ When this occurs, the capital loss attributed to the sale of the partnership interest is increased by an amount equal

¹⁹⁹ See *Pollack v. Commissioner*, 69 T.C. 142, 147 n.7 (1977) (holding that I.R.C. § 741 requires capital gains treatment on the sale of partnership interest independent of I.R.C. § 1221 definition of capital asset; *Corn Products* is an exception to I.R.C. § 1221). The *Pollack* decision has been subject to scholarly criticism. See Note, *The Corn Products Doctrine and Its Application to Partnership Interests*, 79 COLUM. L. REV. 341 (1979); Note, *Section 741 and Corn Products: A Logical Extension?*, 31 U. FLA. L. REV. 90 (1978).

²⁰⁰ See 3 B. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 87.1.3 (1981).

²⁰¹ For a general discussion of the computation of the basis of a partnership interest, see MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 6.01 - ¶ 6.05.

²⁰² I.R.C. § 752(d); Treas. Reg. § 1.752-1(d) (1985).

²⁰³ See I.R.C. § 751(a), (c), (d); Treas. Reg. § 1.751-1(a), (c), (d).

²⁰⁴ See Treas. Reg. § 1.751-1(g), Example (1).

to the ordinary gain; the net loss will be correctly stated, but the character is altered.

Depreciation recapture is within the definition of "unrealized receivables" for purposes of section 751.²⁰⁵ Thus, whenever a syndicate taxed as a partnership holds any horses that have been depreciated and which have a fair market value in excess of their adjusted basis, the seller of a share must recognize as ordinary income his share of the potential section 1245 recapture income. In a very simplified context, this may be illustrated as follows. Assume that T owns one share in a stallion syndicate taxed as a partnership. For the sake of simplicity, assume the partnership has only ten shares. T's basis in his share is \$2,100. The sole asset of the syndicate is a single stallion with an adjusted basis of \$21,000. The recomputed basis of the stallion is \$100,000, and his fair market value is \$200,000. The syndicate has no liabilities. As the owner of a one tenth partnership interest, T sells his interest for \$20,000. He must recognize an overall gain of \$17,900, of which \$7,900 will be treated as ordinary income under section 751 and the remaining \$10,000 will be capital gain under section 741.²⁰⁶

It is important to note that section 751 is a one-way swinging door. If the partnership holds horses that have depreciated in value, and that depreciation is reflected in the price received for the partnership interest, section 751 does not operate to recharacterize as ordinary loss any part of the capital gain or loss on the sale of the partnership interest that is attributable to such horses. Furthermore, if the partnership both holds horses subject to section 1245 recapture, triggering ordinary income under section 751, and horses that would result in recognition of net section 1231 ordinary losses, the losses may not be netted out against the depreciation recapture in computing the portion of the overall gain that will be ordinary gain under section 751. The losses remain part of the computation subject to section 741,²⁰⁷ decreasing the capital gain or increasing the capital loss.

²⁰⁵ I.R.C. § 751(c); Treas. Reg. § 1.751-1(c)(4)(i); -1(c)(5).

²⁰⁶ For a thorough discussion of the mechanics of apportioning the gain realized on the sale of a partnership between ordinary income under I.R.C. § 751 and capital gains under I.R.C. § 741, see MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 16.02.

²⁰⁷ See *id.* at ¶ 16.03[3][a]; S. Horvitz, *Depreciation Recapture—Partnership Transactions*, 289 T.M. A-55-A-58.

It is also important to remember that, although the above rules apply equally to sales of syndicate shares to new syndicate members or to other syndicate members, they do not apply to a sale of shares back to the syndicate itself. Such a transaction is described as a "liquidation" of a partnership interest and is subject to the rules governing distributions from partnerships, as modified by section 736. Because it is very rare for a syndicate to buy back a share, any discussion of liquidation of partnership interests is beyond the scope of this Article. A cautionary note is in order, however, because section 751 also reaches certain partnership distributions,²⁰⁸ particularly those in which a partner's entire interest is liquidated by a cash payment (whether or not deferred), again transmuted what would otherwise be capital gain into ordinary income.

D. Installment Sales

1. General Principles of Deferred Recognition Rules

Gains realized on the sale of a horse for deferred payments may be reported on the installment method regardless of whether the seller uses the cash or accrual method of tax accounting or whether the horse is property used in the seller's business (e.g., a stallion, broodmare or racehorse) or property held for sale to customers (e.g., yearlings sold by a breeder). The installment method may also be used to report gain realized on the sale of a partnership interest or a syndicate share. Different provisions, however, govern sales of horses held for sale to customers by accrual method taxpayers who maintain inventories, than govern other deferred payment sales.

Section 453 governs installment sales of horses used in the seller's business, sales of horses held for sale to customers by cash method farmers not required to maintain inventories, and sales of partnership interests and syndicate shares.²⁰⁹ This section

²⁰⁸ I.R.C. § 751(b); Treas. Reg. § 1.751-1(b).

²⁰⁹ I.R.C. § 453(b); Treas. Reg. § 1.453-1(a) (1981); Temp. Reg. § 15a.453-0(a); -1(b)(4) (1981); Temp. Reg. § 15a.453-1(b)(4) specifically provides that "a farmer who is not required under his method of accounting to maintain inventories may report the gain on the installment method under section 453." A cash method farmer is not required

applies whenever at least one payment is to be received in a taxable year after the close of the taxable year in which the sale occurs.²¹⁰ It requires deferred reporting of the gain unless the seller affirmatively elects to recognize the entire gain in the year of the sale.²¹¹ A loss is always recognized in the year of the sale.²¹² Under the installment method of reporting gain, in each year in which a payment is received the seller includes in income an amount which bears the same proportion to the total gain realized on the transaction as the payments received during the year bear to the "contract price", which is defined as the total amount of payments to be received.²¹³ For this purpose, the assumption of a lien indebtedness by the purchaser is not considered a payment, unless the debt exceeds the seller's basis.²¹⁴ In that case, gain equal to the amount by which the debt exceeds the basis must be recognized in the year of the sale, and subsequent payments will be fully includable as gain.²¹⁵ The buyer's promissory note given to evidence the debt generally is not considered to be a payment.²¹⁶

For example, assume that the taxpayer sold a stallion with a basis of \$100,000 for \$250,000, of which \$100,000 was paid in cash. The balance of \$150,000 was represented by a promissory note calling for payment of \$50,000 of principal on each of the next three anniversary dates of the note, with adequate interest. Assume further (for reasons that will soon be explained) that none of the realized gain of \$150,000 is subject to section 1245 recapture because the horse was sold in the same taxable year in which it was acquired, but that the gain is ordinary income because the horse was held for less than one year. The contract price is \$250,000. Therefore sixty percent of each principal payment will be recognized as gain in the year received;

to maintain inventories. See note 30 *supra*. See Rev. Rul. 75-323, 1975-2 C.B. 346 (applying I.R.C. § 453 to the sale of a partnership interest; particular ruling now overridden by I.R.C. § 453(i)).

²¹⁰ I.R.C. § 453(b)(1).

²¹¹ I.R.C. § 453(d); Temp. Reg. § 15a.453-1(d).

²¹² *Martin v. Commissioner*, 61 F.2d 942 (2d Cir. 1932); Rev. Rul. 70-430, 1970-2 C.B. 51.

²¹³ I.R.C. § 453(c); Temp. Reg. § 15a.453-1(b)(2).

²¹⁴ Temp. Reg. § 15a.453-1(b)(3)(i), (b)(5), Example (2).

²¹⁵ See Temp. Reg. § 15a.453-1(b)(5), Example (3).

²¹⁶ I.R.C. § 453(f)(3), (4); Temp. Reg. § 15a.453-1(b)(3)(i).

\$60,000 of gain is recognized in the year of the sale and \$30,000 of gain is recognized in each of the next three succeeding years as payments are received. All of the gain is ordinary because gain is characterized based on the holding period at the time of the sale, not at the time payment is received.

Section 453C, added by the Tax Reform Act of 1986, restricts the use of the installment method of reporting gains by dealers of real and personal property who have outstanding indebtedness in any year in which they receive an installment obligation on the sale of inventory or property held primarily for sale to customers in the ordinary course of business. Certain lessors of property are also subject to this provision. The mechanical rules of section 453C that determine the extent to which installment reporting of the gain on a particular sale is disallowed are extraordinarily complex. Fortunately for taxpayers selling horses, these rules do not apply to the disposition of "any property used or produced in the trade or business of farming (within the meaning of section 2032A(e)(4) or (5))."²¹⁷ Raising horses clearly is farming within this definition. Therefore, section 453C does not apply to sales by a taxpayer in the business of raising horses for sale. Whether this rule will be applied to dispositions of horses by subsequent owners is unclear. It very likely may not.²¹⁸ In any event, because as far as we are concerned with it here, section 453C applies only to sales by dealers of property held for sale to customers in the ordinary course of business and horses leased by the taxpayer,²¹⁹ the installment method is available without restriction for reporting gains from the sale of horses held for breeding or racing purposes. This is so even if the taxpayer is a dealer. A taxpayer who sells a horse that has been leased to another taxpayer, however, may be subject to section 453C if the sales price of the horse exceeds \$150,000.²²⁰

a. *Treatment of Sales of Horses Subject to Liens*

The treatment of a lien indebtedness assumed by the purchaser can be illustrated by varying the facts slightly. Assume

²¹⁷ I.R.C. § 453C(e)(1)(B)(ii).

²¹⁸ See H.R. REP. No. 841, 99th Cong., 2d Sess. 298 (1986) ("... the proportionate disallowance rule does not apply . . . to installment obligations arising from the sale of crops or livestock held for slaughter.").

²¹⁹ See I.R.C. § 453C(e)(1)(A)(i).

²²⁰ I.R.C. § 453C(e)(1)(A)(i)(III).

that the sale price was increased to \$300,000 because the horse was subject to a \$50,000 debt, which the purchaser assumed or to which he took subject. In all other details the transaction was identical. The realized gain increases to \$200,000, but the contract price remains \$250,000, because the loan assumption is not treated as a payment. Therefore, eighty percent of each payment will be recognized as gain; \$80,000 will be recognized in the year of sale and \$40,000 will be recognized in each of the next three years.

b. *Disallowance of Installment Reporting of Recapture Income*

Most installment sales are not as simple as that in the preceding examples. If the horse was held for more than one taxable year (which may be less than twelve months if the horse was purchased during the year and held on the last day of the year) the seller probably has claimed ACRS deductions with respect to the horse.²²¹ Therefore, a portion of the gain realized on the sale is recharacterized as ordinary income under section 1245. This complicates the installment method of reporting gains because section 1245 recapture income is not eligible for installment reporting.²²² All of the recapture income must be recognized in the year of the sale, even if the amount of recapture income exceeds the payments received in that year, even if no payments are received in that year. As a result of the recognition of recapture income without regard to the receipt of a payment, for purposes of determining the gain recognized on the receipt of payments, the seller's basis in the horse that was sold is increased by the amount of recapture income.²²³

This interaction of recapture and the installment method is illustrated as follows. Assume that the horse sold in the initial example above was originally purchased for \$150,000 and that the seller had claimed ACRS deductions of \$50,000, reducing the adjusted basis to \$100,000. Assume further that the horse

²²¹ See text accompanying note 88 *supra*.

²²² I.R.C. § 453(i).

²²³ See S. REP. No. 169, 98th Cong., 2d Sess. 466 (1984); H.R. REP. No. 432, 98th Cong., 2d Sess. 1008-09 (1984).

had been held for more than twenty-four months prior to sale. In all other respects the transaction is identical to the first example. The gain realized on the transaction is \$150,000, of which \$50,000 is section 1245 recapture income and \$100,000 is section 1231 income. The \$50,000 of recapture income is recognized as ordinary income in the year of the sale. For purposes of determining the portion of each payment that is section 1231 gain, the seller's basis, which was \$100,000, is increased to \$150,000 by adding the recapture income to it. Using the increased basis, the amount of gain is only \$100,000, and since the contract price is \$250,000, forty percent of each payment will be recognized as section 1231 gain. In the first year the seller must recognize \$40,000 of section 1231 gain in addition to the \$50,000 of section 1245 gain. In each of the next three years he must recognize \$20,000 of section 1231 gain.

Similar computations must be made if the taxpayer sells a syndicate share that is treated as undivided ownership and the seller previously claimed ACRS deductions on the horse. Such computations must also be made if the taxpayer sells a partnership interest and part of the gain is characterized as ordinary income under section 751 because there is depreciation recapture inherent in the underlying assets of the partnership.²²⁴

2. *Installment Reporting of Contingent Price Sales*

The Treasury Regulations provide detailed rules for computing the portion of each payment that must be treated as gain in the case of installment sales at an indefinite price.²²⁵ These rules apply, for example, if the sales price of a horse is contingent on future racing purses or stud fees earned by the horse. If there is a stated maximum price, the gross profit ratio will be computed on the assumption that it will be paid. If less than the maximum price is paid, unless one of the specific rules permitting the seller to recompute the maximum selling price applies, the seller is allowed a loss in the final year equal to the excessive

²²⁴ STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984, at 334 (1984). See text accompanying notes 271-74 *infra*.

²²⁵ Temp. Reg. § 15a.453-1(c).

gain previously included in income.²²⁶ If the price is open-ended, but payments are due only for a specified period, the seller's basis is recovered ratably over the period for which payments are received.²²⁷ Finally, if both the purchase price and payment period are indefinite, the seller's basis is recovered ratably over fifteen years, unless the seller can demonstrate that recovery over fifteen years would "substantially and inappropriately defer recovery of the taxpayer's basis."²²⁸ In order to meet this burden, the seller must demonstrate that the alternative method he proposes is reasonable and that under his method he will recover basis at least twice as quickly as under the normal method.²²⁹ Because of the limited useful life of horses, it may be possible to meet these requirements in many instances, but an advance ruling from the IRS is always necessary.²³⁰

3. *Determining What Constitutes a "Payment"*

For installment method reporting of gains, some debt instruments of the buyer delivered to the seller are treated as payments in the year of delivery rather than the year of payment. Section 453 specifically provides that a bond or other evidence of indebtedness, payable on demand or issued by a corporation or government and readily tradeable, is treated as a payment.²³¹ The mere ability of the seller to discount the buyer's obligation, however, should not result in the promissory note being deemed a payment.²³² Similarly, a third party guarantee of the buyer's obligation does not cause delivery of the buyer's note to be deemed a payment.²³³ If, however, the obligation is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, the obligation is treated as a payment.²³⁴ A nonnegotiable, nontransferable standby

²²⁶ Temp. Reg. § 15a.453-1(c)(2)(i)(A), (iii), Example (5).

²²⁷ Temp. Reg. § 15a.453-1(c)(3).

²²⁸ Temp. Reg. § 15a.453-1(c)(4), (7).

²²⁹ Temp. Reg. § 15a.453-1(c)(7).

²³⁰ *Id.*

²³¹ I.R.C. § 453(f)(4). *See* Temp. Reg. § 15a.453-1(e).

²³² *See* Temp. Reg. § 15a.453-1(e)(1)(i), (e)(4).

²³³ Temp. Reg. § 15a.453-1(b)(3)(i).

²³⁴ *Id.*

letter of credit that may not be drawn on in the absence of the buyer's default is treated as a guarantee and not a cash equivalent security.²³⁵ Any other obligation of a third party delivered to the seller, including a negotiable letter of credit or a letter of credit that may be drawn upon by the seller without the buyer's default, is treated as a payment.²³⁶

4. *Premature Dispositions of Installment Obligations*

The sale, satisfaction at less than face, or other disposition of an installment obligation results in the recognition of gain or loss.²³⁷ For this purpose the basis of the installment obligation is the "excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full."²³⁸ In practical application the basis of an installment promissory note usually is computed by adding to the basis of the property for which the obligation was received the amount of gain previously recognized as a result of receiving payments on the note. Thus, using the immediately preceding example of an installment sale in which \$90,000 of gain was realized in the year of sale and the horse sold had a basis of \$100,000, the basis of the note after the first payment is \$190,000. This is the same result as is obtained using the statutory method under which the deferred gain of \$60,000 recognized upon the future receipt of payments is subtracted from the \$250,000 face value of the note to yield a \$190,000 basis. After the second payment, the basis is increased to \$210,000.

The recognition rule has a number of exceptions, but they are not extensive. If an installment obligation is transferred to a partnership in a transaction subject to section 721 or to a corporation in a section 351 transaction, the nonrecognition rules of those sections apply.²³⁹ Distributions of installment obligations by a partnership in liquidation of the partnership or a partner-

²³⁵ Temp. Reg. § 15a.453-1(b)(3)(i), (iii).

²³⁶ *Id.*

²³⁷ I.R.C. § 453B. See also Emory, *Disposition of Installment Obligations: Income Deferral "Thou Art Lost and Gone Forever"*, 54 IOWA L. REV. 945 (1969) (examining former I.R.C. § 453(d), the predecessor of current I.R.C. § 453B).

²³⁸ I.R.C. § 453(b). See Treas. Reg. § 1.453-9(b).

²³⁹ Treas. Reg. § 1.453-9(c)(3); § 1.721-1(a) (1985).

ship interest do not trigger recognition under section 453B,²⁴⁰ but there is only a narrow exception for certain installment notes distributed in corporate liquidations.²⁴¹ A transfer incident to a divorce, subject to section 1041, also is excluded from the recognition requirements.²⁴² Transmission upon death does not result in recognition,²⁴³ but a transfer by gift results in recognition to the transferor.²⁴⁴ The amount realized in such a case is the fair market value of the obligation, which may be different than its face value.²⁴⁵

A seller reporting gain on the installment method also is required to recognize gain upon the buyer's default if the seller repossesses the property.²⁴⁶ The gain recognized is the excess of the fair market value of the property over the basis of the installment obligation. This computation does not merely restore the status quo ante and simply tax as gain all payments previously treated as a return of basis; the repossession is treated as a separate transaction and the reacquired property has a basis equal to the fair market value used in determining the gain realized on the installment note as a result of the repossession.

The character of the gain or loss recognized on the sale or other disposition of the installment obligation is determined with reference to the character of the asset for which it was received.²⁴⁷ Thus, gain recognized on the sale of a note received for a broodmare, stallion or racehorse is section 1231 gain, but if the horse were held for sale to customers the gain is ordinary income.

5. *Installment Sales to Related Persons*

Complexities arise when an installment sale is made to a related person or entity. First, if the horse is depreciable property

²⁴⁰ Treas. Reg. § 1.453-9(c)(3).

²⁴¹ I.R.C. § 453B(d).

²⁴² I.R.C. § 453B(g).

²⁴³ I.R.C. § 453B(c). The deferred income is taxed to the beneficiaries of the decedent's estate who receive the obligations under I.R.C. 691. If, however, the installment obligation passes to the obligor and is thereby discharged, I.R.C. § 691(a)(5) requires that the gain be recognized by the deceased seller's estate.

²⁴⁴ See I.R.C. § 453(f) (gift to obligor); Rev. Rul. 67-167, 1967-1 C.B. 107 (gift to nongrantor trust); Rev. Rul. 55-157, 1955-1 C.B. 293 (gift to obligor on note).

²⁴⁵ I.R.C. § 453(a)(2).

²⁴⁶ See Treas. Reg. § 1.453-1(d).

²⁴⁷ See Treas. Reg. § 1.453-9(a).

in the hands of the buyer, as is any racehorse, stallion or broodmare, the installment method is not available for a sale to a corporation if the seller owns (after taking into account attribution rules) eighty percent of the value of the stock. Similarly, it is not available for a sale to a partnership if the seller owns eighty percent or more of either the capital or profits interest in the partnership or to any trust of which the seller or the seller's spouse is a beneficiary.²⁴⁸ Second, if the installment sale is to any person from whom stock ownership is attributed to the seller under section 318, the resale or other disposition of the horse by the related buyer within two years results in the original seller recognizing all of the deferred gain in the year of the sale by the related person.²⁴⁹ Section 318 attribution is quite broad and includes, among other relationships, spouse, children, grandchildren, parents, corporations of which the taxpayer directly or indirectly owns fifty percent or more of the stock after taking into account the attribution rules, trusts of which the taxpayer or any of his relatives previously mentioned is a beneficiary, and partnerships in which the taxpayer or any such relative is a partner.²⁵⁰ An exception to this recognition rule applies if the taxpayer establishes to the satisfaction of the Commissioner that neither the first nor the second disposition had as one of its principal purposes the avoidance of federal income tax,²⁵¹ but there is no guidance regarding the scope of this exception.

If the amount realized during the year by the second seller is less than the contract price on the first sale, only a portion of the deferred gain is immediately recognized. The balance

²⁴⁸ I.R.C. § 453(g). This prohibition does not apply, however, if the seller can establish to the satisfaction of the Commissioner that one of the principal purposes of the disposition was not tax avoidance. The Committee Reports indicate that this exception is available if "no significant tax deferral benefits will be derived from the sale." S. REP. No. 1000, 96th Cong., 2d Sess. 17 (1980), *reprinted in* 1980-2 C.B. 494, 503. Since significant tax benefits almost always result from such a sale, the taxpayer's burden is difficult to carry.

²⁴⁹ I.R.C. § 453(e).

²⁵⁰ See I.R.C. § 318 (1985); B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 9.21 (4th ed. 1979).

²⁵¹ I.R.C. § 453(e)(7). This exception applies, for example, to an involuntary sale such as foreclosure under a judicial lien or to a second installment sale on terms substantially similar to the terms of the first installment sale. S. REP. No. 1000, 96th Cong., 2d Sess. 16 (1980), *reprinted in* 1980-2 C.B. 494, 502.

continues to be deferred.²⁵² This can be illustrated as follows. Assume that T sells a horse, which has basis of \$1,000, to his son, S, for \$10,000, and S pays the entire purchase price by giving T a promissory note due three years later. One year later S resells the horse, but does not pay the note. If S realized \$10,000 or more on the sale, then T must recognize his \$9,000 gain in the year that S sold the horse. If, however, S realized only \$8,000 on the sale, then T must recognize only \$7,000, the excess of S's amount realized over T's basis, in the year S sold the horse. T's basis in the note will then be \$8,000, and he will recognize the remaining \$2,000 gain when S pays the note. The computations are substantially more complex if there were payments made on the note and the first seller recognized a portion of his gain prior to the resale.

6. *Election Not to Report on Installment Method*

A seller is not required to use the installment method and may elect to recognize the entire gain in the year of the sale.²⁵³ This may be desirable, for example, if the seller has net operating loss carryovers,²⁵⁴ particularly if they are about to expire, or long term capital losses that will offset the inclusion of net section 1231 gains as long term capital gains.²⁵⁵ If the seller does elect out of installment reporting of the gain, the proper treatment depends on whether he uses the cash or accrual method of accounting. If the seller is on the accrual method, the amount realized is the face amount of the obligation, and the entire gain is recognized.²⁵⁶ If the seller uses the cash method of reporting, the amount realized on the sale is the fair market value of the note,²⁵⁷ which, according to the regulations, never will be less

²⁵² I.R.C. § 453(e)(1), (4).

²⁵³ I.R.C. § 453(d); Temp. Reg. § 15a.453-1(d)(1). If the sale is by a partnership, the election must be made by the partnership. I.R.C. § 703(b). The election is binding on all of the partners; partners may not elect inconsistent treatment.

²⁵⁴ See I.R.C. § 172.

²⁵⁵ See I.R.C. §§ 1211, 1212.

²⁵⁶ Temp. Reg. § 15a.453-1(d)(2)(ii)(A), (ii)(B), Example (1); First Fed. Sav. and Loan Ass'n v. Commissioner, 40 T.C. 474 (1963); Castner v. Commissioner, 30 T.C. 1061 (1958).

²⁵⁷ Temp. Reg. § 15a.453-1(d)(2)(ii)(A), (B), Example (2); Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975); Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961).

than the fair market value of the property sold minus the value of other consideration received by the seller.²⁵⁸ In this regard, the regulations, without any apparent support in the legislative history, attempt to overturn prior case law holding that the fair market value of the note could be more or less than its face value, even if the note bore adequate interest.²⁵⁹ Apart from the regulations, if the note bears interest that is higher than the prevailing rate, its fair market value might be more than face. It is much more likely, however, that the fair market value, if different, will be less than face because of the risk of the buyer's default. In the year of the sale the seller recognizes gain equal to the fair market value of the note minus his basis in the horse. The remainder of the gain is recognized as the note is paid.

The gain recognized in the year of the sale that is attributable to the receipt of the note is categorized by reference to the character of the horse for which the note was received. The remainder of the gain, which is recognized when the note is paid, is ordinary income.²⁶⁰ Thus, although the deferral obtained by valuing a note at less than face may look attractive, for years in which capital gains received preferential treatment its beauty was marred substantially by the possible conversion of capital gains into ordinary income. If the term of the note was relatively brief, the tax detriment of this "reverse conversion" outweighed the tax benefit of deferral. If the term was longer, however, the deferral may have been more advantageous. Under the Internal Revenue Code of 1986, which taxes capital gains and ordinary income at the same rate, there generally is no detriment resulting from this "reverse conversion."

7. *Accrual Basis Dealers Maintaining Inventories*

An accrual method taxpayer in the business of selling horses to customers must maintain inventories.²⁶¹ The section 453 installment method rules described in the preceding section do not

²⁵⁸ Temp. Reg. § 15a.453-1(d)(2)(ii)(A).

²⁵⁹ See B. BITTKER, *supra* note 44, at ¶ 43.3.

²⁶⁰ See *Tombari v. Commissioner*, 299 F.2d 889 (9th Cir. 1962), *aff'g*, 35 T.C. 250 (1960). *But see* *Riss v. Commissioner*, 368 F.2d 965 (10th Cir. 1966) (taxing gain on payment by corporate obligor as capital gain under I.R.C. § 1032(a) (1985)).

²⁶¹ Treas. Reg. § 1.61-4(b).

apply to a sale of a horse by such a taxpayer or to a cash basis farmer that has elected to use inventories,²⁶² but installment sale reporting may be available under section 453A. In general terms, the primary difference in the sections is that under section 453A the profit ratio exclusion is not determined on an asset by asset basis, but rather on a global basis including all credit sales, although the seller, with the consent of the Commissioner, may choose among a few alternative methods.²⁶³ For this reason, installment reporting under section 453A must be used consistently once adopted, unlike section 453, which the taxpayer may elect out of on an asset by asset basis. Installment reporting under section 453A is available, however, only to "a person who regularly sells or otherwise disposes of personal property on the installment plan."²⁶⁴ Thus, it might not be available to an accrual method dealer in horses because it is unlikely that a breeder will "regularly" sell horses on the installment method. The scant case law, however, interprets "regularly" quite liberally. A few installment sales each year, even if a relatively small fraction of total sales may suffice to meet the requirement.²⁶⁵ Neither the Code, the Treasury Regulations nor any Revenue Rulings, however, provide guidance on the possible application of section 453A to sales by farmers using one of the inventory methods available to farmers.

8. *Sale of Syndicate Shares and Equine Partnership Interests*

a. *Generally*

Gain realized on the sale of a partnership interest or syndicate share sold for deferred payments may be reported on the

²⁶² I.R.C. § 453(b)(2)(B). See Rev. Rul. 68-13, 1968-1 C.B. 195 (I.R.C. § 453 is not available for a bulk sale of inventory by a sole proprietor.).

²⁶³ See Treas. Reg. § 1.453-2, -7, -8.

²⁶⁴ I.R.C. § 453A(a)(1).

²⁶⁵ See *Greenspon v. Commissioner*, 23 T.C. 138 (1954) (*acq.*), *rev'd on other grounds*, 229 F.2d 947 (8th Cir. 1956); *Davenport Mach. & Foundry Co. v. Commissioner*, 18 T.C. 39 (1952) (*acq.*); *Marshall Bros. Lumber Co. v. Commissioner*, 13 B.T.A. 111 (1928), *rev'd and remanded without opinion*, 51 F.2d 1081 (6th Cir. 1931).

installment method.²⁶⁶ If a syndicate share is treated as an undivided interest in the horse and not as a partnership interest, the rules discussed previously in connection with the outright sale of a horse apply. In the case of the sale of a partnership interest, including a syndicate share that constitutes a partnership interest, the operation of section 453 must be coordinated with the rules governing the sale of partnership interests. This is not an easy task.

b. Interrelationship of Installment Reporting and the Collapsible Partnership Rules

As long as a partnership does not hold any property that could not be sold on the installment method if the property were owned and sold directly by the partner, the gain from a deferred payment sale of the partnership interest is reportable under the installment method. On the other hand, if the partnership holds property, such as inventory, that may not be sold on the installment method under section 453, the analysis is more complex. Rather than entirely denying installment reporting, it appears that a proper coordination requires current recognition only of that portion of the gain attributable to property of the partnership not eligible for installment method reporting if sold by the partnership.²⁶⁷ That portion of the gain may or may not correspond to the portion of the gain characterized as ordinary income under section 751; the proper method of fragmentation is unclear. Nevertheless, there is considerable, but by no means perfect, overlap between the categories of property ineligible for installment sale reporting and the definition of section 751 assets. For example, the sale of inventory may not be reported on the installment method,²⁶⁸ while section 751 recharacterizes as ordinary income only that portion of the gain realized on the sale of a partnership interest attributable to substantially appreciated

²⁶⁶ See Rev. Rul. 76-483, 1976-2 C.B. 131. See also Rev. Rul. 75-323, 1975-2 C.B. 346; *Bailey v. Commissioner*, 18 B.T.A. 105 (1929)(*nonacq.*); James, *The Installment Sale of a Partnership Interest*, 43 TENN. L. REV. 306 (1976).

²⁶⁷ See MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 16.05[2],[3].

²⁶⁸ See Rev. Rul. 68-13, 1968-1 C.B. 195 (prohibition on installment reporting of sale of inventory extended to bulk sale).

inventory.²⁶⁹ In this case, the exclusion from section 453 is a bit broader than the ambit of section 751. As far as the sale of horses is concerned, a cash basis dealer in horses may report sales under section 453. Horses held for sale to customers by a cash basis partnership, however, could be substantially appreciated inventory under section 751.²⁷⁰ Section 751 recharacterizes as ordinary income some of the gain realized on the sale of a partnership interest in a cash basis partnership that is a dealer in horses, but the gain apparently is eligible for installment reporting.

Similar problems arise with respect to that portion of the gain from an installment sale of a partnership interest that is characterized as ordinary income under section 751 because it represents potential depreciation recapture attributable to partnership property. Any sale of an interest in a breeding or racing partnership is subject to section 751, except in rare circumstances, due to prior ACRS deductions claimed with respect to horses held by the partnership.²⁷¹ As previously discussed, recapture income realized on an asset that is sold directly is not eligible for installment reporting, but must be recognized in the year of the sale.²⁷² Thus, it appears that the portion of the gain recharacterized as section 751 ordinary income because it is attributable to depreciation recapture is not eligible for installment sale reporting.²⁷³ Although this result is neither clearly compelled by the statutes involved nor expressly mentioned in the Committee Reports, it is consistent with the intent of both section 453(i)

²⁶⁹ See I.R.C. § 751(a)(2),(d). A partnership has substantially appreciated inventory if the fair market value of its inventory items exceeds both 120% of the basis of the inventory items and 10% of the fair market value of all partnership property, other than money. For this purpose the word "inventory" is expansive and includes not only inventory in the traditional sense, but all property described in I.R.C. § 1222(1); such as uninventoried property held primarily for sale to customers in the ordinary course of business, and any other property that is neither a capital asset nor property described in I.R.C. § 1231. I.R.C. § 751(d). See generally MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 16.04.

²⁷⁰ See note 269 *supra*.

²⁷¹ See text accompanying notes 205-06 *supra*.

²⁷² See text accompanying notes 221-24 *supra*.

²⁷³ See Rev. Rul. 75-323, 1975-2 C.B. 346 (applying pre I.R.C. § 461(i) rule of coordinating I.R.C. § 1245 depreciation recapture and I.R.C. § 453 installment method reporting to sale of partnership interest).

and the fragmentation theory of coordinating section 453 and sections 741 and 751. It is also the position of the Joint Committee staff regarding this particularly knotty problem.²⁷⁴

In summary, the gain realized on a deferred payment sale of an interest in an equine partnership must be fragmented into three categories:

1. Section 751 gain ineligible for installment reporting under section 453, such as gain attributable to depreciation recapture on horses held for use in the partnership's business or inventoried horses held primarily for sale to customers;

2. Section 751 gain eligible for installment reporting under section 453, such as gain on the sale of uninventoried horses by a cash basis dealer in horses;

3. Section 741 gain eligible for installment sale reporting, which is the residual gain after subtracting out the section 751 gain.

A fourth category possibly should be added: section 741 gain ineligible for installment sale reporting, such as gain attributable to inventory that is not substantially appreciated.²⁷⁵ Even if this is theoretically required, however, few equine partnerships will encounter such gain,²⁷⁶ and therefore, no significant practical problem is raised by this possibility.

9. *Unstated Interest*

Deferred payment sales of horses, like sales of other property, are subject to the complex imputed interest rules if any payments are due more than six months from the date of the

²⁷⁴ STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984, 334 (1984). *But see* MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 16.05[2] (asserting that the staff's logic in reaching this conclusion is "dubious at best").

²⁷⁵ *But see* MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 16.05[2].

²⁷⁶ This would not necessarily be true with respect to the sale of a partnership interest in a breeding farm operation. In such a case, the value of the yearlings and weanlings held for sale very well might not be more than ten percent of the value of all of the assets of the partnership, excluding cash, depending mainly on the value of the broodmare band, any stallions owned by the partnership, land, barns, and other equipment.

sale and the deferred payments do not bear adequate interest.²⁷⁷ In general terms, the imputed interest rules recharacterize as "unstated interest," and therefore as ordinary income, a portion of the sales price if the deferred payments do not bear interest at the "test rate." The test rate is determined in one of two ways, depending on the principal amount of the deferred payments. If the total deferred principal payments do not exceed \$2,800,000, the test rate is the lesser of nine percent, compounded semiannually, or the "applicable federal rate" compounded semiannually.²⁷⁸ For any obligation in excess of \$2,800,000, the applicable federal rate is the test rate.²⁷⁹

The applicable federal rate, which is determined monthly, is based on the average annual yield for Treasury obligations with a maturity comparable to the deferred payment obligation.²⁸⁰ For obligations due within three years, the short term federal rate applies; the mid-term federal rate applies to obligations due more than three years but not more than nine years from date of issue; and the long term federal rate applies to obligations with a term of more than nine years.²⁸¹

A deferred payment obligation bears inadequate interest if the discounted present value (using the applicable federal rate as the discount rate) of all payments due on the obligation, including interest, is less than the principal amount of the obligation.²⁸² Thus, assuming that the applicable federal rate is greater than nine percent, any deferred payment obligation bearing stated interest of less than 9.2025 percent annually (the equivalent of nine percent compounded semiannually) bears unstated interest. On the other hand, any deferred payment obligation of \$2,800,000 or less that bears stated interest of at least 9.2025 percent an-

²⁷⁷ See I.R.C. §§ 483, 1272, 1273, 1274, 1274A, 1275. See also S. REP. No. 83, 99th Cong., 1st Sess. 6-9 (1985); H.R. REP. No. 87, 99th Cong., 1st Sess. 12-17 (1985); H.R. REP. No. 250, 99th Cong., 1st Sess. 12-18 (1985); STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984, 89-127 (1984); Blum, Bailey & Rosenberg, *Time Value of Money and TRA '84: Accounting Rules Turned Inside Out*, 26 TAX NOTES 933 (1985).

²⁷⁸ I.R.C. §§ 1274(a), (b)(1)-(2), (c)(1)-(2); 1274A(a), (b).

²⁷⁹ I.R.C. § 1274(a), (b)(1)-(2), (c)(1)-(2).

²⁸⁰ I.R.C. § 1274(d).

²⁸¹ I.R.C. § 1274(d)(1)(A).

²⁸² I.R.C. § 1274(c)(2).

nually, regardless of the rate of principal amortization, does not bear unstated interest, and no part of the principal is recharacterized as interest.

If an obligation does not bear interest at the test rate, it is said to bear "original issue discount",²⁸³ and the difference between the present value of the payments, determined under the method described above, is recharacterized as interest income.²⁸⁴ The gain or loss on the sale of the property is recomputed using the present value of the payments as the amount realized, and the profit ratio for reporting gain on the installment method must be recomputed. Although gain recognized under the installment method and stated interest payable on an original issue discount obligation is reported under the taxpayer's usual method of accounting, any original issue discount interest income generally must be reported using the accrual method at the rate that interest economically accrues.²⁸⁵ There are two exceptions to this rule.

First, if the total payments due under the instrument and all other instruments relating to the same sale do not exceed \$250,000, accrual reporting of the unstated interest is not required.²⁸⁶ Instead, the unstated interest portion of each payment is taxable under the seller's normal method of reporting, although the unstated interest accrues economically, not ratably.²⁸⁷ The meaning of "payments" must be examined carefully to determine the availability of this exception. Only deferred payments are relevant. Both interest and principal fall within its ambit;²⁸⁸ payments received at the time of the sale do not.

²⁸³ I.R.C. § 1273(a)(1).

²⁸⁴ I.R.C. § 1272(a)(1).

²⁸⁵ I.R.C. § 1272(a)(1), (3).

²⁸⁶ I.R.C. § 1274(c)(3)(C).

²⁸⁷ I.R.C. § 483. There appears to be a gap in the coordination of the coverage of I.R.C. § 483 and I.R.C. §§ 1272 and 1274. The original issue discount rules apply to deferred payment sales in which any payment is due more than six months from the date of the sale, but only if the total deferred payments do not exceed \$250,000. I.R.C. § 453 applies to any deferred payment sale with deferred payments of \$250,000 or less, but only if some payments are due more than one year from the date of the sale. Thus, it appears that no unstated interest rules apply to deferred payment sales with total deferred payments of \$250,000 or less where all of the payments are due within one year from the date of the sale.

²⁸⁸ See STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984, 120 (1984).

Second, if the deferred payments to be received exceed \$250,000, but the stated principal amount of the obligation and all other obligations relating to the same transaction does not exceed \$2,000,000, the seller may be able to elect to include the original issue discount on the cash rather than the accrual method.²⁸⁹ This election is available, however, only for cash method taxpayers who are not dealers with respect to the property sold in the transaction. Any such election must be made jointly by the seller-lender and buyer-borrower whose timing of interest deductions is affected by the election.

No useful purpose would be served by numerous examples of the computation of unstated interest under the various rules. In planning a sales transaction, the usual objective is to avoid the application of the unstated interest rules. As stated previously, that is done easily by requiring stated interest on the unpaid balance at 9.2025 percent annually or the annual equivalent of the applicable federal rate, compounded semiannually, whichever is appropriate. Furthermore, except in the simplest cases, the computations generally require a computer. One simple example, under section 483, rather than the Original Issue Discount rules, suffices to illustrate the principle.

Assume that Seller (S) sells a horse held for breeding purposes for more than twenty-four months but on which no ACRS deductions have been claimed.²⁹⁰ S's basis in the horse is \$20,000 and the sales price is \$100,000. S receives no payment at the time of sale but the buyer delivers a promissory note in the principal amount of \$100,000, with five percent interest per year, payable in four annual installments of \$28,201, the first installment due one year from the date of the sale. Using the nine percent test rate under I.R.C. section 1274A, the present value of the four payments would be \$90,959. This then is the amount realized on the sale and S recognizes only \$70,959 of section 1231 gain while receiving \$21,845 of interest income. If the transaction was recognized as structured with five percent interest per year, S would recognize \$80,000 of I.R.C. section 1231

²⁸⁹ I.R.C. § 1274A(c).

²⁹⁰ See note 160 *supra* regarding the reasons that a horse might be held for breeding purposes for two years without claiming ACRS deductions.

gain and only \$12,804 of interest income. As restructured, however, instead of a profit ratio of .80 percent for purposes of installment reporting of the gain, the profit ratio is reduced to .78 percent. Furthermore, because the unstated interest is treated as accruing economically, the payments are treated as follows for tax purposes.

Table I

YEAR	PAYMENT	PRINCI- PAL	INTEREST	SECTION 1231 GAIN
1	\$28,201	\$19,828	\$8,373	\$15,466
2	28,201	21,653	6,548	16,890
3	28,201	23,647	4,554	18,444
4	28,201	25,825	2,378	20,142

If the transaction could be reported for tax purposes as a sale at \$100,000, with the deferred payments bearing interest at only five percent, compounded annually, the payments would be reported as follows.

YEAR	PAYMENT	PRINCI- PAL	INTEREST	SECTION 1231 GAIN
1	\$28,201	\$23,201	\$5,000	\$18,561
2	28,201	24,361	3,840	19,489
3	28,201	25,579	2,622	20,463
4	28,201	26,858	1,343	21,486

Careful comparison of these tables reveals that the unstated interest rules not only recharacterize as ordinary income what would otherwise be I.R.C. section 1231 gain, but also result in an acceleration of income inclusion. After recharacterization and economic accrual of the unstated interest, a greater proportion of the total gross income to be recognized upon receipt of all of the payments is recognized as the earlier payments are received, and a relatively smaller percentage of the later payments is includable in gross income. This effect, however, is not easily avoided. In order to restructure the transaction to avoid the unstated interest rules, the payments would have to be treated expressly as the unstated interest rules require, unless the buyer is willing to increase his aggregate payments by actually paying

adequate stated economic interest.

10. *Tax Finance Benefits of Installment Sales*

It is a mistake to view installment reporting merely as a method of ameliorating the impact of progressive marginal tax rates or the perceived hardship of paying taxes on a gain in a year prior to the year in which the profit is reduced to cash.²⁹¹ Deferred payment sales reported on the installment method increase the seller's after tax yield on the reinvestment of the proceeds from the sale of the property. In this context, the sales proceeds are viewed economically as received at the time of the sale and then as reinvested in a debt instrument issued by the buyer. Deferred reporting of the gain on the sale enables the seller to make a larger investment and thereby earn more interest than he could have earned had he not deferred the payment of taxes attributable to the gain. In short, the investor comes out ahead by an amount equal to the after tax interest earned during the period of deferral on the portion of the amount realized owed for the taxes due on the sale.

This may be illustrated with a simple example. Assume that Seller (S), a cash basis taxpayer, agrees to sell a horse with a zero basis to Buyer (B) for a sales price of \$100,000. The horse was previously depreciated by S, and the entire gain will be ordinary income under section 1245. B offered either to pay the full \$100,000 in cash at the time of the sale or to defer payment for two years, with interest compounded semiannually at nine percent, resulting in a single lump sum payment of \$119,252 two years later. If S were in the thirty-three percent marginal tax bracket and he received the entire payment at the time of the sale, he would have only \$66,667 to invest. If this amount were invested in an interest bearing obligation, such as a United States government security, at ten percent per year compounded annually, at the end of two years, after paying taxes on the interest,

²⁹¹ The purpose of allowing installment reporting of gains from the sale of property has been viewed as both relief from the burden of paying taxes on the entire gain when only a small portion is received in cash and avoidance of the complexities of determining the fair market value of the buyers obligations. See *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 503 (1948); S. REP. No. 52, 69th Cong., 1st Sess. (1926), reprinted in 1939-1 (Part 2) C.B. 332, 346.

S would have \$75,857. This reflects a six and two-thirds percent after tax yield on his investment. On the other hand, if he took the deferred payment arrangement, after paying taxes on the payment he would have \$79,899.²⁹² The after tax yield on the investment is increased to 9.475 percent by accepting the deferred payment terms, even though the interest offered by B was only 9.2025 percent per year and S could obtain ten percent interest elsewhere.

E. Transfer to a Partnership or Syndicate

1. General Principles

A sale of a horse to a partnership or syndicate of which the seller is a member or share owner is treated the same as any other sale. Gain or loss is recognized according to the normal rules,²⁹³ and installment reporting is allowed. If, however, the seller has more than a fifty percent interest in either the profits or capital of the partnership, no loss may be recognized.²⁹⁴ If the horse is depreciable in the hands of the partnership and the seller has an eighty percent or more interest in either the partnership profits or capital, installment reporting of any gain is proscribed.²⁹⁵ If the seller has more than an eighty percent interest in either capital or profits, all of the gain is recognized as ordinary income.²⁹⁶ A transfer of a horse to a partnership in exchange for a partnership interest, however, generally is a non-recognition event, but there are some pitfalls.

²⁹² Under the terms of this particular deferred payment sale there is no original issue discount, and because the seller is on the cash basis of reporting, the entire amount, including interest earned but not payable in earlier years, is reportable in the year received.

²⁹³ I.R.C. § 707(a)(1); Treas. Reg. § 1.707-1(a) (1985).

²⁹⁴ I.R.C. § 707(b)(1); Treas. Reg. § 1.707-1(b)(1). The attribution rules of I.R.C. § 267(c), with the exception of subsection (c)(3), are applied to determine ownership of partnership interests under this proscription. I.R.C. § 707(b)(3); see Treas. Reg. § 1.707-1(b)(3).

²⁹⁵ I.R.C. § 453(g)(1). See text accompanying note 248 *supra*.

²⁹⁶ I.R.C. § 707(b)(2); Treas. Reg. § 1.707-1(b)(2). The attribution rules of I.R.C. § 267(c), except subsection (c)(3) apply to determine ownership. I.R.C. § 707(b)(3). Technically, the rule extends to any property that is not a capital asset in the hands of the transferee. In the context of this Article it is important only in that it includes depreciable assets.

Neither gain nor loss is recognized on the contribution of property to a partnership solely in exchange for a partnership interest.²⁹⁷ This rule applies even if the contributor has claimed ACRS deductions and would otherwise recognize depreciation recapture on the disposition of the horse.²⁹⁸ As a result of this nonrecognition, the contributing partner takes a basis in his partnership interest equal to the adjusted basis of the property transferred to partnership.²⁹⁹ The partnership's basis in the property is equal to the transferor's adjusted basis immediately prior to the transfer.³⁰⁰ Because the partnership's basis is determined with reference to the transferor's basis, any depreciation recapture potential in the property at the time of transfer carries over to the partnership.³⁰¹ The rules for allocating gain or loss among partners, however, will cause that depreciation recapture to be allocated to the transferor partner when it ultimately is recognized.³⁰²

If the property transferred to the partnership is encumbered by a lien in excess of the transferor's basis, the transferor may be required to recognize gain as a result of the transfer of the property and the concomitant relief from that portion of the liability that is allocated to the other partners. The rules for determining the amount of gain to be recognized are complex and fact specific and will not be examined in detail.³⁰³ Rather, a simple example illustrates how these rules are applied to a particular set of facts.

Assume that A and B desire to form a partnership for the purpose of breeding horses. A contributes a broodmare with a basis of \$20,000 and a fair market value of \$110,000, subject to a lien of \$80,000. The recomputed basis of the mare is \$100,000. If the mare was sold, \$80,000 of the gain is section 1245 recap-

²⁹⁷ I.R.C. § 721(a); Treas. Reg. § 1.721-1.

²⁹⁸ I.R.C. § 1245(b)(3); Treas. Reg. § 1.1245-4(c)(1), (2)(vi).

²⁹⁹ I.R.C. § 722; Treas. Reg. § 1.722-1 (1985).

³⁰⁰ I.R.C. § 723; Treas. Reg. § 1.723-1 (1985).

³⁰¹ I.R.C. § 1245(A)(2); Treas. Reg. § 1.1245-2(c)(1), (2)(i), (ii)(b).

³⁰² I.R.C. § 704(c).

³⁰³ See Treas. Reg. § 1.722-1, Example(2). This results from the complex interrelationship of I.R.C. §§ 705 (1986), 721, 722, 731 (1986), 733 (1986), 741 (1986), and 752, and Treas. Reg. § 1.752-1(e). See generally MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 4.03-.05.

ture income and the balance is section 1231 gain. B contributes \$30,000; A and B become equal partners. As a result of the contribution A is relieved of \$40,000 of the lien debt on the horse; B as an equal partner is now responsible for the other \$40,000. As a result, A must recognize a gain of \$20,000, the amount by which his relief from debt exceeded the basis of the property contributed to the partnership in exchange for his interest. Furthermore, the regulations provide that this gain is ordinary income because there would be \$80,000 of section 1245 gain if the horse had been sold.³⁰⁴ If the contributed property were not subject to depreciation recapture, the gain would have been capital gain.³⁰⁵

2. *Formation of Partnership With Services Partner*

Nonrecognition of gain on the contribution of property to a partnership in exchange for a partnership interest is not universal. The Treasury Regulations specifically provide that “[t]o the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply.”³⁰⁶ The application of this regulation is illustrated in *McDougal v. Commissioner*.³⁰⁷

a. *Subchapter K and the “Common Law” Approach*

McDougal purchased a racehorse named Iron Card for \$10,000, and promised McClanahan that if the latter would train the horse, after McDougal had recovered the cost and expenses of acquisition, he would transfer a one-half interest in the horse to McClanahan. In addition, McClanahan would receive a trainer’s fee.

³⁰⁴ Treas. Reg. § 1.1245-4(c)(1), (c)(2)(i), (c)(4), Example (3). There is a theoretical inconsistency between this result and the manner in which the mechanics of the operation of Subchapter K give rise to the gain, but the issue raised by this problem has been neither addressed nor resolved. See MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 4.05.

³⁰⁵ I.R.C. §§ 731(a); 741.

³⁰⁶ Treas. Reg. § 1.721-1(b)(1) (1960). Identical language appears in Prop. Reg. § 1.721-1(b)(1) (1971).

³⁰⁷ 62 T.C. 720 (1974)(*acq.*).

McClanahan trained Iron Card, who proved to be successful on the track, and nine months later, McDougal transferred a one half interest in Iron Card to McClanahan. Shortly thereafter, McDougal and McClanahan entered into an oral partnership to race Iron Card and later hold him as a stud. They continued to race Iron Card until he was retired to stud due to injury.

McDougal claimed that the transfer of the one-half interest in Iron Card was a recognition event and reported a \$25,000 section 1231 gain, basing the amount realized on a contemporaneous third party offer to purchase Iron Card for \$60,000. McDougal also claimed a \$30,000 deduction as a result of the transfer. McClanahan reported the receipt of \$30,000 of income, and the partnership increased its basis in Iron Card to \$35,000 (minus depreciation claimed by McDougal for the period prior to the transfer). The Commissioner argued that the transaction was a nonrecognition event and that the partnership took McDougal's basis in Iron Card.

Although the oral partnership was not finalized at the time, the Tax Court agreed that for income tax purposes a partnership had been formed at the time of the transfer.³⁰⁸ The court nevertheless disagreed with the Commissioner's argument and found the transfer to be a recognition event. Citing the regulation quoted above, the court found that the transfer should be taxed as if McDougal first transferred an undivided one half of the horse to McClanahan and they both then contributed their undivided one halves to form the partnership.³⁰⁹ While the later transfers were nonrecognition events under section 721, the former transfer was clearly a recognition event. Under established precedent, McDougal properly recognized the gain,³¹⁰ and under the regulations, he properly claimed the deduction.³¹¹ Consequently, McClanahan recognized \$30,000 of income, and had a \$30,000 basis in his

³⁰⁸ *Id.* at 724. See text accompanying notes 181-87 *supra*, regarding the standards for determining if co-ownership of a horse constitutes a partnership between the co-owners.

³⁰⁹ *Id.* at 725 (citing Treas. Reg. § 1.721-1(b)(1)).

³¹⁰ *Id.* at 726 (citing *United States v. Davis*, 370 U.S. 65 (1962)); *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940), *aff'g*, 40 B.T.A. 824 (1939). See also *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943).

³¹¹ 62 T.C. at 728 (citing Treas. Reg. § 1.721-1(b)(2)). See also *International Freighting Corp.*, 135 F.2d 310.

undivided one-half interest.³¹² When he transferred that interest in Iron Card to the partnership, the partnership succeeded to his basis.³¹³

b. *Section 83 Approach*

The Tax Court clearly was correct in all aspects of its *McDougal* decision. Section 83 and the Treasury Regulations implementing it express the principles applied in *McDougal* even more clearly than the court did there.³¹⁴ Under section 83 the fair market value of property transferred in consideration of services is gross income to the recipient to the extent that the value of the property exceeds any purchase price paid by the transferee.³¹⁵ Inclusion, however, may be deferred if the transferee's rights in the property are restricted by nontransferability or a substantial risk of forfeiture.³¹⁶ Concomitantly, subject to the capitalization rules of section 263, in the same year, the transferor is allowed a deduction equal to the amount included by the transferee. If the transferee paid no consideration, that amount is the fair market value of the property.³¹⁷ The transferor must, however, treat that same amount as the amount realized on the sale or exchange of the transferred property and recognize gain or loss accordingly.³¹⁸ As a result, the transferor may recognize section 1231 income and an ordinary deduction. If the transferor has any basis in the property, the deduction will be larger than the income, even before taking into account the capital gain preference attaching to net section 1231 gains. These rules apply to all transfers of property in consideration for services, whether in the context of

³¹² See Treas. Reg. § 1.61-2(d)(2).

³¹³ I.R.C. § 723.

³¹⁴ See Treas. Reg. §§ 1.83-1 - 1.83-2 (1978); § 1.83-3; § 1.83-8 (1978); Prop. Reg. § 1.721-1(b)(1) (1971).

³¹⁵ I.R.C. § 83(a); Treas. Reg. § 1.83-1(a)(1).

³¹⁶ I.R.C. § 83(a), (c); Treas. Reg. §§ 1.83-1(a)(1), -3(b), (c), (d). The recipient may elect to include currently the fair market value of the property even though it is nontransferable or subject to a substantial risk of forfeiture. I.R.C. § 83(b); Treas. Reg. § 1.83-2.

³¹⁷ I.R.C. § 83(h); Treas. Reg. § 1.83-6(a).

³¹⁸ Treas. Reg. § 1.83-6(b). See MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 13.03[5].

the formation of a partnership, an ongoing employment relationship, or the engagement of an independent contractor.³¹⁹ It is worth noting, as held in *McDougal*, in forming a partnership, both the gain and deduction should be allocated entirely to the partner or partners surrendering an interest in the property³²⁰ and should not be allocated under the general partnership provisions otherwise applicable to income and loss.³²¹

The principles applied in *McDougal*, and now expressed in section 83, are not always applied as in that case. For example, if the trainer acquired only a right to future profits, such as racing purses or stud fees rather than a capital interest, the transfer probably would not be a recognition event for the transferor of the horse. Although the trainer theoretically may have a recognition event,³²² in all likelihood it would be impossible to value his profits interest and, therefore, he would not be required to recognize any gain.³²³ On the other hand, if the horse in *McDougal* had not commenced its racing career, the training expenses might have been treated as a capital expense rather than a deductible item.³²⁴ In that case, although gain would be recognized on the first transfer, no deduction would be allowed.³²⁵ The partnership would presumably capitalize the amount realized as an addition

³¹⁹ Treas. Reg. § 1.83-1(a); Prop. Reg. 1.721-1(b)(1).

³²⁰ See I.R.C. § 706(d)(1) (requiring that each partner's share of any item of income, gain, loss, deduction or credit of the partnership be determined in accordance with his varying interests if there was any change in any partner's interest during the year); MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 5.03[1][d], [2].

³²¹ See I.R.C. § 704(a), (b); I.R.C. § 704(c).

³²² See *Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974); MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 5.05 - .06.

³²³ See *Vestal v. United States*, 498 F.2d 487 (8th Cir. 1974) (receipt of limited partnership interest in partnership, the sole asset of which was oil and gas rights in then unproductive, but proven, field, was not currently taxable because value of rights was speculative; on rehearing the court found no inconsistency with *Diamond*, *supra* note 322); *St. John v. United States*, 84-1 U.S.T.C. ¶ 9158 (C.D. Ill. 1983) (applying I.R.C. § 83, based on liquidation value of profits interest at time of receipt, the fair market value of an interest only in future partnership profits was zero). See also Gen. Couns. Mem. 36,346 (July 25, 1977).

³²⁴ *Journal Box Serv. Corp. v. United States*, 9 A.F.T.R.2d (P-H) 798 (S.D. Ind. 1962). Expenses of continuing training of a horse during its racing career are currently deductible. See *Hill v. Commissioner*, 26 T.C.M. (CCH) 1287 (1967). See also text accompanying note 83 *supra*.

³²⁵ See I.R.C. § 707(c); Treas. Reg. §§ 1.83-6(a)(4), 1.707-1(c). See also Rev. Rul. 75-214, 1975-1 C.B. 185.

to the horse's cost basis to be recovered through ACRS deductions. If the horse were transferred in consideration of services that did not relate to the horse, the amount would be capitalized or deducted using the same standards that would apply if the payment for the services were made in cash.³²⁶

3. *Receipt of Cash by Transferor to Partnership or Syndicate*

It should be apparent from *McDougal* that proceeds realized upon syndication of a horse should be treated as an amount realized upon the sale of the horse, regardless of the form of the transaction. This conclusion is clear, even without *McDougal*, if the syndicate is not a partnership.³²⁷ If the syndicate is a partnership, *McDougal* makes it clear that the form of the transaction should not govern over substance. Regardless of whether the syndicator is paid directly by purchasers of shares or whether the purchasers "contribute" money to the syndicate for a share followed shortly by a partnership distribution to the syndicator, the transaction should be treated as the sale of an undivided interest in the horse by the syndicator to the shareholder, with the shareholder then contributing his undivided share to the syndicate-partnership. Although this analysis may have been called into question by the decision in *Otey v. Commissioner*,³²⁸ the 1984 amendments to section 707 adding subsection (a)(2)(B)³²⁹ clearly call for treatment of the transaction as a sale, if not to the shareholders, then to the partnership.³³⁰ In any event, the syndicator recognizes gain and the syndicate-partnership steps up its basis in the horse, except with respect to the share attributable to the syndicator-seller.

³²⁶ See MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 13.03[4].

³²⁷ See text accompanying notes 191-95 *supra*. See text accompanying notes 181-87 *supra* regarding the standards for determining whether a syndicate is co-ownership or a partnership for income tax purposes.

³²⁸ 70 T.C. 312 (1978), *aff'd per curiam*, 634 F.2d 1046 (6th Cir. 1980).

³²⁹ Tax Reform Act of 1984, Pub. L. No. 98-369, § 73(a), 98 Stat. 494, 591 (1984).

³³⁰ See S. REP. No. 169, 98th Cong., 2d Sess. 223-32 (1984); H.R. REP. No. 432, 98th Cong., 2d Sess. 1216-21 (1984); H.R. REP. No. 861, 98th Cong., 2d Sess. 859-62 (1984); STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 223-26, 231-33.

II. LIKE KIND EXCHANGES OF HORSES

A. *General Principles*

1. *Nonrecognition of Gain and Substituted Basis*

Section 1031(a) provides that, "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." Furthermore, section 1245(b)(4) expressly subordinates depreciation recapture under section 1245 to nonrecognition under section 1031.

The nonrecognition provided by section 1031, is not permanent; recognition of gain or loss, including depreciation recapture, merely is deferred. This deferral is implemented by section 1031(d), which provides that the basis of property received in an exchange is the same as the basis of the property surrendered.³³¹ The deferred gain is realized either through gain recognized on the sale of the property acquired in the exchange or the increase in future taxable income, effected by the reduced ACRS allowances claimed on the section 1031(d) substituted basis, rather than a basis equal to the fair market value of the property received. Thus, for example, if a horse owner exchanges a horse with a basis of \$10,000 and a fair market value of \$100,000 for another horse of like kind, no gain is recognized. The basis of the horse received in the transaction, however, is only \$10,000. If the second horse were sold for \$100,000, the seller would recognize a gain of \$90,000. In determining the character of the gain, the holding period of the first horse is tacked onto the holding period of the second horse.³³² Thus, if the first horse was held for twenty months prior to the exchange, the horse received in the exchange need only be held for more than four months prior to sale to qualify for section 1231 treatment.³³³ The recomputed basis of the

³³¹ See Treas. Reg. § 1.1031(d)-1(a) (1986).

³³² I.R.C. § 1223(1).

³³³ See text accompanying notes 138-48 *supra*.

second horse, however, includes all ACRS deductions claimed on the first horse,³³⁴ and to the extent of prior ACRS deductions claimed on both horses, the gain is recharacterized as ordinary income.

As a result of the tacked holding period and substituted basis assigned to the horse received in an exchange, the ACRS cost recovery period for the horse is merely a continuation of the recovery period of the horse surrendered, with cost recovery deductions continuing under the same method over the remaining recovery period.³³⁵

Nonrecognition also extends to an exchange in which the taxpayer surrenders property plus cash in exchange for property of like kind. In such a case the additional cash payment results in an increase in the basis of the property received.³³⁶ Thus, if the taxpayer exchanges a horse with a basis of \$10,000 plus \$20,000 in cash for a horse of like kind, the basis of the horse received in the exchange is \$30,000. The value of either horse is not relevant.

When section 1031 applies, nonrecognition is mandatory, not elective. Thus, if a horse with a basis of \$30,000 and a fair market value of \$10,000 is exchanged for a horse of like kind with a value of only \$10,000, the \$20,000 loss realized by the transferor may not be recognized. The horse acquired in the exchange takes a \$30,000 basis and the loss is recognized on the sale of the second horse or through claiming ACRS deductions on the second horse computed on the \$30,000 basis. The loss is easily recognized, however, by selling the first horse and then purchasing the second horse. Section 1031 does not apply to the sale of property followed by reinvestment of the proceeds in like kind property, even if the reinvestment is immediate.³³⁷ If the sale and purchase are interrelated, however, the IRS may be able to apply I.R.C. section 1031 to deny a loss claimed by the taxpayer where the transaction was artificially structured to attempt to evade nonrecognition of

³³⁴ I.R.C. § 1245(a)(2); Treas. Reg. § 1.1245-2(c)(4) (1986).

³³⁵ See Prop. Reg. § 1.168-5(f)(2) (1984).

³³⁶ Treas. Reg. § 1.1031(d)-1(a) (1956).

³³⁷ See *Carlton v. United States*, 385 F.2d 238 (5th Cir. 1967) (gain recognized on sale of property followed by immediate prearranged reinvestment of proceeds in like kind property).

the loss.³³⁸ Such a restructuring of the transaction should apply, however, only where the the first horse is sold to the same person from whom the second horse was purchased, and where neither transaction would have occurred in the absence of the other.³³⁹

2. *Eligibility for Nonrecognition*

Nonrecognition of gain on exchanges of like kind property is circumscribed by a number of restrictions. Section 1031(a)(1), in setting forth the nonrecognition rule, limits its availability to the exchange of property "held for productive use in a trade or business or for investment" for other like kind property "to be held either for productive use in a trade or business or for investment."³⁴⁰ Subsection (a)(2) lists specific exclusions from the scope of section 1031. Most notable among the exclusions is "stock in trade or property held primarily for sale."³⁴¹ Thus, section 1031 generally is not available for the exchange of a yearling or weanling by a breeder. If, however, the breeder can demonstrate that the particular yearling or weanling was held for investment or for future breeding or sporting purposes, section 1031 is available. Proving such intent, however, may be difficult.³⁴² If the breeder holds the horse until it is two years old or older, facts may show an intent to hold the horse for breeding or racing.³⁴³ In general, if the taxpayer would recognize ordinary income, rather than section 1231 gain (or section 1245 recapture) or capital gains if the horse were sold rather than exchanged, then nonrecognition under section 1031 is not available.³⁴⁴

³³⁸ Rev. Rul. 61-119, 1961-1 C.B. 395. See *Red Wing Carriers, Inc. v. Tomlinson*, 399 F.2d 652 (5th Cir. 1968) (sale of used trucks to dealer and purchase of new trucks from same dealer under separate but mutually dependent contracts). *But see Swaim v. United States*, 45 A.F.T.R.2d 1276 (N.D. Tex. 1979) (sale and purchase from buyer were separate transactions).

³³⁹ See *Bell Lines, Inc. v. United States*, 480 F.2d 710 (4th Cir. 1973).

³⁴⁰ I.R.C. § 1031(a)(1).

³⁴¹ I.R.C. § 1031(a)(2).

³⁴² *But see Woodbury v. Commissioner*, 49 T.C. 180 (1967) (*acq.*).

³⁴³ See *Margolis v. Commissioner*, 337 F.2d 1001 (9th Cir. 1964) (dealer in real estate allowed I.R.C. § 1031 nonrecognition on exchange of selected properties held for rental); *Wylie v. United States*, 1968-1 U.S.T.C. ¶ 9286 (N.D. Tex. 1968) (exchange of breeding cattle); *Jewel v. Commissioner*, 25 T.C. 109 (1955) (taxpayer in business of selling horses allowed I.R.C. § 1231 gains on horses held for breeding and racing).

³⁴⁴ See text accompanying notes 108-37, 157-73 *supra* for a detailed discussion of

It is worth noting that section 1031(b)(1) excludes from the ambit of nonrecognition an exchange involving property held "primarily for sale", in contrast to the language of I.R.C. section 1221(1) which excludes from the definition of capital asset property held "primarily for sale to customers in the ordinary course of business." The Tax Court has given express effect to this difference by denying to a taxpayer who was not a dealer in real estate nonrecognition on the exchange of real estate acquired for the purpose of renovation and sale.³⁴⁵ The gain recognized on the exchange was, nevertheless, capital gain. In a similar vein, the limiting language in subsection (a) has been interpreted by the IRS to deny nonrecognition on a like kind exchange followed by a contribution to a corporation in a section 351 transaction of property received in the exchange.³⁴⁶ In *Magneson v. Commissioner*,³⁴⁷ however, nonrecognition was allowed when the property received in the like kind exchange was contributed to a partnership for a general partnership interest. A crucial factor to the result was that the other property of the partnership was predominantly like kind to the contributed property.

Simply because a horse is not held primarily for sale does not mean that it is held for one of the purposes specified in section 1031(a). A horse held for use in an activity that is not conducted for profit may not be exchanged in a like kind exchange subject to nonrecognition under section 1031.³⁴⁸ These use requirements apply separately to each taxpayer involved in the exchange, and the other taxpayer's prior use of the horse previously owned by him and future use of the horse to be obtained by him are irrelevant. Only the prior use of the horse surrendered and the future use of the horse received are considered. Both taxpayers' uses, however, may bear on whether the horses are "like kind."³⁴⁹ Nevertheless, in some instances, the prior use of a horse by one taxpayer could exclude that taxpayer, but not the other, from

the factors used to determine whether horses are held primarily for sale, or for breeding or sporting purposes.

³⁴⁵ *Black v. Commissioner*, 35 T.C. 90 (1960).

³⁴⁶ Rev. Rul. 75-292, 1975-2 C.B. 333.

³⁴⁷ 81 T.C. 767 (1983), *aff'd*, 753 F.2d 1490 (9th Cir. 1985).

³⁴⁸ See Rev. Rul. 59-229, 1959-2 C.B. 180 (exchange of real property held for personal use not within I.R.C. § 1031).

³⁴⁹ See text accompanying notes 351-77 *infra*.

nonrecognition under section 1031. For example, if a taxpayer in the business of racing horses exchanged a three year old colt previously raced by him with a taxpayer who was a dealer in horses, for a three year old colt that would be held for racing by the first taxpayer, the taxpayer engaged in racing would have a nonrecognition transaction while the dealer would be required to recognize gain or loss on the exchange.

Section 1031(a)(2) lists a variety of other types of property which are excluded from nonrecognition under section 1031.³⁵⁰ Except for the exclusion of exchanges of partnership interests, none are particularly relevant here.

B. Identifying Horses of Like Kind

1. Same Sex Requirement

Determining whether two horses are of like kind for purposes of section 1031 is difficult because there is little authority interpreting the meaning of "like kind" in this or any closely analogous context. One thing, however, is clear; section 1031(e) expressly provides that livestock of different sexes are not property of like kind. Thus, an exchange of a broodmare for a stallion or a colt for a filly can never be a like kind exchange. Although Congress may not have had the exchange of racehorses in mind when enacting this section,³⁵¹ this proscription of the Code is so clear and unambiguous that there can be no doubt that a filly and a colt, although both held for racing, are not like kind.³⁵²

2. Relevance of Purpose for Which Horses of the Same Sex are Held

The Treasury Regulations provide that the term "like kind" has "reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not

³⁵⁰ I.R.C. § 1031(a)(2) excluded property includes stocks, bonds, notes, securities, certificates of trust or beneficial interest and choses in action.

³⁵¹ See text accompanying note 361 *infra*.

³⁵² See *Greenwood v. United States*, 350 U.S. 366, 374 (1956) ("[T]his is a case for applying the canon of construction of the wag who said, when the legislative history is doubtful, go to the statute." The case involved interpretation of a criminal statute.).

. . . be exchanged for property of a different kind or class.”³⁵³ Although this standard has been interpreted extensively relative to real estate exchanges,³⁵⁴ there is sparse interpretation with respect to any livestock.³⁵⁵ Any attempt to apply the standards developed with respect to real estate exchanges may be hazardous. As far as real estate is concerned, both the IRS and the courts, based on substantial support from specific examples in the Regulations,³⁵⁶ generally have taken the position that “real estate is real estate.” They have gone so far as to conclude that an exchange of improved urban real estate and a mineral interest, treated as real property under state law, was entitled to nonrecognition under section 1031.³⁵⁷ The specific business or investment purpose for which the real property was held generally has been considered to be irrelevant.

When personal property is involved, however, the words “like kind” often have been construed more narrowly, and one cannot say confidently that “a horse is a horse.” The only examples of like kind exchanges of personal property set forth in the regulations are the exchange of a used automobile for a new automobile and the exchange of a used truck for a new truck.³⁵⁸ Thus it is reasonable to conclude that a difference in the ages of the horses alone will not prevent them from being like kind. A difference in the ages of horses, however, sometimes results in the horses being put to different uses. As a result, determining whether the horses are “like kind” may be more difficult. The difficulty of deter-

³⁵³ Treas. Reg. § 1.1031(a)-1(b).

³⁵⁴ See 2 B. BITTKER, *supra* note 44, at ¶ 44.2.2 for a discussion of the principles that have evolved for identifying like kind real estate and for citations to leading cases.

³⁵⁵ See *Woodbury v. Commissioner*, 49 T.C. 180 (1967); *Wylie v. United States*, 1968-1 U.S.T.C. ¶ 9286 (N.D. Tex. 1968) (exchange of steer calves for registered Aberdeen Angus livestock in a year prior to enactment of I.R.C. § 1031(e)); *Rutherford v. Commissioner*, 37 T.C.M. (CCH) 1851 (1975) (exchange of three-quarter blooded heifers for one-half blooded heifers).

³⁵⁶ See Treas. Reg. § 1.1031(a)-1(b) (“The fact that any real estate involved is improved or unimproved is not material . . .”); -1(c)(2) (exchange of city real estate for a ranch or farm, improved for unimproved real estate, or a fee interest for a leasehold with more than thirty years to run are all accorded nonrecognition).

³⁵⁷ See *Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941).

³⁵⁸ Treas. Reg. § 1.1031(a)-1(c)(2). For a discussion of the cases and Revenue Rulings determining whether exchanges of personalty constitute “like kind” exchanges, see Goldstein & Lewis, *Tax Treatment of Like Kind Exchanges of Property Used in a Trade or Business or for Investment*, 5 REV. TAX. IND. 191, 221-23 (1981).

mining the scope of the term "like kind" as applied to horses, and most other personalty for that matter, is compounded by the recently developed view of the IRS that the purpose for which the taxpayer held the property surrendered and will hold the property received is relevant. This approach has been applied most notably in a series of Revenue Rulings dealing with exchanges of gold coins.³⁵⁹ In these rulings the IRS has taken the position that coins, the value of which is determined by bullion content, and coins, the value of which is determined by numismatic considerations, are not like kind because they are held for different purposes. According to the rulings this logic emanates from the legislative history of section 1031(e).³⁶⁰

In enacting section 1031(e) Congress sought to halt the practice of exchanging slaughter cattle (i.e., steers) for female cattle to be held for breeding purposes.³⁶¹ Congress was concerned that the practice of exchanging steers for female breeding cattle would allow the building of a breeding herd without tax consequences. Congress sought to foreclose the avoidance of ordinary income on the sale of steers that would occur by allowing such a transaction to come within section 1031. The Committee Reports state that allowing nonrecognition for such exchanges was erroneous under then current law: "[w]hen male calves are exchanged for female calves, the exchange does not involve like-kind property since the male animals are not held for breeding purposes and, in fact are not of a 'like-kind' with females."³⁶²

Basing the availability of nonrecognition under section 1031 on the purpose for which the taxpayer holds the property is

³⁵⁹ Compare Rev. Rul. 79-143, 1979-1 C.B. 264 and Rev. Rul. 82-96, 1982-1 C.B. 113 and *California Fed. Life Ins. Co. v. Commissioner*, 76 T.C. 107 (1981) (United States double eagle gold coins and Swiss francs are not like kind) with Rev. Rul. 76-214, 1976-1 C.B. 218 (exchange of peso bullion type coins for corona bullion type coins was like kind exchange).

³⁶⁰ This logic has led Boris Bittker to comment, "[the] ruling does not state which type [of coins] is masculine and which feminine." 2 B. BITTKER, *supra* note 44, at ¶ 44.2.2, n.11 (1981).

³⁶¹ See S. REP. NO. 552, 91st Cong., 1st Sess. 102 (1969), reprinted in 1969-3 C.B. 488-89; H.R. REP. NO. 413, 91st Cong., 1st Sess. 66 (1969), reprinted in 1969-3 C.B. 200, 241-42.

³⁶² S. REP. NO. 552, 91st Cong., 1st Sess. 102 (1969), reprinted in 1969-3 C.B. 488-89; H.R. REP. NO. 413, 91st Cong., 1st Sess. 66 (1969), reprinted in 1969-3 C.B. 200, 241-42.

consistent with the general theory of the inclusion of nonrecognition provisions in the Code. The Treasury Regulations promulgated under section 1002 state, with respect to the nonrecognition provisions, that "[t]he underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated"³⁶³

Applying this to horses, the question is whether the exchange of a horse held for breeding purposes for a horse held for racing purposes is more properly described as the old investment continued or as a liquidation of the old investment and a reinvestment in the newly acquired horse. Because the risks and profit potentials of breeding and racing differ, the transaction may be said to more nearly resemble a liquidation and reinvestment. Therefore, the exchange of a horse held for racing with another horse held for breeding probably should not be treated as a like kind exchange.

Facially, however, it appears that exchanges of personalty should be judged under the same criteria as are exchanges of real estate, because the statute makes no distinction between realty and personalty. Exchanges of real estate held for different purposes and entailing substantially different risks routinely are accorded like kind exchange treatment.³⁶⁴ From this perspective, against only the statute and the broad rationale for nonrecognition, one might reasonably conclude that the error lies in the latitude accorded to exchanges of real estate, not in restrictions imposed on exchanges of personalty. But we are not writing on a clean slate, and applying consistent criteria has merit. From this perspective, the gold coin rulings may be reconciled as transactions that were closer to sales since bullion coins are essentially a medium of payment. This was not, however, the logic employed in those rulings.

If this logic is accepted, the exchange of a filly held for racing for a broodmare, and the exchange of a colt held for racing for a stallion, would both qualify as like kind exchanges. There is, however, some basis for believing that the IRS may take a dif-

³⁶³ Treas. Reg. § 1.1002-1(c) (1960). See also *Century Elec. Co. v. Commissioner*, 192 F.2d 155, 159 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952).

³⁶⁴ See Goldstein & Lewis, *supra* note 358, at 223-26.

ferent view. In a 1971 private letter ruling the IRS concluded that the exchange of two five-year-old geldings for a "one-year-old stallion" was not a like kind exchange. The stated rationale for this conclusion was, "[s]ince a gelded horse can never be used for breeding purposes an exchange of such an animal for a stallion, which is used for breeding and other purposes, does not involve property of a like kind."³⁶⁵ On the other hand, this ruling might be confined to geldings on the theory that there exist three sexes of horse—male, female, and gelding. The absolute inability to use the gelding for breeding purposes renders him not like kind with any colt or stallion. A horse currently held for racing, however, can be said to be held for two purposes—current racing and future breeding.³⁶⁶ Because fillies and colts have breeding potential while being held for racing, the exchange of a filly for a broodmare and the exchange of a colt for a stallion might be considered to be like kind without regard to the current use of the horse. Furthermore, because of the uncertainty surrounding when a horse will be retired from racing for breeding, administrative considerations may warrant ignoring the difference between use in racing and breeding as long as the horses are of the same sex.

3. *Horses of Different Breeds*

An exchange of horses of different breeds should not be excluded *per se* from the ambit of section 1031 nonrecognition.³⁶⁷ Nevertheless, such an exchange might not qualify for nonrecognition under other applicable standards. This especially is true if the different uses of horses precludes their exchange without recognition under I.R.C. section 1031. But even if that standard did not apply, most breeds are used in activities not engaged in for profit, and section 1031 is unavailable in any event. Probably the most difficult question that arises if the exchange of horses

³⁶⁵ Priv. Ltr. Rul. 7110050290.

³⁶⁶ See *Gamble v. Commissioner*, 68 T.C. 800 (1977); *McDougal v. Commissioner*, 62 T.C. 720 (1974).

³⁶⁷ *Wylie*, 1968-1 U.S.T.C. ¶ 9286 (exchange of steer calves for registered Aberdeen Angus livestock qualified for nonrecognition in a year prior to enactment of I.R.C. § 1031(e)); *Rutherford*, 37 T.C.M. (CCH) 1851, 1851-77 (exchange of three-quarter blooded heifers for one-half blooded heifers was like kind exchange).

held for different purposes is not sheltered from recognition by section 1031 is whether a standardbred held for racing or breeding is like kind with a thoroughbred held for racing or breeding. The answer is entirely problematical, and the structure of the industry is such that the question is not likely to be answered soon.

4. *Mares in Foal*

An exchange involving a mare in foal presents difficult problems. If only one of the mares is in foal, the initial question is whether a mare in foal is like kind to a mare that is not in foal. Although there is no authority providing any guidance, logic appears to dictate that the mares themselves are like kind,³⁶⁸ and the real issue concerns the treatment of the unborn foal. If this is true, then the issues generally will be the same regardless of whether one or both of the mares involved in the exchange is in foal. If the unborn foal is treated as separate from the mare carrying it, should the foal be treated as boot by the person receiving the mare in foal and as additional property transferred by the person surrendering the foal? The answer, by no means clear under any scenario, might vary with the facts. For example, if a mare in foal were exchanged for a broodmare not in foal, the foal might not be boot if, when born, it was a filly that the taxpayer planned to hold for breeding or racing. If it were a colt or a filly that the taxpayer planned to sell, however, it would be boot.

If the foal is treated as boot, the transferee of the mare in foal recognizes gain, and the foal takes a basis equal to its fair market value.³⁶⁹ The basis of the mare in foal received in the transaction then equals the basis of the mare surrendered, plus the gain recognized, minus the basis assigned to the foal.³⁷⁰ If the foal is not treated as boot, then no gain would be recognized and the basis of the mare and the foal received would be determined by prorating the basis of the mare surrendered between the two horses received relative to their fair market values. These alloca-

³⁶⁸ *But see* *Sonneborn Bros. v. Cureton*, 262 U.S. 506, 522 (1923) (McReynolds, J., concurring) ("Logic and taxation are not always the best of friends.").

³⁶⁹ See I.R.C. § 1031(d); Treas. Reg. § 1.1031(d)-1(c), (d).

³⁷⁰ See I.R.C. § 1031(d); Treas. Reg. § 1.1031(d)-1(c), (d).

tions, of course, will have a significant impact on basis recovery rates under ACRS, as well as on the gain to be recognized on the subsequent sale of one of the horses before it is fully depreciated.

To the extent that the foal is boot to the recipient, it may constitute additional property transferred by the transferor. As a result, the transferor would recognize gain equal to the difference between his basis in the foal and its fair market value.³⁷¹ He would also add the fair market value of the foal to the basis of the mare surrendered to determine the basis of the mare received.³⁷² If, however, the foal is not treated as boot, the basis of the mare surrendered will be transferred to the mare received in the exchange if the stud fee was capitalized, it would be added to the basis of the new mare.

The reciprocal exchange of two broodmares in foal is even more complicated. If both mares bear fillies, then the exchange presumably would be entirely a like kind exchange, and the only issue is apportionment of basis between the mare and the foal. If one foal is a filly and one is a colt, however, the transaction might be treated either of two ways. Simply, the transaction could be treated as a like kind exchange of mares and a taxable exchange of foals.³⁷³ Alternatively, the transaction could be treated as a like kind exchange with boot by the person receiving the colt foal and as a like kind exchange with an additional payment made with appreciated property by the person receiving the filly foal.³⁷⁴ Although both treatments result in recognition by both transferors, the details of computations of gain recognized and the resultant basis of the four horses might differ.

Whether the foals should be considered separately is not entirely clear, and drawing analogies to the few decided cases involving the treatment of unborn foals leads to differing conclusions. On one hand, the Sixth Circuit Court of Appeals, in *Greer*

³⁷¹ *United States v. Davis*, 370 U.S. 65 (1962); *International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943); Treas. Reg. § 1.1031(d)-1(e).

³⁷² Treas. Reg. § 1.1031(d)-1(e).

³⁷³ *See Rev. Rul. 59-229*, 1959-2 C.B. 180 (in a reciprocal exchange of farms, I.R.C. § 1031 applies to property other than personal residences; gain is recognized on separate exchange of personal residences, subject to nonrecognition under I.R.C. § 1034).

³⁷⁴ *See Rev. Rul. 72-151*, 1972-1 C.B. 225 (exchange of land and building for farm and farm machinery was like kind exchange as to realty; farm machinery was boot).

v. *United States*,³⁷⁵ concluded that for purposes of determining the applicability of section 1231, the holding period of a foal does not begin until birth. This indicates that the foals should not be considered to be separate property. On the other hand, in *Gamble v. Commissioner*,³⁷⁶ the Tax Court concluded that it was proper to apportion the purchase price of a mare in foal between the mare and the foal when the foal is born. This indicates that the separate existence of the foal should be recognized.

These two cases might be reconciled by concluding that *Gamble* requires that independent significance be accorded to the foals, while *Greer* dictates that we adopt a "wait and see" rule under which the final determination of the tax consequences of the exchange is suspended pending the birth of the foal.³⁷⁷ This may result in some administrative difficulties, such as the problem of reporting the exchange when the taxpayer's tax return for the year in which the exchange occurs is due prior to the foal's birth. It will, however, result in taxing the transaction in the manner most consistent with the ultimate result. In absence of any clear authority in this area, however, attempting a like kind exchange of mares in foal is hazardous unless a private ruling can be obtained. Even if a ruling is available, the ultimate tax consequences would turn on a gamble on the sex of the unborn foal.

5. Partnership Interests and Syndicate Shares

a. Partnerships

Section 1031(a)(2)(D) specifically excludes partnership interests from the categories of property which may be exchanged without the recognition of gain or loss. This provision was enacted in

³⁷⁵ 408 F.2d 631 (6th Cir. 1969).

³⁷⁶ 68 T.C. 800 (1977)(*acq.*).

³⁷⁷ See *Rutherford*, 37 T.C.M. (CCH) 1851, in which the taxpayer was held to have acquired half blood heifers in a I.R.C. § 1031 exchange when the heifers were received in consideration of the subsequent transfer of their three quarter blood heifer offspring raised by the taxpayer. At the time the taxpayer received the half blood heifers, they were not yet in calf; they were artificially inseminated following their acquisition. Thus the property transferred by the taxpayer was not even in existence under any standard when the first transfer occurred. The transaction was held open pending the birth of the three quarter blood heifers.

1984 specifically to overrule prior court decisions holding that section 1031(a)(1) applied to the exchange of partnership interests if the underlying assets of the partnerships were substantially similar in nature.³⁷⁸ Thus, gain or loss must be recognized on the exchange of an interest in one equine partnership for an interest in another equine partnership.

b. *Syndicate Shares*

The unavailability of section 1031 nonrecognition also extends to exchanges of interests in arrangements described as syndicates if, under the standards used to define the term partnership for tax purposes, the syndicates are partnerships.³⁷⁹ An election under section 761(a) not to be taxed as a partnership, even if otherwise valid, is of no avail in this context.³⁸⁰ Thus, exchanges of interests in racing syndicates and breeding syndicates holding broodmares are always recognition events.

When the syndicate shares exchanged are stallion syndicate shares, a closer examination of the organization of each syndicate is necessary to determine whether the exchange may qualify under section 1031. A stallion syndicate may or may not be a partnership. If neither syndicate is a partnership the exchange should be treated as a like kind exchange of undivided fractional interests in the stallions owned by the syndicates.³⁸¹ If both syndicates are

³⁷⁸ See S. REP. NO. 169, 98th Cong., 2d Sess. 242-44 (1984); H.R. REP. NO. 432, 98th Cong., 2d Sess. 1232-34 (1984); H.R. REP. NO. 861, 98th Cong., 2d Sess. 866-67 (1984). The Committee Reports indicate that this rule does not apply to interests in the same partnership, but *Estate of Meyer v. Commissioner*, 58 T.C. 311 (1972), *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974), to which specific reference is made in the Committee Reports, held that an exchange of a general partnership interest for a limited partnership interest was not a like kind exchange. Therefore only an exchange of a general partnership interest for a general partnership interest or a limited partnership interest for a limited partnership interest in the same partnership can qualify under I.R.C. § 1031. Such an exchange, however, would be pointless.

³⁷⁹ See text accompanying notes 181-87 *supra* regarding the factors for determining whether a syndicate is a partnership.

³⁸⁰ See *Bryant v. Commissioner*, 399 F.2d 800 (5th Cir. 1968) (election under I.R.C. § 761 applies only to rules of Subchapter K; Investment Tax Credit under I.R.C. § 38 computed for partners in same manner as if subchapter K applied); Rev. Rul. 65-118, 1965-1 C.B. 30 (same).

³⁸¹ Although it might be argued that a stallion share is a "chose in action" for which nonrecognition is unavailable under I.R.C. § 1031(a)(2)(F), under the logic of *Guggenheim v. Commissioner*, 46 T.C. 559 (1966), discussed in the text accompanying notes 191-95 *supra*, the stallion shares should be viewed as undivided interests in the horse owned by the syndicate if the syndicate is not a partnership.

partnerships, however, section 1031 is applicable by virtue of subsection (a)(2)(D). If one syndicate is a partnership and the other is not, gain must be recognized because the exchange simply is not one of like kind property.³⁸²

c. *Exchange of Syndicate Shares For A Horse*

Another area of uncertainty is whether the gain or loss realized on the exchange of a syndicate share for outright ownership of a horse will be accorded nonrecognition under section 1031. Because all syndicates other than stallion syndicates should be taxed as partnerships, this issue arises only on the exchange of a share in a stallion syndicate for a colt or stallion. Although a stallion share represents an undivided ownership interest in the stallion, the rights of the share owner with respect to the stallion are much more restricted than are the rights of the owner of the entire interest in a horse.³⁸³ A share owner has neither possession nor control nor any management authority with respect to the horse. Furthermore, his interest generally is not freely transferable. Again, different analogies point in different directions.

On one hand, as far as real estate is concerned, the exchange of a fee interest for a long term leasehold interest is considered

³⁸² This would be an exchange of a partnership interest for an undivided interest in a horse. *But see* Reynolds, *Tax-Free Exchanges of Interests in Thoroughbred Horses*, 59 TAXES 547, 553 (1981), in which it is asserted that the treatment of one of the syndicates involved in the exchange as a partnership for federal income tax purposes should not preclude the application of I.R.C. § 1031 if the syndicate would not be characterized as a partnership under state law, citing *Morgan v. Commissioner*, 309 U.S. 78 (1940) for the proposition that state law determines the "nature and character of the property involved in the exchange." *Id. Morgan* involved estate taxation of a power of appointment, and in that context the proposition is true. But if an organization is a partnership for tax purposes under the standards of I.R.C. § 761, that § specifically provides that it will be a partnership for "purposes of this subtitle," and "this subtitle" is Subtitle A of the I.R.C., which encompasses all of the Income Tax provisions, including I.R.C. § 1031. *See also* I.R.C. § 7701(a)(2) (1986); Treas. Reg. § 301.7701-3 (extending the I.R.C. § 761 definition of partnership to the entire I.R.C.). *Compare* note 380 *supra* with text accompanying notes 513-16 *infra*.

³⁸³ *See* text accompanying notes 181-86 *supra*. The mere fact that an undivided fractional interest in one horse is exchanged for sole ownership of another horse should not present any impediment to the application of I.R.C. § 1031. *See* Rev. Rul. 79-44, 1979-1 C.B. 265 (reciprocal exchange of undivided one half interests in farms resulting in each transferor holding sole ownership of one farm was a I.R.C. § 1031 exchange).

to be a like kind exchange.³⁸⁴ This supports like kind exchange treatment for an exchange of a stallion share for a horse. Section 1031 applies to "like kind" property, not just identical property. If the core rights to and fundamental use of the property, which give the property value, are essentially similar, then section 1031 arguably should apply.³⁸⁵ In this case, at least as far as the exchange of a stallion share for a stallion (as contrasted to a colt to be raced) is concerned, the core interest is the right to breed the horse. Both properties derive their value from this right, and the difference between the limited legal rights attached to a stallion share and the unlimited legal rights attached to outright ownership might be said to be differences in "quality", not kind.

On the other hand, even before the enactment of section 1031(a)(2)(D), the Tax Court held in *Estate of Meyer v. Commissioner*³⁸⁶ that section 1031 nonrecognition did not extend to the exchange of a general partnership interest in one partnership for a limited partnership interest in another partnership. Although both partnerships held real estate, and under the logic discussed above one might conclude that the interests were similar, the court found the legal interests of general partners and limited partners to be dissimilar. Although the rights of a stallion share owner and an outright owner of a stallion are not as dissimilar as the rights of general partners and limited partners, they may be dissimilar enough to cause an exchange of such properties to fall outside of section 1031 by analogy to *Estate of Meyer*.

C. Receipt of Boot

1. Cash Boot

The broad nonrecognition directive of section 1031(a) is subject to a number of statutory qualifications. Although section

³⁸⁴ Treas. Reg. § 1.1031(a)-1(c); *Century Elec. Co.*, 192 F.2d 155.

³⁸⁵ See *Koch v. Commissioner*, 71 T.C. 54, 65 (1978). In determining that the exchange of a golf course owned and operated by the taxpayer for land subject to a 99 year ground lease qualified for nonrecognition, the Tax Court stated, "section 1031(a) requires a comparison of the exchanged properties to ascertain whether the nature of the transferred rights in and to the respective properties are substantially alike."

³⁸⁶ 58 T.C. 311 (1972), *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974).

1031(a) appears to limit nonrecognition to transactions in which only like kind property is received, section 1031(b) relaxes the stricture of the "solely" qualification, by providing that if both qualified like kind property and "boot" are received in an exchange, gain is recognized, but only to the extent of the money received plus the fair market value of the other property received.³⁸⁷ If gain is recognized, the computation of the basis of the property received is complicated. If only cash boot is received, then the basis of the horse received in the transaction equals the basis of the horse surrendered plus the gain recognized minus the cash received.³⁸⁸ Thus, if a horse with a basis of \$10,000 is exchanged for a horse of like kind worth \$40,000 plus \$10,000 in cash, a \$10,000 gain is recognized and the basis of the horse received in the transaction is zero. If the transferor received only \$4,000 of cash, he recognizes that amount as gain on the exchange of the horse surrendered and the basis of the horse received is reduced from \$10,000 to \$6,000. On the other hand, if a horse with a basis of \$40,000 is exchanged for a horse with a fair market value of \$35,000 and boot of \$15,000 of cash, a gain of only \$10,000 is recognized and the horse received in the exchange takes a basis of \$35,000.

If gain is recognized on a like kind exchange because boot is received, the gain is subject to treatment as ordinary income under section 1245 to the extent of the depreciation recapture inherent in the property surrendered in the exchange.³⁸⁹

2. *Exchanges of Encumbered Property*

When encumbered property is surrendered in a like kind exchange, the transferor is treated as receiving cash boot equal to the amount of the debt.³⁹⁰ If the property received is also subject to an encumbrance, then only the net debt relief inuring to the

³⁸⁷ See Treas. Reg. § 1.1031(b)-1. No loss may be recognized if boot is received. The only effect of boot in an exchange in which a loss is realized is that the basis of the like kind property received will be equal to the basis of the property surrendered minus the sum of the cash and the fair market value of other property received. Treas. Reg. § 1.1031(d)-1(d).

³⁸⁸ I.R.C. § 1031(d); Treas. Reg. § 1.1031(d)-1(b).

³⁸⁹ I.R.C. § 1245(a)(2); Treas. Reg. § 1.1245-2(c)(4).

³⁹⁰ I.R.C. § 1031(d); Treas. Reg. § 1.1031(d)-2.

transferor is treated as boot. Similar treatment results if the transferor of the encumbered property pays cash along with the surrendered property. For example, suppose a taxpayer exchanges a horse with a basis of \$15,000, subject to a lien of \$12,000, for a horse of like kind with a fair market value of \$30,000, subject to a lien of \$10,000. The transferor is deemed to receive cash boot of \$2,000. Because the transferor's gain exceeds the boot received, the entire \$2,000 is recognized as gain, and the basis of the horse received is \$15,000. The same result obtains if the horse received in the exchange is unencumbered, but the transferor paid \$10,000 cash in addition to the horse surrendered.

From the preceding examples, it should be readily apparent that section 1031 does not shelter from recognition the gain realized on the transfer of property subject to an encumbrance in excess of basis, unless the property received is subject to an encumbrance at least equal to the amount by which the lien on the property surrendered exceeds the basis of the property surrendered or the taxpayer also pays cash equal to that amount. This problem may be encountered frequently due to the rapid depreciation allowances under the ACRS cost recovery system.³⁹¹ Because payment of boot is determined by the economics of the transaction, not tax considerations, recognizing gain may be unavoidable. For example, if a taxpayer exchanges a horse with a basis of \$21,000 and a fair market value of \$100,000, subject to a lien of \$40,000, for a horse of like kind with a fair market value of \$60,000, the exchange is equal and the taxpayer must recognize a gain of \$19,000. This gain cannot be eliminated by a boot payment because to do so would render the economics of the exchange nonsensical. As a consequence of the recognition of the gain, however, the basis of the horse received is increased from \$21,000 to \$40,000. Although net debt relief is treated as boot for purposes of gain recognition, it is not boot for purposes of computing the basis of the property received in the transaction.

If a like kind exchange results in a net increase in the lien indebtedness of the transferor, rather than a decrease, the net increase is treated as additional cash paid for the horse received

³⁹¹ See Comment, *Thoroughbred Horse Racing and Breeding as a Tax Sheltered Investment: Recent Tax Law Developments*, 13 GOLDEN GATE U.L. REV. 399 (1983).

in the exchange. As a result, the basis of the horse received equals the basis of the horse surrendered plus the net increase in indebtedness. This rule applies both when the horse received is subject to a greater lien than the horse surrendered and when only the horse received is encumbered.

3. *Receipt of Both Qualified and Nonqualified Property in an Exchange*

If both like kind property and other property are received in an exchange, the other property is treated as boot to the extent of its fair market value, and its basis is equal to its fair market value.³⁹² Any remaining basis is allocated to the like kind property received in the exchange. This may be illustrated as follows. Assume that the taxpayer exchanges a six year old stallion with a basis of \$50,000 for a six year old stallion with a fair market value of \$40,000 and a six year old broodmare with a fair market value of \$60,000. Only the stallions qualify as like kind property. The transferor realizes a gain of \$50,000 on the transaction. Because he received boot of \$60,000, the entire gain is recognized. The broodmare has a basis of \$60,000, and the stallion received in the exchange has a basis of \$40,000. If the relative fair market values of the broodmare and stallion received in the exchange were reversed, only \$40,000 of the gain would be recognized, and the broodmare's basis will be \$40,000. Using the formula for computing the basis of the like kind property received in the exchange—(1) basis of property surrendered (\$50,000), plus (2) gain recognized (\$40,000), minus (3) cash and fair market value of boot received (\$40,000)—the basis of the stallion received in the exchange will be \$50,000.

4. *Coordination With Installment Reporting of Gain*

Section 453(f)(6) provides that, for the purpose of computing the profit ratio for reporting gain recognized under the installment method, the fair market value of property received subject to the nonrecognition rules of section 1031 is disregarded. Consonantly, the receipt of like kind property is not considered to be a payment.

³⁹² I.R.C. § 1031(d); Treas. Reg. § 1.1031(d)-1(c).

Section 453(f)(6) generally applies to like kind exchanges in which boot is received in the form of an installment obligation. In its application, the gross profit on the "sale" is the amount of gain that would be recognized if the installment obligation were satisfied in full. The contract price is the sum of the cash and fair market value of other property received, plus the face amount of the installment note.

The following example illustrates the operation of this provision. Assume that the taxpayer exchanges a horse with a basis of \$40,000 for a horse of like kind worth \$20,000 plus an installment obligation (bearing adequate interest) for \$80,000, of which \$10,000 is payable in the year of the sale and the balance payable the next year. The contract price is \$80,000, and the gross profit is \$60,000, resulting in a profit ratio of 75%. Assuming that none of the gain is recapture income, in year 1 the taxpayer must recognize \$7,500 of gain and in year 2, he must recognize \$52,500 of gain. His basis in the horse received is \$20,000.

D. Multiparty Exchanges

A horse owner seeking a like kind exchange does not need to engage in a direct exchange with the owner of the horse that he wishes to acquire. If that were required, the utility of the nonrecognition provisions of section 1031 would be greatly diminished. Like kind exchanges can be, and frequently are, effected through the use of middlemen in so called three corner exchanges.³⁹³ In a typical three corner exchange the taxpayer locates the property he wants to acquire and then finds a middleman to purchase the target property. After the middleman has purchased the target property, the taxpayer engages in a like kind exchange with the middleman, transferring to the middleman the property that he desires to dispose of and receiving the target property. The middleman then sells the property received from the taxpayer.

³⁹³ See, e.g., *Biggs v. Commissioner*, 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980); Rev. Rul. 77-297, 1977-2 C.B. 304. The actual structuring of a three cornered exchange is complex and has numerous variables and possible pitfalls. A thorough discussion of the mechanics of such exchanges is beyond the scope of this Article. For further discussion of multiparty exchanges, see Goldstein & Lewis, *supra* note 358, at 252-68; Guerin, *A Proposed Test For Evaluating Multiparty Like Kind Exchanges*, 35 TAX L. REV. 547 (1980); Levine & McCormick, *Taxfree Exchanges Under Section 1031*, 61-4th T.M. A-15-A-21 (1982).

A three corner exchange must be structured so that the middleman is not considered to be the transferor's agent. If he is the transferor's agent, then section 1031 will not apply and the gain must be recognized.³⁹⁴ An examination of the cases involving three cornered exchanges, however, indicates that it is easy to avoid having the middleman treated as the transferor's agent. The taxpayer apparently may control all details of the transaction, advance the middleman funds as a loan to purchase the target property, and pay the middleman a fee as compensation for his services.³⁹⁵ If, however, the transferor has the right to receive cash from the middleman at any time, then section 1031 does not apply.³⁹⁶ All of the transactions that are part of the three corner exchange may occur simultaneously or there may be time delays. The taxpayer seeking the exchange may locate the buyer in advance, and the obligation to perform any one of the contracts may be conditioned on performance of all other contracts. On the other hand, the sale by the middleman might be delayed for as long as the middleman is willing. If that sale is not contemporaneous with the acquisition and exchange of the target property, however, the middleman probably will seek increased compensation for the increased risk that he incurs.

E. Special Rules for Deferred Exchanges

The situation may arise in which a taxpayer locates a potential buyer for a horse, and although the seller is seeking to defer recognition of the gain through a like kind exchange, he has not located the horse that he wishes to purchase. In that case, the transferor might transfer his horse to the buyer in exchange for

³⁹⁴ See *Coupe v. Commissioner*, 52 T.C. 394 (1969)(*acq.*), in which the Commissioner unsuccessfully argued that the role of the transferor's attorney as the middleman precluded the applicability of I.R.C. § 1031 because the attorney received cash from the sale of the property as the taxpayer's agent. The court agreed that if the attorney was the taxpayer's agent, I.R.C. § 1031 would not apply, but found on the facts that the attorney was not acting as the taxpayer's agent.

³⁹⁵ See *Biggs*, 69 T.C. 905; *Barker v. Commissioner*, 74 T.C. 555 (1980); *Rutland v. Commissioner*, 36 T.C.M. (CCH) 40 (1977).

³⁹⁶ See *Halpern v. United States*, 286 F. Supp. 255 (N.D. Ga. 1968) (right to receive cash from escrow if no property transferred within six months precluded nonrecognition). See also *Carlton v. United States*, 385 F.2d 238 (5th Cir. 1967) (receipt of cash, even if promptly reinvested in like kind property, precludes nonrecognition).

the buyer's promise to acquire and transfer to the seller another horse to be selected by the seller at some future time. The exchange contract will specify the maximum price to be paid for the horse to be selected and call for the payment of cash boot if the price is less than a specified minimum (which might be equal to the maximum price). The contract may permit the seller to select a more expensive horse if he agrees to make an additional cash payment.

The transaction can be effected through a middleman if the buyer is unwilling to be involved in anything other than a straight purchase transaction. The taxpayer would then transfer to the middleman the horse to be sold in exchange for the middleman's promise to subsequently transfer to the taxpayer a horse to be selected by the taxpayer. The middleman would then immediately close the sale and hold the proceeds pending the selection of a horse by the taxpayer.

Regardless of whether such a deferred exchange is made directly or through a middleman, the Code restricts the period for which the final exchange may be delayed if section 1031 is to apply to the transaction.³⁹⁷ First, the property to be received by the taxpayer seeking section 1031 nonrecognition must be identified no more than forty-five days after the day that the taxpayer transfers his surrendered property.³⁹⁸ Second, even if the property has been identified within the requisite time limit, the second half of the exchange must be completed on or before the earlier of (1) one hundred eighty days after the date on which the initial transfer occurred, or (2) the due date for the tax return for the year in which the taxpayer transferred the surrendered property.³⁹⁹ Thus, if on November 17 of Year 1, taxpayer surrenders a horse in exchange for a horse to be designated at a later time, the horse to be received must be designated before January 1 of Year 2 and must be received on or before April 15 of Year 2. If the first

³⁹⁷ I.R.C. § 1031(a)(3). This provision, enacted in 1984, was intended to limit the scope of *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979). See S. REP. No. 169, 98th Cong., 2d Sess. 241-44 (1984); H.R. REP. No. 432, 98th Cong., 2d Sess. 1231-34 (1984).

³⁹⁸ I.R.C. § 1031(a)(3)(A).

³⁹⁹ I.R.C. § 1031(a)(3)(B). Extensions of the due date are taken into account, and extend the time for completing the transfer.

horse is transferred on November 15, the horse to be received must be designated before December 30 of Year 1 and received on or before April 15 of Year 2. If, however, the first horse is transferred on June 30, the horse to be received must be designated prior to August 14 of Year 1, and it must be received on or before December 27 of Year 1.

The unstated interest rules do not apply to deferred like kind exchanges meeting the requirements for nonrecognition because a deferred like kind exchange must be completed within 180 days to qualify for nonrecognition. The unstated interest rules do not apply unless a payment is due more than six months from the date of sale.⁴⁰⁰ If, however, a deferred like kind exchange fails to qualify for nonrecognition and the property to be received by the taxpayer is not received within six months of the transfer of the property surrendered, the unstated interest rules are applicable if the deferred obligation does not bear interest, and a portion of the amount realized upon receipt of the like kind property may be recharacterized as interest.⁴⁰¹

F. Determining the Desirability of a Like Kind Exchange

Prior to the repeal of the capital gains preference, disposing of a horse in a like kind exchange generally was not desirable. An exception was when almost all of the gain that would have been recognized on the sale of a horse would have been ordinary income, either because the twenty four month holding period for section 1231 was not met or the gain would have been subject to recapture. The tax price for nonrecognition exacted by section 1031 is a transferred basis. This reduces, or if the cost of the horse surrendered has been recovered entirely, eliminates ACRS deductions on the horse acquired. By selling the first horse and purchasing the

⁴⁰⁰ See *supra* note 277 and accompanying text.

⁴⁰¹ See *Starker v. United States*, 602 F.2d 1341, 1356 (9th Cir. 1979), in which the portion of the property received in the deferred exchange transaction that was attributable to a 6% per year "growth factor" in the value of the property that the taxpayer was to receive was re-characterized as interest and recognized as ordinary income outside of the nonrecognition accorded by I.R.C. § 1031.

second horse, the taxpayer obtains a cost basis for depreciation and his subsequent ACRS deductions are increased greatly. If a substantial portion of the gain realized on the sale of the first horse would have been section 1231 gain, the combination of capital gains and ordinary deductions dictated that it was more profitable after taxes to sell the first horse and buy the new one rather than engage in a like kind exchange.

Under prior law it was necessary to evaluate separately each potential transaction to determine which route was best. A number of factors had to be considered, including the amount of net section 1231 gain and section 1245 gain that would be realized on a sale, the taxpayer's marginal tax rate at which income would be included and deductions claimed, the recovery period for the horse to be obtained, and the after tax discount rate to be used by the taxpayer in valuing cash flows.

Assume, for example, that the taxpayer owned a seven year old stallion held for stud purposes that has been fully depreciated. The original cost of the stallion was \$100,000 and its fair market value was \$200,000. If the taxpayer was in the fifty percent tax bracket, he would have owed taxes of \$70,000 on the \$200,000 gain that would have been realized on the sale of the horse.⁴⁰² However, if he had purchased another stallion to be held for stud purposes for a price of \$200,000, he would have had an ACRS deduction in the same year of \$30,000. As a result he would have saved \$15,000 of taxes and the net tax increase for the year would have been \$55,000. In the next year he would have had an ACRS deduction of \$44,000, saving \$22,000 in taxes. In each of the next three years he would have had a deduction of \$42,000, saving \$21,000 of taxes in each year.⁴⁰³

Looking at the taxes paid and taxes saved, this can be viewed, entirely apart from profits generated from stud fees, as an investment of \$55,000 in the first year that yields \$22,000 in the second year and \$21,000 in each of the next three years. Assuming the

⁴⁰² The recomputed basis of the property under I.R.C. § 1245(a)(2) is \$100,000. Therefore \$100,000 of the gain is taxed as ordinary income at the fifty percent rate. The remaining \$100,000 of gain is net I.R.C. § 1231 gain, of which \$60,000 is deducted under I.R.C. § 1202(b). The tax on the remaining \$40,000 is \$20,000, and the total tax is \$70,000.

⁴⁰³ See I.R.C. § 168(b)(1).

taxpayer could have invested cash in a portfolio investment at ten percent per year, before tax, his after tax discount rate is five percent. Using a five percent after tax discount rate, the net present value of the tax detriments and benefits associated with the sale is \$20,417. That sum is an additional after tax profit generated by the tax system that would not be obtained if the taxpayer utilized a like kind exchange for the disposition and acquisition.⁴⁰⁴

If the original cost of the first horse were \$180,000, however, only \$20,000 of the gain on the sale would have been section 1231 gain, and the taxes on the gain recognized on a sale would have been \$94,000.⁴⁰⁵ The same ACRS benefits could have been obtained on the new horse, and net taxes due in the year of the sale would have been \$77,000. The hypothetical transaction would be an investment of \$77,000 that generated a return of \$22,000 the next year and \$21,000 in each of the succeeding three years. Using a five percent after tax discount rate, the net present value of the after tax cash flow is negative \$1,583. The taxpayer would be poorer by this amount because he sold the first horse and bought the new one rather than acquiring the new horse through a like kind exchange.

Varying any of the factors can change the result. For example, if the taxpayer used an after tax discount rate of only four percent, the net present value of the cash flows would be \$189, and it would be slightly more profitable to sell the first horse and purchase the second instead of engaging in a like kind exchange.

As long as there was a capital gains preference, there was no neat, generalized rule for determining the more desirable alternative. Each fact pattern must have been specifically analyzed. There were, however, a few guidelines that held true. All other things being equal, it was more likely that a sale and reinvestment was more desirable if the horse to be acquired was three year ACRS property⁴⁰⁶ as opposed to five year ACRS property.⁴⁰⁷ This is because in present

⁴⁰⁴ For an explanation of the use of time value of money analysis of after tax cash flows generated by a potential investment, see McMahon, *Applied Tax Finance Analysis of Real Estate Tax Investments*, 27 B.C.L. REV. 721 (1986). The methodology used in that article can be applied to any type of investment.

⁴⁰⁵ The recomputed basis of the property is \$180,000, which results in \$90,000 of tax under I.R.C. § 1245(a). Only \$20,000 of the gain is I.R.C. § 1231 gain, on which the tax is \$4,000.

⁴⁰⁶ See I.R.C. § 168(h)(1).

⁴⁰⁷ For years after 1986, horses that are not 3 year ACRS property are 7 year ACRS property. I.R.C. § 168(e)(3)(c)(iii).

value terms, the ACRS deductions for three year property are more valuable than are the deductions for five year property.⁴⁰⁸ Furthermore, although at first blush it is counterintuitive, the higher the marginal tax bracket faced by the taxpayer, the more likely it was that a sale and reinvestment would have been more profitable than a like kind exchange. For taxpayers in higher tax brackets, the capital gains preference and the ACRS deductions were more valuable. Conversely, as the discount rate increased, the desirability of a sale and purchase decreased. The higher discount rate reduced the value of the ACRS deductions, while the tax burden in the year of the sale was unchanged. This also pointed to relatively greater desirability for taxpayers in higher tax brackets because they face lower after tax discount rates than lower bracket taxpayers facing the same before tax discount rate.

After the repeal of the preferential treatment of long term capital gains by the Tax Reform Act of 1986, it will always be more advantageous to engage in a like kind exchange than it will be to sell an appreciated horse and purchase a new horse. The gain on the sale of the horse will be taxed at the same rate as the ACRS deductions on the new horse will be allowed. Thus, absent extraordinary circumstances, the net present value of the taxes saved in future years through ACRS deductions will never exceed the taxes paid in the year of the sale.

A sale may be more desirable, however, if the taxpayer has capital losses to offset the capital gain or net operating carryforwards that could not otherwise be used, which can shelter both capital gain and recapture income. In either of these cases the taxes on the gain otherwise payable in the year of the sale will be reduced. Future taxes saved through the increased ACRS deductions may have a net present value greater than the taxes due in the year of the sale. To be completely accurate, however, the analysis must take into account future tax increases attributable to the loss of the capital loss or net operating loss carryforwards used to shelter the gain on the sale of the horse.

⁴⁰⁸ See McMahon, *Reforming Cost Recovery Allowances For Debt Financed Depreciable Property*, 29 St. Louis U.L.J. 1029, 1048-49 n.99, 1051-52 n.107 (1985).

III. INVOLUNTARY CONVERSIONS

A. Introduction

1. *Elective Nonrecognition of Gain and Basis Rules*

Section 1033 allows a taxpayer realizing a gain on the “involuntary conversion” of property to defer recognition to the extent that the amount realized is used to purchase replacement “property similar or related in service or use to the property so converted.”⁴⁰⁹ The amount realized on a involuntary conversion most frequently is the proceeds of an insurance policy, although damage awards, settlements and, occasionally, sales proceeds may be included in the amount realized. Insurance proceeds or other amounts paid to lienholders are included in the amount realized.⁴¹⁰

Unlike section 1031, section 1033 is elective and applies only to gains.⁴¹¹ To benefit from section 1033, a taxpayer must replace the involuntarily converted property before the end of the second taxable year following the taxable year in which gain is first realized on the involuntary conversion.⁴¹² The replacement property must be “purchased” for nonrecognition to apply.⁴¹³ Furthermore, it must be purchased for the specific purpose of replacing the converted property. A purchase that would have occurred in any event does not qualify the gain for nonrecognition.⁴¹⁴

⁴⁰⁹ I.R.C. § 1033(a) (1986). See Treas. Reg. § 1.1033(a)-1, -2 (1986).

⁴¹⁰ See Treas. Reg. § 1.1033(a)-2(c)(11) (payment by government of portion of condemnation award); *Commissioner v. Fortee Properties, Inc.*, 211 F.2d 915 (2d Cir.), cert. denied, 348 U.S. 826 (1954).

⁴¹¹ I.R.C. § 1033(a)(2)(A); Treas. Reg. § 1.1033(a)-2(c). The election may be made simply by failing to report the gain. For a discussion of the collateral rules attending the making of the election, see Edwards, *Involuntary Conversions* 33-7th T.M. A-13-A-15 (1984).

I.R.C. § 1033 does not apply to losses because Congress considered recognition of losses to be “more equitable.” See S. REP. No. 1631, 77th Cong., 2d Sess. (1942), reprinted in 1942-2 C.B. 504, 595.

⁴¹² I.R.C. § 1033(a)(2)(B); Treas. Reg. § 1.1033(a)-2(c)(2), (3).

⁴¹³ I.R.C. § 1033(a)(2)(A)(ii); Treas. Reg. § 1.1033(a)-2(c)(4). “Purchase” means that the replacement property would otherwise take a cost basis under I.R.C. § 1012.

⁴¹⁴ See Rev. Rul. 59-8, 1959-1 C.B. 202, amplified by Rev. Rul. 62-161, 1962-2 C.B. 175.

As is true with respect to section 1031, the price of nonrecognition of gain is the loss of actual cost as basis. Rather than cost, the basis of the replacement property is its cost minus the amount of unrecognized gain.⁴¹⁵ If the cost of the replacement property is the same as the amount realized, this is approximately equal to the basis of the property converted. Due to the manner in which the basis of the replacement property is computed, the holding period of the converted property is tacked onto the holding period of the replacement property.⁴¹⁶ Because section 1245 recapture is subordinated to nonrecognition under section 1033, any depreciation recapture inherent in the converted property carries over to the replacement property. The recomputed basis of the replacement property is the basis, as computed above, plus the ACRS deductions claimed with respect to the converted property.⁴¹⁷

If the cost of the replacement property is less than the amount realized on the involuntary conversion, then gain is recognized to the extent of the proceeds that were not reinvested in the replacement property.⁴¹⁸ The basis of the replacement property, computed as described above, again equals roughly the basis used to compute gain on the disposition of the original property. On the other hand, if the cost of the replacement property is more than the amount realized on the conversion, the basis of the replacement property is greater than the basis of the converted property by an amount equal to such excess.⁴¹⁹

The "reinvestment" of the proceeds from the involuntary conversion need not be literal; there is no tracing of funds.⁴²⁰ If, for example, the taxpayer received \$100,000 of insurance proceeds on the involuntary conversion of a horse and purchased a replacement horse for \$100,000, using only \$20,000 of the actual proceeds and borrowing the remaining \$80,000 of the purchase price, the entire gain is entitled to nonrecognition.⁴²¹ The use to which the taxpayer

⁴¹⁵ I.R.C. § 1033(b); Treas. Reg. § 1.1033(b)-1 (1986).

⁴¹⁶ I.R.C. § 1223(1)(A); Treas. Reg. § 1.1223-1(a) (1986).

⁴¹⁷ I.R.C. § 1245(a)(2); (b)(4); Treas. Reg. § 1245-2(c)(4); -4(d) (1986).

⁴¹⁸ I.R.C. § 1033(a)(2)(A); Treas. Reg. § 1.1033(a)-2(c)(1) (1986).

⁴¹⁹ See Rev. Rul. 73-18, 1973-1 C.B. 368 (infusion of new funds to purchase replacement land and buildings increased basis).

⁴²⁰ See 2 B. BITTKER, *supra* note 44, at ¶ 44.3.6.

⁴²¹ See *Harsh Inv. Corp. v. United States*, 323 F. Supp. 409 (D. Or. 1970).

puts the remaining \$80,000 of cash proceeds is irrelevant.

2. *Characterization of Recognized Gain*

If gain is recognized as a result of an involuntary conversion of a horse, either because the owner chose not to elect nonrecognition or because the entire amount realized as a result of the involuntary conversion was not reinvested, the character of the gain is determined with reference to the purpose for which the horse was held, just as it would be if the horse was sold. Unlike section 1031, deferred recognition is available under section 1033 for gains realized on the involuntary conversion of property held for sale to customers in the ordinary course of business.⁴²² Thus, the proceeds realized on an involuntary conversion of a weanling or yearling owned by a dealer in horses may be entitled to nonrecognition if the dealer reinvests the proceeds in qualified property. For purposes of qualifying the gain as section 1231 gain, the twenty four month holding period applies to horses held for breeding or sporting purposes.⁴²³ As long as the holding period requirement is met, gains from the involuntary conversion of horses held for use in the taxpayer's trade or business are accorded section 1231 treatment, and ultimately long term capital gains treatment if section 1231 gains exceed section 1231 losses, even though there was no sale or exchange.⁴²⁴

The interrelationship of involuntary gains and losses and section 1231 gains and losses recognized on sales and exchanges is complex, and a discussion of the operation of the section 1231 hotchpot that ultimately determines characterization is beyond the scope of this Article.⁴²⁵ The most important limitation on the availability of section 1231, as always, is the potential for depreciation recapture under section 1245. If gain is recognized on an involuntary conver-

⁴²² See *Westchester Dev. Co. v. Commissioner*, 63 T.C. 198 (1974) (land held for sale replaced by land held for sale); Rev. Rul 59-8, 1959-1 C.B. 202, *modified* by Rev. Rul. 81-279, 1981-2 C.B. 163 (farmer may replace standing crop with standing or harvested crop).

⁴²³ See text accompanying notes 138-48 *supra*.

⁴²⁴ I.R.C. § 1231(a)(3)(A)(ii).

⁴²⁵ See 2 B. BITTKER, *supra* note 44, at ¶ 54.1 (1981); Edwards, *supra* note 411, at A-3-A-4 for a discussion of the interaction of involuntary conversions, casualty losses, and the I.R.C. § 1231 main hotchpot.

sion, the gain is ordinary income to the extent of prior ACRS deductions claimed with respect to the converted property.⁴²⁶ Any potential depreciation recapture not recognized at that time carries over to the replacement horse because the recomputed basis of the replacement horse includes ACRS deductions claimed with respect to the converted horse to the extent that they were not recaptured at the time the gain on the conversion was realized.⁴²⁷

3. *Meaning of Involuntary Conversion*

Strictly speaking, an involuntary conversion is not the event that deprives the taxpayer of his property, but is the sequence of events by which the old property is lost and the new property acquired.⁴²⁸ Colloquially speaking, however, the phrase generally is applied to the event that deprives the owner of the enjoyment of the old property. Within that usage, section 1033 applies to destruction, in whole or in part, theft, seizure, and requisition or condemnation (or threat or imminence thereof) of the property. Among these, destruction is the most likely to apply to a horse. Occasionally, a horse owner may experience a theft loss. While a horse might be condemned, this is far more likely to occur with respect to livestock raised for food, such as cattle, and the seizure or requisitioning of a horse by the government would indeed be surprising.

Destruction by any event that constitutes a casualty within the meaning of section 165, fire, shipwreck, hail, lightning or other accident, clearly is an involuntary conversion.⁴²⁹ Also included in the meaning of involuntary conversion, however, are certain other causes of destruction that are not sudden and, therefore, not casualties under section 165.⁴³⁰ In addition, under section 1033(e), livestock destroyed or sold on account of disease are deemed to have been involuntarily converted.⁴³¹ Thus, gain realized upon the

⁴²⁶ Treas. Reg. § 1.1245-4(d).

⁴²⁷ I.R.C. § 1245(a)(2); Treas. Reg. § 1.1245-2(c)(4).

⁴²⁸ See 2 B. BITTKER, *supra* note 44, at ¶ 44.3 (1981).

⁴²⁹ See S. REP. NO. 275, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 (Part 2) C.B. 181; H.R. REP. 486, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 (Part 2) C.B. 206.

⁴³⁰ See Rev. Rul. 66-334, 1966-2 C.B. 302 (salt water pollution of well); Rev. Rul. 59-102, 1959-1 C.B. 200 (livestock converted by drought), *superseded by* I.R.C. § 1033(e).

⁴³¹ See Treas. Reg. § 1.1033(d)-1.

collection of insurance proceeds on the life of a horse that prematurely dies from sickness or disease, as well as one killed in a barn fire or struck by lightning,⁴³² is eligible for nonrecognition under section 1033. Normal mortality, however, does not constitute an involuntary conversion. Furthermore, despite the facial applicability of section 1033(e), if a horse is sold as a result of disease it is unclear whether nonrecognition extends to the gain realized on the sale.⁴³³

Although the gain recognized on the receipt of mortality insurance on the premature death of a horse clearly qualifies for nonrecognition, insurance may be payable for a number of other events not so easily categorized. There is absolutely no authority construing the possible application of section 1033 to many of these events, which are discussed in Part III.B.

4. *Property Similar or Related in Service or Use*

Nonrecognition under I.R.C. section 1033 is available only to the extent that the proceeds from the involuntary conversion are reinvested in "other property similar or related in service or use to the property so converted."⁴³⁴ Neither the Code nor the Treasury Regulations provide any helpful definition of this phrase. Delineation of the scope of the phrase "similar or related in service or use" has been left to the courts and, through Revenue Rulings, to the IRS. An examination of the cases does not disclose any easily applicable definition, but rather a series of factual inquiries.⁴³⁵ The replacement property need not be identical,⁴³⁶ and the standard is

⁴³² See Rev. Rul. 59-102, 1959-1 C.B. 200 (livestock poisoned by contaminated feed); Rev. Rul. 195, 1953-2 C.B. 169 (livestock struck by lightning).

⁴³³ See text accompanying notes 459-63 *infra*.

⁴³⁴ I.R.C. § 1033(a)(1). The replacement may be made indirectly by purchasing control of the stock of a corporation owning property that is similar or related in service or use to the converted property. I.R.C. § 1033(a)(2)(A), (E)(i); Treas. Reg. § 1.1033(a)-2(c). For this provision to apply, however, the assets of the replacement corporation must be "principally" similar property. *Templeton v. Commissioner*, 67 T.C. 518 (1976), *aff'd per curiam*, 573 F.2d 866 (4th Cir. 1978).

⁴³⁵ For a compilation of examples of decisions determining what type of replacement meets the statutory standard, see Edwards, *supra* note 411, at A-19-A-21.

⁴³⁶ See Priv. Ltr. Rul. 7903064 (Oct. 18, 1978) (breeding cattle replaced breeding buffalo of same sex). *But see* Treas. Reg. § 1.1033(e)-1(d) (breeding or dairy livestock is not qualified replacement for draft livestock); Rev. Rul. 76-319, 1976-2 C.B. 242 (replacement of bowling alley with billiards center was not qualified).

different than the "like kind" standard for nonrecognition under section 1031.⁴³⁷ The best available general definition is that property is not "similar or related in service or use" if the taxpayer has "change[d] the character of his investment." Section 1033 "requires a reasonable degree of continuity in the nature of the assets as well as in the general character of the business."⁴³⁸

No purpose would be served by a general exposition of the application of these principles in the context of other businesses. Some analogies may be drawn between decided issues and potential issues in the horse industry, however, and a few answers are relatively clear. As far as livestock are concerned, the Regulations provide that "the new livestock must be functionally the same as the livestock involuntarily converted. This means that the new livestock must be held for the same useful purpose as the old was held."⁴³⁹ Thus, for example, the replacement of a broodmare with a broodmare, a stallion with a stallion, or a yearling held for resale with a yearling held for resale, all clearly would qualify, as would the replacement of a colt held for racing with a colt held for racing or a filly held for racing with a filly held for racing. There also is no doubt that several horses could be replaced by one horse or that one horse could replace several horses.⁴⁴⁰ The consequences attached to numerous other potential replacements are less clear. For example, may a gelding held for racing be replaced by a colt held for racing? May a broodmare be replaced by a stallion? May a foal be replaced by paying stud fees with the proceeds of foal insurance? These are all difficult questions, with no clear answers. Possible resolutions to some of these questions are discussed in Part III.C.

B. Identifying Involuntary Conversions

As noted above, a horse is most frequently involuntarily converted due to accident, disease or sickness. If the horse dies or is

⁴³⁷ See text accompanying notes 351-76 *supra* regarding the meaning of "like kind" under I.R.C. § 1031.

⁴³⁸ *Maloof v. Commissioner*, 65 T.C. 263, 269-71 (1975).

⁴³⁹ Treas. Reg. § 1.1033(e)-1(d) (replacement of breeding, draft, or dairy livestock with breeding, draft, or dairy livestock, respectively, qualifies).

⁴⁴⁰ See, e.g., Treas. Reg. § 1.1033(b)-1(b) (providing rules for allocating basis among multiple replacement properties); *Cotton Concentration Co. v. Commissioner*, 4 B.T.A. 121 (1926) (Acq.) (two buildings may be replaced by one).

humanely destroyed as a result of accident, disease or sickness, the gain realized upon receipt of mortality insurance proceeds generally may be deferred under section 1033. A number of situations, however, present particular problems.

1. *Collection of Foal Insurance*

The owner of a broodmare may obtain foal insurance to compensate him in the event that a foal is born dead or dies soon after birth. In large part, foal insurance protects the owner against the loss of a stud fee if the fee was not refundable, and compensates him for depreciation on the mare for the year.⁴⁴¹ The tax benefit rule has been applied in the past to deny nonrecognition under section 1033 to gain attributable to a basis reduction resulting from the prior deduction of a loss.⁴⁴² It has been suggested that the tax benefit rule might also preclude the applicability of section 1033 to foal insurance to the extent that the owner previously deducted the stud fees attributable to the foal.⁴⁴³ This issue has been mooted for future years by the enactment of section 263A, requiring the capitalization of stud fees. It remains relevant, however, for tax years prior to 1987 not closed by the statute of limitations and during years subsequent to 1986 for replacements of involuntarily converted foals the stud fee for which was paid and properly deducted prior to 1987.

Since the Supreme Court decision in *Hillsboro National Bank v. Commissioner*,⁴⁴⁴ the touchstone for applying the tax benefit rule is that the later "recovery" of the previously deducted item is "fundamentally inconsistent" with the earlier deduction. Applying this standard, one might reasonably conclude that to the extent that the proceeds are used to pay another stud fee there is no fundamental inconsistency. No deduction should be allowed for the second stud fee for years prior to 1987 (except to the extent that it exceeds the portion of the insurance proceeds attributable to the

⁴⁴¹ See Reynolds, *Applying Section 1033 to Involuntary Conversions of Thoroughbred Horses*, 70 Ky. L.J. 987, 991-92 (1981-82).

⁴⁴² See Mager v. United States, 499 F. Supp. 37 (M.D. Pa.), *aff'd*, 636 F.2d 1209 (3d Cir. 1980). *But see* Buffalo Wire Works Co., Inc v. Commissioner, 37 T.C.M. (CCH) 1775 (1978).

⁴⁴³ Reynolds, *supra* note 441, at 991-92.

⁴⁴⁴ 460 U.S. 370 (1983).

first stud fee).⁴⁴⁵ For purposes of section 1033, the payment of a nondeductible stud fee is analogous to the payment of the purchase price of replacement property that is denied a cost basis. For years after 1986, in which stud fees must be capitalized under section 263A, the payment of a stud fee would be treated in the same manner as the purchase price for any other replacement property. The stud fee would enter into the basis of the replacement foal, but the foal's basis would be reduced by the unrecognized gain realized on the involuntary conversion.

The purchase of a horse to replace the foal, however, would appear to be fundamentally inconsistent with the earlier proper deduction of a stud fee in a year prior to 1987, because even prior to the enactment of section 263A a cash basis farmer was required to capitalize the cost of purchased livestock, including horses held for resale.⁴⁴⁶ In this context it is important to recall that the term "conversion" technically does not refer to the event that caused the disposition of the first horse, but to the entire sequence of events that result in the acquisition of the second horse. In a Revenue Ruling issued prior to the decision in *Hillsborough National Bank*, however, the IRS ruled that section 1033 was available when a farmer reinvested crop insurance proceeds, received upon the destruction of a standing crop, in a harvested crop.⁴⁴⁷ Although the cost of planting the destroyed crop was deducted previously, the IRS did not attempt to apply the tax benefit rule to deny nonrecognition. To the extent that this Ruling retains vitality, the tax benefit rule should not stand in the way of nonrecognition upon replacement with another foal. Acquisition of an older horse, however, might fail the "similar or related in service or use" requirement.⁴⁴⁸

To the extent this issue survives the enactment of section 263A, it is mooted in any event if the stud fee is paid with the insurance

⁴⁴⁵ See Rev. Rul. 59-8, 1959-1 C.B. 202, modified by Rev. Rul. 81-279, 1981-2 C.B. 163.

⁴⁴⁶ See note 30 *supra*.

⁴⁴⁷ See Rev. Rul. 81-279, 1981-2 C.B. 163 (replacement of destroyed standing crop by using crop insurance proceeds to plant new crop qualifies to extent proceeds are used to bring new crop to same level of maturity as destroyed crop).

⁴⁴⁸ See *Manocchio v. Commissioner*, 710 F.2d 1400 (9th Cir. 1983), *aff'g*, 78 T.C. 989 (1982) (disallowing deduction for educational expenses reimbursed by tax exempt payments received from Veterans Administration). *But see Baker v. United States*, 748 F.2d 1465 (11th Cir. 1984).

proceeds in the same year that the proceeds are received. The inclusion and the deduction cancel each other out. But if the stud fee is not paid until the next year (or the one following that) then the inapplicability of section 1033 effects an acceleration of income. Inclusion of the gain attributable to the insurance proceeds in the year of receipt is not cancelled out until a future year.

To the extent that the foal insurance exceeds the previously deducted stud fee, the tax benefit rule does not present a problem, but the corollary of gain exclusion is denial of the deduction for the second stud fee. Again, if the stud fee is paid in the same year that the insurance is received, the issue is moot. If the stud fee is not payable until a later year, however, then the potential availability of section 1033 benefits the taxpayer because in present value terms the tax detriment of income in an earlier year is not entirely offset by the tax benefit of a deduction in a later year.⁴⁴⁹

2. *Accident, Disease or Sickness Rendering a Horse Unfit for Racing or Breeding*

Insurance sometimes is obtained to compensate a horse owner for the premature retirement of a horse from racing or breeding due to an accident or sickness that does not result in the death or destruction of the horse. The potential application of section 1033 to the receipt of such insurance proceeds and the purchase of a replacement horse is complicated by the fact that the owner may retain ownership of the horse. Accidents are treated somewhat differently than disease, therefore the two are discussed separately.

a. *Accident*

If a horse is so injured by an accident to require retirement from racing or breeding, the reinvestment of the accident insurance proceeds might qualify as an involuntary conversion arising from "destruction . . . in part"⁴⁵⁰ of the horse. Reinvestment of insurance proceeds attributable to the partial destruction of real estate or equipment qualifies for nonrecognition as an involuntary conver-

⁴⁴⁹ See McMahon, *supra* note 404.

⁴⁵⁰ I.R.C. § 1033(a).

sion.⁴⁵¹ In the usual situation, however, the insurance proceeds are used to repair the partially destroyed property. In the case of a horse retired from racing or breeding, however, not only may the partially destroyed property be retained, but the insurance proceeds are used to purchase additional property. Nevertheless, if insurance proceeds are to compensate an owner for lost value, section 1033 should apply if a horse is no longer useful in the purpose for which it was held, even though it is retained. Furthermore, the availability of section 1033 with respect to the gain attributable to the insurance proceeds should be unaffected by the taxpayer's decision to sell the horse.⁴⁵² Nonrecognition should not extend, however, to the gains from the sale of the horse.⁴⁵³

A potentially serious problem, possibly negating this analysis, is that policies insuring against the risks discussed above generally are written to insure against the loss of use of the horse, not the loss of the horse itself. The Treasury Regulations provide that the proceeds of "a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion," but are ordinary income.⁴⁵⁴ Case law appears to establish that the proceeds of insurance for loss of use of real estate may be reinvested without recognition under section 1033 as long as the policy insures against loss of use rather than loss of profits.⁴⁵⁵ Determining whether a policy insures against loss of use or lost profits requires an examination of all of the facts and circumstances, and where horses are concerned, the relevant factors may differ from those in real estate cases. The inquiry is not limited to the face of the policy, but

⁴⁵¹ See, e.g., *Marcal Pulp and Paper v. Commissioner*, 268 F.2d 739 (3d Cir.), cert. denied, 361 U.S. 924 (1959); Rev. Rul. 67-254, 1967-2 C.B. 269.

⁴⁵² See Reynolds, *supra* note 441, at 993-95.

⁴⁵³ See *C.G. Willis, Inc. v. Commissioner*, 41 T.C. 468 (1964) (gain on sale of partially destroyed ship was not entitled to nonrecognition under I.R.C. § 1033, even though sinking was an involuntary conversion by partial destruction).

⁴⁵⁴ Treas. Reg. § 1.1033(a)-2(c)(8) (1959).

⁴⁵⁵ Compare *Shakertown Corp. v. Commissioner*, 277 F.2d 625 (6th Cir. 1960); *Williams Furniture Corp. v. Commissioner*, 45 B.T.A. 928 (1941)(*acq.*); Rev. Rul. 74-447, 1974-2 C.B. 302, with *Marshall Foods, Inc. v. United States*, 393 F. Supp. 1097 (D. Minn. 1974), *aff'd per curiam*, 75-2 U.S.T.C. ¶ 9536 (8th Cir.), cert. denied, 423 U.S. 928 (1975).

includes the underwriting and actuarial criteria used in writing the policy.⁴⁵⁶

A substance over form analysis of the risk against which the owner is protected by such insurance might point to the proceeds being treated as a substitute for lost profits. Mortality insurance protects against the loss of the horse itself. Loss of use is therefore largely a euphemism for loss of profits—racing purses and stud fees. The policies are payable with reference to the activity, or lack of activity, of the horse, not its condition. This suggests that the risk insured is loss of profits.

This analysis, however, may be more accurate with respect to insurance against termination of a racing career than with respect to a breeding career. Permanent loss of use for breeding fundamentally represents destruction of the business value of the animal, and although the policy may in form be a loss of use policy, the proceeds represent substantially all of the value that will be realized from the horse. The same would hold true with respect to insurance against the premature termination of the racing career of a gelding. As far as colts and fillies held for racing are concerned, however, unless the insurance is substantially in excess of reasonably expected purses that might be earned and therefore actually represents potential loss of value as a broodmare or stallion that might result from premature termination of a racing career, the proceeds resemble lost profits. If that is so, they should be taxable as ordinary income and not eligible for nonrecognition under section 1033. Given the dearth of authority, however, generalization is dangerous, and each case should be examined against the factors applied in the relevant cases and Revenue Rulings.

If the obstacles to the application of section 1033 discussed above can be overcome, the general rules discussed at the beginning of this section would apply as follows. Assume, for example, that the taxpayer owned a fully depreciated filly held for racing, for which he had originally paid \$25,000. Due to an injury, the owner retired her from racing and collected insurance proceeds of \$50,000. Because the owner was not engaged in breeding and the filly had potential as a broodmare despite her injury, he sold her for \$40,000.

⁴⁵⁶ See *Marshall Foods, Inc.*, 393 F. Supp. 1097; Rev. Rul. 86-12, 1986-5 I.R.B. 32. See also Reynolds, *supra* note 441, at 997-1002.

The gain realized on the collection of the \$50,000 insurance proceeds could go unrecognized if the taxpayer replaced the filly with another filly held for racing; however, the \$40,000 gain realized on the sale would be recognized.

Another difficult question involves characterization of the gain that is recognized. Should the \$25,000 of ACRS deductions be recaptured on the sale of the filly and the replacement filly be purged of any recapture taint, or should the recapture taint carry over to the replacement filly and all of the gain be accorded section 1231 treatment, as would be the case if the converted filly was totally destroyed? A strict reading of the Treasury Regulations appear to require transferring all of the recapture potential to the replacement property, leaving the entire gain on the sale as section 1231 gain.⁴⁵⁷ This result is unsettling, however, and the regulations do not appear to have been written with this scenario in mind.

The alternative solution of characterizing the gain on the sale as section 1245 recapture gives rise to another issue. If all of the recapture inherent in the horse at the time of its conversion by partial destruction is not recaptured on the sale because the recomputed basis exceeds the amount realized, it seems that the remaining recapture potential should be transferred to the replacement horse. How would recapture be computed if the replacement horse was sold before the converted horse was sold? Perhaps the best solution is to give each horse a recomputed basis that includes all ACRS deductions claimed with respect to the converted horse, then subsequently reduce the recomputed basis of either by the amount of recapture income recognized on the prior sale of the other.

Another difficult question is presented in determining the respective bases of the retained partially destroyed horse and the replacement horse, if the converted horse was not fully depreciated. Section 1033(c) contemplates that the basis of destroyed property will be transferred to the replacement property. While the application of this rule may seem incongruous if the converted property is not totally destroyed and is retained or sold at a profit, it is actually entirely consistent with the theory of section 1033. Nonrecognition is permitted under section 1033 on the theory that the taxpayer's investment continues in a different form. Transferring the entire

⁴⁵⁷ See Treas. Reg. § 1.1245-2(c)(4).

basis of the converted property to the replacement property reflects that continuation of the taxpayer's original investment. The converted property no longer reflects any investment, and all the proceeds of its sale reflect gain because the original investment continues in the replacement property. The basis will be recovered through ACRS deductions on the replacement property over the remaining cost recovery period of the converted property, to the extent that the basis of the replacement property does not exceed the basis of the converted property. Any additional basis is considered separate property for purposes of computing ACRS deductions, and it has an independent cost recovery period.⁴⁵⁸

b. *Sickness or Disease*

If a horse is retired from or cannot commence a racing or breeding career due to sickness or disease rather than accident, the gain attributable to any insurance proceeds received on account of the sickness or disease and any proceeds from the sale of the horse may be eligible for nonrecognition.⁴⁵⁹ Section 1033(d) treats the destruction or sale of any livestock due to sickness or disease as an involuntary conversion. Sickness or disease, not resulting in death, however, does not appear to be an involuntary conversion in the absence of the forced sale contemplated by section 1033(d).⁴⁶⁰ Therefore, unless the horse is sold, any gain realized on the collection of insurance proceeds exceeding basis probably cannot be deferred under section 1033.

The proper application of this provision to horses is unclear. For gain from a sale to be eligible for nonrecognition the taxpayer must show that the livestock were sold "because of the disease," and that it "would not otherwise have been sold or exchanged at that particular time"⁴⁶¹ Although the legislative history is totally silent as to the intended scope of section 1033(d),⁴⁶² it appears

⁴⁵⁸ Prop. Reg. § 1.168-5(f)(1) (1984).

⁴⁵⁹ I.R.C. § 1033(d) applies regardless of whether the disease is of epidemic proportions or is isolated. Rev. Rul. 61-216, 1961-2 C.B. 134. See generally Reynolds, *supra* note 389, at 995-97.

⁴⁶⁰ See Treas. Reg. § 1.1033(d)-1.

⁴⁶¹ Treas. Reg. § 1.1033(d)-1(a).

⁴⁶² See H.R. REP. No. 2543, 83d Cong., 2d Sess., reprinted in 1954 U.S. CODE CONG. & AD. NEWS 5280.

that it contemplates a sale for slaughter, not a sale for continued use for a different purpose.⁴⁶³ Under this standard it may be difficult, for example, to prove that a horse retired from racing and sold for breeding would not have been sold at that time even if the disease had not occurred. If, however, a horse previously used for breeding was sold to a purchaser for use outside the breeding and racing industry, the standard would probably be met more easily.

Not all physical infirmities qualify as sickness or disease under section 1033(d). In Revenue Ruling 59-174,⁴⁶⁴ the IRS ruled that genetic dwarfism in cattle was not a disease. Presumably this applies to any congenital infirmity, whenever manifested. There might be some argument, however, that an involuntary conversion has occurred if the congenital infirmity arose from sickness or disease of the dam. When livestock illness arises from external sources, "disease" will probably be broadly construed, and should include chemical causes, such as contaminated feed,⁴⁶⁵ as well as infectious biological causes.

Injury to a horse from chemical causes might qualify as partial destruction by accident as well as sickness.⁴⁶⁶ If so, nonrecognition of gain attributable to insurance proceeds might be available even though it cannot be proven that the horse was sold because of the sickness. Claiming nonrecognition under this standard, however, precludes sheltering any gain realized on the sale under section 1033.⁴⁶⁷

c. *Fertility Insurance Proceeds*

Eligibility for nonrecognition under section 1033 of gain realized on the collection of fertility insurance on a stallion should be

⁴⁶³ See Reynolds, *supra* note 441, at 996-97.

⁴⁶⁴ 1959-1 C.B. 203.

⁴⁶⁵ Rev. Rul. 54-395, 1954-2 C.B. 143, *modified by* Rev. Rul. 59-102, 1959-2 C.B. 200. See also Rev. Rul. 75-381, 1975-2 C.B. 25 (honeybees killed by pesticides).

⁴⁶⁶ See Rev. Rul. 75-381, 1975-2 C.B. 25 (honeybees killed by pesticides); Rev. Rul. 54-395, 1954-2 C.B. 143 (cattle killed by disease, caused by consumption of contaminated food, were involuntarily converted through destruction for year prior to enactment of I.R.C. § 1033(e)), *modified by* Rev. Rul. 59-102, 1959-2 C.B. 200.

⁴⁶⁷ See Rev. Rul. 78-337, 1978-2 C.B. 208 (nonrecognition does not extend to proceeds of sale of shopping center partially destroyed by fire, but gain realized on insurance proceeds qualified for nonrecognition to the extent reinvested in qualified property).

determined under the standards discussed in the preceding sections.⁴⁶⁸ The cause of the infertility should determine the proper treatment of the gain attributable to the insurance proceeds. If an accident can be established as the cause of the infertility, this should pose no problem. Infertility from another cause, however, presents problems. First, the burden is on the taxpayer to prove that the infertility was caused by sickness or disease. If the infertility is genetic, section 1033 does not apply. Even if the infertility was caused by disease, the stallion must be sold. This problem cures itself if the insurance underwriter takes title to the stallion, as most fertility insurance policies provide for, but if the underwriter does not take title, this may present a problem.

C. Identifying Horses Similar or Related in Service or Use to the Converted Horses

As previously noted, there is no single easily applied meaning of the phrase "property similar or related in service or use."⁴⁶⁹ The most frequently cited criteria are drawn from *Maloof v. Commissioner*,⁴⁷⁰ in which the court set out the following four general principles: (1) the replacement property must be "substantially similar" to the converted property; (2) the replacement property must represent a "continuation of the prior commitment of capital and not a departure from it;" (3) the replacement property need not exactly duplicate the converted property; and (4) the purpose of section 1033 is to provide "a means by which a taxpayer whose enjoyment of his property is interrupted without his consent may arrange to have that interruption ignored for tax purposes, by returning as closely as possible to his original position." Actual determinations have been made on a case by case basis, taking all of the facts and circumstances into account.

Two broad tests have evolved. The first, the so-called "functional use test", looks to the physical characteristics and the taxpayer's end use of the property.⁴⁷¹ Because this test proved difficult to apply to passive investors, a second test, the so-called "similar

⁴⁶⁸ See Reynolds, *supra* note 441, at 1002-03.

⁴⁶⁹ See text accompanying notes 434-40 *supra*.

⁴⁷⁰ 65 T.C. 263, 269-70 (1975)(*acq.*).

⁴⁷¹ See Rev. Rul. 64-237, 1964-2 C.B. 319.

economic relationship” test has developed and is applied to passive investors.⁴⁷² This test, primarily applicable only to real estate and equipment lessors, examines the extent and type of the owner-lessor’s management activity, the services rendered by him to the users (tenants), and the nature of the business risks. The similar economic relationship test generally does not apply to horses, which usually are owned by the user. If a horse is leased either for breeding or racing purposes, however, the similar economic relationship test probably will apply to determine whether the replacement property purchased by the owner-lessor of the converted horse is qualified.

1. *Owner-Users and the “Functional Use” Test*

Application of the functional use test in the context of involuntary conversions of horses presents a number of certainties and uncertainties, and its exact scope remains unclear.

a. *Replacement With Animals of Different Sex*

As far as breeding stock is concerned, a stallion may be replaced with a stallion and a broodmare with a broodmare. But in a private letter ruling the IRS has taken the position that the the replacement of breeding cattle of one sex with breeding cattle of the opposite sex is not replacement with property that is similar or related in service or use.⁴⁷³ This ruling was based on the different roles played in the overall breeding process by animals of different sexes. A male animal services numerous female animals and has no continuing connection with the gestating calf. Females, on the other hand, play a role in the gestation of a single calf. A cattle breeding herd requires many cows, but only a few bulls.

Although there may be some differences in industry operations, the fundamental roles in the breeding process of bulls and stallions and cows and broodmares, respectively, are analogous. Therefore,

⁴⁷² This test compares “the services or uses of the original and replacement properties to the taxpayer-owner.” *Liant Record, Inc. v. Commissioner*, 303 F.2d 326, 329 (2d Cir. 1962); *Johnson v. Commissioner*, 43 T.C. 736 (1965)(*acq.*); Rev. Rul. 64-237, 1964-2 C.B. 319.

⁴⁷³ Priv. Ltr. Ruling 7903064 (Oct. 18, 1978). See also Treas. Reg. § 1.1033(e)-1(c) (livestock replacing livestock sold because of drought must “be functionally the same as the livestock involuntarily converted”).

the same principles used with cattle should apply to horses held for breeding. The risks associated with deriving profits from owning a stallion differ from the risks from owning a broodmare, and the replacement of one with the other can hardly be called a continuation of the original investment.

If the converted horse was held for racing, however, there is some basis for arguing that the horse's sex should be irrelevant. Although larger purses generally are earned by colts than by fillies, and races in which they may be entered might differ slightly, they are trained and raced in the same manner, and certainly seem to qualify under the *Maloof* criteria as "substantially similar" property representing a continuation of the original investment. Nevertheless, a problem is presented by the potential dual purpose for which any racehorse capable of breeding might be held. If the taxpayer engages solely in the business of racing horses, consistently selling all horses, male or female, when retired from racing, perhaps this dual purpose problem can be overcome. For the owner who both races and breeds horses, however, it is an unsolved problem.⁴⁷⁴

b. *Replacement With a Horse Held For a Different Purpose*

According to the IRS, horses held for different purposes are not "similar or related in service or use."⁴⁷⁵ Therefore, the replacement of a converted racehorse with breeding stock or the replacement of breeding stock with a racehorse, even if of the same sex, will not qualify for nonrecognition under section 1033. Analyzed against the criteria that have been applied to determine whether replacement property meets the "similar or related in service or use" standard, this conclusion is logical. Different business risks, potential profits and management skills are associated with breeding and racing. Replacing a horse used for one purpose with one used for the other can hardly be said to return the taxpayer to his original position. This is, nevertheless, a difficult rule to apply to horses.

In determining whether the replacement property is similar or related in service or use, courts have looked to the taxpayer's

⁴⁷⁴ See Treas. Reg. § 1.1033(e)-1(c) (I.R.C. § 1033(e) extending involuntary conversion treatment to livestock sold because of drought extends only to sales of livestock in excess of the number of sales that would occur in any event).

⁴⁷⁵ I.R.S. Field Release No. 121. See also Treas. Reg. § 1.1033(e)-1(d).

ultimate use of the replacement property.⁴⁷⁶ A transitory unrelated use is ignored. Although this test may be applied without inordinate difficulty in examining real estate, which may or may not be converted to a different use as the taxpayer chooses, it is not easily applied to horses. Except for geldings, all racehorses are held not only for racing, but also for future breeding use or for sale to another person for breeding use.⁴⁷⁷ This different use, breeding, is preordained for racehorses. Furthermore, the exact time at which a horse will be retired from racing for breeding is unpredictable. Any workout or race might result in an injury forcing retirement.⁴⁷⁸ Thus, if a long run perspective is adopted, it is difficult to determine, particularly for a horse nearing the end of an expected racing career, whether the horse is held primarily for racing or primarily for breeding.

In practice, consideration of the dual purposes for which horses are held may produce different results depending on the "direction" of the replacement. The replacement of a stallion with a colt (or of a broodmare with a filly) might be argued to be qualified on the theory that the colt was acquired primarily for breeding purposes, and that he was being raced only to enhance his value as a stallion.⁴⁷⁹ Evidence indicating this would be that the colt was an older colt, and, using hindsight, that he indeed was retired to stud within some reasonable period. Sale or syndication of the horse upon retirement from racing, however, indicates that the horse was acquired for racing, not breeding, unless other evidence indicates that the sale became more desirable due to a change of circumstances arising after the replacement.

On the other hand, the replacement of a racehorse, other than a gelding, with a stallion or broodmare should be much more

⁴⁷⁶ See, e.g., *S.H. Kress and Co. v. Commissioner*, 40 T.C. 142 (1963) (interim use of real estate for parking lot pending construction of building); *Scheuber v. Commissioner*, 25 T.C.M. (CCH) 559 (1966), *rev'd on other grounds*, 371 F.2d 996 (7th Cir. 1967) (improvements on replacement for unimproved land had no value and were held for transitory rental).

⁴⁷⁷ See *McDougal v. Commissioner*, 62 T.C. 720 (1974); *Fowler v. Commissioner*, 37 T.C. 1124 (1962); *Reynolds*, *supra* note 441, at 1009.

⁴⁷⁸ See *McDougal*, 62 T.C. 720; *Fowler*, 37 T.C. 1124.

⁴⁷⁹ See *Jewell v. Commissioner*, 25 T.C. 109 (1955) (commissioner unsuccessfully argued that gain on sale of horse held for racing was not I.R.C. § 1231 gain on theory that the only purpose for racing was to enhance value on subsequent sale to customers of horse breeder and dealer); *Fowler*, 37 T.C. 1124 (same).

difficult to qualify. A taxpayer engaged in both breeding and racing might argue that the converted horse was at or close to the end of its racing career and that most of its value was derived from breeding potential, rather than from expected future purses. This might support treatment of the stallion or broodmare as qualified replacement property. If the converted racehorse is young, however, this argument loses much of its weight.

For the taxpayer engaged only in racing, replacement would seem to be limited to horses used for racing. Furthermore, if the preceding argument has any validity, the replacement racehorse's value may need to be derived primarily from its value as a racehorse, rather than its value as potential breeding stock. This often might be difficult to show given the relationship of prices of thoroughbreds with good bloodlines to the size of purses available. Most horses cannot recoup their cost in purses won. Full recovery of cost is available, if at all, only through breeding following their racing careers. In this light, perhaps it should be sufficient if the replacement horse merely has significant value as a racehorse.⁴⁸⁰ In any event, replacement with an older racehorse that will soon be sold or syndicated for breeding may less likely qualify than would replacement with a younger horse with a longer expected racing career.

Despite the possibly sound theoretical basis for allowing some leeway in the distinction between horses held for breeding and horses held for racing, however, there is little basis for treating the replacement of yearlings, weanlings or foals held by a dealer with horses held for racing or breeding as a qualified replacement. This should not, of course, preclude a dealer from proving that a particular yearling (or younger horse) would not have been sold in the ordinary course of business, but would have been held for breeding

⁴⁸⁰ Compare *Massillon-Cleveland-Akron Sign Co. v. Commissioner*, 15 T.C. 79 (1950)(acq.) (court rejected IRS argument that on replacement of going business the amount realized must be allocated among classes of converted property and cost allocated among classes of replacement property to determine whether entire amount realized was reinvested in qualified property) with *Maloof*, 65 T.C. 263 (replacement of business, substantially all of the property of which was inventory, with manufacturing business represented too great a shift of investment from current to fixed assets, and only inventory replacement qualified under I.R.C. § 1033).

or racing.⁴⁸¹ If the taxpayer can meet this difficult burden, then replacement with a horse used for the purpose for which the yearling would have been used should be accorded nonrecognition.

c. *Replacements Involving Mares in Foal*

The application of I.R.C. section 1033 to mares in foal is far more complex and uncertain than in the contexts already considered. Most of the uncertainty emanates from the question of whether the unborn foal should be considered property separate from the mare.⁴⁸² If it is separate property, then on the mare's death two involuntary conversions may occur, and the replacement of each must be tested separately.⁴⁸³ If the foal is not separate, then there is only one involuntary conversion, and identifying "property similar or related in service or use" becomes more difficult.

If the foal is not separate from the mare, the crucial question is whether a replacement mare must be in foal in order to be considered "similar or related in service or use." Viewed from a long term perspective, one might reasonably conclude that replacement with another broodmare, in foal or not, would be sufficient to return the taxpayer as nearly as possible to his position before the conversion. If the foal is separately insured, however, the foal insurance cannot be sheltered from recognition under section 1033 by the purchase of a mare not in foal.⁴⁸⁴ Indeed, the foal insurance

⁴⁸¹ This determination would be the same as the test employed to determine if a dealer in horses is entitled to I.R.C. § 1231 treatment with respect to the sale of a particular horse. See text accompanying notes 108-37 *supra* for a discussion of this issue.

⁴⁸² See Reynolds, *supra* note 441, at 1014-18.

⁴⁸³ See Rev. Rul. 77-192, 1977-1 C.B. 249 (replacement of seafood processing building and equipment with seagoing seafood process plant and equipment was qualified only as to equipment); Rev. Rul. 70-501, 1970-2 C.B. 163 (replacement of factory building and equipment separately tested, based on insurance proceeds attributable to building and equipment and respective replacement costs). *But see* Rev. Rul. 73-18, 1973-1 C.B. 368 (replacement of land and building with land and building does not require apportionment of proceeds between converted land and building and separate test against apportioned cost of replacement land and building); Rev. Rul. 70-465, 1970-2 C.B. 162 (same).

⁴⁸⁴ See *International Boiler Works Co. v. Commissioner*, 3 B.T.A. 283 (1926)(*acq.*) (proceeds of settlement of single fire insurance policy separately settled as to building and equipment between insured and insurance company required reinvestment be separately tested for building and equipment); Rev. Rul. 70-501, 1970-2 C.B. 163 (same). See note 483 *supra*.

possibly may be reinvested only in another foal or stud fees.⁴⁸⁵ A similar conclusion may be indicated if, for example, the mare was purchased in foal and a substantial portion of the purchase price is actually attributable to the foal, but there is a single insurance policy. This fact pattern, however, makes a good case for treating the mare and the foal as separate property. Whether an unborn foal and the mare are separate property has been discussed already in the context of allocation of purchase price and like kind exchanges, concluding that the foal generally should be recognized as separate property for those purposes.⁴⁸⁶ In that analysis, however, the foal was always presumed to be born alive, while in this context the foal is presumed never born. Therefore, as far as the application of section 1033 is concerned, the decision in *Greer v. United States*⁴⁸⁷ that the holding period of a foal does not begin until its birth presents a significant impediment to treating the unborn foal as separate property. In the context of apportionment of basis it was suggested previously that *Greer* might be interpreted as requiring that the tax consequences of the transaction be held open pending the birth of the foal rather than as an absolute prohibition on treating the unborn foal as separate property. Only if the foal is born alive could it be considered separate property to which basis and amount realized on the sale might be allocated.⁴⁸⁸ This interpretation of *Greer* is not so easily applied if the foal is not born alive.

Treating a foal that is not born alive as property separate from the mare carrying it opens up difficult questions which cannot be fully answered here. For example, if a mare purchased in foal aborts, may the purchaser claim a loss deduction under I.R.C. section 165(a) for the portion of the purchase price allocable to the foal if it is not insured? If the foal is property separate from the mare for purposes of section 1033, the logical corollary is that it is also separate property for purposes of section 165. Initially, allowing a deduction upon the abortion may appear to be incorrect, but closer examination indicates that such a deduction may be proper.

⁴⁸⁵ See text accompanying notes 441-49 *supra* for a discussion of the replacement of a dead foal with stud fees or a live foal.

⁴⁸⁶ See text accompanying notes 174-80, 368-77 *supra*.

⁴⁸⁷ 408 F.2d 631 (6th Cir. 1969), *aff'g*, 269 F. Supp. 801 (E.D. Tenn. 1967).

⁴⁸⁸ *Id.* at 636.

Treating the foal as separate property may find support in Revenue Ruling 86-24,⁴⁸⁹ in which the IRS determined that purebred calf embryos, implanted in mixed breed cows, were separate property from the cows for purposes of apportioning basis. Relying on *Gamble v. Commissioner*,⁴⁹⁰ the IRS required the purchase price of each cow to be allocated between the cow and the embryo on the basis of the fair market value of each to determine the gain realized on the sale of the cows following the birth of the purebred calves. The acquisition of the purebred embryos was treated as a separate transaction for tax purposes, and the taxpayer was required to capitalize as the basis of the embryos the portion of the acquisition costs allocable to them.

It may be significant that the Ruling, while relying on *Gamble*, at all times discussed cows and "embryos", never mentioning "calves" or giving any consideration to the possibility that the basis allocated to the cow would depend on whether the embryonic calf was born alive. This may indicate that livestock embryos should be treated as separate property from the carrying animal when the embryo has independent economic value. Although the embryonic animals in the Ruling were surgically implanted in surrogate cows, the Ruling does not appear to treat this as a significant fact that would distinguish this case from one in which embryonic calves were the natural offspring of the cows. Thus, treating an embryonic foal and the broodmare carrying it as separate property for purposes of section 1033 appears to be correct.

This conclusion is reinforced by analogizing the unborn foal to standing crops. In several Revenue Rulings, the IRS has acknowledged that standing crops are property for which insurance received on their destruction may be reinvested in similar property and the gain is entitled to nonrecognition under section 1033.⁴⁹¹ The analogy is best seen by comparing a mare in foal, when the owner elected to capitalize rather than deduct the stud fees, with crops grown by a farmer using the crop method of accounting. In the case of the

⁴⁸⁹ 1986-1 C.B. 80.

⁴⁹⁰ 68 T.C. 800 (1977)(*acq.*). *Gamble* is discussed in detail in the text accompanying notes 157-73 *supra*.

⁴⁹¹ Rev. Rul. 62-161, 1962-2 C.B. 175, *amplified by* Rev. Rul. 81-279, 1981-2 C.B. 163; Rev. Rul. 59-8, 1959-1 C.B. 202, *modified by* Rev. Rul. 81-279, 1981-2 C.B. 163.

mare in foal, the capitalized stud fees become the basis of the foal when born; they are not added to the basis of the mare.⁴⁹² If the foal is stillborn or the mare aborts, the stud fees, if not refunded, clearly constitute an section 165 loss.

For a farmer using the crop method of accounting, the costs of planting a crop are not deducted, but are capitalized as the basis of the crop.⁴⁹³ If the crop is destroyed, the insurance proceeds may be reinvested in either a standing or harvested crop or through the expense of planting a new crop without recognition pursuant to section 1033. A foal, therefore, should be treated as separate property upon the death of the mare in foal. Furthermore, it should not matter that the stud fees were deducted previously. If the proceeds of crop insurance received by a cash basis taxpayer are reinvested in planting a new crop or purchasing a standing or harvested crop, nonrecognition under section 1033 is available. Stud fees are deducted by a cash basis taxpayer under the same provisions that authorize the deduction of the expenses of planting crops, so the same treatment should be available.

Treating the foal as separate property is the better result when the foal was insured separately, for there would be two distinct involuntary conversions, and the proceeds of insurance received with respect to each conversion should be separately tested for nonrecognition through reinvestment in similar property. Section 1033 might apply to one, but not to the other. The proceeds from the mare could be reinvested in another mare, and the proceeds of the foal insurance could be reinvested in another foal or in stud fees.

With respect to the conversion of the foal, however, if the owner had deducted the stud fees, a reinvestment in stud fees for another mare could be neither deducted nor capitalized.⁴⁹⁴ In addition, the taxpayer might be required to show that the "reinvestment" stud fees would not have been incurred but for the involuntary conversion. Thus, stud fees incurred in the next year for a mare already owned by the taxpayer might not qualify. Apparently the

⁴⁹² See text accompanying note 51 *supra*.

⁴⁹³ See Treas. Reg. § 1.162-12 (1986). The crop method of accounting is not widely used but provides a useful analogy. See J. O'BYRNE & C. DAVENPORT, *supra* note 141, at § 114.

⁴⁹⁴ See text accompanying note 445 *supra*.

only unquestionably qualified replacement stud fees would be those incurred with respect to a replacement mare. Finally, if the stud fees were deducted previously, replacement for the foal might be limited to stud fees. The purchase of a foal may be "fundamentally inconsistent" with the prior deduction, and the tax benefit rule may override section 1033.⁴⁹⁵

When the foal is not insured separately, allocating to the foal any portion of the insurance proceeds on the mare may be difficult. If no such allocation can be made, the entire reinvestment presumably must be in another mare to avoid recognition totally. The terms of the insurance policy, however, should not be controlling.⁴⁹⁶ If, for example, the owner purchased the mare in foal, insured her for the full purchase price or more, and was able to prove the portion of the purchase price attributable to the foal, the insurance proceeds should be apportioned between the mare and the foal. A ratable apportionment would make the most sense. In that case, separate reinvestment would be appropriate.

If the foal is separate property, may the reinvestment be in the form of another mare in foal? If so, to obtain total nonrecognition, must the purchase prices attributable to the replacement mare and foal, respectively, equal or exceed the insurance proceeds attributable to the converted mare and foal, or is it sufficient that their aggregate cost exceed the insurance proceeds, even if the portion attributable to either the mare or the foal is less than the insurance attributable to it? Logic would indicate that if the mare and foal are separate for one purpose, they must be separate for all purposes, and that the purchase price of the new mare must be allocated between the mare and the foal. To the extent that the purchase price of either is less than the amount realized on the conversion of the original counterpart, gain must be recognized. This presents no more administrative difficulty than permitting the reinvestment to qualify on an aggregate basis, because the basis of the converted mare and foal would have to be apportioned between the replacement mare and foal under such a rule.⁴⁹⁷ On the other hand, some

⁴⁹⁵ See text accompanying notes 441-47 *supra*.

⁴⁹⁶ See text accompanying note 456 *supra*.

⁴⁹⁷ See *Maloof*, 65 T.C. 263 (replacement of business substantially all of the property of which was inventory with manufacturing business represented too great a shift of investment from current to fixed assets, and only inventory replacement

authority suggests that reinvestment on an aggregate basis would be adequate to support nonrecognition and that separate computations should not be required.⁴⁹⁸

2. Investors and the "Similar Economic Relationship" Test

Although the IRS originally applied the functional use test to replacements of property by lessors by looking to the use to which the lessee put the leased property, this analysis was rejected by a number of appellate courts⁴⁹⁹ and the IRS finally acceded to the application of the similar economic relationship test to lessors.⁵⁰⁰ This test has been developed primarily in the context of rental real estate owned by taxpayers who did not actively manage the property⁵⁰¹ and may be difficult to apply in the equine context. In an abstract sense, however, the test is no different than the test applied to owner-users. The IRS and the courts will examine the taxpayer's relationship to the property in terms of the services or management activities required of the taxpayer and the risks associated with the ownership of the respective properties.⁵⁰² Generally,

qualified under I.R.C. § 1033); Rev. Rul. 77-192, 1977-1 C.B. 249 (replacement of seafood processing building and equipment with seagoing seafood process plant and equipment was qualified only as to equipment); Rev. Rul. 70-501, 1970-2 C.B. 163.

⁴⁹⁸ See *Massillon-Cleveland-Akron Sign Co.*, 15 T.C. 79 (court rejected IRS argument that, on replacement of going business, the amount realized must be allocated among classes of converted property and cost allocated among classes of replacement property to determine whether entire amount realized was reinvested in qualified property); Rev. Rul. 73-18, 1973-1 C.B. 368 (replacement of land and building with land and building does not require apportionment of proceeds between converted land and building and separate test against apportioned cost of replacement land and building); Rev. Rul. 70-465, 1970-2 C.B. 162 (same). *But see* Rev. Rul. 70-501, 1970-2 C.B. 163 (replacement of factory building and equipment separately tested based on insurance proceeds attributable to building and equipment and respective replacement costs).

⁴⁹⁹ See, e.g., *Liant Record, Inc.*, 303 F.2d 326.

⁵⁰⁰ *Johnson*, 43 T.C. 736; Rev. Rul. 64-237, 1964-2 C.B. 319.

⁵⁰¹ See generally 2 B. BITTKER, *supra* note 44, at ¶ 44.3.3; Edwards, *supra* note 411, at 33-7th T.M. A-19-A-21.

⁵⁰² See *Liant Record, Inc.*, 303 F.2d at 328-29:

There is, therefore, a single test to be applied to both users and investors, i.e., a comparison of the services or uses of the original and replacement properties to the taxpayer-owner. In applying such a test to a lessor, a court must compare, *inter alia*, the extent and type of a lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of the business risks connected with the properties.

this requires that the taxpayer not replace rental property with respect to which his role is passive management with property that requires active management.⁵⁰³ It might also preclude replacement of property leased for a fixed rental with property leased for rentals that vary with the lessee's profits or vice versa.

Applying these standards, one can conclude, for example, that a broodmare net-leased for a fixed rental could be replaced with another broodmare similarly leased, but that it could not be replaced with a filly leased for a percentage share of racing purses. Whether this test would permit the replacement of a filly leased for a share of racing purses with a mare leased for a share of the sales proceeds of her foals is unclear. Although the relative risks of leasing different types of real estate for a percentage of the lessee's profits might not differ dramatically, the same cannot be said so easily for the lease of horses for different purposes. As far as equine leases are concerned, the similar economic relationship test possibly may produce results identical to the functional use test applied to owner-users.

The similar economic relationship test may apply to the replacement by a share owner of his interest in an involuntarily converted horse owned by a syndicate if the shareholder regularly sold the seasons to which he was entitled rather than using them himself.⁵⁰⁴ This problem, however, arises only with respect to stallion syndicates, because all other syndicates should be taxed as partnerships⁵⁰⁵ and the application of section 1033 to such syndicates is determined at the partnership level, not the investor-partner level.⁵⁰⁶ In either case, the share owner has no management responsibilities, but the risks incurred in using a season to breed the stallion to a mare owned by the share owner are significantly different from the risks incurred in regularly selling the right to the season. The risk differential probably should be sufficient to treat the passive share owner as an investor and limit his replacement property to another stallion share held for the purpose of selling seasons or, possibly, a stallion

⁵⁰³ See, e.g., Rev. Rul. 70-399, 1970-2 C.B. 164 (replacement of hotel leased to operator by taxpayer with hotel operated by taxpayer did not qualify).

⁵⁰⁴ See Reynolds, *supra* note 411, at 1006.

⁵⁰⁵ See text accompanying note 182 *supra*.

⁵⁰⁶ See text accompanying notes 508-17 *infra*.

leased to a user.

D. *Special Problems of Syndicates*

The proper application of section 1033 to the involuntary conversion of a syndicated horse depends upon whether the syndicate is characterized as a partnership for federal income tax purposes.⁵⁰⁷ Similar considerations govern an attempt to reinvest the proceeds of an involuntarily converted horse in a syndicate share.

1. *Syndicate Treated as a Partnership*

If a horse held by a syndicate that is a partnership for federal income tax purposes is involuntarily converted, section 1033 applies only at the partnership level.⁵⁰⁸ The horse must be replaced by the partnership, and the election not to recognize gain must be made by the partnership. All partners are bound by the partnership choice. Thus, if the partnership replaces the horse, but elects to recognize gain, all partners must recognize gain;⁵⁰⁹ individual non-recognition elections are not permitted. If the partnership does not replace the horse, all partners must recognize their share of the gain. Individual replacement with another horse is not permitted. If the partnership replaces the converted horse, it must be with a horse that is similar or related in service or use.

This analysis would not differ if, as is the frequent practice, the individual shareholders separately insure their interests in the horse held by the syndicate. If the syndicate is a partnership, the horse is partnership property and must be replaced by the partnership for the gain to escape recognition under section 1033. It is not necessary,

⁵⁰⁷ See text accompanying notes 181-87 *supra* for a discussion of the factors governing the characterization of a syndicate as a partnership.

⁵⁰⁸ I.R.C. § 703(b) (all elections must be made by the partnership). *E.g.*, *Demirjian v. Commissioner*, 54 T.C. 1691 (1970), *aff'd*, 457 F.2d 1 (3d Cir. 1972) (proceeds from condemned real estate owned by partnership reinvested by partner acting in individual capacity did not qualify for nonrecognition because both election and reinvestment must be made by partnership); Rev. Rul. 66-191, 1966-2 C.B. 300 (cattle owned by partnership and sold because of drought must be replaced by partnership, not individual partners, for I.R.C. § 1033(f) to apply).

⁵⁰⁹ Each partner recognizes gain according to his distributive share of partnership gain determined under I.R.C. § 704. In most syndicates this is a simple proportionate part of the gain, but gains sometimes may be allocated other than on a simple percentage basis.

however, that the replacement be with funds traceable to the insurance proceeds, but that is a likely source.

Properly characterizing the receipt of the insurance proceeds by the share owners and the contribution of those proceeds back to the syndicate to purchase the replacement horse presents a formidable challenge in the application of Subchapter K of the I.R.C. Thorough analysis of this problem is beyond the scope of this paper. Note, however, that even if the gain on the horse escapes taxation under section 1033, the receipt of the insurance proceeds by the share owners might be characterized as a partnership distribution that could trigger the recognition of gain under section 731.⁵¹⁰ Whether the prompt contribution of the insurance proceeds to the partnership results in ignoring the transitory possession by the share owners, thereby avoiding the recognition of gain under section 731, is a difficult question.⁵¹¹ As long as each share owner has the choice of contributing or not contributing, however, there is significant risk that a distribution would be deemed to have occurred, even with respect to those shareholders who contribute the insurance proceeds to the syndicate to purchase a replacement horse.⁵¹²

These problems involving the constructive distribution might be avoided by a valid election under section 761 not to be taxed as a partnership,⁵¹³ and such an election should also permit the share owners to elect nonrecognition and reinvest as individuals rather

⁵¹⁰ See Rev. Rul. 81-242, 1981-2 C.B. 147 (involuntary conversion of mortgaged property effected a deemed cash distribution under I.R.C. § 752(b) resulting in recognition of gain under I.R.C. § 731, notwithstanding valid I.R.C. § 1033 election and reinvestment of amount equal to proceeds of conversion).

⁵¹¹ This question should be answered by applying the familiar "step transaction doctrine." Discussion of this doctrine is beyond the scope of this Article. For a discussion of the step transaction doctrine, see, e.g., Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 How. L.J. 693, 717-23 (1978); McMahon, *Defining the "Acquisition" in B Reorganizations Through the Step Transaction Doctrine*, 67 IOWA L. REV. 31, 67-84 (1981).

⁵¹² Application of either the "binding commitment" or "mutual interdependence" forms of the step transaction doctrine would clearly result in recognizing the constructive distribution as a separate transaction. Only the "intention of the parties" variant of the step transaction doctrine would integrate the distribution and the recontribution to treat the distribution as never having occurred. Although generalizations are hazardous in this area, this test usually is applied at the request of the IRS to prevent taxpayers from disguising the true form of a transaction.

⁵¹³ See text accompanying note 380 *supra* regarding elections not to be taxed as a partnership in the context of I.R.C. § 1031 exchanges.

than through the partnership. Although a section 761 election affects only the application of Subchapter K to the partnership and not the application of other provisions,⁵¹⁴ the rationale for requiring the partnership to make a section 1033 election rather than the individual partners is that section 703(b), which is part of Subchapter K, requires that all elections, with certain exceptions, be made by the partnership and not the partners individually.⁵¹⁵ A valid election under section 761 negates the application of section 703(b), however, and the partners are presumably free to make individual elections under section 1033 because that section, on which an section 761 election has no effect, does not address partners.⁵¹⁶ Therefore, for purposes of section 1033, the partners will be co-owners.

A word of caution is in order, however. In the context of equine syndications and partnerships, the discussion in the preceding paragraph may be more theoretical than practical. Because of the strict limitations on the availability of section 761 elections, it is doubtful that a syndicate that crosses the line from co-ownership to partnership generally could make a valid section 761 election not to be taxed as a partnership. In those cases in which a valid section 761 election could be made, it will not be necessary because the syndicate

⁵¹⁴ See *Bryant v. Commissioner*, 399 F.2d 800 (5th Cir. 1968) (Investment Tax Credit computed without regard to election not to be taxed as partnership); Rev. Rul. 65-118, 1965-1 C.B. 30 (same).

⁵¹⁵ See Rev. Rul. 66-191, 1966-2 C.B. 300.

⁵¹⁶ Compare Rev. Rul. 83-129, 1983-2 C.B. 105 (partners in mining partnership that made valid I.R.C. § 761 election were allowed separate elections under I.R.C. § 616 dealing with capitalization and amortization of mine development expenses because I.R.C. § 761 election negates requirement of I.R.C. § 703(b) that all elections be made by partnership) with Rev. Rul. 65-118, 1965-1 C.B. 30 (valid I.R.C. § 761 election does not affect computation of Investment Tax Credit on partnership level because I.R.C. § 48 specifically refers to partnerships independently of Subchapter K). See also *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980). The Tax Court in dicta suggested that a valid I.R.C. § 761 election negates partnership status for all provisions of the Code, outside of Subchapter K, that do not specifically refer to partnerships. *Madison Gas & Elec. Co.*, 72 T.C. at 559 n.9. The Seventh Circuit Court of Appeals on the other hand, noted that I.R.C. § 7701(a)(2) defines partnerships for all sections of the Code in the same manner as I.R.C. § 761, and that the effect of an I.R.C. § 761 election is limited to Subchapter K, possibly implying a more restrictive view of the effect of an election. *Madison Gas & Elec. Co.*, 633 F.2d at 515-16 n.2.

will not be a partnership anyway.⁵¹⁷

2. *Syndicate That is Co-Ownership of Undivided Shares*

If the syndicate is not a partnership, a share owner in a syndicate owning a horse that has been involuntarily converted may avail himself of nonrecognition under section 1033 by investing in another syndicate that is not a partnership. The horse held by the syndicate in which the reinvestment is made must, of course, be similar or related in service or use to the horse held by the first syndicate.

Reinvestment in a syndicate that is a partnership, however, does not qualify even if the horse held by the partnership syndicate is similar or related in service or use to the horse held by the non-partnership syndicate.⁵¹⁸ The syndicate share that was not a partnership was an undivided interest in the horse—tangible personalty. A share in a syndicate that is a partnership is an intangible partnership interest, and it is not similar or related in service or use to an undivided interest in a horse. Therefore, the share owner seeking the shelter of section 1033 must be certain that neither the syndicate that held the converted horse nor the syndicate that holds the replacement horse is a partnership.⁵¹⁹

Another question to which the answer is unclear is whether a share owner in a syndicate that held an involuntarily converted horse may replace his undivided interest in the syndicated horse with outright ownership of another horse, otherwise meeting the similar or related in service or use standard. The IRS has ruled that

⁵¹⁷ See Reynolds, *supra* note 441, at 1012-13.

⁵¹⁸ See *M.H.S. Co., Inc. v. Commissioner*, 35 T.C.M. (CCH) 733 (1976), *aff'd*, 575 F.2d 1177 (6th Cir. 1978) (replacement of real estate with interest in joint venture owning real estate does not qualify under I.R.C. § 1033(g)); Rev. Rul. 57-154, 1957-1 C.B. 262 (purchase of replacement property as undivided tenant in common with other owner is qualified replacement); Rev. Rul. 55-351, 1955-1 C.B. 343 (purchase of partnership interest in partnership holding property similar to converted property is not a qualified replacement). *But see* Rev. Rul. 70-144, 1970-1 C.B. 170 (purchase by 50 percent partner of other 50 percent interest in partnership holding property similar to partner's individually converted property was a qualified replacement because purchase effected liquidation of partnership, making taxpayer the sole owner of the replacement property).

⁵¹⁹ In determining whether the syndicate is a partnership for these purposes, the standards developed under I.R.C. §§ 761 and 7701(a)(2) should be determinative, not the state law determination of whether the syndicate is a partnership. See note 182 *supra*.

a fractional undivided interest in a farm is a qualified replacement for fee ownership of a farm,⁵²⁰ and the converse should also hold true. Thus, the replacement of a fractional interest in a horse with a wholly owned horse should not fail *per se* the similar or related in service or use test. But a syndicate share is not a simple fractional undivided interest in a horse. A share owner's rights with respect to the horse are much more limited than the rights of a simple co-owner. The share holder has no rights of possession or management, while a co-owner or outright owner does. This difference very well may result in any investment other than an investment in another syndicate share being treated as the purchase of property not similar or related in service or use. Once again, the question is whether the taxpayer is returning to his original position or is changing the form of his investment. Moving from an investment without active management responsibilities to one which carries management responsibilities appears to be a disqualifying change.⁵²¹

Similar considerations may prevent the outright owner of a horse that has been involuntarily converted from using section 1033 to avoid recognition if his reinvestment is in the form of a syndicate share rather than another horse. In this case the taxpayer is moving from an investment requiring active management to one that is relatively passive.⁵²²

E. Determining the Desirability of a Section 1033 Election

The primary criteria governing the desirability of an election to defer gain under section 1033 are the same as the criteria used to determine if a like kind exchange is desirable. If all of the gain to be recognized will be ordinary income, it almost always is desirable to elect nonrecognition. Thus, to the extent that it is available, section 1033 may be very useful for a dealer in horses who suffers

⁵²⁰ Rev. Rul. 57-154, 1957-1 T.C. 262.

⁵²¹ See *Clifton Investment Co. v. Commissioner*, 312 F.2d 719 (6th Cir.), cert. denied, 373 U.S. 921 (1963) (replacement of bank office building operated for tenants by two employees with hotel requiring 130-140 employees was not qualified); Rev. Rul. 79-261, 1979-2 C.B. 295 (replacement of tenant-occupied office building with building partially tenant-occupied and partially owner-occupied qualified only to extent of tenant occupied portion).

⁵²² See Rev. Rul. 70-399, 1970-2 C.B. 164 (replacement of hotel leased to operator by taxpayer with hotel operated by taxpayer did not qualify).

an involuntary conversion of a horse held for sale to customers. An election to defer gain under section 1033 also is desirable whenever a horse, held for breeding or racing for less than the twenty four month holding period requisite for obtaining section 1231 treatment, is involuntarily converted. In both cases, all of the gain is ordinary income. For the dealer, there is no benefit gained by a step up in basis. For the owner of a horse held for breeding or racing, the step up in basis increases ACRS deductions, but in the absence of a section 1033 election, the replacement horse has its own recovery period.

Using a time value of money analysis, the present value of the tax benefit of the future ACRS deductions can never equal the tax detriment of current taxation of the gains as ordinary income, unless the taxpayer has other current deductions to offset the gain or is in a low tax bracket in the current year but expects to be in a much higher bracket in the years when the ACRS deductions are claimed. If a significant portion of the gain is taxed as capital gain, however, then for years prior to 1987 it more often was desirable to currently recognize the gain, step up the basis of the replacement horse to its full cost, and claim ACRS deductions on the cost basis. When the gain on the sale was section 1231 gain, taxed as capital gain, the discounted value of the future ACRS deductions on the increased basis was greater than the current tax detriment.⁵²³ Thus, for years in which the capital gains preference was in effect, section 1033 nonrecognition frequently was not desirable with respect to horses held for breeding or racing for more than twenty four months. For years after 1986, however, when section 1231 gains that are treated as capital gains are nevertheless taxed at the same rates as ordinary income, making a section 1033 election will be advisable for most involuntary conversions.

CONCLUSION

This Article has attempted to provide an encyclopedic exposition of the taxation of sales and exchanges of horses, focusing primarily on the thoroughbred breeding and racing business. Even after lengthy discourse, however, the answers to many questions remain

⁵²³ See text at Part II.F. *supra*.

clouded, and more definite answers are unlikely to be forthcoming soon. This stems not so much from ambiguity of the statutory provisions governing sales and exchanges of horses, as from difficulty in applying to horses principles that may be relatively clear when applied to other types of property.

Taxation of sales and exchanges of horses is, with a few exceptions, governed by the same statutory provisions that control taxation of the sale of property generally. When applied to horses, however, otherwise relatively clear rules may be ambiguous because of the nature of horses and the industry. Because horses are living organisms, capable of reproducing, numerous questions unique to transactions involving animals arise in applying those rules. Thus, we must grapple with difficult issues such as whether any portion of the purchase price paid or the sales proceeds received for a mare in foal should be attributed to the foal, and if so, how much, or whether for purposes of section 1033 a two year old filly is "substantially similar in service or use" to a two year old colt. The embryonic foal can be an ephemeral asset; it has value, but that value is contingent on a live birth. Both a filly and a colt may have the same use—racing—for a few years, but ultimately they fill different roles in the breeding function, and the maximum potential value of a colt far exceeds the maximum potential value of a filly.

The relative dearth of answers to the types of questions that arise in sophisticated tax planning transactions should serve as a yellow caution flag to anyone attempting to structure a complicated exchange of horses or an acquisition of a horse to replace one that has been involuntarily converted. While certain straightforward exchanges and replacements present few problems, even a significant age difference between the horses in the transaction may preclude nonrecognition. One might say that the rules of law are clear, but the facts, which are the uses for which the horses are held, are all too often ambiguous. Thus, the key to planning transactions involving the sale and exchange of horses, before attempting to apply any rule or law, is to understand that a "horse is not a horse." A horse is a horse held for a particular use, and horses held for different uses are quite different.

