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Thoroughbred Horse Racing and Breeding as a Tax Sheltered Investment: Recent Tax Law Developments

Joel B. Turner

COMMENTS

THOROUGHBRED HORSE RACING AND BREEDING AS A TAX SHELTERED INVESTMENT: RECENT TAX LAW DEVELOPMENTS

I. INTRODUCTION

In the last six years the United States Congress has passed four major tax restructuring acts.[1] These acts have all contained provisions designed to restrict tax shelter abuse. Perhaps the most profound effect of these provisions has been their substantial limitation of tax shelters using highly leveraged investments.[2] Although investors in racing and/or breeding horses[3] have not escaped these new limitations, in many instances the new legislation has enhanced certain other benefits. By accelerating the rate of recovery of the investment value of horses,[4] Congress has offset some of the negative impact of the new restrictions. Because investments in horses have been statutorily assigned recovery periods of three and five years (the two shortest allowable recovery rates), the accelerated rates of recovery have had a particularly positive effect on racing and breeding

1. Tax Reform Act of 1976, Pub. L. No. 94-555, 90 Stat. 1520 (1976); Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2814 (1978); Economic Recovery Tax Act of 1981; Pub. L. No. 97-34, 95 Stat. 172 (1981); and Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

2. I.R.C. § 465 (1982); The at risk limitations first imposed by the 1976 Act and retained in succeeding acts virtually eliminated those highly leveraged tax shelters in which the investor had a minimal amount of capital at risk, but was able to take substantial tax deductions. *See also* text accompanying notes 23-27 *infra*.

3. Although the focus of this article is on thoroughbred horse racing and breeding as a tax-sheltered investment, the same principles apply to all other varieties of horses.

4. The investment value of the horse is established by the purchase price. I.R.C. § 1012 (1976).

investments. Although recently there has been some retreat from the very generous cost recovery allowances granted to the investor/taxpayer by the Economic Recovery Tax Act of 1981,[5] thoroughbred racing and breeding still offer unique tax shelter investment opportunities.

This comment will first discuss principal tax shelter methods in general terms and then address the effects of recent tax legislation on tax-sheltered investments. Finally, the application of the current rules to hypothetical thoroughbred tax-sheltered investments will be undertaken to illustrate some of the options available to investors.

II. Tax Shelters in General

The tax shelter investment exists today as an outgrowth of the desire of high income earners to avoid paying what they feel are excessively high income taxes. These individuals can shelter income from taxation by investing in activities that give them legislatively provided tax preferences. These preferences are often included in tax legislation to encourage investment in those areas of the economy needing an increased flow of private investment capital support to stay healthy. To encourage such investment the tax legislation allows for the deduction of business expenses, depreciation, and direct tax credits (as well as many other deductions) by the investor participating in the tax-preferred activity which can be used to offset the investor's high income.[6] Tax shelter investments are usually based upon one or more of the following concepts: a) deferral of tax liability, b) conversion of ordinary income into capital gains and c) leveraging. Each of these concepts will be discussed separately.

A. Deferral

By investing in certain activities or businesses allowing substantial deductions (for development costs, prepayment of inter-

5. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

6. Some investments qualify the investor for more direct tax relief in the form of investment tax credits. The investment credit allows taxpayers holding income property or operating a business to reduce their income tax liability by purchasing or constructing equipment and other qualified property. The tax reduction can be as high as ninety percent. In certain instances the credits might completely eliminate tax liability and might even result in a refund of taxes paid in previous years. Horses do not qualify for the credit. I.R.C. § 48(a)(6) (1976).

est or other expenses) in the early years of the investment, taxpayers are able to offset income from other sources before the investment itself begins to generate income. By accelerating these deductions the investor effectively defers tax liability to future years and essentially secures an interest-free loan from the government, which becomes due only when the investment starts to generate income in excess of its deductions, is sold, or is otherwise disposed of. This method of sheltering income, commonly known as deferral, has been a central element of many tax-sheltered investments. As such, deferral has been closely scrutinized by Congress and the use of the deferral-based tax-shelter investment has been severely limited by the recent tax acts.[7]

B. Conversion

A second tax shelter benefit of many investments is the conversion of profit from ordinary income to capital gain by the time the investment is sold or otherwise dissolved. Conversion exists when the investment that has been sheltering ordinary income by providing deductions (in this case primarily for depreciation) is sold after it has qualified for capital gains treatment. The income from the sale of the investment is taxed at the capital gains rate, thereby effectively qualifying the ordinary income that has been sheltered by the deduction for capital gains treatment. This practice has also been curtailed by the recapture provisions of the recent tax acts.[8] The use of the depreciation deduction to defer ordinary income, however, is still a viable sheltering device under the current recapture provisions.[9]

C. Leverage

A third and equally important aspect of tax-sheltered investments is leverage. Leveraging is the use of borrowed funds for investment purposes. Often the borrowed funds are used to invest in activities producing substantial deductions, thereby sheltering ordinary income from taxation. Prior to the imple-

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7. *See* note 1 *supra* and I.R.C. §§ 461 & 464 (1982), Rev. Rul. 75-152, 1975-1 C.B. 144.

8. "Recapture" is discussed in detail at text accompanying notes 140-144, *infra*. *See* note 1 *supra;* I.R.C. §§ 1245 & 1250 (1982).

9. I.R.C. §§ 1245, 1250 (1982).

mentation of the at risk rules[10] in the 1976 Tax Reform Act[11] borrowed funds were, for tax purposes, treated as if they were the taxpayer's own funds contributed as equity in the investment. By using highly leveraged investments, the astute taxpayer could generate deductions in excess of the amount actually invested in the tax shelter activity and tax liability on income from other sources could be substantially reduced if not eliminated completely. As will later be discussed in detail, the at risk provisions of the 1976 Act have substantially restricted the use of leveraged investments to generate deductions in excess of the amount of equity the investor could actually lose or be personally liable for in the event that the investment were to fail or be lost completely.

As the use of tax shelters exploiting the leveraging, conversion, and deferral techniques increased in the late 1960's and the early 1970's, abuses increased as well. Investors, with the help of accountants and tax attorneys, used increasingly imaginative investment strategies to shelter large portions of their income with a minimum amount of capital exposure.[12] This activity, legitimate insofar as it conformed with Internal Revenue Service regulations, led to large windfalls for high income earning individuals and corporations. Ultimately these abuses subverted the investment encouraging policy of Congress. Consequently, new legislation was passed that restricted many abused shelter opportunities.

Despite past abuses, congressional policy is still aimed at encouraging investment in business and agriculture. New methods of rewarding such investments are currently being implemented by Congress.[13] Presently, legislators hope that the abuses will be reduced, if not eliminated, and the public will perceive the new tax legislation as a more equitable and effective means of implementing congressional policy.[14]

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10. I.R.C. § 465 (1982).

11. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

12. This was usually accomplished by making heavily leveraged investments as discussed at text accompanying notes 10-13 *supra*.

13. These methods have been incorporated into the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981), and the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

14. S. REP. No. 97-144, 97th Cong., 1st Sess. 3 (1981) *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105.

The recent changes in the laws regulating tax shelters have had a direct impact on the thoroughbred breeding and racing industry. In particular, the at risk rules first promulgated in the 1976 Tax Reform Act restricted leveraged investments in thoroughbreds in the same manner as other shelter investments. The primary benefits of breeding and racing tax shelters, however, have been the deductions resulting from the depreciation or cost recovery of the investment value of the horse over the useful life or statutory class recovery period.[15] These deductions have been greatly enhanced by the accelerated cost recovery system promulgated by the Economic Recovery Tax Act of 1981 (ERTA).[16] Consequently, the new legislation restricting many of the advantages of the more commonly used shelters based on leveraging or pre-payment of expenses[17] will not have as adverse an effect on breeding and racing shelters. Both the thoroughbred breeding and racing shelters are in a position to counterbalance the negative impact of the restrictive at risk provisions by taking advantage of the liberalized cost recovery provisions of the Economic Recovery Tax Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[18]

III. Recent Legislative Changes Affecting Tax Shelters

A. Tax Reform Act of 1976

The at risk provisions of the Tax Reform Act of 1976[19] (1976 Act) represent a strong legislative response to abusive deferment of taxes by the wealthy. Evaluating the sources of tax revenue, Congress concluded that high income taxpayers, by using abusive tax shelters based primarily upon leveraging, were paying substantially less than their proportionate share of taxes.[20] The use of highly leveraged shelters by wealthy taxpay-

15. The terms "depreciation" and "useful life" were the backbone of the Asset Depreciation Range (hereinafter ADR) system implemented by the 1976 Act. The terms "cost recovery" and "class recovery period" introduced by the 1981 Act to be used with the accelerated cost recovery (hereinafter ACR) system have replaced the ADR terminology.

16. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

17. I.R.C. § 464(a) (1982).

18. The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981), and the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

19. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976). *See also* I.R.C. § 465 (1982) for at risk provisions.

20. H.R. Rep. No. 94-658, 94th Cong., 2d Sess. 3 (1976).

ers undercut the original legislative purpose, as large tax advantages were being realized without the desired concurrent capital investments. The 1976 Act directly attacked this abuse by amending the provision that had previously allowed investors to generate large deductions (actually artificial losses[21]) with very little capital at risk.[22]

The 1976 Act at risk provision[23] requires that any deductions taken must not be in excess of actual capital or secure capital at risk in the venture. Non-recourse loans[24] secured by property are included in the at risk amount only if the pledged property is not used in the particular activity and is not directly or indirectly financed by indebtedness secured by property used in the activity.[25] No amount borrowed from any person who has an interest in the activity is considered at risk.[26] Only to the extent that the taxpayer is personally liable or has pledged property other than property used in the activity, and then only to the extent that the property has equity value as security, are amounts borrowed for use in an activity considered at risk.[27]

The point of departure for determining deductible losses[28] for at risk activities (or for determining gain or loss from the disposition of property, or for computing annual deductions under the accelerated cost recovery system[29]) is the concept of basis. For tax purposes, basis is a broad term designed to deter-

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21. Such losses would include deductible business expenses as well as other deductions such as depreciation and actual losses due to the destruction of the asset amounting to net operating losses (NOL's). NOL's are the excess of business deductions over income for a particular year. I.R.C. § 172(a) (1976).

22. I.R.C. § 465 (*amended by* § 204(a) 1976 Act).

23. *Id.*

24. Non-recourse loans are loans for which the borrower is not personally liable. These loans are usually secured only by the value of the investment for which the loan is made.

25. I.R.C. § 465(b)(2)(B) (1982). This provision was included in the code to prevent cross-collateralization. H.R. REP. No. 94-658, 94th Cong., 1st Sess. at 50 (1976).

26. I.R.C. §§ 465(b)(3)(A) & (B) (1982).

27. *Id. See also* I.R.C. § 465(b)(2)(B) (1982).

28. I.R.C. § 465(d) (1982) defines deductible loss as "the excess of the deductions allowable under this chapter for the taxable year (determined without regard to the first sentence of subsection (a)) and allocable to an activity to which this section applies over the income received or accrued by the taxpayer during the taxable year from such activity . . . ."

29. See text accompanying notes 51-80 for a detailed discussion of the Accelerated Cost Recovery (ACR) system.

mine the capital invested in property. Although the at risk rules of section 465 are not rules directly affecting the determination of basis, it is important to understand the concept in order to fully understand how the at risk limitations work.

In 1947 the United States Supreme Court in *Crane v. Commissioner*[30] held that the tax basis for property includes not only liabilities against the property for which the taxpayer is liable, but also liabilities to which the property itself is subject, at least where the fair market value of the property is equal to or exceeds the amount of indebtedness.[31] The decision in *Crane* essentially allowed investors to establish a tax basis equal to the fair market value of the property with very little capital at risk by using borrowed funds to leverage the investment, with only the property itself as security for the indebtedness. With a minimal capital expenditure, investors could realize depreciation and other deductions far exceeding the amount for which they were personally liable should the investment fail.

For example, before the at risk provisions, if an investor purchased a $100,000 thoroughbred with a $5,000 down payment, the balance secured by the horse itself (or in the event of its death, by a mortality insurance policy for the amount of the indebtedness) under *Crane* and the depreciation rules then in effect, the purchaser would establish a tax basis of $100,000. Assuming the horse had a five-year useful life classification, $20,000 per year could be deducted for depreciation alone. The tax sheltering ratio of twenty dollars sheltered for every one dollar actually invested made such an investment very attractive. The abuse of such investments led to limitations being imposed upon the use of the *Crane* rule.

Under the at risk rules of the 1976 Tax Reform Act[32] the taxpayer must first determine how much is at risk in the activity in the first year there is an allowance depreciation deduction from such activity.[33] If the allowance depreciation is less than the amount at risk, it is fully deductible and the amount to be

30. 331 U.S. 1 (1947).

31. *Id. See also* S. REP. No. 94-938, 94th Cong., 2d Sess. 46 (1976).

32. *See* Tax Reform Act 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976); I.R.C. § 465 (1982).

33. I.R.C. § 465(b)(1) (1982).

considered at risk in future years is reduced by that amount.[34] If the allowance depreciation is greater than the amount at risk, the deduction is limited to the amount at risk, the amount at risk for future years is reduced to zero,[35] and the unused depreciation may be carried forward to be used when, and if, the amount at risk is increased.[36]

Applying these rules to the hypothetical purchase of the $100,000 thoroughbred discussed above, the amount at risk according to I.R.C. sections 465(b)(1)(A) and 465(b)(2)(B) is $5,000 (i.e. the amount of money contributed by the taxpayer to the activity, not including any borrowed amount secured by property used in the activity). The depreciation "loss" of $20,000 which would have been allowed under pre-at risk rules, is in excess of the at risk amount and would be limited to $5,000. The amount considered at risk for future years would be reduced to zero.[37] The unused portion of the loss ($15,000) could be carried forward and used if and when the investor either: (1) contributes additional capital to the investment; (2) refinances the debt and secures it in such a manner as to be personally liable should the investment fail; or, (3) pledges property (the pledged value of which is not encumbered by unsecured, i.e. non-recourse, debt) unrelated to the activity. Should the investor fulfill one of these conditions, the at risk limitation on deductions would be increased by the newly increased amount of the investment the investor would be liable for in the event of total loss or failure.

In summary, the at risk rules of the 1976 Act[38] attack highly leveraged investments not by altering the *Crane* rule for the calculation of basis, but by limiting that portion of basis which can ultimately be deducted. Section 465 is not a basis-changing rule; although it limits deductions allowable under *Crane*, it doesn't overrule the *Crane* principle in a wholesale fashion. Presently corporations[39] are exempt from the at risk limitations as are real

34. I.R.C. § 465(b)(5) (1982).
35. *Id.*
36. I.R.C. § 465(a)(2) (1982).
37. I.R.C. § 465(b)(5) (1982).
38. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1982); I.R.C. § 465 (1982).
39. Close corporations were later included in the rule by the 1978 Revenue Act. I.R.C. § 465(a)(1)(B) (*amended by* Pub. L. No. 95-600, § 201, 92 Stat. 2814, 2815 (1978)).

estate investments and certain corporate equipment leasing activities.[40] As noted above, the at risk rules attack leveraging primarily by disallowing deductions in excess of the portion of the basis for which the investor is personally liable. The use of nonrecourse loans in depreciation allowances has been made more difficult by the restrictions imposed by sections 465(b)(2)(B) and 465(b)(3)(A) & (B).

Since the primary source of sheltering income in a horse racing or breeding investment is gained from the cost recovery deduction (formerly "depreciation"), horse owners and investors will feel the impact of the at risk provisions to the extent that their investments were financed by debt that will not be considered a portion of the at risk amount under the new rules. In short, these taxpayers will feel the effect of the at risk rules to the extent that their prior deductions were in excess of the amounts now considered to be at risk in the investment.

B. The Revenue Act of 1978

Two of Congress' stated purposes for promulgating the Revenue Act of 1978[41] (the 1978 Act) were to simplify the tax system and to make it more equitable.[42]

Implicit in the Senate's explanation of the 1978 Act was the suggestion that these changes were the result of a review of the 1976 Act.[43] Apparently Congress felt that the application of the at risk rules to an almost totally inclusive range of activities would be both simpler to administer and more equitable than the 1976 Act standards which had numerous loopholes. The resulting amendment to section 465[44] included a "catch all" category to which the at risk rules applied.[45] The amended at risk

40. Revenue Act of 1978, Pub. L. No. 95-600, § 201, 92 Stat. 2814, 2815 (*amending* I.R.C. § 465 (1978)).

41. *Id.*

42. S. REP. No. 95-1263, 95th Cong., 2d Sess. 13, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6761, 6776.

43. *Id.*

44. Revenue Act of 1978, Pub. L. No. 95-600, § 201, 92 Stat. 2814, 2815 (*amending* I.R.C. § 465 (1978)).

45. I.R.C. § 465 (c)(3)(A)(i) & (ii) (1982), provides that "In the case of taxable years beginning after December 31, 1978, this section also applies to each activity—(i) engaged in by the taxpayer in carrying on a trade or business or for the production of income, and (ii) which is not described in paragraph 1."

rules excepted only real estate activities and certain corporate leasing operations from their purview. This change was the major change affecting tax shelters, but was only one of many changes made by the new law.

In addition to the "catch all" amendment, section 202 of the 1978 Act specifically extended the at risk rules to closely held corporations.[46] With this extension in effect, the opportunity for the horse investor to escape the limitations of the at risk rules by forming a close corporation, through which his investments could be channeled, was effectively foreclosed. The 1976 Act made it clear that the at risk rules were to apply almost universally and that their impact on the financing of tax shelter investments would be an effective restraint on the widespread practice of leveraging. The at risk rules as amended by the 1978 Act have survived subsequent changes in the tax laws essentially intact.

The 1978 Act also introduced a new alternative minimum tax in an effort to alleviate some of the burden of the then existing fifteen percent add-on minimum tax.[47] These taxes were computed for individuals who accumulated deductions in tax preference activities. Their application to the horse investor was then, and is now, limited to the excess of accelerated cost recovery deductions over the straight line depreciation under the asset depreciation range recovery period when such deductions are taken for leased personal property (horses).[48] Since the minimum taxes are somewhat different under current tax law, a further detailed discussion of their present state will be deferred until later in this article. Nevertheless, it is worthwhile to note that while Congress in 1978 wanted to encourage investment in certain areas through the creation of tax preference activities, it didn't want the resulting gains to go wholly untaxed.[49] Although

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46. Revenue Act of 1978, Pub. L. No. 95-600, § 201, 92 Stat. 2814, 2815 (*amending* I.R.C. § 465 (1978)).

47. S. REP. No. 95-1263, 95th Cong., 2d Sess. 15, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6761, 6778.

48. *See* note 54 *infra* for explanation.

49. I.R.C. § 1245(a)(1)(B)(ii) (1982). When a gain is realized from the sale of a depreciated asset, § 1245 requires any gain in excess of the adjusted basis, up to the unadjusted basis, to be taxed as ordinary income. The gain from the sale suggests that the value of the asset in fact has not depreciated, although the allowance for depreciation has been granted. When a gain is actually realized by the taxpayer despite the anticipated depreciation (on the basis of which the deduction is allowed), apparently Congress saw no reason to let that gain go untaxed. Hence, the recapture provisions of § 1245.

at first blush it may seem enigmatic that Congress would give with one hand (tax preferences) and take away with the other (alternative minimum tax and the at risk rules), upon closer inspection the rules seem to be consistent with the express purposes of the 1978 Act: to provide tax reductions to stimulate the economy *and* improve the equity of the tax system overall.[50]

C. The Accelerated Cost Recovery System

The Economic Recovery Tax Act of 1981[51] was enacted by Congress in an attempt to stimulate a slow-moving and inflationary economy. The basic theory of ERTA was that a wide range of carefully structured tax cuts would stimulate capital investment essential to economic growth. Other Congressional goals, similar to those of the 1978 Act, were to improve the equity of the tax system overall and to simplify its administration.[52] The former goal was pursued by the implementation of rules significantly restricting tax sheltering devices used to defer taxes by converting ordinary income and short term capital gains into long term capital gains.[53] The pursuit of the latter goal resulted in a new system for the recovery of capital costs, the Accelerated Cost Recovery (ACR) system. The ACR system replaces the Asset Depreciation Range (ADR) system[54] and introduces the concept of statutory rate of recovery[55] and statutory class life[56] to replace the ADR concepts of useful class life[57]

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50. S. REP. No. 95-1263, 95th Cong., 2d Sess. 2, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6761, 6765.

51. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

52. S. REP. No. 97-144, 97th Cong., 1st Sess. 3, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105.

53. 1981 U.S. CODE CONG. & AD. NEWS at 110.

54. The Asset Depreciation Range system is based on the concept of useful life of the capital asset. The useful life of 132 classes of capital assets were established by the I.R.S. A taxpayer could elect to deviate up to twenty percent, higher or lower, from these guidelines. The most familiar example, perhaps, is the depreciation of income-producing real estate. Generally speaking, the owner of such income property could accept the I.R.S. guideline useful life of fifteen years and recover the cost of the investment over that period, or accelerate the period by twenty percent to twelve years, or prolong the recovery period by twenty percent to eighteen years. The rate of recovery could also be elected from the straight line method, the 150 percent declining balance method, or the sum of the years digits method.

55. The statutory rate of recovery is the investment cost allowed by statute to be deducted in a given year.

56. Statutory class life is the fixed term over which the investment cost can be recovered. There are five basic class life periods: three- five- and ten-year property, fifteen-year property and fifteen-year public utility property I.R.C. § 168(b)(3)(A) (1982). The

and facts and circumstances method of recovery.[58] The new ACR system applies to all tangible depreciable property placed in service[59] after December 31, 1980 and before January 1, 1985.[60] Not only did the ACR system simplify the administration of the tax system by eliminating disputes over useful life under the ADR system (which allowed appeals based on particular facts and circumstances related to the life of the asset), the ACR system also provided the means for Congress to allow investors to recover their capital costs more rapidly. The hope was that the capital recovered at the accelerated rate would be reinvested in other ventures, thereby stimulating the economy.[61]

The implementation of the ACR system substantially increases the benefits of investing in thoroughbred racing and breeding stock and makes such investments a more attractive tax shelter option. Under the former ADR regulations a horse owner/investor could depreciate the capital costs[62] (i.e. the purchase price, plus any cost of training the horse that would increase its value) of a horse under the age of fourteen held for breeding purposes over a minimum period of eight years and maximum period of twelve years.[63] A horse over the age of fourteen could be depreciated over a two-year period.[64] Horses held for racing could be depreciated over a minimum period of five

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longer the class life, the slower the statutory rate of recovery.

57. The useful class life rate of recovery was based upon a rough estimate of how long an asset would be useful before wearing out or otherwise losing its useful value (as determined by the I.R.S.) I.R.C. § 167(a) & (d) (1976). Thus the concept of property depreciating with time was closely linked to this method of recovery.

58. The facts and circumstances method of recovery came into play when there was actual loss of the use of an asset before the class life expired. Under this method of recovery the taxpayer could argue on appeal before the I.R.S. that the facts and circumstances of his/her particular use of the property allow it to be depreciated over a shorter period than the class life.

59. "Placed in service" means when the property is placed in a state of readiness and availability for a specifically assigned function. This may be a function of the taxpayer's trade or business, in the production of income or in a personal activity. Treas. Reg. § 1.167(a)-11(c)(1)(i); Rev. Rul. 76-238, 1976-1 C.B. 55-56.

60. I.R.C. § 168(b)(1)(A) (1982).

61. S. REP. No. 97-144, 97th Cong., 1st Sess. 6, 11, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 112, 117-118.

62. I.R.C. § 1012 (1976).

63. Treas. Reg. § 1.167(a)-(f), T.D. 7593 (*amending* 26 C.F.R. § 1.167(a)-11(f) (1977)).

64. *Id.* This provision made the horse over fourteen years of age a much more attractive tax shelter investment. It provided for the shortest recovery period possible under the ADR system.

years and maximum of ten years. Under the ACR system, non-race horses, twelve years or younger[65] are classified as five-year recovery property and, race horses over two-years-old when placed in service by the taxpayer and other horses over twelve-years-old when placed in service[66] are classified as three-year recovery property. To calculate the maximum allowable depreciation, the taxpayer need only look at the statutory rate of recovery (accelerated) and the statutory class of the asset as provided by I.R.C. section 168(b)(1)(A), (B), and (C)[67] and multiply that

65. I.R.C. § 168(c)(2)(B) (1982). Non-racehorses twelve years and under are not included in the three-year, ten-year, or fifteen-year public utilities classes. For further clarification *see* (RIA) ¶ L 7423 and H.R. REP. No. 4242, 97th Cong., 1st Sess. 208, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 285, 298.

66. I.R.C. § 168(h)(1) (1982).

67. I.R.C. § 168(b)(1)(A), (B), & (C) (1982) provides:

(A) For property placed in service after December 31, 1980 and before January 1, 1985.

If the recovery year is:	The applicable percentage for the class of property is:	
	3-year	5-year
1	25	15
2	38	22
3	37	21
4		21
5		21

(B) For property placed in service in 1985.

If the recovery year is:	The applicable percentage for the class of property is:	
	3-year	5-year
1	29	18
2	47	33
3	24	25
4		16
5		8

(C) For property placed in service after December 31, 1985.

If the recovery year is:	The applicable percentage for the class of property is:	
	3-year	5-year
1	33	20
2	45	32
3	22	24
4		16
5		8

Because the ACR system was to be phased in over three separate time periods the rates of recovery accelerate to the maximum only for the post-1985 tax years. I.R.C. §

percentage rate of recovery by the unadjusted basis of the property.[68]

An example of how the ACR system might be used is as follows: An investor or investors desiring to shelter income invest in a retired four-year-old stakes-winning horse with good bloodlines, intending to use the horse for breeding purposes. The cost of the horse is $1,000,000.[69] According to Section 168 (c)(2)(B)[70] the horse would be a five-year class property since it is a non-race horse under twelve years of age.[71] Using the ACR system chart for property placed in service after December 31, 1980 and before January 1, 1985, it is evident that the investor(s) would be able to recover fifteen percent ($150,000) of the capital cost of their investment in the first year and deduct that amount from their gross income for that tax year. For the second year the taxpayer would be entitled to a twenty-two percent ($220,000) deduction. For the last three years the deduction would be twenty-one percent ($210,000) per year. Thus, the full cost of the investment is recovered in five years.

Had the same investment been made when the 1976 Tax Reform Act system was in effect, the Asset Depreciation Range or useful life of a four-year-old horse held for breeding purposes would have been ten years. Under the ACR system now in effect an investor can recover the full cost of the investment in half the time that would have been required by the ADR method.

There was one area, however, where the ADR rules would have allowed a faster recovery of the capital cost of the horse. If

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168(b)(1)(C) (1982).

68. *See* I.R.C. § 1016(a) (1976) Explaining that unadjusted basis means the basis of the property as determined by that section, less any portion of that basis that has been amortized or expensed; basically, cost as determined by the purchase price plus any capital improvements.

69. This is not an unusually high figure. Recently a stakes winning three-year-old named Conquistador Cielo was purchased by a partnership for 36.4 million dollars, in order to secure the breeding rights after his racing career ends. *Record Review*, 216 THOROUGHBRED REC. 1064 (1982).

70. I.R.C. § 168(c)(2)(B) (1982).

71. Whether the horse is a mare or a stallion is of no consequence for tax purposes so long as it is not a gelding. A gelding (a castrated male horse) can only be used for cost recovery over a three-year period (unless the straight line election is made. *See, e.g.*, text accompanying notes 75 and 76, *infra*.) because he can be used only for racing and has no value for breeding purposes.

an investor purchased a horse over the age of fourteen the useful life would have been only two years. The ACR system designates horses over twelve years old as three-year recovery property.[72] This change might hurt the market for horses over twelve years old since the possibility for a quick recovery of investment cost in the age group has been reduced by thirty-three percent.

If for some reason an investor would like to recover the investment cost over a longer peiod of time, the ACR system allows such an election.[73] To do this the taxpayer elects a longer recovery period from a chart provided in section 168(b)(3)(A) and then recovers the cost over that period using the straight line method.[74] This optional method of recovery is an election that must be made annually. Once made, it is irrevocable (without prior I.R.S. consent) and applies to all property of the same class put in service that year.[75] Property of other classes and property of the same class placed in service in other tax years, however, are still eligible for different methods of recovery provided by the ACR system.[76]

With one exception[77] the time required to recover investment costs is dramatically reduced by the statutory class and rate of recovery provisions of the ACR system. As the charts in secton 168(b)(1)(B) and (C) illustrate,[78] the rate of recovery would accelerate to the most rapid rate in the years following 1985. These provisions,[79] however, have been recently amended by TEFRA.

D. TEFRA 1982

1. ACR Provisions for 1985 and Thereafter Repealed.

In general the Tax Equity and Fiscal Responsibility Act of

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72. I.R.C. § 168(h)(1) (1982).
73. I.R.C. § 168(b)(3)(A) (1982).
74. *Id.*

Category:	*Elective Straight-line Recovery Periods:*
1) 3-year property	3, 5, 12 years
2) 5-year property	5, 12, 25 years

75. I.R.C. § 168(b)(3)(B) (1982).
76. S. REP. No. 97-266, 97th Cong., 1st Sess. 52 (1981).
77. *See* text accompanying note 73 *supra.*
78. *See* note 67 *supra.*
79. *Id.* at 52.

1982[80] represents a substantial retreat from the generous tax reductions introduced by ERTA in 1981. No single enactment of tax legislation since the 1976 Tax Reform Act has done more to restrict tax breaks.[81] Faced with the immediate threat of a very large federal deficit, Congress passed legislation that, when enacted in September, 1982, represented the largest tax increase in history.[82] In the formative stages of the Act, congressional concern had focused upon the slow moving economy that had failed to respond to the liberal provisions of ERTA after an eighteen month trial period.[83] With the economy staggering along, the prospect of decreased tax revenues under ERTA legislation and increased Federal spending prompted legislative action.[84] ERTA legislation was amended and/or repealed in many areas and new legislation was introduced in TEFRA that was desinged to redistribute tax burdens and raise revenues.

The ACR system, central to ERTA's business incentive oriented tax relief program, suffered the repeal of two key provisions that would have accelerated the rate of recovery of capital investments to the maximum rate in two steps; one beginning in 1985 and the second in 1986.[85] The TEFRA amendment of the ACR provisions effectively limits the maximum rate of recovery to 1982 levels.[86] In most other respects TEFRA retains the principles and policy of the ACR system as introduced by ERTA. The impact of TEFRA on investors in thoroughbreds will be felt primarily from the amendment of the ACR provisions. At first blush the effects of the repeal of the 1985 and 1986 recovery rates seemed onerous; it seemed to follow that any reduction in the allowable rate of recovery would have a negative effect on the sheltering potential of the thoroughbred investment. After careful consideration, however, it is apparent that the amendment will, in fact, have a minimal effect on the overall tax benefit potential of the thoroughbred shelter. This is particularly evi-

80. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

81. [1982] 9/2 Special Study: Highlights of '82 Tax Equity and Fiscal Responsibility Act, (RIA) 2.

82. *Id.*

83. S. REP. No. 97-494, 97th Cong., 2d Sess. 96-99 (1982), *reprinted in* [1982] P.H. TEFRA of 1982; Report of the Comm. of Fin., U.S. Senate on H.R. 4961, 96-99.

84. *Id.* at 96.

85. I.R.C. § 168(b)(1)(B) & (C) (1982).

86. *See* note 67 *supra*.

dent when the ACR system, as amended by TEFRA, is compared with the 1976 Tax Reform Act ADR system.

The increased benefits (over the life of the investment) provided by ACR under ERTA relative to the allowable benefits under the ADR system have not been reduced at all by TEFRA. The cost recovery periods provided by ACR, reducing ADR depreciation recovery/useful life rates in many cases by as much as 100 percent, have not been changed. To the thoroughbred investor concerned with tax benefits, TEFRA's principal modification of ACR is the freezing of the percentage rates of recovery[87] that would have been further accelerated in 1985 and again in 1986.

What has been lost in TEFRA's repeal of the 1985 and 1986 provisions is largely the increase in the percentage rate of recovery those provisions would have allowed in the first two years of a three-year class property, and the first three years of a five-year class property.[88] The total investment cost can still be recovered using the three-year and five-year ACR class recovery periods. Only the percentage rate per year of recovery that would have been redistributed to reflect a further accelerated rate in 1985 and again in 1986 has been modified and will not be redistributed to reflect the ERTA rates.[89] Considering that the total capital investment in thoroughbreds can still be recovered in as little as three to five years, the TEFRA Amendment limiting the accelerated per year recovery percentages to 1982 levels

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87. I.R.C. § 168(b)(1) (1982) (*amended by* § 206(a) Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982)).

88. *See* note 67 *supra*. By adding the total allowable percentage of recovery for the first two years of a three-year recovery property, and for the first three years on a five-year recovery property, for the tax years 1982 (chart A) and 1986 (chart C) and then subtracting the '82 figure from the '86 figure, the effective reduction of recovery for the first two years of a three-year recovery property is fifteen percent and for the first three years of a five-year recovery property is eighteen percent. Over the entire statutory recovery period the total investment is still completely recovered. The essential difference is only in the *rate* of recovery.

89. *See* note 50 *supra*. For example: An investor buys a horse for $100,000 to race. The horse is a three-year recovery property under I.R.C. § 168(c)(2) (1982).

Recovery Basis of 3-yr. property = $100,000

	1982	1985	1986
Year 1	$ 25,000	$ 29,000	$ 33,000
Year 2	$ 38,000	$ 47,000	$ 45,000
Year 3	$ 37,000	$ 24,000	$ 22,000
TOTAL	$ 100,000	$ 100,000	$ 100,000

The same comparison can be made for a five-year property.

will have a very minimal effect on the overall benefits afforded by the ACR system.

2. TEFRA repeals fifteen percent add-on minimum tax and establishes new basis for alternative minimum tax.

Under ERTA rules, individual and non-corporate taxpayers claiming deductions based on investments in property classified as a tax preference item by the I.R.S. were subject to an automatic add-on tax of fifteen percent on the excess of depreciation taken (using the ACR system) over the depreciation that would have been allowed using the straight line method (over the property's useful life; i.e. the ADR system).[90] Personal property subject to lease is classified as a tax preference item. A leased horse, the value of which was being recovered using the ACR system, would have subjected the owner/taxpayer to the add-on minimum tax to the extent that the depreciation of any leased horses (and any other investments in tax preference areas) would have exceeded the rate of recovery under ADR. An exemption was available, (the greater of $10,000 or one half of regular tax) that could be used to offset some of the minimum tax.[91]

An alternative minimum tax still applies to non-corporate taxpayers. The basis of this tax has been amended by TEFRA to

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90. I.R.C. § 57(a)(12) (1982). Treas. Reg. § 1.167(b)-1(a) (1956).

91. For example: A thoroughbred investor has an income of $100,000 for the taxable year. He has purchased five thoroughbreds at $100,000 per horse and has leased them for racing purposes. Under ACR rules for three-year recovery property he is entitled to a cost recovery deduction of twenty-five percent ($125,000) of his investment. Under the ADR straight line system the allowable rate of recovery per year for a five-year useful life property would have been $100,000. (i.e. one-fifth of the total investment price of $500,000 = $100,000. One-fifth represents one year in the five-year recovery period under ADR rules.) The accelerated depreciation in excess of straight line would be $25,000.

The minimum tax would be figured as follows:

Accelerated cost recovery in excess of straight line	$25,000
Other tax preference liability	0
Total tax preferences	$25,000
Less exemption (greater of $10,000 or 1/2 regular tax; regular tax equals $40,000)	$20,000
Subject to minimum tax	5,000
Minimum Tax 15%	$ 750
Regular Income Tax	$40,000
Total Tax Due	$40,750

If the amount of tax figured under the alternative minimum tax is greater, that amount will be added to the regular income tax in lieu of the add-on minimum of fifteen percent.

include adjusted gross income plus specified preferences, minus specified itemized deductions. The tax is computed in basically the same way as the add-on minimum tax and affects only the thoroughbred investor who generates large deductions from personal property subject to lease. With the alternative minimum tax the exemption has been set at $30,000 for single persons, $40,000 for married couples filing joint returns and $20,000 for married persons filing separate returns, as well as for trusts and estates. The total minimum taxable income exceeding the exemption is taxed at twenty percent.[92] Under ERTA rules if the alternative minimum tax had exceeded the amount of add-on minimum tax the greater amount would be due as a tax.

With the TEFRA repeal of the ERTA provision for the add-on minimum tax, non-corporate taxpayers subject to tax preference classifications must compute the alternative minimum tax in addition to their regular income tax for the year and if the alternative minimum tax exceeds the regular tax, the higher figure must be paid. Fortunately for the taxpayer the increases in exemptions granted by TEFRA mitigate some of the increases in the tax burden that might occur due to the elimination of the add-on minimum tax method. Nevertheless, an investor who accumulates large cost recovery deductions from horses leased for racing and/or breeding purposes must be alert to the possible alternative tax that could subject excess depreciation from tax preference items to the twenty percent tax.[93] By electing to take a prolonged recovery period,[94] however, the taxpayer can avoid

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92. Using the same example as note 91 *supra*, the *alternative minimum tax* would be figured as follows:

Accelerated Cost Recovery in excess of straight line	$ 25,000
Other tax preference liability	0
Total tax preferences	$ 25,000
Adjusted Gross Income	$ 100,000
less exemption (here, married taxpayer filing separate return)	$ 20,000
Subject to *Alternative Minimum Tax*	$ 105,000
Alternative Minimum Tax 20%	$ 21,000
Regular Tax Liability	$ 46,521
Total Tax due (greater of alternative and regular)	$ 46,521

93. If the exemption for a single person ($30,000) or for a married person filing a joint return ($40,000) had been used in the above example the alternative tax liability would have been further reduced. For the taxpayer in this example to incur an alternative tax liability, his/her total preferences would have to be greater than $152,065 + $100,000 gross income x 20% = $46,521.

94. *See* discussion on ACR election alternatives at text accompanying notes 74 & 75 *supra*.

the tax preference treatment and the alternative minimum tax.

3. TEFRA reduces the basis for recovery under ACR by one-half the amount of claimed investment tax credits.

Under ERTA legislation a taxpayer could claim an investment tax credit for qualified property in the year such property is placed in service.[95] Horses do not qualify for the investment tax credit[96] despite concerted efforts by the American Horse Council to lobby for a change in the rule.[97] The TEFRA addition of section 48(q)(1) calls for a reduction in the cost recovery basis of fifty percent of the claimed investment tax credit. Since horses as property do not qualify for the investment tax credit, no reduction in the recovery basis can be assessed. In this respect, not qualifying for the investment tax credit has simplified matters for those who figure the income taxes of thoroughbred investors, but has done little to remedy the basic inequity of the investment tax credit system as applied to investments in horses.[98]

Although the investment tax credit amendment doesn't apply to horses directly as recovery property, indirectly it may affect the investor considering a tax-sheltered investment in thoroughbreds. Much of the related equipment used in the care and transportation of thoroughbreds does qualify for the investment tax credit.[99] As such the qualifying property would be affected by the TEFRA amendment reducing the recovery basis by fifty percent of the investment credit claimed.[100] Because of the indirect affects on the thoroughbred investor, the amendment is worth mentioning in light of the overall tax shelter plan.

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95. I.R.C. § 46(c)(1) (1982).

96. I.R.C. §§ 38(a), 48(a)(b) (1982).

97. *Proposed Amendments to I.R.C. of 1954, 1981: Hearings on S.450 Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance*, 97th Cong., 1st Sess. 51-57 (1981) (Statement of Richard Rollapp, President, American Horse Council).

98. For example, most other forms of livestock qualify for the investment tax credit.

99. I.R.C. § 48(a)(1) (1982) (particularly § 48(a)(1)(A) & (D).

100. An option is also provided that gives the taxpayer the choice to reduce the percentage of the investment tax credit by two percent overall rather than reducing the recovery basis of the investment by fifty percent of the investment tax credit claimed. I.R.C. § 48(q)(4) (1983) as promulgated by Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248.

IV. Tax Sheltered Investments in Thoroughbred Horses

Now that the basic tax shelter concept and the recent legislative changes that have affected them have been discussed in general, perhaps it is time to look closely at specific varieties of sheltered investment in the thoroughbred industry.

There are basically two types of thoroughbred sheltered investments available; racing and breeding. The breeding investments break down into two additional subdivisions; stud ownership and broodmare ownership. These investments are accomplished by using many different forms of ownership such as syndications,[101] general partnerships, limited partnerships, close corporations, co-tenancies, and individual ownerships. Syndications (particularly for stud ownership), limited partnerships, and individual ownerships are perhaps the most common forms used by investors. The various investments in racing and breeding have different objectives and offer a variety of benefits and risks.

A. Investments in Racing

Those considering investing in thoroughbreds for racing purposes should be well aware of the risks involved and the high likelihood of generating net operating losses. Only a small percentage of racing stock have the potential for earning significant amounts from purses.[102] A still smaller percentage of racehorses are likely to be retired into profitable breeding programs. Nevertheless, the potential for profit from purses and the hope of later profit from breeding, as well as the tax shelter benefits, continue to attract investors.

Despite the limited potential for showing a net profit from racing, the investment offers benefits that counterbalance the risk of losses. The glamorous aspects of racing ownership have attracted investors as much interested in the sport of racing as in the potential for gain. Other investors are attracted by the ability to use the tax benefits or racing investments to shelter other income. These tax benefits are realized by recovering the

101. For an interesting discussion of the impact of securities laws on the syndication form of ownership see, *Maximum Profit, Minimum Problems*, 212 Thoroughbred Rec. 320 (1980).

102. *All About Purses*, 215 Thoroughbred Rec. 2509, at 2511 (1982).

cost of the capital asset and by deducting losses related to the maintenance and management of the horse.

The racing shelter investment is most often made by an individual or a partnership with an interest in racing and a need to shelter a high income from taxation. In considering what kind of investment to make in racing, the investor is confronted by many choices. Perhaps the foremost consideration is how much income needs to be sheltered over a particular period of time. At this point the investor needs to carefully assess the options available under the ACR system.[103] Once it has been decided what amount and rate of income need be sheltered, it must then be determined how much money to invest to implement this decision. This calculation can be approximated by anticipating the operating expenses from the time of purchase until the time the shelter will be liquidated and adding that figure to the benefits of depreciation that will be gained according to the schedule printed in section 168(b)(1)(A).[104]

There are further considerations that should be made before the actual purchase. With the risk potential a preeminent factor, the possibility of decreasing that risk by purchasing more than one horse must be counterbalanced by the fact that higher priced individual horses generally have better bloodlines, and thereby greater potential for success at the track.[105] The high priced horse also has a greater residual value as potential breeding stock after the racing career has ended.[106] It must also be decided what sex (colt, gelding or mare) will best provide the investment benefits desired.[107] Other factors, such as the costs

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103. *See, e.g.*, I.R.C. § 168(b)(1)(A) (1982) and I.R.C. § 168(b)(3)(A) (1982) discussed at notes 67 & 68 and accompanying text.

104. *Id.* Also, a racehorse under thirteen years old and over two years old is a three-year recovery property. I.R.C. § 168(h)(1) (1982). But a longer period of recovery can be elected. I.R.C. § 168(b)(3)(A) (1982).

105. Immediate success at the track might generate sufficient income to jeopardize the tax benefits of the investment.

106. Perhaps this statement should be qualified. It is an increasingly common practice to syndicate a highly successful horse for breeding purposes before the racing career has ended. Often the syndication agreement provides for future additional payments to be made by shareholders should the performance of the horse appreciate in value.

107. This decision becomes particularly important when the investor considers how he may want to dissolve the tax shelter when its utility has expired. Colts, geldings, and fillies, that are comparably priced when sold as yearlings or two-year-olds and have comparable success at the track, have widely varying residual values for breeding which are

related to maintaining and racing one horse versus the cost of racing a greater number, must be calculated as well.[108]

Horses can be purchased at auction sales, at the track or through private negotiations. There are many bloodstock agencies that can locate and purchase racing stock suitable for any tax shelter investment need.[109] It is their primary business to make such arrangements for individuals and partnerships. Their expertise in negotiating and their familarity with trainers, owners and sales company representatives can make a transaction far less troublesome for the investor. The full range of their services, therefore, is worth looking into.

Whether the purchase is made through an agent, negotiated privately, or made by a trainer placing a claim at the track, the timing of the purchase and the age of the animal can critically affect the tax aspects of the investment. Under the ACR system the individual investor can recover the full allowable percentage rate for half of the first year of service regardless of when during that year the horse is placed in service.[110] In the event of a short taxable year during the same year the horse is purchased and placed in service, however, the purchaser qualifies only for a percentage of the full year of recovery.[111] A partnership in existence in the tax year prior to the purchase and placing of the horse in

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dependent upon sex as well as bloodlines. Of course, geldings have no residual value for breeding. Consequently, geldings generally have longer racing careers, and greater potential for generating racing-related losses. For example, an outstanding stakes winning mare with excellent bloodlines might be worth as much as two million dollars as a broodmare. A stallion with comparable characteristics might be syndicated for as much as thirty-six million dollars. Also, as a general rule, well-bred mares with unsuccessful racing careers generally hold their value for breeding much better than similarly situated male horses.

108. Maintenance and racing expenses include shelter, feed, straw, transportation, veterinarian care, grooming, horseshoeing, exercise, entrance fees, eligibility fees, medication, insurance, and jockey fees (to name a few of the major expenses, there are others).

109. These agencies advertise regularly in trade journals such as *The Thoroughbred Record*, *The Blood Horse*, and *The California Thoroughbred*.

110. The half-year convention, I.R.C. § 168(b)(3)(B)(iii) (1982) stipulates that one-half of the first year of cost recovery is to be taken in the first year of the investment and the full year's deduction in the remaining years of the class life. The additional unrecovered half-year of allowable recovery is then taken in the year following the last full year of statutory class life recovery. If, however, the asset is disposed of prior to the expiration of the class life, the half-year to be taken after the final year of regular recovery will not be allowed. No recovery is allowed in the year of disposition if the disposition takes place before the end of the class life. *See also* Treas. Reg. § 1.167(a)-10(b) (1956).

111. I.R.C. § 168(f)(5) (1982).

service however, would still qualify for the full rate of recovery for the first year.[112]

Not only is the timing of the purchase and subsequent placing of the horse in service an important consideration, the horse must be of the proper age to qualify for the recovery period desired. Since most horses race between the ages of two and five (rarely will a horse race beyond the age of ten) there is seldom any problem qualifying these horses as three-year recovery property under the ACR system.[113] The problem of timing and age arises when a yearling is purchased for racing. Since a yearling doesn't qualify as recoverable property under any class in the ACR system (because it cannot be placed in service until the age of two) there is going to be a lag time, between the time of purchase and the time the horse reaches two years of age, in which the investor cannot qualify for cost recovery benefits under the ACR system. In other words, if the yearling is bought at auction in the summer the investor cannot claim any cost recovery benefits until the next tax year.[114]

This presents another interesting problem unique to the thoroughbred horse investor. Section 168(h)(1) places in the three-year recovery class, "any race horse which is more than 2 years old at the time such horse is placed in service; or (B) any other horse which is more than 12 years old at such time."[115] The Jockey Club rules add one year to the age of a thoroughbred horse at midnight on December thirty-first of each year.[116] The I.R.C. does not specify whether Jockey Club rules apply or if a horse's age should be measured from the date of birth.[117]

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112. *Id.* A purchaser with a short tax year who acquires a horse in August could claim only five-twelfths of the first year's allowable recovery. If a partnership had been formed and had been conducting business in the preceeding tax year, however, the full year's recovery value could be deducted, subject to the half-year convention. The rule is that the taxpayer must have a full tax year to claim the full deduction. This prevents partnerships from being formed at year's end with the primary goal in mind to acquire investments that can give write-offs for the full year.

113. I.R.C. § 168(h)(1) (1982).

114. I.R.C. § 162(a) (1976). Any reasonably related business expenses up to the at risk amount could still be deducted.

115. I.R.C. § 168(h)(1) (1982). *See also* H.R. REP. No. 4242, 97th Cong., 1st Sess. 208 (1981).

116. JOCKEY CLUB RULE #5.

117. The underlying purpose for the Jockey Club rule is to simplify administration. Generally the I.R.S. has similar goals in mind when promulgating its rules. Should the

Most horses turning age two on January first are not two full calendar years old. The language of the code section is also ambiguous when it states that the horse must be "*more than*" two years old or twelve years old. This could mean that the horse must be three years old and thirteen years old, respectively, or alternatively two years and one day or twelve years and one day to qualify as three- or thirteen-year property under the ACR system. As might be obvious, if the former reading was ruled the correct one, the lag time between the time a yearling is purchased and the time it qualifies for ACR tax benefits would be increased by a full year. This ruling wouldn't make much sense because most race horses are raced considerably during their two-year-old season and to be consistent with the underlying principles of cost recovery the I.R.C. should allow cost recovery during such a period of use. A resolution of this issue is currently being sought by the American Horse Council.[118] Until such a resolution is reached and a ruling issued by the Treasury Department or the IRS, the Thoroughbred Record advises the use of the Jockey Club rules.[119]

Once the investor purchases the race horse and places the animal in service, both the cost recovery benefits of ACR and the losses generated relative to the racing venture will begin to yield their tax benefits. Those benefits can only be mitigated by a sudden loss of income by the investor, or by the substantial success of the race horse. The investor must take heed of the progress of his charge lest the tax shelter become a tax liability.[120] At this point the investor must also consider the dissolution of the shelter and the tax consequences of that transaction.[121] Usually the dissolution of the racing shelter takes place after the recovery period has expired, the race horse has been retired and is sold for other uses.

I.R.S. require that a horse be two years old from the date of birth, it would create enormous accounting and administration problems.

118. [1981] 132 American Horse Council Tax Reference Serv. Bull. 1.

119. *Income Taxation for Horse Owners,* 215 THOROUGHBRED REC. 1668 (1981).

120. If this should happen, of course, most investors would be delighted. Since it usually takes more than one racing season for a horse to earn enough to cancel out tax benefits, the alert investor should be able to shelter that income by reinvesting the earnings in more horses.

121. *See* discussion at text accompanying notes 140-147 *infra.*

B. Investments in Breeding

The most common investment use of a retired racehorse is breeding. Thoroughbred breeding investments present far fewer risks than racing investments. The horse selected for breeding quite literally has a track record; the retired race horse is a proven commodity. Combining the horse's performance at the track with the carefully analyzed genetic background (i.e., the bloodlines) gives the experienced horseman a very strong indication of the probable success a horse will experience when bred. Careful selection of breeding stock and a vastly reduced potential for serious injury relative to the risk of racing make the breeding investment a much more conservative choice for sheltering the tax dollar. Because the thoroughbred selected for breeding purposes must undergo such close scrutiny, the likelihood that the breeding investment is going to eventually generate additional income is almost a certainty. The tax shelter benefits of a breeding investment, therefore, have a limited life and must be carefully managed to return maximum tax benefits.

There are basically two ways to invest in breeding stock: participation in stud ownership or broodmare ownership. The tax shelter benefits resulting from investments in broodmares represent a unique combination of cost recovery and business expense deductions. Once again, the usual forms of investing in broodmares are the partnership, the individual owner and the corporate entity (usually in the form of a large breeding farm operation). Investments in broodmares are generally made for two purposes: (1) to shelter high income; and, (2) to generate income in the future from sales of the mares. The tax shelter benefits other than cost recovery deductions are conditioned upon the business showing a profit in two of every seven years.[122] Consequently, the management of the broodmare shelter is crucial. The profit motive must exist and be realized to avoid the loss of benefits from business deductions.[123]

Broodmares can be purchased at sales, by private negotia-

122. I.R.C. § 183(d) (1976).

123. If the activity realizes a profit in two of seven years the IRS will assume that the activity is a business being operated with a profit motive. If this condition were not imposed, recreational and hobby owners of horses would be able to take deductions. Since business activities generate taxable income, the IRS will allow the deductions. Since hobby ownership doesn't, the deductions are not allowed. I.R.C. § 183(d) (1976).

tion, or by having a trainer at the track claim a mare from a claiming race. As with the purchase of racing stock, the broodmare should be selected with a particular shelter investment figure in mind. Arriving at this figure involves a wide variety of calculations and should only be attempted by the inexperienced investor with the assistance of an experienced horseman. Once again, bloodstock agents are worth the fees they charge. Their experience in the marketplace will greatly enhance the chances of the investor purchasing a broodmare compatible with the sheltering plan.

A single high-priced broodmare generates the same cost recovery benefits under ACR as do several broodmares purchased for the same total price.[124] The similarity in the sheltering benefits of a single broodmare and multiple broodmares ends at this point. The business expense deduction is an important benefit to be realized by the broodmare investor in addition to the cost recovery benefits.[125] With this in mind, it should be clear that buying several moderately-priced broodmares has advantages not realizable by the investor buying the single high-priced broodmare. Such advantages are increased deductible business expenses for such things as veterinary care, feed, shelter, stud fees, transportation, insurance, grooming, and shoeing, to name only a few.[126] In many cases these expenses will exceed the value of the broodmare in the first year, particularly with a high stud fee figured in the equation, and offer the investor the opportunity to defer large amounts of tax liability. This can be accomplished by deducting the maximum allowable amount under the at risk rules and carrying forward any additional deductions to be used to offset income realized in future years from the sale of offspring.[127]

The benefits per dollar invested in broodmares over the first two years of the investment will return a tax benefit on par with the other thoroughbred shelter investments. Beyond that time, however, the broodmare, if properly managed, is generally pro-

124. The same total investment will yield the same percentage rate of recovery (15% in the first year of the five-year recovery period) regardless of how many mares make up the total investment value.

125. *See* I.R.C. § 162(a) (1976).

126. I.R.S. § 162(a) (1976); Treas. Reg. § 1.162-1(a).

127. I.R.S. § 465(a), (b) & (d) (1982).

ducing income sufficient to negate the tax shelter benefits. The broodmare then becomes a good investment and an obsolete tax shelter. This circumstance in broodmare tax shelter investing can be delayed almost indefinitely by careful management and continual upgrading of the broodmare operation. But this becomes a full scale business venture in a realtively short period of time. Consequently, an investor who is more interested in quick, uncomplicated tax shelters than a thoroughbred breeding operation should look elsewhere to shelter the high income from immediate taxation.

The stud horse investment is perhaps the best known thoroughbred tax shelter opportunity. The value of male breeding stock has soared in recent years. As prices increase the value of these studs as tax shelters also increases.[128] Although the stud investment will often begin to generate some income in the second year, the shelter benefits of deferring large amounts of income for that two year period can be considerable. An example of how a hypothetical partnership formed[129] for the purpose of sheltering high income would most clearly illustrate how the stud shelter investment works.

In December of 1980 a limited partnership of ten individuals is formed for the purpose of investing in a thoroughbred stud to gain tax shelter benefits.[130] The goal of the partnership is to shelter an average of $50,000 of income per partner over the first two years of the investment. Looking to the ACR tables to calculate what total amount of capital investment is necessary to generate the desired deductions, it is evident that a stud in the $3,300,000 range would fulfill the sheltering goals of the partnership.[131] After contacting several bloodstock agents, a suitable

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128. The cost recovery basis for the purpose of ACR is established by the cost of the capital asset. When a partnership or syndication buys a stud for 36.4 million dollars (as was done in the purchase of Conquistador Cielo in August of 1982) the basis for ACR is established. That means a deduction of $5,100,000 in the first year for the partnership, or $170,000 per share, based on a five-year recovery period (*see* I.R.C. § 168(c)(2)(B) (1982)). At fifteen percent recovery for the first year, these deductions are subject to the at risk rules, of course. *See also* notes 67 and 68, *supra.*

129. *See* note 113 and accompanying text.

130. The partnership would not be subject to the short tax year limitation of I.R.C. § 168(f)(5) (1982).

131. This figure is reached by multiplying the amount to be sheltered ($50,000 x 10 = $500,000) by 6.6 (100 ÷ 15 = 6.6) = $3,333,333. Fifteen percent of $3,333,333 = $499,999.95 representing the first year recovery allowed by ACR. *See* note 67 *supra;*

stud is located and purchased for $3,500,000 in November of 1981.[132] The stud fee is set at $25,000[133] and the stud is placed in service shortly thereafter.

In the first taxable year of the investment (1981)[134] the partnership will be able to recover fifteen percent of the purchase price of the stud, or $52,500 per partner on a per partner investment of $350,000. Assuming that the partnership has been able to finance the investment with a loan (for which each is personally liable for his/her share) calling for ten percent down and the balance due as stud fees become due and payable, each partner's actual capital outlay could be as low as $35,000 per partner. In addition to the 15% deduction under ACR the interest on the loan could be deducted along with other business expenses to the extent with which the at risk rules[135] are complied.

In the second tax year there would still be no income generated by the stud investment. The eleven-month ordinary gestation period for horses and the common trade practice of collecting stud fees when the foal stands and nurses, allows the deferral of stud fee income to a period beyond the second tax year.[136] Under ACR rules, during that second year each partner will be able to deduct twenty-two percent ($77,000) of investment value ($350,000) of their share in the investment from

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I.R.C. § 168(b)(1)(A) (1982).

132. The process of selecting a suitable stud would be a highly complex one involving close scrutiny of the animal by a veterinarian (including fertility tests), an in-depth analysis of the bloodlines of the stud (to calculate the stud fee likely to be commanded), and the available financial terms of the agreement. The costs of such an in-depth analysis are deductible as business expenses under I.R.S. § 162(a) (1976).

133. Usually a stud fee can be roughly figured by dividing the purchase price by thirty (the usual number of shares in a partnership) and then dividing that number by five (the number of years in which an investor can recover the cost of the investment.)

134. Since the stud was purchased and placed in service in 1981, even though owned by the partnership for only two months, the half-year deduction can be taken. This is possible because under ACR rules the seller can take *no* cost recovery deduction in the tax year the sale is made. In reality the first year deduction would be half of the stated amounts in the text, with the remaining half to be recovered in the year following the last year of the property's class life. *See* I.R.C. § 168(b)(3)(B)(iii) (1982) and note 110 *supra*.

135. I.R.C. § 465 (1982).

136. Of course, if the stud had been purchased in January 1981 and bred that season, income would be generated in the second tax year. To the extent that income is generated the tax benefits are reduced.

their respective gross incomes. The shelter benefits in the first two years of the investment to each partner from cost recovery alone will be $129,500. To this figure additional deductions can be added for all expenses reasonably related to the management of the partnership and the upkeep of the stud. Once again, these expense deductions are limited by the amount at risk in the investment.

Unless the partnership is breeding exclusively to its own broodmares, in the third year and in succeeding years the well-managed stud partnership will begin to generate a substantial income. A carefully selected stud will be in great demand. With a full book (usually around forty, but sometimes as high as fifty-five) of mares each season the average stud will impregnate approximately eighty percent of them. Assuming the partnership books forty mares for the stud to service each year, with an impregnation rate of eighty percent (thirty-two mares) the total stud fees receivable in the third year and thereafter (based on the $25,000 fee) would be $800,000 for the partnership or $80,000 per partner. The cost recovery deductions for the remaining three years of the investment are twenty-one percent ($735,000) of the investment basis ($3,500,000) or a $73,500 deduction per partner per year. At this point the investment, now generating ordinary income in excess of deductions, loses its ability to shelter income from other sources. Although it still shelters most of the income it generates, it actually creates a small additional ordinary income tax liability. The sheltered investment in the stud, however, has served the purpose of the partnership well by sheltering over an average of $50,000 per year per partner for the first two years of the investment, the original goal of the partners.

The stud shelter has gained its recent notoriety largely because of the highly publicized stud syndications of horses such as Affirmed (purchased for $24,000,000), Spectacular Bid (purchased for $26,000,000) and most recently Conquistador Cielo (purchased for $34,300,000).[137] In the Conquistador Cielo syndication the original owner retained ten shares. Thirty additional shares were sold for approximately $900,000 to which was added

137. *Record Review*, 216 THOROUGHBRED REC. 1064 (1982).

a $20,000 premium for mortality insurance.[138] The first year deduction for cost recovery alone will net the investors in the neighborhood of $125,000 of shelter benefit. While such a syndication offers significant income shelter, the investors stand to gain up to $150,000 a year per share in stud fees and perhaps even greater profits if they use their shares to breed to their own broodmares and sell the foals as yearlings. As must be clear by this point, sheltering income is not the only reason such investments are made.

C. The Dissolution of the Thoroughbred Tax Shelter

One of the most often overlooked aspects of tax shelter investment planning is preparing for the dissolution of the investment that exhausts its sheltering benefits. This preparation should occur well in advance of the drying up of the benefits. Thoroughbred shelters are usually dissolved by the sale of the horse. Often owners whose tax shelter benefits have run out simply retain the horse for breeding purposes and hope to recoup the residual value (after cost recovery) of the animal through the sale of breeding privileges of future offspring. There are also the unexpected complete losses due to severe injury or disease that prematurely bring the investment to an end. These unfortunate and unexpected losses can be insured against, but the coverage may not benefit the investor in the same manner as if the horse had survived for the duration of the investment. Regardless of how the investor chooses to dissolve the investment, two critical considerations must be made: recapture of cost recovery and the potential for capital gains treatment.

The basic notion of recapture involves the taxing at the rate of ordinary income any gain from the sale of cost recovery property (or depreciation property under ADR) in excess of the recomputed basis of that property.[139] Any gain in excess of the original unadjusted basis—which is ordinarily cost—will be taxed as ordinary income or capital gains dependent upon how long the property has been held. Because horses are cost recovery property under section 1245 (i.e. the cost of horses can be

138. *Id.*

139. Recomputed basis simply means the unadjusted basis (for horses usually the purchase price) minus any cost recovery that has been taken. I.R.C. § 1245(a)(2)(A) (1976).

recovered under ACR rules) they are subject to recapture under the recapture rule stated above.[140]

For example, a thoroughbred is purchased for racing purposes at a cost of $100,000. After two years of ownership the horse is sold for $200,000. Cost recovery benefits of $63,000 had been deducted from income taxes in the two prior tax years as provided by the ACR system.[141] The adjusted basis of the property at the time of sale is $37,000 (unadjusted basis, $100,000, minus cost recovered, $63,000). The excess of the adjusted basis, gained from the sale, up to the unadjusted basis (equal to the amount deducted as cost recovery benefits, i.e., $63,000) is subject to recapture and will be taxed at ordinary income rates. The excess of the unadjusted basis ($100,000) will be taxed at the capital gain rate since the property has been held for twenty-four months.

In effect, the tax on the ordinary income has been deferred for a minimum of two years.[142] The importance of this kind of income tax deferral increases significantly during a period, such as the present, when income tax cuts are being phased in over a three-year period. To be able to shelter income and defer payment of income tax until the tax rates are reduced can result in measurable gains to the tax conscious investor.

In considering the consequences of recapture of depreciation[143] or cost recovery, plans should be made to carefully time sales of recapture property to coincide with the maturation of benefits from tax shelters. If the gain from sale is recapturable, it will be taxed as ordinary income, absent an offsetting deduction.

Qualifying for capital gains treatment on income from the sale of a thoroughbred used in a tax shelter investment is a relatively easy task. Knowledge of the statutory holding period re-

140. Treas. Reg. § 1.1245-3(a)(4).

141. I.R.C. § 168(b)(1)(A) (1982).

142. The tax is deferred for a minimum of two years because if the transactions were timed correctly (for example a purchase in January of 1981 and a sale in January of 1983) no tax would be due until April of 1984. The investor gets the full use of the capital tax free for three years and three months.

143. Recapture of depreciation under the ADR system works in basically the same way as recapture of cost recovery under the ACR system.

quired to qualify enables the investor to time the sale of the capital asset so that capital gains treatment is ensured.[144] The holding period for horses is twenty-four months.[145] Capital gains treatment will only be applied to gains in excess of the original purchase price of the horse.[146] Because the capital gains tax rate is beneficial to sellers who qualify, all sales that are expected to produce large gains should be made only after the two-year holding period has elapsed. This is rarely a problem for thoroughbred shelter investors because the shelter benefits gradually yield their highest returns in the first two years of the investment. In other words, an investor seeking an income tax shelter is unlikely to sell that shelter in order to take a gain taxable at ordinary income rates, particularly when the shelter is still performing its function.

V. Conclusion

While it has been the general congressional policy in recent years to eliminate abusive tax shelters, the accelerated cost recovery system introduced as a primary part of the Economic Recovery Tax Act of 1981 has made investing in thoroughbreds a much more viable tax shelter alternative. Although it is not without its limitations, with the rapid rates of recovery available under the ACR system investors are now able to shelter more income in less time. Undeniably there are many more prosaic investments offering similar and even greater tax incentives to investors. Thoroughbred racing and breeding, however, offers a unique combination of business, pleasure, and sport to the tax shelter seeker.

*Joel B. Turner**

144. I.R.C. § 1231(a) (1976).
145. I.R.C. § 1231(b)(3)(A) (1976).
146. For further discusson, *see* (R.I.A.) ¶ I-6004 (May 1, 1980).
* Second year student, Golden Gate University School of Law.