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Horse Syndication: A Sure Footed Winner in the Investment Sweepstakes

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Recent changes in the scheme of federal taxation coupled with increasing interest in the equine industry has propelled that industry into the forefront of tax sheltered investments. In this article the author takes an in-depth look at the federal securities and tax law aspects of a typical equine syndication as a tax sheltered investment.

I. INTRODUCTION

The Tax Reform Act of 1976[1] was promulgated in an effort to eliminate certain investment programs. Specifically, Congress targeted for extinction the so-called "abusive" tax shelter.[2] The Tax Reform Act and those taxation acts which followed[3] created new and confounding problems for the high income, high tax bracket individual.[4] Such an individual was confronted with this

1. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 [hereinafter cited as Tax Reform Act].

2. *See* S. REP. NO. 938, 94th Cong., 2d Sess. 9, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS, 3439, 3445. An abusive tax shelter is one where the individual investor's "[l]oss returns . . . lack economic reality or viability in varying degrees," and is characteristically "[those] transactions . . . [which fail] to produce a return relative to the risk involved. . . ." *See* E.F. HUTTON & CO., UNDERSTANDING TAX SHELTERS (1979). A basic tenet subscribed to by Congress in enacting the Tax Reform Act was that "[too many] investments have been motivated by excessive concern with the tax benefits associated with them [and] not [because of the investment's] economic merits. . . ." S. REP. NO. 938, 94th Cong., 2d Sess. 9, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3445. Although Congress acted to restrict those tax savings programs deemed valueless, it left untouched those tax laws already in effect which allowed and promoted economically worthwhile investments which had incidental tax benefit features. *See generally* STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 (Comm. Print 1976).

3. Subsequent to the enactment of the Tax Reform Act, Congress passed a series of tax acts which clarified, amended, and corrected the Tax Reform Act. These later acts are the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 [hereinafter cited as Revenue Act]; The Technical Corrections Act of 1979, Pub. L. No. 96-222, 94 Stat. 194; and the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 [hereinafter cited as Economic Recovery Act]. Most notable are the Revenue Act's modification of the "at-risk" rules and the Economic Recovery Act's extension of the "at-risk" rules to the investment tax credit. *See infra* notes 78 and 147 and accompanying text.

4. By enacting tax legislation in piecemeal fashion, Congress relinquished both equity and economy, two basic principles of tax law, in favor of generating additional revenue through the disallowance of abusive tax shelters. Presently,

scenario: first, he could invest in a speculative investment program masquerading as a tax shelter; or second, he could choose to contribute his investment capital to an investment well-founded in law and business.[5] If he opted for the first alternative, he was faced with dubious tax consequences because the Internal Revenue Service (IRS) might disallow part or all of the investment's purported tax benefits claimed to exist by its promoters, and his chances of realizing a profit from his investment were usually remote.[6] Thus, the question was, "Do I pay my money to the government in the form of taxes or do I invest my money in something I hardly understand and hope I come out a winner?" If, however, this same individual decided to take a reasonable approach in his investment planning, as the second alternative suggests, his investment posture would improve considerably. By contributing his investment capital to a *bona fide* investment vehicle, he would most probably enjoy "front end"[7] tax benefits

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the uninformed investor, without competent counseling, is likely to become detrimentally entangled in the thread of legal concepts now interwoven in the fabric of the tax law. *See infra* notes 46 & 161 and accompanying text. The Tax Equity and Fiscal Responsibility Act of 1982, 29 U.S.C. § 1101 (1976 & Supp. III 1982) [hereinafter cited as Tax Equity Act], includes a provision which imposes a penalty on those found guilty of promoting abusive tax shelters. A penalty of $1,000 or 10% of gross income derived or to be derived from the activity may be imposed on promoters of abusive tax avoidance schemes. An abusive tax shelter, under the Tax Equity Act, is defined as any "plan or arrangement" in which the promoter makes a statement of tax benefits which he knows or has reason to know is false or fraudulent, or a valuation error in services or property of more than twice the correct value. I.R.C. §§ 6700, 7408 (West 1982) (added by §§ 320, 321 of the Tax Equity Act). *See also infra* note 6 regarding penalties.

5. This choice seems quite obvious; however, not all investment situations are so easily distinguished. Many times an investor, ignorant of the true tax and business consequences of a particular investment, is forced to rely on the counsel of others. Unfortunately, there are too many instances where those giving advice are interested parties and/or are lax in keeping abreast of the law and its requirements. The combination of the unsophisticated investor and an unscrupulous advisor or promoter increases the chances of the innocent investor being manipulated and injured.

6. Cognizant of the preference accorded partnerships by those seeking to shelter income, the IRS implemented an auditing plan in 1972 designed to scrutinize abusive tax shelters using the limited partnership as an ownership entity. In enforcing the tax laws, the IRS may disallow certain tax deductions, credits, or exclusions claimed by a partnership and its constituent members. When the IRS disallows such tax benefits, members of the limited partnership may become individually responsible for those taxes deferred or unpaid to the extent they applied these apparent tax benefits to their own taxes. Moreover, such a disallowance may entail the imposition of a penalty. *See* I.R.C. §§ 6653, 6659 (West 1982). *See generally* United States Master Tax Guide (CCH) ¶ 1435 (1981). *See also* Comment, *Auditing Partnership Tax Shelters; IRS Procedures and Taxpayer Liability*, 60 NEB. L. REV. 564 (1981).

7. "Front end" in investment situations means short-term or the early years of the investment program. These include high depreciation, loss allowances, and tax credits, which are used to defer or eliminate taxes incurred on income from the investment activity as well as unrelated income.

which would be truly available and unlikely to be contested by the IRS. Further, he could participate in "back end"[8] benefits, such as profits produced, if any, from the investment program and the long-term capital gain treatment[9] such profits might receive. These characteristics are those of the classic tax shelter envisioned and encouraged by Congress.

Once the individual commits to making a reasonable investment in the hope of sheltering current income from immediate taxation, while simultaneously creating the possibility of future profit, what kind of investment should he make? There are numerous investments he could make, and many are quite suitable to accomplish the ends just discussed,[10] but virtually none combine the necessary foundation of law and business with sheer excitement and pride. An investment which accomplishes all of this is the investment in a horse.

From the dawn of civilization, throughout recorded history and into the present time, horses have delighted, mystified and awed human beings. It is not uncommon that people, even today, often refer to the equine racing industry as the "Sport of Kings."[11] Arabians, Thoroughbreds, Standardbreds and Quarter Horses have each sustained, with varying degree, a meteoric rise in monetary value over the last decade. When compared to recognized

8. "Back end," the reciprocal of front end, means the intermediate to late years of an investment program, including those years following its termination. Generally, back end benefits are profits, the availability of long-term capital gains treatment, and any remaining credits or depreciation allowance. *See infra* notes 9 and 231 regarding capital gains treatment of gain recognized from an investment.

9. Gain realized from the sale or exchange of property is taxed at 100%. I.R.C. § 61(a)(3)(West 1982). The noncorporate individual taxpayer is entitled to treat some transactions as long-term gains. The gain must be the result of a transaction involving a capital asset held for the required holding period (normally more than one year). Then, only 40% of the gain would be taxable. *See* I.R.C. §§ 1202, 1221, 1222, and 1231(b)(3) (West 1982). Note: if the property is a horse, the holding period is two years for long-term capital gain treatment. *See also* CRAIGO, *Making Tax Dollars Out of Horse Sense,* TAX SERVICE IDEAS ¶¶ 17,261, 17,272 (1982).

10. The most common tax shelter programs are those centered around real estate, oil and gas, equipment leasing, and farming. For a fine analysis of tax shelters, *see* R. HAFT & P. FUSS, TAX SHELTERED INVESTMENTS HANDBOOK (1983).

11. This phrase is traceable to the reign of Charles II, King of England. It was at this time, during the middle to late 1600's, that the ancestors of the modern day Thoroughbred, which incidentally were Arabian horses, were brought to England. The kings of Europe made the sport of horse racing into a royal pastime and to this day the equine industry pays tribute to this influence. The author wishes to acknowledge the assistance of Mary Fleming, Associate Editor, *The Thoroughbred of California,* who was consulted on this material.

indexes of economic prosperity, the rise of horse values has been nothing short of spectacular.[12] Besides the monetary benefits of investing in horses, there are intangible benefits—watching your Thoroughbred win a stakes race or your purebred Arabian take a national championship.

This article will analyze *horse syndication* as an investment and as a tax shelter. No attempt is made here to cover all the issues which could conceivably arise in a typical horse syndication. Rather, the intent is to analyze the primary factors of a properly structured horse syndicate. The emphasis is on the tax, securities and general business considerations inherent to a syndication.

II. THE SYNDICATION OF A COMMODITY

A. *Some Background*

For many years the enormous cost of purchasing a high quality race or show horse, together with the high costs and expenses incidental to maintaining and training such a horse, prohibited most individuals from equity participation in these types of exclusive horses.[13] Additionally, those within and without the industry had a feeling, largely because of the associated capital outlays, that such an investment was reserved for the very rich. Even those who had the discretionary financial resources to make such a commitment often refrained because of the novelty of the investment and their lack of sophistication concerning the equine industry.[14] In an effort to encourage an influx of new investment capital, certain groups in the equine industry developed new investment vehicles and adapted existing ones to accommodate their purpose.[15] To accomplish this end, owners and promoters of

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12. The average price of Thoroughbreds has increased 341% from an average sales price of $8,797 in 1971 to $30,000 in 1980. During this same period, the price of Arabians has increased 623% in average sales price, moving from $19,822 in 1971 to $123,628 in 1980. *See* Barrons National Business and Financial Weekly, Feb. 14, 1983, p. 106. In contrast, the Dow Jones Industrial Average increased approximately 9.5% from 890.20 at year's end in 1971 to 963.99 at year's end in 1980. *See Id. See also* Appendix I at the close of this article which illustrates, in graphic form, the tremendous value appreciation which has occurred in the equine industry. *See also* Gardner, *Arabian Horses: A "Living Art Form" with Tax Benefits,* NAT'L TAX SHELTER DIG. 6 (September 1982).

13. Foreseeable expenses are feed, board, veterinary, farrier services (horseshoeing), insurance, and training. These fees can quickly deplete an individual's resources allocated for his horse business. *See generally* Gardner, *Syndications in Mares,* ARABIAN HORSE WORLD 193 (September 1981).

14. As is generally the case with investors delving into a new and unfamiliar area, prudent investors were shy to make an investment without some assurance and contacts in the horse industry. This resulted from fears of losing large sums of money.

15. Various entities are available which allow for the amalgamation of finance and experience; i.e., the general partnership, joint venture, or corporation. The

horses had to develop a means to diffuse the burdens of horse ownership and allow for a fair participation in the profits a horse might generate, in addition to providing expert management and promotion of the horse for those investors incapable of or disinterested in doing so on their own.[16] The methods adopted to facilitate these goals vary; however, the two methods favored, almost to the exclusion of all others, are the *syndication* and the *securities offering.*[17]

When a horse is syndicated, a legal fiction is created. Simply, the subject horse is theoretically divided into a certain number of undivided fractional interests,[18] usually, via a "Syndicate Agreement." Such an agreement will state the identity of the horse, what each interest will cost, and the rights and responsibilities attendant each interest.[19] Generally, the number of undivided fractional interests created in a horse will range between thirty-two and forty, although no definite prohibition against creating more or less than this number of interests exists.[20]

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preferred entity in the horse industry, however, is the syndicate. *See* Husband, *Stallion Syndication*, THE WESTERN HORSEMAN 22 (March 1981).

16. Syndication allows for risk spreading and collective ownership. Syndication does not, where commodity based, provide centralized management which controls the course of the investment. Conversely, a limited partnership allows for limited liability, limited risk, and passive investment. For investors seeking the advice and expertise of others, the limited partnership is ideal.

17. Many times, the word syndication is used interchangeably with reference to a commodity syndication or a securities offering. For purposes herein and unless otherwise stated, syndication refers *only* to the investment programs wherein the horse is treated as a commodity, whereas the term securities offering refers to those investment programs in which the interests offered are considered securities. Note also that unless otherwise indicated, syndicate or syndication as used herein shall refer to stallion breeding syndicates.

18. This fiction is in the nature of a tenancy in common. When a tenancy in common is created in property, each tenant in common retains a vested undivided interest in the res which is subject to co-ownership. Each co-tenant has a distinct, proportionate, undivided interest in the property which is freely alienable. Usually purchasers of syndicate interests are referred to as "co-owners"; such purchasers are referred to interchangeably herein as interest holders, interest purchasers or co-owners. BLACK'S LAW DICTIONARY 1314, 1315 (5th ed. 1979).

19. The typical syndicate agreement will also have provisions which address risk of loss or injury, horse infertility (if a breeding syndicate), restraints on interest transfer or disposal of excess nominations, tax considerations, election of a syndicate manager, and other miscellaneous items. Those clauses which restrict transfer of interests and disposition of excess nominations are part of any good syndicate agreement. For the rationale behind these clauses, see *infra* notes 39 and 243 and accompanying text.

20. The range is the result of two conditions, one physiological, the other legal, although the legal consideration may be of questionable importance. The physiological element rests in a stallion's ability to "cover" a certain number of mares.

Essentially, when a horse is syndicated it is treated as a commodity. As a chattel the horse has certain attributes and potential which, depending upon the skill and expertise of its owners (the fractional interest holders), can be exploited to produce value.[21] To illustrate, assume individual "A" owns stallion "X". A decides to syndicate stallion X. Through a syndicate agreement, A creates thirty undivided fractional interests in X, retains ten interests and sells twenty interests to investors one through twenty. Assume further that X is now retired to stud and has value as a breeding stallion. As is the case in most stallion breeding syndicates, the syndicate agreement provides that each interest holder is entitled to "nominations." A nomination, or breeding right, is the right to have a mare "serviced" by the stallion to the end that she conceives.[22] Thus, if each interest holder in the X syndicate were entitled to two nominations, each interest holder would have the right to the stud services of X twice per year.

The nature and purpose of a syndicate is joint ownership of a horse, *absent* third party management (for other than administrative purposes), pooling of income, and dependency on the efforts of others for the success of the enterprise.[23] Albeit a syndicate has at its center a particular horse (stallion X in the above example) the true attribute and legal character of a syndicate is the individual interests created in the horse and the separate uses made of the interests by each separate interest holder. In form and in substance, each interest holder is a distinct enterprise and what that holder does with his interest is his exclusive province.

Cover is horseman's vernacular to describe the number of mares a stallion is capable of servicing during any one breeding season. This will depend, of course, on whether artificial insemination is allowed by that breed's registry. Thoroughbreds may be bred by natural service only, according to the rules of the American Jockey Club, Jockey Club Rules and Regulations of the American Stud Books, registration rules and requirements, Rule 2(c) (Standards of Registration of Foals) (1980). Arabians may be bred by either natural or artificial service. Legally, there are arguably a number of reasons why this range exists, but the most logical reason is grounded in the securities laws. Most exemptions from registration pursuant to the securities laws, where "private offerings" are made, generally restrict to 35 the number of purchasers. Thus, a nexus between this number (35) and the range of interests normally offered (32-40) seems to exist.

21. *See infra* note 22.

22. Basically, where a breeding stallion is syndicated, there are three avenues for profit. The interest holder can profit from the "get" (meaning a horse's offspring) produced by mating the stallion to a mare. Profit can be gained by selling any nominations to which the interest holder may be entitled. Or, an interest holder, if fortunate, can realize a gain on the sale of his interest in the syndicate because the interest appreciated in value. *See* SEC Release No. 33-5347, 38 Fed. Reg. 1735 (1973), which discusses securities law and commodities in condominium developments.

23. Such attributes are prima facie evidence that interests offered in a syndicate are not securities. *See supra* note 3 and accompanying text.

Whether an interest holder will realize a gain on his investment rests solely on his entrepreneurial ability.[24] Notwithstanding certain restrictions contained in most syndicate agreements, an interest owner is free to capitalize on his investment at his discretion. Generally, this encompasses selection of mares to be bred to the stallion[25] (assuming a stallion breeding syndicate), the breeding facilities to be used, retention of insurance and arrangements for related breeding expenses.

B. The Application of the Securities Laws to a Syndicate

Pursuant to section 5[26] of the Securities Act of 1933,[27] no *security* may be lawfully offered, sold or transported by means of interstate commerce unless either a registration statement has been filed with the Securities and Exchange Commission (SEC) in connection with the security offered or an exemption from regulation is available.[28] Section 2(1)[29] of the 1933 Act defines three categories of securities; two specific and one general. The first specific classification of a security is any interest commonly known as a security, i.e., bonds, stocks, debentures, etc. The second specific classification of a security includes interests or instruments specifically mentioned in the 1933 Act: i.e., subscriptions for securities, fractional undivided interests in oil, gas or other mineral rights. However, the most significant portion of section 2(1) is its general catch-all classification which refers to *investment contracts* and *certificates of interest* or *participation* in any profit-sharing agreement. This general provision is deter-

24. This fact weighs heavily on the securities and tax laws pertinent to a syndicate. *See infra* notes 30-39 and 178 and accompanying text.

25. The great majority of horses which are syndicated are breeding stallions. Interests offered in breeding stallion syndicates are likely not securities; however, interests offered in the syndication of a broodmare or where the investment focus is on showing or racing a horse (necessitating dependence of the investor on the skills of others for profit) may be found to be securities unless the deal is carefully structured. *See infra* notes 42 and 43. Because interests offered in a nonbreeding stallion syndicate border on being securities, such types of syndications are few. Aware of this risk, a promoter who desires to avoid this problem entirely might well formulate his deal in a way which vitiates the very essence of the investment plan, making the amended plan less palatable to investors. CRAIGO, *Making Tax Dollars Out of Horse Sense,* 1982 TAX SERVICE IDEAS ¶ 17,011.8 (1982).

26. The Securities Act of 1933, § 5, 15 U.S.C. § 77e (1981) [hereinafter cited as 1933 Act].

27. 1933 Act, 15 U.S.C. §§ 77a-77aa (1981).

28. 1933 Act, § 4(2), 15 U.S.C. §§ 77b and 77c (1981).

29. 1933 Act, § 2(1) 15 U.S.C. § 77(b)(1) (1981).

minative of the question whether interests created in a horse syndicate are securities subject to the registration requirements of the 1933 Act.

Because the phrases *investment contract* and *certificate of participation* were necessarily inexact, the scope and reach of these phrases had to be determined through litigation.[30] On the one hand American entrepreneurs are truly adept at creating financing techniques *sui generis,* and with the help of lawyers, these plans are implemented. On the other hand, the SEC has a duty to enforce the securities laws. It was inevitable, then, that the courts would be called upon to decide, interpret, and apply the general provision of section 2(1) to unique financial arrangements.[31] In the landmark decision of *SEC v. W.J. Howey Co.,*[32] the United States Supreme Court laid down this rule with respect to what constitutes an investment contract: "[T]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[33] Like the phrase "investment contract," this test, though seemingly concrete, was the subject of continued judicial interpretation.[34] As a result of such litigation, the *Howey* test has been refined to include an investment of money; in a common enterprise; with an expectation of financial benefit; to be derived solely from the efforts of others. The basic horse syndicate, as discussed above, clearly exhibits two of these elements. When a syndicate interest is purchased, there is an investment of money made with an expectation of financial benefit.[35] Not so definite,

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30. These phrases were broadly phrased to account for those situations which in substance involved securities, but where no specific rule or regulation was applicable. *See generally* H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).

31. The following instruments and interests have been held to be securities: small tracts of land sold to investors for fruit growing where the seller of the land grew, harvested, and sold the fruit, giving a percentage of net profits thereby derived to the investor (SEC v. W.J. Howey Co., 328 U.S. 293 (1946)); leasehold rights in small plots of land which entitled each purchaser to a drilled test well as the property (SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943)); membership in a social organization where certificates were issued to members for loans made (United States v. Monjar, 47 F. Supp. 421 (D.C. Del. 1942)); memberships sold to raise "risk capital" for club construction (Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811 (1961)).

32. 328 U.S. 293 (1946).

33. *Id.* at 301.

34. The requirements of a common enterprise (Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977)); solely from the efforts of owners (SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973)); and investment of money with an expectation of profit (International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979)), each have been the subject of litigation.

35. The Supreme Court, in United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975) (purchase of shares of common stock of a cooperative housing corporation by residents thereof held not to involve "securities"), examined the issue of an expectation of profits. The Court held "[b]y profits, the Court has meant either capi-

however, is the applicability of the *common enterprise* and *sole efforts* elements of the test.

The courts disagree as to what constitutes a common enterprise,[36] but in general a common enterprise exists where there are multiple investors who pool their invested funds for use as a source for producing profits. Arguably, a syndication involves multiple investors who pool their funds. But pooling of funds is absent from a horse syndication. Each investor purchases an interest or interests in the horse; he is not making a contribution of investment capital to a common fund. The investor's money is given in consideration for the interest he takes in the syndicated horse.

Of importance in resolving the issue of whether the element of *solely from the efforts of others* applies is *SEC v. Glenn W. Turner Enterprises, Inc.*,[37] a case decided by the Ninth Circuit Court of Appeals in 1973. *Turner* was predicated on the meaning of the term "solely." The Ninth Circuit altered the *Howey* test by interpreting "solely" to mean "whether the efforts made by those other

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tal appreciation resulting from the development of the initial investment . . . or a participation in the earnings resulting from the use of investors' funds. . . ." *Id.* at 852. The Supreme Court went on to state "[b]y contrast, when a purchaser is motivated by a desire to use or consume the item purchased—'to occupy the land or to develop it themselves,' . . .—the securities laws do not apply." *Id.* at 852-53. When an individual purchases an interest in a syndicate he is not committing an idle act. The purchaser does so because he expects to profit from his investment. Notwithstanding this fact, when the law is applied to a syndicate situation, via *Forman*, the investor is deemed to have no expectation of profit because the purchaser is acquiring the interest with the idea of "developing" the interest. This reasoning is apocryphal when applied to a horse syndication, particularly with respect to *Forman*, where the interests at issue were provided with the motivation of finding a place to live. 421 U.S. at 853.

36. The United States Supreme Court has not decided this issue directly. Instead it has tacitly supported the position of the Ninth Circuit Court of Appeals by refusing to grant a writ of certiorari for a case where this issue was decided by the Ninth Circuit. SEC v. Glenn W. Turner Enterprises, 474 F.2d 476, 482 n.7 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). The Fifth Circuit Court of Appeals in SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974), held that a common enterprise exists where "the fortunes of the investor are interwoven with and dependent upon the effort and success of those seeking the investment of third parties." 497 F.2d at 522 (quoting SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478 (5th Cir. 1974)). This position is an adoption of the Ninth Circuit's rule enunciated in Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162, 172 (9th Cir.), *cert. denied*, 366 U.S. 919 (1961). A contrary position is taken by the Seventh Circuit Court of Appeals, which was first postulated in Milnarid v. MS Commodities, Inc., 457 F.2d 274 (7th Cir. 1972), *upheld* in Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977).

37. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[38] Tentatively, because the basic horse syndication involves an administrator, commonly referred to as a "syndicate manager," and because this administrator has certain responsibilities and duties, there is slight reason to conclude that this expansive version of *Howey's* fourth element should apply.[39] Based on the following, this is untenable. By its very *nature,* a horse syndication is meant to orchestrate the profitable exploitation of a commodity (the horse) by multiple parties. Each individual interest holder has the inherent right to do with his interest what he pleases free from the restraint of others. The success or failure of the investment is solely dependent upon the abilities of the individual investor. Thus, even under this expanded definition of the *Howey* test, the fourth element would have no force concerning the average horse syndicate.

An economical way to avoid the potential risk of violating the securities laws and to obtain, in effect, a prior ruling by the SEC on a particular matter is to request a no-action letter from the SEC.[40] When a party asks the SEC to issue a no-action letter, the request is accompanied by a detailed statement of the investment program to be used which outlines all of the relevant mechanisms of the program and, where appropriate, law is cited.[41] If the SEC does issue such a letter, it is proclaiming that with reference to the information supplied, it will refrain from instituting legal action based on a particular aspect of the securities laws; i.e., failure to register a securities offering. A party successful in procuring a no-action letter is usually relieved of the expense and burden of registration or qualification for exemption. This being the case, in 1977, John R. Gainesway of Gainesway Farm, Inc., asked for and received a notice of no-action from the SEC regarding a stallion syndicate Gainesway was about to promote.[42] Specifically, the SEC stated that it did not view interests offered in the Gainesway

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38. *Id.* at 482. The policy enforced by the *Turner* court was the "remedial nature of [the Securities Act of 1933 and] . . . the statutory policy of affording broad protection to the public. . . ." *Id.*

39. A viable nonsecurities syndicate expressly limits the powers of a syndicate manager and most allow for his removal. Moreover, the function of a syndicate manager should be ministerial at most. Problems are certain to arise when a syndicate manager is given broad powers indicative of a control relationship over the investors. The more powers granted a syndicate manager, the more likely the interests offered in a syndicate will be securities.

40. Examples of the form a no-action letter should take is found in No-Action and Interpretive Letters, FED. SEC. L. REP. (CCH) ¶ 76,001 (1982).

41. *Id.*

42. No-action letter issued by the SEC, July 18, 1977, regarding Gainesway Farm, Inc. (CCH) ¶ 81-311 (1977).

stallion syndicate as securities. This event instigated the widespread use of syndication in the equine industry. The thinking was, although the Gainesway letter was not binding on the SEC when a different syndication was involved, another syndicate might be premised on and structured after the Gainesway syndicate; still, such a letter was persuasive and indicative of the position the SEC would likely take where other Gainesway-type syndicates were at issue.[43]

In summary, the answer to whether an interest in a horse syndication is a security is twofold. First, if the syndicate closely parallels the mechanics and operation of the Gainesway syndicate, then any interest offered in such a syndicate is unlikely to be

43. *Id.* The syndicate interests found not to be securities in the Gainesway letter were interests in a breeding stallion. Therefore, the elements which follow and the decision rendered in the Gainesway letter by the SEC may not always support a claim that a nonbreeding stallion syndicate or a breeding stallion syndicate which deviates significantly from these elements will be free from a claim that its interests offered are securities. According to the SEC no-action letter pertaining to the Gainesway syndicate, a syndicate exhibiting the following characteristics will not be treated as the source of a securities offering:

(a) undivided fractional interests are sold to investors who desire to breed mares to the stallion;

(b) each interest holder who obtains "get" (from the activities discussed on paragraph (a) above) holds title in such "get" free and clear of any interest of the syndicate as a whole;

(c) the syndicate does not pool funds paid by investors, gains are not shared and risk of loss is on each investor;

(d) unsold interests are retained by the original owner of the stallion;

(e) expenses incurred for stallion care are borne pro rata by each interest owner in relation to the number of nominations to which he is entitled during each breeding season;

(f) the entity providing board for the stallion had a right to use a set number of nominations in each breeding season and a per diem reimbursement for boarding the stallion;

(g) nominations in excess of those exercised were to be disposed of between the interest holders by lot and were not to be offered to the public;

(h) each interest holder had an insurable interest in the stallion;

(i) the owner of a syndicate interest had to give other interest holders the right to first purchase his interest before such an interest could be sold to a third party not a member of the syndicate;

(j) nominations to which each interest owner was entitled may be offered and sold to third party non-syndicate members; and

(k) syndicate interests offered are done so absent any claim of profits to be realized through the efforts of others.

Id. Placing a restriction on disposition of excess and unused nominations is critical to a finding that interests offered in a syndicate are not securities. Absent this restriction, it is foreseeable that the syndicate manager would sell unused nominations to the public and thereafter distribute the proceeds among the syndicate membership. This fact alone would probably be sufficient grounds for the SEC to assert that interests sold in a syndicate allowing such activity are securities.

treated by the SEC as a security. Secondly, and more importantly, the *Howey* test is composed of four elements, each of which must be established before a court may label a certain interest an investment contract, and thus a security. The result is that if the syndicate is not modeled after Gainesway and tailored accordingly, every effort should be made to ensure that at least one element of the *Howey* test is absent from the character of the syndicate. If this can be done, one may reasonably conduct the syndication of a horse with no immediate risk of violating the securities laws now in effect.

C. *The Syndicate as a Tax Shelter and Other Tax Considerations*

1. *The Limitation on Loss Deductions to Amount "At Risk"*

Suppose Mr. Investor purchases an "interest" in "X" syndicate for $20,000. He finances this purchase by making a $5,000 cash down payment and by executing a nonrecourse promissory note in favor of the party selling the interest for the balance of $15,000. Further, in the same year, Mr. Investor has $10,000 worth of loss deductions incurred in his syndicate related activities. Mr. Investor claims the full loss deduction and offsets his ordinary income derived from other unrelated activities. What is the real economic effect of Mr. Investor's investment in X syndicate? Inherently, the nature of the financing permits Mr. Investor the advantage of a $10,000 tax deduction, which reduces his taxable income, while having incurred a present out-of-pocket cost of $5,000. Although it appears Mr. Investor's cost for the interest is $20,000, in reality he is only "on the line" for $5,000 because the promissory note is nonrecourse (meaning Mr. Investor is not personally liable for the obligation underlying the promissory note). Therefore, until such time as Mr. Investor contributes additional cash, property, and/or becomes personally liable for any remaining obligation, his actual stake in the investment remains his original cash contribution of $5,000. That part of the claimed deduction which exceeds his out-of-pocket expenditure, contribution of property or deferred obligation for which he is personally accountable, is *artificial* in the sense that there is no real asset or commitment supporting the deduction.

Prior to 1976, there was no restriction on the amount of *artificial* deductions a taxpayer might claim.[44] However, in 1976, as

44. Prior to the enactment of the Tax Reform Act, a taxpayer's losses were limited, in general, to the taxpayer's cost or other basis in the activity. There was no accounting for true risk in the investment. *See* STAFF OF JOINT COMM. ON TAXA-

part of the Tax Reform Act,[45] Congress enacted section 465 of the Internal Revenue Code (Code), a sweeping measure which curtails the amount of loss deductions a taxpayer is entitled to claim with respect to a particular investment activity.[46] After 1976, under section 465 of the Code a taxpayer can only take loss deductions where he has a corresponding balance "at-risk."[47] A taxpayer is considered at-risk to the extent of cash or the adjusted basis of property contributed to the activity, amounts borrowed for use in the activity for which the taxpayer has personal liability which is compensable by reaching his personal assets, and the net fair market value of his personal assets which secure nonrecourse debt financing used in the activity.[48]

Section 465 provides that a loss deduction otherwise allowable during the tax year which occurred in an activity engaged in the production of income or in carrying on a trade or business cannot exceed the aggregate amount the taxpayer is at-risk in such activity at the close of the tax year.[49] In other words, loss deductions from an investment activity are allowed insofar as the investor has an equal at-risk figure supporting the deductions.

The premise underlying the at-risk rule is simple: limit loss deductions claimed by the taxpayer as a result of investment to that amount which the taxpayer has an equal investment position truly subject to a measurable risk of loss.[50] Though this concept is easily articulated, mastering the rule which implements the concept can be an exasperating task. Moreover, transactions failing to heed the rule, not dutifully patterned in accordance with its

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TION 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 (Comm. Print 1976).

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

46. The rule eventually adopted was the "at-risk" rule discussed *infra* at notes 47-53 and accompanying text. Initially, the House proposed a system termed "limitation on artificial losses" (LAL) to restrict loss deductions claimed in an investment activity. LAL would have required revenue and expenses originating in the same activity to be recognized in the same taxable year. This method prevents deferral of income recognition and acceleration of deductions. *See generally* H. REP. No. 94-658, 94th Cong., 1st Sess. 9, 25-85 (1976); S. REP. No. 94-938, 94th Cong., 2nd Sess. 2 (1976). The Senate favored the at-risk rule over the LAL. S. REP. No. 94-938, 94th Cong., 2nd Sess. 2 (1976).

47. *See Deductions Limited to Amount at Risk in Case of Certain Activities,* I.R.C. § 465. *See infra* notes 48-53 and accompanying text.

48. I.R.C. § 465(b) (West 1982). Unless otherwise stated herein, all references to the "Code" are to the Internal Revenue Code of 1954, as amended.

49. I.R.C. § 465(a)(1) (West 1982).

50. S. REP. No. 94-938, 94th Cong., 2d Sess., at 49 (1976); S. REP. No. 94-1236, 94th Cong., 2d Sess. 412 (1976); *See* GENERAL EXPLANATION, *supra* note 44, at 36-37.

precepts, can result in serious and burdensome tax consequences for the unwary.[51]

The at-risk rule is not a concern where the deductions attributable to a particular investment activity are equalled or exceeded by any income received or accrued from that same activity during the taxable year.[52] The only time the at-risk rule affects the availability of a proper deduction is where losses from an investment activity exceed any income or accruals from such activity to which the taxpayer is entitled or has received.[53] Any investment made in a syndicate should always be evaluated in light of the at-risk rule. A syndicate may offer a bevy of tax benefits, but may well be of little use to an investor whose deductions in the activity are limited by the at-risk rule. Therefore, it is advisable to tailor any financing scheme to comport with the constraints of the at-risk rule.

One of the signposts of a potential conflict with the at-risk rule is the use of risk-alleviation devices. Any time the investor is protected against loss on his investment because of guarantees, stop loss orders, or repurchase agreements, or is made immune from personal liability through the use of nonrecourse financing, he is not at-risk.[54] In addition, the at-risk rule is broad enough to apply to covert methods employed to circumvent the rule.[55] It behooves the promoter and the investor in the horse industry, therefore, to create risk in the investment. To the extent risk is present, the at-risk rule is satisfied.[56]

In an effort to prevent possible collusion or impropriety between the investor/taxpayer and a "related"[57] party or an "inter-

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51. The at-risk limitation on losses can be the ruination of a syndicate. Unsophisticated investors may be shocked to realize that the deductions taken to offset ordinary income are disallowed. Unfortunately, the investor may have no funds to satisfy an increase in tax liability caused by the disallowance and potential penalty. The tax burden is increased if the investor made an investment in a shaky syndicate which is unlikely to return a profit. The result is a poor investment and unplanned tax burdens—surely not what the investor had in mind when he made his investment.

52. I.R.C. §465(a)(1) (West 1982), states in part, "any *loss* . . . for the taxable year shall be allowed only to the extent . . . to which the taxpayer is at risk. . . ." (emphasis added). *See also* General Rules; allowance for deductions, Treas. Reg. § 1.465-2 (proposed June 5, 1979).

53. I.R.C. § 465(a)(1) (West 1982).

54. I.R.C. § 465(b)(4) (West 1982). *See also* General Rules; amounts protected against loss, Treas. Reg. § 1.465-6 (proposed June 5, 1979).

55. Treas. Reg. § 1.465-1(b) (proposed June 5, 1979).

56. The most efficient way to create risk where deferred payment is planned is to make any obligation recourse so that in the event the obligor (promisor) fails to pay as promised, resort can be made to his personal assets for satisfaction.

57. I.R.C. § 465(b)(3)(B) (West 1982), cites I.R.C. § 267(b) (West 1982), as a definition of related party. I.R.C. § 267(b) (West 1982), provides in general part that related parties include "(1) [m]embers of a family [meaning an individual's

ested"[58] party, section 465 imposes a further limitation on amounts considered at-risk. Where the investor borrows money from an interested or related party, notwithstanding the investor is wholly liable for any such borrowed sums, the at-risk rule prevents the inclusion of such debts in the amount at-risk.[59] Generally, a related party is a member of one's immediate family.[60] An interested party is one who has an interest in the investment activity other than simply as a creditor.[61] Treasury Regulations which have been proposed, but not yet adopted, attempt to further define what constitutes an interested party. According to the proposed regulations, a party has an interest in an activity where that person has a capital or net profits interest in the activity.[62] A capital interest is defined as "an interest in the assets of the activity which is distributable to the owner of the capital interest upon liquidation of the activity."[63] Further, the tentative regulations state that "it is not necessary for a person to have any incidents of ownership in the activity in order to have an interest in the net profits of the activity."[64] As one commentator put it: "[a]pparently, the rationale for denying at risk to borrowers who receive loans from persons having an interest in the activity other than that of a lender is based on the assumption that the loan may not be enforced and, therefore, it is really the lender's funds which are at risk."[65]

This aspect of the at-risk rule was recently contested.[66] The

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brothers, sisters, spouse, ancestors, and lineal descendants I.R.C. § 267(c)(4)] . . . (2) a corporation [wherein] more than 50 percent [of its] outstanding stock [value] . . . is owned directly or indirectly, by or for . . . [the investor] . . . ." *Id.*

58. I.R.C. § 465(b)(3)(A) (West 1982). *See also* General Rules; interest other than that of a creditor, Treas. Reg. § 1.465-8 (proposed June 5, 1979). The concept of extending the at-risk rule to cover transactions with so-called interested parties is axiomatic.

59. I.R.C. § 465(b)(3) (West 1982).

60. *See supra* note 57.

61. *See supra* note 58.

62. Treas. Reg. § 1.465-8(b)(1) (proposed June 5, 1979).

63. Treas. Reg. § 1.465-8(b)(2) (proposed June 5, 1979).

64. Treas. Reg. § 1.465-8(b)(3) (proposed June 5, 1979).

65. Gould, *Problems Encountered In Working With the At-Risk Provisions,* 58 TAXES 868, 880 (1980).

66. The context under which this issue was argued involved the syndication of the Arabian stallion known as Ibin Moniet El Nefous by Bentwood Farms, Inc., of Waco, Texas. The factual basis of the dispute was as follows. The syndicator (Bentwood Farms) owned the horse in fee simple. In order to further capitalize on the horse, its owners decided to create a syndicate with respect to only one-half of the total ownership interest. Pursuant to the syndicate agreement, the one-half

case involved a syndicator who sold interests in a syndicate using a deferred payment plan. The deferred payments were to be made to the syndicator and were full recourse. Investors in the syndicate then claimed certain depreciation deductions respecting their fractional interests in the syndicate. The IRS sought to limit the amount of deductions the syndicate members claimed because the IRS judged the syndicator to be an *interested* party. The IRS' position rested upon the implicit assumption that the entire syndicate was one activity. On the other hand, the investor/taxpayer argued that the syndicate was more than a single activity, i.e., the horse. He posited that each individual interest holder was conducting a separate and distinct activity. According to the taxpayer the syndicated horse was a mere instrumentality of each individual interest holder's horse breeding activity. In other words the horse was a commonly owned asset used by each interest holder in his own breeding activity. Ultimately the Service accepted this reasoning and allowed the challenged deductions.[67] The net profits element of the interested party definition has no application to the above fact situation because the syndicator has no right to any profits an individual interest holder might produce in the pursuit of capitalizing on his interest in the syndicate. However, it appears the capital interest segment of the test is relevant. The horse, the subject of syndication, when sold or transferred, where the syndicator retains an interest in the horse will give rise to income for the syndicator. So in this regard the test of an interested party is fulfilled. The proposed regulations and section 465 fail to define "activity."[68] Rather, section 465

interest in the horse offered in syndication was fractionalized into twenty undivided fractional interests. Each fractional interest had a purchase price of $100,000, which was usually financed with a $10,000 down payment and a deferred payment plan for the balance over a five year period. Further, each fractional interest entitled the holder thereof to three nominations to the stallion per year until the stallion died or became impotent. Additionally, the syndicator, and not a third party, was extending the credit on any unpaid portion of the purchase price for a syndicate interest. Note that this was the crux of the Service's claim. The IRS was claiming the syndicator was an interested party because it had an ownership interest in the horse and was extending credit on the purchase price of part of the horse to others.

67. This case is an unreported case primarily because it never progressed past the first level of administrative appeal within the IRS. Therefore the IRS never took an official position regarding this issue in this case. An IRS field agent in Waco, Texas pulled a tax return of one of the syndicate members, whereupon the taxpayer was informed that depreciation deductions taken in connection with his ownership interest in the syndicate were disallowed under the interested party exclusion of § 465. The field office concurred. The taxpayer filed an appeal in Austin, Texas. There the appeals officer agreed with the taxpayer and the field officer was instructed to permit the claimed deductions.

68. I.R.C. § 465(c) (West 1982), discusses "activities to which section applies" but never defines what exactly connotes an "activity." Further, the proposed regu-

lists certain activities to which it applies specifically[69] and states that it applies generally to all activities "engaged in by the taxpayer in carrying on a trade or business or for the production of income. . . ."[70] If the specific categorization is inappropriate, then the determination of whether the syndicator is an interested party hinges on whether the horse itself is an activity engaged in by the taxpayer for the production of income. As was earlier discussed, the activity is not the horse, but rather the investment program practiced by each individual syndicate member.[71] The IRS correctly accepted this reasoning.[72] Even though, the syndicator in the case mentioned above was held not to be an interested party, prudence demands that the draftsman as well as the investor avoid even the appearance that debt financing was procured from an interested party if favorable tax treatment, free from an IRS challenge in the context of the at-risk rule, is desired.

The amount the investor is at-risk in relation to any one investment activity is calculated at the end of each tax year.[73] The sum at-risk is adjusted upward if any category, which is recognized as part of the sum at-risk is increased; i.e., the taxpayer contributes additional cash to the activity or the taxpayer becomes liable on a loan previously nonrecourse.[74] Conversely, the amount at-risk is adjusted downward by a reduction of any constituent element of the amount at-risk; i.e., the investor takes back property previously contributed to the activity.[75] More importantly, the amount at-risk is reduced by any loss deductions actually claimed against ordinary income and by any increase in profits distributed or ac-

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lations are devoid of a definition for activity. *See generally* Treas. Reg. § 1.465 (proposed June 5, 1979). However, the treasury regulations which accompany F.R.C. § 183 (West 1982) do define what is meant by activity for purposes of that section. *See* Treas. Reg. § 1.183-1(d)(1) (1972). By analogy this may be appropriate in determining what activities are within the purview of I.R.C. § 465 (West 1982).

69. I.R.C. § 465(c)(1) (West 1982), delineates those activities to which § 465, as enacted in 1976, was made specifically applicable. Generally, the specific activities included motion picture films, farming, equipment leasing, and exploration for oil, gas, or geothermal deposits.

70. In 1978, pursuant to the Revenue Act of 1978, § 465 was amended to include a vast array of activities limited only to whether the activity was engaged in for the production of income or for trade or business. *See* I.R.C. § 465(c)(1)(3) (West 1982).

71. *See supra* note 24 and accompanying text.

72. The appeals officer was persuaded by the taxpayer that the syndicator had no interest in the individual breeding activities of each co-owner in the syndicate.

73. I.R.C. § 465(a)(1) (West 1982).

74. I.R.C. § 465(b) (West 1982).

75. *Id.*

crued for the benefit of the taxpayer, provided the income and profits derive from the same investment activity for which there is an amount at-risk.[76] Any loss deduction allocable to the investment activity and passed on to the investor can do no more, in and of itself, than reduce the sum at-risk to zero.[77] However, where the elements which comprise the amount at-risk decrease, it is possible a *negative* at-risk amount will result.[78] The amount at-risk will be negative, meaning the at-risk balance is reduced below zero, where an event or a series of events occur which act to adjust the at-risk balance below zero. For example, if the taxpayer has an at-risk amount of $1,000 in an activity and converts a recourse loan of $1,200 into a nonrecourse loan respecting that same activity at year's end, with respect to the same activity, the taxpayer will have a negative amount at-risk of $200.

Section 465 was amended in 1978 under the Code.[79] One of the changes transacted in section 465 was the addition of a "recapture" provision similar to the recapture of depreciation.[80] Recapture, as employed by section 465, prevents a taxpayer from stockpiling his at-risk amount in one or more years in order to satisfy the at-risk rule and thereafter reduce the amount at-risk, having already received the benefit of a tax deduction. The recapture of deductions pursuant to section 465 only applies to deductions taken after December 31, 1978.[81] Mechanically, recapture of deductions subject to the at-risk rule works as follows: Assume Mr. A has at-risk $3,000 in a certain activity in 1983. In 1984 Mr. A properly claimed a loss deduction of $2,000 incurred for his investment in the activity. Assume further that he has not increased his amount at-risk but rather converts a $3,000 promissory note from recourse to nonrecourse in 1985. In so doing, Mr. A gained a $2,000 tax benefit for which he is not currently at-risk. The effect of recapture is that Mr. A must now report an additional $2,000 as ordinary income in 1985 because his amount at-risk fell below the

76. I.R.C. § 465(b)(5) (West 1982).

77. General Rules; amount at-risk below zero, Treas. Reg. § 1.465-3 (proposed June 5, 1979).

78. Where the at-risk balance becomes negative; the recapture provisions of § 465 become operative. The negative at-risk balance can be best understood as a benefit measuring device. Although an individual may have losses in excess of his at-risk balance, if he has not reduced his tax burden because of the excess riskless losses he has received no tax benefit. Conversely, if a taxpayer had previously claimed loss deductions in conformance with the at-risk rule, but later reduced his at-risk balance, he has gained an unsupported tax benefit. Any losses claimed absent risk, where the at-risk rule applies, will be the measure of the negative at-risk balance.

79. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763.

80. *See infra* notes 135-36 and accompanying text.

81. I.R.C. § 465(e)(2)(A) (West 1982).

amount of tax deductions previously taken. The taxpayer must report as ordinary income due to recapture only that amount of deductions which were previously claimed against ordinary income, less any deductions already recaptured and reported as income by the taxpayer.[82] Thus, if no tax benefit has been realized by the taxpayer because of loss deductions attributable to an investment activity then the recapture provision of section 465 will be of no consequence.

Any investment activity loss deductions to which a taxpayer is entitled which cannot be used in the current tax year to offset ordinary income are carried forward indefinitely.[83] When the at-risk balance increases, loss deductions carried forward may be claimed until such time as the deductible amount is exhausted.[84]

The significance of the at-risk rule cannot be overstated. The failure or success of an investment as a tax shelter is dependent on the availability of certain tax deductions in its early years. Where these deductions are limited or nullified altogether because of the at-risk limitation, it can mean the "death knell" of an otherwise viable investment. To make the optimum use of any deductions allocable to the investor from an investment, while remaining within the bounds of the at-risk rule, the investor should at the end of the taxable year have an amount at-risk at least equal to any loss deduction which will be claimed.

2. *The Cost Recovery Allowance*

A truck wears out, a barn begins to rot, or a horse grows old—all are examples of "asset value diminution." Business assets lose value because of exhaustion, wear and tear, and normal obsolescence. Not unmindful of this fact, Congress allows the business taxpayer a reasonable[85] allowance for loss sustained because his business assets decrease in worth. This reasonable allowance is manifested in the form of a depreciation deduction for the

82. I.R.C. § 465(e)(2) (West 1982).
83. I.R.C. § 465(a)(2) (West 1982); Treas. Reg. § 1.465-2(b) (proposed June 5, 1979).
84. I.R.C. § 465(b)(5) (West 1982).
85. Pursuant to § 167, which was the bulwark of the depreciation rules until § 168 was enacted under the Economic Recovery Act, "[t]here shall be allowed as a depreciation deduction a *reasonable* allowance for the exhaustion, wear and tear [including] . . . property used in [a] trade or business . . . [or] held for the production of income." I.R.C. § 167(a) (emphasis added). *See also* Treas. Reg. § 1.167(a)-1(a) (1965).

taxpayer.[86]

The newest depreciation apparatus constructed by Congress is the "accelerated cost recovery system" (ACRS)[87] found in section 168 of the Code.[88] Section 168 became law with the passage of the Economic Recovery Tax Act of 1981.[89] In theory, any system of cost recovery (depreciation) should be based on the true economic rate of loss suffered by the underlying asset. However, ACRS is a congressional attempt to spur investment by creating an incentive for investment.[90] The incentive is an accelerated level of depreciation. Therefore, the rates of depreciation provided by the ACRS are not indicative of an asset's real useful life and its true rate of value diminution.[91]

Section 168 is non-elective, in that when its elements apply to a particular asset, that asset must be depreciated in accordance with the ACRS.[92] Section 168 applies only to recovery property[93]

86. Presently there are two Code sections which pertain to depreciation deductions: § 167, which generally applies to all depreciable property placed in service before January 1, 1981, and § 168 which applies where depreciable property is first placed in service after December 31, 1980. These two Code sections co-exist; however, where property falls under § 168 it must be depreciated in accordance with § 168. *See generally* I.R.C. §§ 167-68 (West 1982).

87. The phrase Accelerated Cost Recovery System is the name of the depreciation system enacted in I.R.C. § 168.

88. I.R.C. § 168 (West 1982).

89. Pub. L. No. 97-34, 95 Stat. 172 (1981).

90. A Senate Finance Committee Report details the rationale behind the ACRS,

> [the] present rules for determining depreciation allowances . . . need to be replaced because they do not provide the investment stimulus that is essential for economic expansion . . . .
>
> The real value of depreciation deductions allowed under [Section 167] has declined for several years due to successively higher rates of inflation. Reductions in the real value of depreciation deductions diminish the profitability of investment and discourage businesses from replacing old equipment and structures with more modern assets that reflect recent technology.

SEN. FIN. COMM. REP. NO. 97-144, 97th Cong., 1st Sess., 47 (1981).

91. Most depreciable property placed in service prior to 1981 is depreciated under § 167. Section 167 incorporates a "useful life requirement" for depreciable property. Property must have a useful life before it may be depreciated. To assist the taxpayer, the IRS developed a classification system for property called "class lives." Property was divided into certain class life categories depending on the character of the property. Early on, class life categories were based on the appropriate life expectancy of certain assets within the class. However, the Treasury began to mitigate the class lives burden by issuing procedural guidelines for the taxpayer which effectively shortened the tax life of depreciable assets. Section 168 is the culmination of a trend away from a proximate relationship between depreciation and the actual life expectancy of an asset. *See* Rev. Proc. 62-21 (1962); I.R.C. § 167(m), which established the "asset depreciation range" (ADR) as a class life system in 1971 pursuant to the Revenue Act.

92. I.R.C. § 168(a) (West 1982).

93. *Id. See also* I.R.C. § 168(e)(1) (West 1982).

placed in service[94] after December 31, 1980 *unless* property otherwise within the scope of section 168 is excepted.[95] Recovery property is defined as tangible personal property used in a trade or business or held for the production of income which is eligible for depreciation.[96] Certain kinds of property are ineligible for depreciation. Property not held for the production of income or not used in a trade or business will not qualify for a depreciation allowance.[97] Further, even if property is used in a trade or business or used for the production of income such property is ineligible for the depreciation allowance provided in the ACRS if the property is held primarily for sale, such as inventory.[98] A business asset is considered placed in service, "when it is in a condition or state of readiness and availability."[99] Once the taxpayer begins to develop the asset or capitalize on the asset's value then, at that time, the asset is considered placed in service. Thus, the taxpayer may own a horse for some time, but be denied a depreciation deduction because the horse is not placed in service. To satisfy this criterion of the ACRS, the taxpayer must place the horse in a program of training and conditioning, be it for racing, showing, or any other business activity.[100] Although a horse may have been owned prior to December 31, 1980, if it was not placed in service until after December 31, 1980, the ACRS still prevails.[101]

The ACRS divides horses into two classes of recovery property. Race horses more than two years old and all other horses more than 12 years old are treated as "3-year property."[102] All other horses, not considered 3-year property, are termed "5-year prop-

94. I.R.C. § 168(b)(1)(A) (West 1982).

95. Property acquired from a related party, otherwise depreciable under § 168, is excluded (I.R.C. § 168(e)(4)(A)(i) (West 1982)); *see also infra* note 120 and accompanying text; property depreciated using a method not expressed in terms of a useful life is excluded, e.g., property depreciated under the unit-of-production method (I.R.C. § 168(e)(2)(B) (West 1982)). *See generally* I.R.C. § 168(e) (West 1982).

96. I.R.C. § 168(c)(1) (West 1982).

97. Recovery property, as defined, negates the inclusion of nonbusiness property. *Id.* Further, this follows the usual rule that inventory and personal items are not depreciable assets. Treas. Reg. §§ 1.167(a)(1) (2) (1956).

98. I.R.C. § 168(c)(1) (West 1982); Treas. Reg. (a)(2) (1956).

99. United States Master Tax Guide, (CCH) ¶ 1153 (1982).

100. Whether or not an asset is placed in service is a question of fact and circumstance.

101. I.R.C. § 168(e)(1) (West 1982).

102. I.R.C. § 168(h) (West 1982).

erty."[103] The ACRS provides depreciation tables for both three-year and five-year property.[104] These tables must be used in calculating the depreciation allowance. For three-year property, the taxpayer is allowed to recover twenty-five percent of his asset's cost the first year it is placed in service, thirty-eight percent in the second and thirty-seven percent in the third year. With respect to five-year property, the capital expenditure for the asset is recovered fifteen percent in the first year, twenty-two percent in the second, and twenty-one percent in the third, fourth and fifth years the asset is in service for the year the asset is first placed in actual use.[105]

Regardless of when the property is placed in service during the year, under the ACRS a full allowance is permitted.[106] If a horseman placed his race horse in service in November of 1983, he would be permitted to claim a full twenty-five percent of the horse's cost as a depreciation deduction for the tax year 1983. Section 168 is not so lenient where recovery property is removed from service. The ACRS disallows a depreciation deduction in the year recovery property is sold or disposed of.[107] To realize the full advantage of the ACRS, a horseman, where possible, should place his property in service late in the year and sell or dispose of the property early in the year succeeding the last year wherein cost recovery was available.[108]

Section 168 also provides that, at the taxpayer's election, recovery property can be depreciated using the straight line method as

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103. I.R.C. § 168(c)(2)(B) (West 1982).

104. I.R.C. § 168(b)(1)(A) (West 1982).

105. I.R.C. § 168(b)(1)(A) (West 1982). The depreciation table for recovery property is based on a 150% straight line depreciation with a half year convention. Straight line depreciation may be illustrated as follows: an asset has a value of $10,000, a useful life of 10 years and no salvage value. If straight line depreciation is used, the cost of the asset is divided by the asset's number of useful years; *viz,* $10,000 divided by 10 equals $1,000 a year. *See* Treas. Reg. § 1.167(b)(1) (1956). Thus, under straight line the taxpayer could take a $1,000 per year deduction for depreciation. By accelerating this to 150% of straight line, the first year's deduction would equal 1.5 × $1,000 or $1,500, and so on. The ACRS table incorporates this formula into its predetermined allowance. *See* SEN. FIN. COMM. REP. NO. 97-144, 97th Cong., 1st Sess., 50 (1981). However, because the ACRS, as a matter of convenience, disposed of prorating depreciation when an asset is first placed in service, it also incorporates the half year convention rule which acts to partially offset the first year allowance for depreciation under the ACRS table. *See infra* note 114.

106. I.R.C. § 168(b)(3)(B)(i) (West 1982).

107. I.R.C. § 168(d)(2)(B) (West 1982).

108. For example, by placing a horse in service in November of 1983 (assuming the horse is 5-year property), and depreciating him fully until the horse is disposed of in January of 1988, the taxpayer receives a full 100% cost recovery for 5-year property while holding the asset for approximately 4 years and 3 months.

opposed to the tables.[109] However, this election must be made in the first year the property is depreciated under the ACRS or else it is lost.[110] Further, after the election to use straight line depreciation is made, the taxpayer may not switch over to the tables.[111] Using straight line depreciation, the taxpayer may depreciate three-year property at three, five or twelve year intervals,[112] while five-year property may be recovered over five, twelve or twenty-five years.[113] In addition, the election to use straight line depreciation entails the integration of the "half year convention" into the taxpayer's depreciation schedule irrespective of when the property was actually placed in service during the taxable year.[114] The result is if a straight line election is made for three-year property and the taxpayer opts for the five year interval, then, because of the half year convention, the property will not be fully recovered until six years have elapsed.[115]

Generally, new businesses do not start up on the first day of the year, nor do businesses electing to use a fiscal tax year[116] have their first day of operations coincide with the first day of their fiscal year. Similarly, businesses rarely cease operating on the last day of a calendar or fiscal year. To account for this circumstance, section 168 incorporates the "short tax year" rule[117] which acts to limit depreciation allowable under the ACRS. Thus, if a business commences activities in October and is operating under

109. I.R.C. § 168(b)(3)(A) (West 1982). See *supra* note 105 for a definition of straight line depreciation.

110. I.R.C. § 168(b)(3)(B) (West 1982).

111. *Id.*

112. I.R.C. § 168(b)(3)(A) (West 1982).

113. *Id.*

114. I.R.C. § 168(b)(3)(B)(iii) (West 1982). The "half year convention" is another administrative rule of convenience drafted into the ACRS. For § 168 depreciation purposes, the half year convention mandates that one-half of the first year straight line allowance be deferred and taken in the year following the last year under which a straight line allowance will be claimed. This rule applies regardless of the month the property is first placed in service.

115. To illustrate, if 5-year recovery property costing $20,000 is placed in service in 1984 and a straight line election is made, the depreciation schedule would look like this:

1984	1985	1986	1987	1988	1989
2,000	4,000	4,000	4,000	4,000	2,000

116. The calendar year runs from January 1 to December 31. Taxable income may also be computed based on a fiscal year which may not exceed twelve months and must end on the last day of its last month; however, the last month of a fiscal year may not be December. *See* Treas. Reg. § 1.441-1 (1957).

117. I.R.C. § 168(f)(5) (West 1982).

a calendar tax year which ends December 31, then any cost recovery allowed under the ACRS must be reduced to reflect the short tax year. In the above situation, the business had a short tax year equal to three months.[118] Multiplying the calculated deduction by 3/12 gives the taxpayer that portion of the deduction which can be claimed. The deduction is allowed in direct proportion to the number of months the business has existed since its inception. Analogous to the accommodation given where the half-year convention acts to extend a straight line election, any disallowed depreciation because of the short tax year rule may be recovered in a later tax year.[119]

Property acquired from a "related"[120] party who has previously placed the property in service is not eligible for accelerated depreciation under the ACRS.[121] The purpose of the ACRS is to encourage new investment, not to provide an accelerated write-off for property already in use and subject to existing depreciation rules.[122] Consistent with this policy, section 168 contains a set of "anti-churning" rules which prevent a taxpayer from rolling property in service prior to the ACRS into the ACRS.[123] As was noted previously, section 168 only applies to property placed in service after December 31, 1980. Interestingly enough, this same principle used inversely creates an exception to the anti-churning rules. Although property is acquired from a related party, if the property was never placed in service by the related party, and if the property is thereafter placed in service by the taxpayer, section 168 applies if its other requirements are satisfied.[124] The anti-churning rules also apply to certain leasing transactions, sale-

118. *Id.* A full month is accorded even though the business may not have started on the first of the month. Thus, October 5th to December is three months.

119. The year in which the unused allowance may be taken is to be determined by regulations which have not yet been adopted. In all probability any allowance not used because of a short tax year will be allocated and may be taken in the year succeeding the last year of the predetermined depreciation allowance schedule.

120. I.R.C. § 168(e)(4)(A)(i) (West 1982), excludes property from cost recovery under § 168 if the subject property is received from a related party (defined in I.R.C. § 168(e)(4)(D) (West 1982), as those persons having a relationship with the taxpayer as defined in I.R.C. § 267(b) (West 1982), (*see supra* note 57); partnerships where the taxpayer owns, directly or indirectly, more than 10% of a capital interest, etc. (*see* I.R.C. § 707(b)(1) (West 1982)); or the taxpayer and related person are engaged in trades or businesses under common control (*see* I.R.C. § 52 (West 1982)).

121. *Id.*

122. *See supra* note 90.

123. These anti-churning rules are found in I.R.C. § 168(e)(4) (West 1982).

124. Technically, this is not an exception. The anti-churning rules apply only to property placed in service, either by the taxpayer or a related party, prior to 1981. Therefore, property not placed in service prior to 1981 is beyond the reach of the anti-churning rules.

leaseback arrangements, some types of property exchanges, and in general to any transaction which exhibits as one of its principal purposes the avoidance of the anti-churning rules.[125]

Investors who purchase interests in syndicates which offer deferred payment encounter tax problems when, pursuant to the at-risk rule, they are denied tax deductions because the debt they owe is to an individual or entity who has an interest in the syndicate or is a related party.[126] Likewise, because a syndicator (the entity or individual which syndicates a horse) may retain a certain equity position greater than ten percent in a syndicated horse, the IRS might assert that he is a related party and as such might disallow the ACRS for use in depreciating the syndicated horse.[127] However, if such a disallowance were contested the IRS would probably lose. Where a classic syndicate exists there is no pooling of income or a sharing of profits.[128] Each syndicate member conducts his activities free from the restraint of other syndicate members. For this reason, most syndicates elect not to be treated as a partnership for tax purposes.[129] Therefore, there is no activity (i.e., no partnership), for the syndicator to be related at the time the syndicate members acquire their interests.

A property's tax basis is reduced in direct proportion to any claimed depreciation deduction taken in connection with the property.[130] Ordinary income is offset by any deduction allowed.[131] In addition, if the depreciable property is held for the requisite number of months, any gain realized on the sale or other disposition of the property receives capital gains treat-

125. I.R.C. § 168(e)(4)(F) (West 1982); I.R.C. § 168(f)(8) (West 1982).

126. *See supra* notes 57-58 and accompanying text.

127. If the IRS were to prevail in disallowing the use of the ACRS, I.R.C. § 167 would still be available. However, under § 167 deductions are drastically reduced in comparison to the accelerated recovery permitted under the ACRS. Under § 167 the cost of a breeding horse may be recovered over 10 years or until the horse reaches 16 years of age, which ever is less. The cost of a race horse may be recovered over two to six years, depending on the horse's bloodline and date of service placement.

128. *See supra* note 23 and accompanying text.

129. *Id.*

130. I.R.C. § 1016(a)(2) (West 1982). Note that the at-risk rules have no effect on the basis of property. Property is assigned a tax basis, usually its cost, when it is acquired. This tax basis is used to determine gain or loss on the sale or other disposition of the property. This same basis is generally used when property is depreciated. *See generally* I.R.C. § 1011 (West 1982) and Treas. Reg. § 1.1011-1 (1957).

131. I.R.C. § 62 (West 1982); Treas. Reg. § 1.62-1 (1957).

ment.[132] Left unchecked, this sequence of events and the resulting tax consequences are quite favorable for the taxpayer. Substantively, the above scenario permits a taxpayer the advantage of using a deduction to decrease current taxable income in exchange for incurring the illusory detriment of increasing his later capital gains.[133] Disheartening for the taxpayer is section 1245 entitled "Gain from Disposition of Certain Depreciable Property."[134] Section 1245 has the effect of shutting off the unintended tax benefit bestowed on the taxpayer as a result of tax law interaction. Where appropriate, section 1245 acts to "recapture" depreciation previously deducted by the taxpayer against his ordinary income. The rationale behind the rule is tax equity. If the law gives the taxpayer a deduction against ordinary income, then if the underlying asset is sold at a gain this deduction should be recaptured as ordinary income. If no gain is realized in the sale or other disposition of depreciable property, section 1245 has no application.[135] Furthermore, section 1245, with one limited exception,[136] refers only to personal property.

There are at least two unresolved questions under section 168. First, will the depreciation allowance for a race horse, treated as three-year property, be affected if the horse is retired and used for show or breeding purposes before it is fully depreciated. In response to this question, section 168 is silent. Under the ACRS there is no provision to account for the change in use of a horse (or any depreciable asset for that matter). Moreover, no promulgated treasury regulations exist relating to section 168 which address this point. Due to this absence of legislative coverage, reasonable inferences need be drawn. Arguably, as a matter of administrative convenience such a change in use should be disregarded.[137] The difficulties incurred with imposing a rescheduling of depreciation are immense and certainly not deserving of the

132. *See infra* note 231 and accompanying text.

133. Assume Mr. A owns stallion "X." Mr. A purchased stallion X in 1984 for $50,000 and placed stallion X in service that same year. Stallion X is treated as 5-year property and depreciated under the ACRS table. In years 1984 and 1985, Mr. A claims depreciation deductions of $7,500 and $11,000, respectively, reducing his basis in the stallion to $31,500. Along comes Mr. B in 1986 who offers Mr. A $70,000 for stallion X. Mr. A accepts. Absent correction, Mr. A will have received $18,500 worth of deductions against ordinary income before he sells stallion X. In addition, upon the sale of stallion X, Mr. A will have a $38,500 ($70,000–$31,500) long-term capital gain which is taxed at a lower rate than ordinary income.

134. I.R.C. § 1245 (West 1982).

135. I.R.C. § 1245(a)(1) (West 1982).

136. By implication, § 1245 does not exclude 15-year nonresidential rental property which is depreciated at an accelerated rate in excess of straight line. I.R.C. § 1245(a)(5) (West 1982).

137. This would be in harmony with the policy of simplification underlying I.R.C. § 168.

time and effort the taxpayer and the IRS would expend. Not only would depreciation have to be reapportioned, but what of recapture if a horse previously classified as three-year property is reclassified as five-year property? Problems would also occur where a horse was removed from showing and placed in a racing program.[138] As is readily apparent, the burdens of redetermining the cost recovery allowance where a horse is placed in a new mode of service far outweighs any appreciable gain in tax revenues the government might derive therefrom.[139] For these reasons and until there is legislative or agency action to the contrary, the taxpayer, having properly placed his horse within the three-year or five-year class of recovery property, should be able to continue with his original depreciation schedule notwithstanding a change in the horse's use.

The second question posed presents a construction of language problem. The equine industry has traditionally determined a horse's age as one full year at the beginning of each calendar year regardless of a horse's date of birth. The question naturally arises whether a horse which is properly considered three-year property when, though it is actually less than two or twelve years of age, the horse is, according to common usage and trade practice of the equine industry, held to be more than two or twelve years old. Section 168 on its face states that "[t]he term '3-year property' includes—(A) 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."[140] A restrictive interpretation of this language would indicate that "more than 2 or 12 years old" refers to true physical age. The better approach, however, is to look to the context of the rule. Special provision was made for race horses and older horses. It would seem fairly consistent with the policy behind the ACRS to adopt the equine industry's practice of artificial aging, especially in light of the

138. In this case 5-year property would be used as 3-year property and the question would be how much more depreciation should be allocated the taxpayer.

139. If a horse is 3-year property and in the third year of its depreciation under the ACRS, the percentage of basis left to be recovered should equal 37%. If the cost of that same horse were being recovered under the 5-year property schedule, 63% of the horse's cost would be left for recovery. Although 26% of the horse's cost separates the two schedules, were the IRS to readjust the depreciation schedule up or down, more confusion would certainly result and possibly less revenue would be collected by the IRS. I.R.C. § 168(b)(1)(A) (West 1982).

140. I.R.C. § 168(h)(1) (West 1982).

artificial cost recovery allowances granted in the ACRS. The ACRS was enacted as an incentive for investment. By adopting an industry-wide practice to explain an ambiguity in such a rule, whereby a greater depreciation allowance is achieved, the policy underlying the ACRS would be furthered. How this issue will be decided is currently unclear. Therefore, if the taxpayer acts pursuant to industry standards and depreciates his horses accordingly, there is no assurance the IRS will not challenge the action. In light of the purpose of section 168, however, this is an unlikely possibility.[141]

3. *The Investment Tax Credit and Bonus Depreciation*

Congress promotes many of its economic policies through the taxation system.[142] For example, the ACRS is designed to stimulate investment by allowing a faster rate of return on investment capital. To influence investment at an even higher level than proffered deductions, Congress creates credits to offset tax. A credit offsets any tax owed dollar for dollar, whereas a deduction serves only to reduce ordinary income from which the tax is computed. From a taxpayer's standpoint it makes sense, when given the opportunity, to avail himself of any available tax credit.

Section 38 of the Code authorizes an investment tax credit for certain property.[143] Property classified as "section 38 property"[144] is eligible for the investment tax credit, and generally this means tangible property.[145] Thus, horses would normally be included as section 38 property, except that horses are specifically excluded as section 38 property, which denies the taxpayer any investment tax credit.[146] Fortunately for the equine industry, a lion's share of property associated with the business qualifies as section 38 prop-

141. The American Horse Council reports that it is in the process of establishing a more definite position from the IRS on this particular issue. *See* AMERICAN HORSE COUNCIL, TAX REFERENCE SERVICE BULL. NO. 132 (September, 1981).

142. Taxes mean money and where money is concerned people generally pay attention. Cognizant of this relationship, Congress, through the taxing scheme, implements many, if not most, of its economic programs.

143. I.R.C. § 38 (West 1982).

144. Section 38 property is defined in I.R.C. § 48 (West 1982).

145. Tangible property to be eligible for the investment credit must have a useful life of three years or more. I.R.C. § 48(a) (West 1982).

146. I.R.C. § 48(a)(6) (West 1982). The Revenue Act of 1977 reinstituted the investment tax credit. As proposed by the House, the investment tax credit would have included livestock subject to depreciation recapture. H.R. REP. NO. 92-533, 92d Cong., 1st Sess., *reprinted in* 1971 U.S. CODE CONG. & AD. NEWS 1835 (1971). The Senate Finance Committee disagreed with the proposal and acted to exclude horses from the investment tax credit, stating that "the committee does not believe it is necessary to provide an incentive to investments of this type." S. REP. No. 92-437, 92d Cong., 1st Sess., *reprinted in* 1971 U.S. CODE CONG. & AD. NEWS 1939 (1971).

erty and permits an investment tax credit.[147]

Congress provided the taxpayer with still another tax benefit (incentive) when, as part of the Economic Recovery Tax Act, it completely revised section 179.[148] Though section 179 is actually an expensing section, it grants the taxpayer what has come to be known as "bonus depreciation."[149] The expense deduction furnished under section 179 permits the taxpayer to recover a greater portion of his depreciable asset cost in the first year in which a depreciation deduction accrues.[150] This expense deduction is an addition to any depreciation deduction allowed.[151]

Where the taxpayer elects to invoke section 179, this will have an effect on the basis available from which to calculate the investment tax credit provided in section 38.[152] To the extent bonus depreciation is taken, the basis in the depreciable property must be reduced accordingly. After basis is lowered the investment tax credit is calculated. Thus, it is possible that with a single property both bonus depreciation and investment tax credit can be claimed.

Section 179 combines with section 38 by disallowing bonus depreciation for non-section 38 property.[153] Stated another way, to be eligible for bonus depreciation the property must be eligible for the investment tax credit. Consequently, horses are again disqualified as property deemed suitable for an additional tax allowance.[154] A majority of property and equipment used in an equine

147. *See generally* I.R.C. § 48(a)(1) (West 1982), which includes most property as eligible for the investment tax credit. *See infra* note 156. *See also* § 46(c)(8) concerning the "at-risk" rule and its application to the investment tax credit.

148. I.R.C. § 179 (West 1982).

149. I.R.C. § 179 (West 1982), is referred to as "bonus depreciation" because when the election to use § 179 is made the effect is the same as if additional depreciation were allowed. The asset's basis and ordinary income are both reduced in equal part.

150. The additional expense deduction provided by § 179 may only be taken in the taxable year in which the property is placed in service. In tax year 1982, the maximum deduction allowed was $5,000. This allowance increases to $7,500 in 1984, and to $10,000 for the years 1986 and thereafter. I.R.C. § 179(b)(1) (West 1982).

151. When the expense deduction granted by § 179 is elected, the amount of the expense must be subtracted from the basis of the property prior to the calculation for any allowable depreciation deductions and investment tax credits made thereafter. Thus, if property having a basis of $15,000 was expensed under § 179 in its first year of service, only $10,000 of its basis would be available as a basis for depreciation and the application of the investment tax credit.

152. I.R.C. § 179(d)(9) (West 1982).

153. I.R.C. § 179(d)(1) (West 1982).

154. There is no indication of whether horses, because they were made ineligi-

business could, however, be expensed in accordance with section 179, so long as the property qualifies under section 179.[155]

Whether the taxpayer is an individual or business entity, if property is held which qualifies under both section 38 and section 179, an election decision will have to be made. In most cases a credit is preferable because it directly lowers any tax owed, but there may be instances where it is better to claim the bonus depreciation and forego the investment credit.[156] The decision will vary for each taxpayer depending on the surrounding facts and circumstances. Whichever section the taxpayer chooses to elect, the investment tax credit and the allowance for bonus depreciation represent a valid method of reducing taxes. Further, their overall effect should be gauged and their availability investigated when analyzing the feasibility of a horse syndicate as a tax shelter.

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ble for the investment tax credit, were inadvertently disqualified from the benefits of § 179 because of § 179(d)(1) or whether this was a deliberate exclusion.

155. *See supra* note 148.

156. With the passage of the Tax Equity and Fiscal Responsibility Act of 1982, I.R.C. § 48 was amended so that as of January 1, 1983, when an investment tax credit is claimed, the underlying asset will have its basis reduced by 50% of the amount of the credit claimed. This new law will impact on the decision of whether to elect § 179 or § 38. An illustration may be helpful: Assume that Syndicate X owns a mobile quarantine facility which has a tax basis of $100,000 and is placed in service by the syndicate in 1984. Further, this asset is treated as 5-year property. If the syndicate claimed bonus depreciation under § 179 or took an investment tax credit under § 38, the result would be as follows:

	§ 179	§ 38
Tax Basis of Quarantine Facility	$100,000	$100,000
Less Election	5,000	5,000*
Basis For Depreciation Calculation	95,000	95,000
15% of 95,000	14,250	14,250
Adjusted Basis	$ 80,750	$ 80,750

* I.R.C. § 46 provides the calculation of the credit for recovery property. Credit equals the property's cost multiplied by the applicable percentage (for 5-year §168 property the percentage is 100%) which sum is then multiplied by the regular percentage (10%). Thus, $100,000 × 10% = $10,000. Basis is reduced by 50% of the credit claimed. $10,000 divided by two equals $5,000.

	§ 179	§ 38
Expense Deduction Allowed	$ 5,000	$ -0-
Depreciation Deduction Allowed	14,250	14,250
Credit Allowed	-0-	10,000

(Note, however, that if bonus depreciation is taken under § 179, an investment tax credit may still be available under § 38. *See supra* notes 151-52 and accompanying text.)

In this case, regardless of the election taken the reduction in basis would equal $19,250. However, § 179 affords no direct tax benefit against the calculated tax, dollar for dollar, but will allow additional reduction in ordinary income. On the other hand, by employing § 38, ordinary income is reduced by $14,250 and computed tax is offset dollar for dollar, by a $10,000 credit.

4. *The Hobby Loss Rule.*

Where taxation is concerned, perhaps the most important aspect of any equine oriented activity is whether or not the activity is considered a business entered into with an intent to earn a profit. Regardless of the nature of operation, be it a sole proprietorship or a partnership, the issue of business intent exists. This issue has significance because of the so-called section 183 "Hobby Loss Rule"[157] enacted by Congress as part of the Code in 1969.[158] This Code section is a legislative response to the "gentlemen farmer" taxpayer.[159] Before this section was in effect, certain taxpayers would engage in farm activities under the auspices of engaging in a business activity only to receive favorable tax benefits.[160]

When it applies, the Hobby Loss Rule limits losses from an activity to an amount equal to any income produced by the same activity.[161] Stated another way, if operative, the Hobby Loss Rule disallows losses to the extent they exceed profits derived from the same activity.[162] Losses from the activity may offset activity income, but not other unrelated income. At the risk of oversimplification, if an activity is found to be engaged in for profit, all losses from the particular activity, otherwise allowable, are permitted to offset ordinary income from whatever source. If, however, the activity is judged not to be engaged in for profit, then any losses attributable to such activity may only be claimed to the extent they reduce income from that same activity. This expression is the essence of the Hobby Loss Rule.

The seeming simplicity of the Hobby Loss Rule, like the at-risk rule,[163] belies the nuances and quirks of its operation. Individu-

157. The rule is known as the Hobby Loss Rule because it restricts losses on activities not engaged in for profit.

158. I.R.C. § 183 (West 1982).

159. In truth, many times this type of situation was entered into not for purposes of gaining a profit, but as a form of leisure which generated losses used to offset other ordinary income. Section 183, like § 465, is an attempt by Congress to limit artificial loss deductions.

160. The limitations of § 183 apply if it is determined that the activity was "not engaged in for profit". I.R.C. § 183(a) (West 1982). *See supra* notes 44 & 47 and accompanying text.

161. I.R.C. § 183(b)(2) (West 1982). Note that the regulations prioritize the deductions in order of interest and taxes, repair and maintenance expenses, and depreciation allowances. *See* Treas. Reg. § 1.183-1(b) (1972).

162. *Id.*

163. *See supra* note 51 and accompanying text.

als, partnerships, and other entities to which this rule applies must plan and prepare to meet its impositions.[164] For the investor in a syndicate, this entails a thorough analysis of the investor's intent regarding his purpose for the investment, how he will operate his activities, and what kind of loss and income figures he can expect.[165] The taxpayer may have catered to other tax restrictions, but if his activity is held to be one not engaged in with an intent to garner a profit, losses allocable to the particular activity are limited.[166] Therefore, an investor, prior to setting up a program to facilitate his interest in a syndicate, should examine his motives and investment posture.

Section 183, together with regulations promulgated thereunder,[167] establishes a series of factors and circumstances which, when evaluated cumulatively, help to define an activity's character as either profit or nonprofit motivated.[168] Before analyzing these factors it is advisable to highlight the principal tenets of section 183. An activity, if it is to earn the classification "business" as opposed to "hobby," must be entered into with the intent to produce a profit.[169] This principle is *sine qua non* to the *nonapplicability* of section 183. Furthermore, whether the taxpayer is engaged in an activity with an intent to generate profit is inextricably related to all relevant facts and circumstances having a nexus to the activity.[170] This principle permeates section 183. These two basic tenets form the cornerstone of the Hobby Loss Rule and should always be considered when the taxpayer is contemplating the viability of an investment program.

To possess the requisite profit motive and intent does not necessarily mean the taxpayer must have a reasonable expectation of

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164. Section 183 applies only to individuals, partnerships, and Subchapter S corporations, which are defined in I.R.C. § 1371(b) (West 1982). I.R.C. § 183(a) (West 1982).

165. Projecting income and loss from the investment is a factor given great weight in favor of finding a profit motive. The taxpayer should draw up a long range investment program in order to show how he intends to derive a profit from the activity. *See* Golanty v. Commissioner, 72 T.C. 411 (1979). *See also* Husband, *Horse Business Owners Beware; Tax Court Changes Tune at an Arabian Breeder's Expense — The Next Dance Could Be Yours,* ARABIAN HORSE WORLD, 360 (November 1979).

166. *See supra* note 161 and accompanying text.

167. *See* Treas. Reg. §§ 1.183-1 - 1.183-2 (1972).

168. *See* Treas. Reg. § 1.183-2(a) (1972).

169. The regulations, as well as § 183, define an activity as entered into for profit if deductions would be allowable for the taxable year under I.R.C. § 162 (trade or business expenses) or under I.R.C. § 212 (1), (2) (for the production of income). I.R.C. § 183(c) (West 1982) and Treas. Reg. § 1.183-2 (1972). The requirement that the taxpayer manifest an objective intent to produce a profit is unique to § 183 and is not mentioned in either § 162 or § 212. *See* Treas. Reg. §§ 1.183-2(a)-1.183-2(b) (1972).

170. *Id.*

actually realizing a profit in the activity.[171] Thus, an individual who speculates in a wildcat oil well searching for oil in an unexplored region where chances are remote that he will strike oil is still considered to be engaged in an activity for profit because on those rare occasions where oil is discovered, substantial revenues will be realized.[172] Although the likelihood of realizing a profit is marginal, nonethless, if the taxpayer conducts himself in a manner indicative of a profit motive, section 183 will pose no barrier to claimed losses. Moreover, if the taxpayer can prove that a reasonable probability of realizing a profit from the activity exists (giving rise to a reasonable expectation of profit), this will bolster any assertion by the taxpayer that he had a profit motive.[173]

Facts and circumstances revolving about the activity are decisive to a finding that an activity was engaged in for profit, and continued for profit.[174] As an aid to the taxpayer the regulations enumerate a set of objective factors which indicate whether an activity is engaged in for profit or not.[175] No single factor is controlling, nor will a majority of the factors, if found to exist or not to exist, cause an activity to be treated as a business or hobby by the IRS.[176] Rather, all the facts and circumstances must be weighed with reference to the objective factors supplied in the regulations and the overriding principles of section 183. Only after this has been done may a conclusion be drawn. The following paragraphs will discuss these objective criteria.

The manner in which the taxpayer conducts the activity is especially pertinent to any horse activity.[177] This relates to the operation, procedure, and management of the activity. Where "the taxpayer carries on the activity in a businesslike manner . . . [maintaining] complete and accurate books and records [this] may indicate that the activity is engaged in for profit."[178] Further, by emulating the procedures and management techniques of sim-

171. *See* Treas. Reg. § 1.183-2(a) (1972).

172. *Id. See also* Treas. Reg. § 1.183-2(c) (1972).

173. If the taxpayer proves a reasonable expectation, this is within the general facts and circumstances surrounding the activity and will be judged accordingly. *See infra* note 174 and accompanying text.

174. The regulations provide that any determination is to rest on all the facts and circumstances relevant to the activity. Treas. Reg. § 1.183-2(b) (1972).

175. *Id.*

176. *Id.*

177. *See* Treas. Reg. § 1.183-2(b)(1) (1972).

178. *Id.* The taxpayer should also keep written records of his cost and income projections as evidence of his profit motive.

ilar successful equine operations, an appropriate inference would be that the activity is engaged in for profit. On several occasions the courts have cited this element.[179] A corollary to this element is whether the taxpayer adopted a new business strategy in lieu of one proven to be unsuccessful.[180] This corollary condition may at times be the deciding factor in a section 183 dispute with the IRS. In line with conducting the activity in a businesslike manner is the idea that *pro forma* statements, or other projections of income and losses, should be prepared in an effort to further demonstrate an intent to realize a profit in the activity.[181] The soundness of this proposition can be illustrated as follows: In some cases, the IRS, in the absence of a taxpayer's projections, might develop its own income and expense projections for the taxpayer's activity and, by so doing, prove to the court that no possibility of the taxpayer realizing a profit from the activity exists; therefore, the activity could not have been entered into with an expectation of profit.[182]

Another factor material to the section 183 equation is the expertise of the taxpayer or his advisors.[183] This is generally shown if the taxpayer has commissioned a professional or experienced person to produce a feasibility study for the proposed activity. Also, by investigating the general business practices and economic climate of the activity, a taxpayer can show that he had an intent to produce a profit in a particular activity.[184] For the equine investor, this necessitates an expenditure of time and resources to learn something about the activity. Even though the taxpayer researches and investigates the feasibility of the planned activity, if he ignores what he has learned or the advice received, the IRS may assert that the taxpayer evinces no real profit motive.[185]

179. *See* Walter E. Edge, T.C.M. 1973-274; Willard and Florence Deerman, T.C.M. 1974-84.

180. This fact was given added weight by the court in Patterson v. United States, 459 F.2d 487 (Ct. Cl. 1972).

181. Problems in equity may occur where a person who fails to meet the objective criteria, even though they had a real profit motive and reasonable expectation, is denied certain deductions when compared to another taxpayer who, because he maintained adequate and complete records, though harboring an unreasonable expectation of profits, might be deemed to have possessed the necessary profit intent. *See infra* text accompanying note 202; *see also* Treas. Reg. § 1.183-2(a) (1972).

182. This was an actual case. In Dunn v. Commissioner, 70 T.C. 715 (1978), the taxpayer made no written projections. The IRS compiled a projection and proved to the court that even in the best environment the taxpayer would have incurred losses.

183. *See* Treas. Reg. § 1.183-2(b)(2) (1972).

184. *Id.*

185. The regulations qualify this by stating a lack of intent is indicated by such action "unless it appears that the taxpayer is attempting to develop new or supe-

Also to be weighed is the expenditure of time and effort by the taxpayer in conducting the activity.[186] An intention to derive a profit from the activity may be inferred where, without personal or recreational benefit, the taxpayer expends a substantial degree of time and effort in the activity. The taxpayer will not be penalized, however, if only a limited portion of his time is directed towards the activity.[187] Where the taxpayer employs others to handle the management and everyday requirements of the activity, this is viewed favorably, even though the taxpayer contributes little of his own time.[188]

A fourth factor which is particularly relevant to any horse operation is an expectation of capital appreciation.[189] This factor considers whether there is a reasonable expectation that the activity's assets will appreciate in value so that when liquidated the activity will sustain a profit because the liquidation amount exceeds the cost of the assets and all previous losses incurred by the activity. For taxpayers involved in equine activities this factor is a blessing. Equine operations seldom produce a profit in the early years and sometimes fail to produce a profit at all. Current operations may fail to yield a profit and losses can mount. However, the activity may own horses or other assets that have significantly appreciated in value so that when sold all previous activity losses are recouped with a resulting net profit. When this occurs, it helps to substantiate a claim that the activity was engaged in for profit.[190]

The success of the taxpayer in conducting similar or dissimilar activities in the past is supportive of a profit intent.[191] Moreover, if the taxpayer can prove he turned an unprofitable activity into a profitable one, the burden is on the IRS to prove his lack of profit motive.[192]

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rior techniques which may result in profits from the activity." Treas. Reg. § 1.183-2(b)(2) (1972).

186. Treas. Reg. § 1.183-2(b)(3) (1972).

187. *Id.*

188. *Id. See also* John F. (Walton) Farris, T.C.M. (CCH) (165) (1972).

189. *See* Treas. Reg. § 1.183-2(b)(4) (1972).

190. *Id.*

191. *See* Treas. Reg. § 1.183-2(b)(5) (1972).

192. This technically does not shift the burden of proof, but where this can be shown it is persuasive unless rebutted by the IRS. In Fisher v. Commissioner, T.C.M. (CCH) (212) (1968), the taxpayer purchased a partnership which had a history of losses in conducting Thoroughbred race horse operations. After the taxpayer assumed ownership, she was able to reverse the operation's losses and

A factor within the control of the taxpayer is the taxpayer's history of income or losses with respect to the activity.[193] By planning and projecting costs and income, the taxpayer can direct his loss and profit years. Understandably, the regulations state "[a] series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit."[194] Detrimental for the taxpayer is that a series of loss years in excess of the number of years that a similar activity would be expected to suffer losses may be indicative that the activity is not being engaged in for profit.[195] An explanation for the extended period of loss years, such as the occurrence of unforeseen and disruptive events, may mitigate the harmful effect of a long period of loss years.[196] Substantial losses incurred without interruption or on a continual basis presents a red flag to the IRS and is an accurate forecaster of whether or not to expect an IRS audit. However, the courts have held that this element, by itself, is not enough to prove that the taxpayer is without a profit intent.[197]

Occasional profits realized by the taxpayer in the activity is another component in the equation.[198] The regulations affirm that profits earned in the activity are always to be considered; however, little importance will be attached if profits realized in profit years are inconsequential when compared to losses realized in loss years.[199] On the other hand, a substantial profit in a profit year, though such a profit is infrequent, will be beneficial to the taxpayer if, when loss years occurred, the losses were minor.[200] Although consistent with the general approach that profit and loss

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began to turn a profit. When the IRS challenged deductions taken in her early loss years the court looked to the taxpayer's business history. The court gave considerable weight to the fact that she was successful in making a profit from an earlier loss producing activity.

193. *See* Treas. Reg. § 1.183-2(b)(6) (1972).

194. *Id.* This is an understatement. The policy behind § 183 is to limit artificial losses. Where profits are derived, especially if regularly, then § 183 has no relevance, although the IRS might argue to the contrary.

195. *Id.*

196. *Id.* Where unforeseen and unexpected losses occur, the taxpayer should keep accurate records as to the reasons why the losses occurred, i.e., the nature and date of occurrence of the extraordinary costs.

197. In Patterson v. United States, 459 F.2d 487 (Ct. Cl. 1972), the taxpayer sustained losses in 29 of his 30 years of operation. The court refused to find the activity as one not engaged in for profit because of this fact alone. *See also* Engdahl v. Commissioner, 72 T.C. 659 (1979).

198. *See* Treas. Reg. § 1.183-2(b)(7) (1972).

199. *Id.* This factor supports tax planning. A business must be able to show a normal flow of income and expenses. Except in extreme cases (e.g., the wildcat oil speculator), the relevant balance between income years and loss years is important in showing a profit motive. *See infra* note 240 and accompanying text.

200. Treas. Reg. § 1.183-2(b)(7) (1972). The equine industry does not guarantee profits for all participants. There are instances, however, where certain groups or individuals earn tremendous revenues from their equine operations. This particu-

in taxable years should be balanced, the regulations allow for an anomaly in that "an opportunity to earn substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated."[201] The regulations seem to indicate that if there is a possibility, however slight, that a sizeable profit will be realized (allowing for sizeable taxes) then losses, if maintained at reasonable levels, will not cause an inference that the taxpayer lacks a profit motive. Apparently, because the opportunity for large tax revenues exists in such a situation, the IRS is willing to compromise. This seemingly is out of tune with the spirit of the regulations which requires a modicum of reasonableness where profit expectations are concerned, although this is never expressly stated.[202]

The regulations also list the financial status of the taxpayer as a criterion.[203] The regulations allow the taxpayer a positive inference that he is, indeed, engaged in an activity for profit where he has no (or very little) income from activities or sources other than the activity in question. This premise relies on the supposition that if the taxpayer depends on the activity for his livelihood, it is likely that he conducts it in a manner conducive to profits. Conversely, the regulations place a negative brand on a situation where the taxpayer receives a substantial percentage of his income from sources apart from the activity if the activity is a loss.[204]

A somewhat elusive element, the last of the objective factors described in the regulations, is the degree of personal pleasure or recreation present in the activity.[205] Personal motives, not business motives, combined with an activity which exhibits a minimal chance of producing profit will serve to indicate an absence of a profit motive.[206] If little or no personal pleasure can be derived from the activity, it is more likely an intent to produce a profit will

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lar element, in light of the above, appears to mesh with the realities of the equine industry.

201. *Id.*

202. The regulations make allowance for the "big hit"; otherwise they stress reasonableness of losses. *See generally* Treas. Reg. § 1.183-2(b) (1972).

203. *See* Treas. Reg. § 1.183-2(b)(8) (1972).

204. *Id.*

205. *See* Treas. Reg. § 1.183-2(b)(9) (1972).

206. *Id.*

be inferred.[207] The regulations do not require the taxpayer to reserve only profit intentions for an activity. The taxpayer may (and probably will) have other reasons for the investment and still be deemed to have engaged in the activity with an intent to produce profit. Almost without exception, this is the case in equine investments. The taxpayer is entitled to enjoy his horse activities so long as there is an accompanying profit motive.

The regulations attempt to give the taxpayer an objective measuring rod. Even if the taxpayer diligently follows the regulations, however, there is no absolute assurance that his activity and any losses originating therefrom will be unchallenged by the IRS. Congress remedied this by allowing for two statutory presumptions in section 183.[208] Both presumptions fall under the "two out of seven rule."[209] This general rule provides that if a taxpayer is engaged in an activity for which over 50% of the operation is comprised of equine activities[210] then if in any seven year period the activity realizes and reports a profit in at least two of those seven years, the activity will be *presumed* to be engaged in for profit.[211]

The first presumption provided in section 183 is a "General Rule Presumption."[212] The General Rule Presumption does not depend on the taxpayer to the extent that he must elect to invoke this rule.[213] This General Rule Presumption arises by force of one thing—profit years. Thus, if the taxpayer is audited by the IRS and certain losses are disallowed because the underlying activity is held not to be engaged in for profit, the taxpayer may resort to the General Rule Presumption, although no earlier action on his part was made.[214] If the taxpayer can prove that two profit years have occurred in the requisite period, then all or a portion of the disallowed losses may be claimed unless the IRS establishes that the activity was not engaged in for a profit.[215] The General Rule Presumption, however, has a limitation. The presumption will operate only for losses in excess of income to be used against

207. *Id.*
208. I.R.C. § 183(d), (e) (West 1982).
209. *Id.*
210. "[A]n activity consists in major part of the breeding, training, showing, or racing of horses for the taxable year if the average of the portion of expenditures attributable . . . [to such activities] was at least 50 percent of the total expenditures attributable to the activity for such prior taxable years." Treas. Reg. § 1.183-1(c)(3) (1972).
211. I.R.C. § 183(d) (West 1982).
212. *Id.*
213. Where two profit years exist in any seven years the General Rule Presumption is automatic.
214. *Id.*
215. *See infra* note 217.

other ordinary income *only* for the years following the *second* profit year up to seven years from the first profit year.[216] Therefore, if in year one a profit is realized, but not until year five is another profit realized, then only years six and seven would be encompassed by the General Rule Presumption.[217]

The General Rule Presumption is just that—a presumption. It is a rebuttable presumption which, when activated, shifts the burden of proof.[218] Where the General Rule Presumption is in effect, the IRS has the burden of proving no profit motive in the years affected. The taxpayer enjoys the presumption that he was engaged in the activity for profit. This shift in the burden of proof is often the key ingredient to a taxpayer prevailing in a section 183 case over the IRS.[219]

The second presumption provided by section 183 is only available for new businesses.[220] This "Special Rule Presumption" is elective and thus is of no consequence unless the taxpayer chooses to invoke it.[221] Invoking the "Special Rule Presumption," however, has both benefits and risks. If the election is seasonably made[222] *and* the activity has two profit years at any time during the next seven years, then for each of the seven years, any losses sustained are afforded the presumption that they are proper and may be used against ordinary income.[223] So unlike the General Rule Presumption, so long as two profit years occur, *all* losses

216. I.R.C. § 183(d) (West 1982); *see also* Treas. Reg. § 1.183-1(c) (1972).

217. If the taxpayer had an income statement which looked like this:

Year:	1	2	3	4	5	6	7
Profit:	$100				100		
Loss:		$(20)	(40)	(50)		(70)	(80)

the taxpayer would have the burden of proving that he was engaged in the activity with an intention to derive a profit in loss years two through four; however, because of the General Rule Presumption, the IRS would have the burden of proving the taxpayer lacked an intent to produce a profit from the activity in years six and seven. It should be remembered that the presumption arises only if the equine activity engaged in is substantially the same throughout all of the relevant taxable period. *See generally,* Treas. Reg. § 1.183-1(c)(3) (1972).

218. I.R.C. § 183(d) (West 1982).

219. It is possible also that in the face of the General Rule Presumption the IRS may refrain from challenging any losses claimed.

220. I.R.C. § 183(e)(2) (West 1982).

221. I.R.C. § 183(e)(1) (West 1982).

222. The taxpayer generally has three years from the date that his first tax return is due (without regard to extensions), but no later than 60 days after the taxpayer receives a written notice that the IRS is about to disallow certain loss deductions attributable to a certain activity engaged in by the taxpayer. Temp. Treas. Reg. § 12.9(c)(2) (adopted March 14, 1974 by T.D. 7308).

223. I.R.C. § 183(e) (West 1982).

from any year within the first seven years are allowable, not just from those years following the second profit year.[224] The effect of the Special Rule Presumption is to prevent an audit by the IRS until after the sixth year of operations.[225] What if the activity fails to generate two profit years in the first seven years of operation? This is the risk in invoking the election. In electing to use the Special Rule Presumption the taxpayer stops the IRS from conducting an audit in the first years of the activity.[226] Combine this with a failure to meet the terms of the presumption, and an invitation for an audit is given to the IRS. This election puts the IRS on notice.[227] A cautious taxpayer should, therefore, proceed carefully when an election to use the Special Rule Presumption is considered.

The roles of the General Rule Presumption, the Special Rule Presumption, and the taxpayer can best be explained by an analogy. Suppose we are at a circus and viewing a high wire act. The high wire is the Special Rule Presumption and the tightrope walker is the taxpayer. If he manages to remain on the high wire (meets the elements of the Special Rule), he makes a safe crossing; however, should he slip and fall from the wire, the net below will save him. The lifesaving net is the General Rule Presumption. Thus, even if the Special Rule is unavailable, the taxpayer can also attempt to minimize his tax burden if he can show the availability of the General Rule Presumption.[228]

The General Rule Presumption and the Special Rule Presumption each have a common requirement that at least two profit years must occur during a seven year period. Profit years and the ability to plan for them are essential to the taxpayer who wishes, pursuant to section 183, to avoid an audit by the IRS. Generally, a profit year exists if "the gross income derived from an activity . . . exceeds the deductions attributable to the activity. . . ."[229] It is incumbent upon the taxpayer to plan for profit years by structuring his activity to make the optimum use of the tax laws.

224. Thus, with reference to the example *supra* at note 217, the losses sustained in years two through four would also be allowed a presumption of deductability in addition to those losses incurred in years six and seven.

225. I.R.C. § 183(e)(1) (West 1982). However, by making the election the taxpayer agrees to allow the IRS to assess any deficiency from the early years of the operation up through the later years until two full years after the seventh year has expired. *See* I.R.C. § 183(e)(4) (West 1982).

226. I.R.C. § 183(e) (West 1982).

227. *See* AMERICAN HORSE COUNCIL, TAX REFERENCE SERVICE BULL. NO. 139 (May 1982).

228. Although not all taxable years under IRS scrutiny may be covered by the General Rule Presumption, some would possibly be. As a result, some loss deductions may be salvaged.

229. Treas. Reg. § 1.183(1)(c) (1972).

Section 183 allows the taxpayer the advantage of including the full amount of any gain realized in gross income even though any such gain is taxed at the preferable long-term capital gains rate.[230] Thus, if an asset were sold at a profit of $100, then even if only $40 of this was taxed because of capital gains treatment,[231] the full $100 is included in gross income for section 183 purposes. Furthermore, section 183 does not account for net operating loss carryovers.[232] Losses are only calculated based on the year in question and do not include carryover losses. A profit year is determined based on events which occurred in that same year.[233]

In addition to the tax treatment of long-term capital gains and net operating losses carried forward by section 183, there are other avenues open to the taxpayer to create a profit year. To increase income and lessen expenses, the taxpayer can tailor his depreciation schedules,[234] sale of assets,[235] payment of expenses,[236] and he can manage other expenses in his operation so that a profit year is achieved.[237] The best approach is to maintain

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230. *Id.*

231. Section 1231(b)(3) (West 1982), qualifies horses for capital gains treatment if they are held for at least two years. This means that any gain realized which is treated as a long-term capital gain will be discounted 60% before taxed. Thus, of $100 in long-term capital gain, only $40 is taxed. I.R.C. § 1231 (West 1982); I.R.C. § 1202 (West 1982).

232. Treas. Reg. § 1.183-1(c)(1) (1972).

233. *See generally* Treas. Reg. § 1.183-1(c) (1972).

234. If the taxpayer is engaged in a new activity wherein depreciable assets are being depreciated under the ACRS it might be profitable to elect straight line depreciation because it allows a smaller depreciation expense which permits a larger income. Furthermore, if the taxpayer will elect to take additional expensing under § 179 this should be done in a year where no profit is derived.

235. There is an obvious priority when selling assets: first, after they are eligible for long-term capital gains treatment; and second, in a year where a profit can be shown. Of course, if business dictates otherwise, i.e., a horse is losing value rapidly, a sound business decision should prevail.

236. By prepaying expenses, the taxpayer can cause a loss year or create a profit year. However, there are restrictions on the prepayment of expenses. Basically, the prepayment must not materially distort income and should be a payment as opposed to a refundable deposit. *See* Van Raden v. Commissioner, 71 T.C. 1083 (1979), *aff'd*, 650 F.2d 1046 (9th Cir. 1981) (allowing deduction) and Rev. Rul. 75-152, 1975-1 C.B. 144. Further, the material-distortion test requires that prepayment have a business purpose other than the avoidance of taxes. For further detail, *see* Comment, *Prepaid Feed Expense: Another Look At The Deposit, Business Purpose, And Distortion Of Income Tests,* 31 DRAKE L. REV. 653 (1981-82).

237. This would entail the use of installment sales, etc. *See Planning the Profit Year,* 2 THE PROFESSIONAL HORSEMAN (August 1981).

a balance of loss and profit amounts.[238] It is better to have a respectable profit year as opposed to a huge profit year, and the opposite is true where losses are concerned. The emphasis should be on evidencing a profit intent via the facts and circumstances surrounding the activity. If the taxpayer modifies his activity to such an extent that his profit and losses appear wholly artificial, the purpose of the planning is vitiated.[239]

5. *Election Not to be Treated as a Partnership*

In most syndicates, the syndicate agreement will contain a provision where it states that if the syndicate is found to be a partnership for taxation, the syndicate members elect not to be treated as a partnership.[240] This provision exists because it is generally more favorable for the syndicate to be treated as a co-ownership vehicle rather than as a partnership.[241] If the syndicate were treated as a partnership and no election made to disavow this, the syndicate would have to file a partnership information return[242] with the IRS, and any losses would have to be allocated to the syndicate members as if they were partners. Further, the taxation of partnerships is a complex area which can confuse the most astute advisor. If no plan were made to address partnership tax issues, the syndicate and its members would become immersed in the mire of separating out expenses and income at the partnership level, instead of at the individual level as envisioned by the syndicate membership.[243]

Various types of syndicates exist. There is the typical stallion breeding syndicate, which has been the subject of this article, mare syndicates, and racing syndicates. For federal taxation pur-

238. *See* DAVIS, HORSE OWNERS AND BREEDERS TAX MANUAL, (1982) for an excellent discussion of the Hobby Loss Rule and how to plan for a profit year.

239. The clumsy taxpayer who mismatches his expenses and income may be in for a rude awakening if the IRS decides his motive was not to make a profit, but rather was to claim artificial losses. If the IRS is successful in showing an artificial series of loss and profit years, a court might disallow losses to the extent they exceed income from the activity.

240. This is done as a matter of convenience as much as a matter of tax planning. By including it in the syndicate agreement, the administrative problem of securing the membership's consent at a later time is avoided. Further, the Code allows certain taxpayers to elect out of the provisions of subchapter k which governs the taxation of partnership. *See* Treas. Reg. § 1.761-2 (1972).

241. A partnership reports its income at two levels: the partnership level and individual partner level. If the syndicate is treated as a co-ownership entity only, the syndicate is not required to file a tax return.

242. I.R.S. Form 1065.

243. A nonsecurities syndicate involves no pooling of income or expenses for allocation. Each syndicate member channels his expenses and income in his own way; whereas if the members were partners, income and expenses would be determined at the partnership level.

poses, a partnership includes those relationships consisting of two or more persons who have joined together to carry on a financial operation or venture, not including a trust, estate or corporation.[244] Thus, a stallion breeding syndicate, where excess nominations are offered to syndicate members first, would most likely be considered as a co-ownership of property.[245] But, where the activity of the syndicate is such that income and losses are pooled and shared, it is probable that the IRS will treat the activity as a partnership.[246] This may develop where a racing or breeding syndicate is involved.[247] The nature and operation of the syndicate controls whether it should be treated as a partnership. Thus, to avoid classification as a partnership, and to avoid a violation of the securities laws,[248] the syndicate agreement should prevent the pooling of income for distribution to syndicate members.

The regulations permit the syndicate to make an election not to be treated as a partnership if it is found to be one.[249] The regulations provide that "[t]he commissioner [of the IRS] may exclude from partnership status, at the election of the members, certain unincorporated organizations used for investment only or for the joint production, extraction, or use—but not the sale—of property under an operating agreement. . . ."[250] Thus, because there is a proviso requiring that no services or products be sold from the jointly held property, if a mare syndicate sold off foals and the proceeds were divided among the syndicate membership, the election would be unavailable.[251]

For the advisor and the investor, whether a syndicate will be treated as a partnership and, if it is, whether the syndicate can

244. I.R.C. § 761 (West 1982).

245. The syndicate must take steps to avoid a sale of an asset with a concomitant distribution of income. This may cause the syndicate to be viewed as a partnership as well as supporting a claim that the interests sold in the syndicate are securities.

246. Treas. Reg. § 1.761-1(a) (1956).

247. A racing or breeding syndicate in the absence of constraints could be viewed as a partnership for tax purposes. If a horse is raced and a sizable purse is won it must be distributed to the syndicate membership. Arguably, this is a partnership because there is a group of individuals engaged in a common enterprise and a profit amount is shared.

248. A security may be found to exist where money is pooled to engage in a business with profits to come from others. *See supra* note 35 and accompanying text.

249. *See* Treas. Reg. § 1.761-2 (1972).

250. *See* United States Master Tax Guide, (CCH) ¶ 304 (1981).

251. *See* I.R.C. § 761(a) (West 1982).

properly elect not to be treated as a partnership is significant. If the syndicate is treated as a partnership for tax purposes, then the individual investor has little control over what expenses of the syndicated horse he may claim because as an asset of the partnership, the horse's depreciating schedule as well as other expenses must be figured at the partnership level and then allocated.[252] In addition, there is considerable expense in connection with filing a partnership return. These are but two of the problems to be encountered. The investor should proceed cautiously in this respect and should ascertain the nature of the syndicate before investing.

III. CONCLUSION

In the final analysis, does an investment in a horse syndication make sense? As a tax shelter, an equine investment is an excellent means to accomplish, in the same activity, both short-term losses and long-term capital gains.[253] The real test, however, is whether any one particular syndicate is a good business investment. By making a good business decision, the potential of gaining a profit is exponentially increased. A good tax shelter is not one which merely allows for massive loss deductions, since this alone would be disfavorable,[254] but a good tax shelter also allows for the potential of gaining profits at a later time. Considered in this context, an equine investment is proper so long as the underlying program is workable and truly capable of producing a profit.

Apart from the business aspects of a syndicate, the investor or his advisor must always be cognizant of the securities and tax laws.[255] A good business investment is of little use if the tax benefits flowing from it are denied or deferred.[256] It makes good

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252. *See supra* note 241; *see also* I.R.C. §§ 701-761 (West 1982).

253. Short-term losses can be accomplished by depreciation, general business and related expenses, plus investment tax credits where available. Furthermore, an interest in a horse or other property held for the production of income or used in a trade or business may qualify for preferential capital gains treatment. Therefore, where a tax shelter works, it allows the investor short-term tax savings or deferral which is presently valuable since it frees current income for other uses. At the same time, the investor may participate in later profits which are taxed at a lower rate because they are considered long-term capital gains.

254. This will necessarily depend on the horse or horses involved, the management, boarding, facilities, and promotional activities.

255. The investor need only concern himself with the potential penalties he might experience if he were to wade in muddy tax waters. The advisor, on the other hand, especially if a member of the bar, must concern himself with the recent tax enactments, *see supra* note 4, as well as with ethical considerations. *See* P. Sax, *Lawyer Responsibility In Tax Shelter Opinions,* 34 TAX LAWYER 5 (Fall, 1980); and D. Block, *An Overview: Responsibilities of Attorneys Under the Federal Securities Laws,* 36 BUSINESS LAWYER 1781 (July, 1981).

256. Because a dollar invested today is worth more than a dollar to be received

business sense as well as legal sense to review and consider the potential legal implications.

Once the business and legal aspects of the syndicate are considered, then the investor's decision becomes easier. When the business and legal elements turn up positive, then the investor need only decide whether he likes the horse or horses offered in syndication.[257] If the horse appeals to the investor and if the investor opts to purchase a syndicate interest, he will then become a co-owner of a beautiful living art object which has the incidental benefits of allowing tax benefits and profits. In this world of inanimate and intangible investments, it is comforting to know that a horse is an investment you can get on and write-off into the sunset.

THOMAS R. CATANESE*

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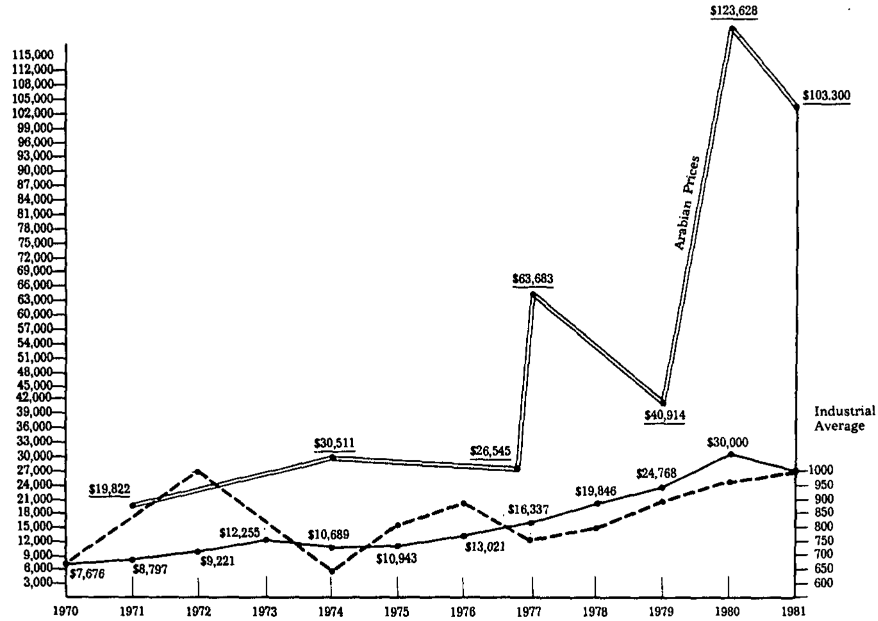
in the future, the value of a tax shelter is emasculated if the purported tax benefits are hindered and substantially delayed.

257. This aspect of an equine investment sets it apart from most other tax sheltered investments. One additional benefit of investing in horses is that they have the ability to reproduce.

* The author gratefully acknowledges the assistance of Mr. B. Paul Husband, member of the California Bar. However, it is emphasized that to the extent there are errors or omissions, the article and the views expressed herein are to be attributed solely to the author.

APPENDIX I

Average Thoroughbred and Arabian Prices Compared to Dow-Jones Industrial Yearly Close 1970 to 1980



1- Thoroughbred prices by the American Horse Council, Washington, D.C.

2- Lasma sale prices by the Arabian Council and Bask Classic

3- The Dow Jones Industrial Average figure for 1980 is the closing average on Nov. 1, 1980.