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Win, Place, or Show Through Multiple Ownership of Thoroughbreds in Alabama

Part 1

by

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WIN, PLACE, OR SHOW THROUGH MULTIPLE OWNERSHIP OF THOROUGHBREDS IN ALABAMA

JOHN H. COOPER*

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JOHN H. COOPER

The author presents a broad synopsis of the predominant legal issues surrounding multiple ownership arrangements of Thoroughbred horses. The attraction of this novel form of investment in Alabama will require practitioners to have a fundamental understanding of those issues as they pertain to local legislation, industry practices, forms of ownership, partnership law, tax law, and state and federal securities laws. The author points out some common trouble spots and offers suggestions or solutions.

I. INTRODUCTION

With the passage of the horse racing bill[1] by the Alabama Legislature in 1984, and the subsequent approval of horse racing and pari-mutuel wagering in Birmingham, Alabama, public interest in Thoroughbred horses in the State of Alabama has increased greatly. The raising, breeding, and racing of Thoroughbreds long has been an established business in many other states.[2] The economic forces inherent in, and glamour associated with, horse racing should result in the creation of a new and substantial industry in Alabama.[3] The introduction of the "sport of kings"[4] to Alabama inevitably will result in the diversion of capital by Alabama investors from traditional investments to horse racing and breeding investments.[5]

Horse racing and breeding in Alabama will require a sub-

[1] 1984 Ala. Acts No. 84-131 (April 6, 1984) [hereinafter cited as the Bill].

[2] As of January, 1985, approximately 35 states had approved horse racing and pari-mutuel wagering of one type or another.

[3] The horse racing business usually requires a substantial investment as a result of the facilities required to breed, train, and care for the horses, not to mention the cost of the horses themselves. The potential for profit, especially in a breeding investment, can be substantial and more predictable than a racing investment.

[4] This phrase probably originated in England where the monarchs historically have been enamoured with the breeding and racing of horses. The ancestors of the modern day Thoroughbred racehorses were Arabian horses brought to England during the seventeenth century.

[5] Developing a quality equine industry in Alabama will require a substantial amount of private capital. A portion of this capital likely will be diverted from more

stantial amount of capital investment and will offer investors exciting and attractive investment opportunities. The construction, development, and implementation of the horse racing track in Birmingham alone will require over $30,000,000 in equity capital from Alabama investors.[6] The construction of the track will be only the beginning of this complex new industry. Once the track is constructed, horses will have to be acquired, bred, and trained to race. The Bill contains provisions designed to encourage the breeding, raising, training, and racing of Alabama Thoroughbreds.[7] An integral part of the equine industry in Alabama will be the ownership and breeding of Alabama-bred Thoroughbreds.[8]

Historically, equine investments have proven excellent tax shelters and attractive investment alternatives for investors.[9] The cost of quality Thoroughbreds[10] has risen dramatically since World War II, thus facilitating the use of multiple ownership arrangements.[11] The analysis and structuring of multiple ownership of Thoroughbreds requires expert

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traditional investments in Alabama, such as real estate, oil and gas, corporate equities and indebtednesses, and bonds.

[6] This figure is derived from the applications submitted by Magnolia Downs, Greater Birmingham Sports Association, and Birmingham Downs, the three investment groups that submitted applications to the Birmingham Racing Commission for the right to build and operate the racetrack.

[7] Bill § 34. *See infra* notes 14-21 and accompanying text for a discussion of these provisions.

[8] Bill § 2(a).

[9] *See* notes 140-325 *infra* and accompanying text. The Internal Revenue Code of 1954, as amended, contains a number of provisions applicable to equine investments that permit substantial deductions to the investors. In addition, the profit to be derived from an investment in horses, particularly a breeding investment, can be substantial. Thoroughbreds have appreciated over the last 15 years at a spectacular rate, far outstripping the growth of the Dow Jones Industrial Average. *See* Catanese, *Horse Syndication: A Sure Footed Winner in the Investment Sweepstakes*, 10 PEPPERDINE L. REV. 615, 618 n.12 (1983).

[10] The quality of a Thoroughbred generally is based upon its blood lines, performance at the racetrack, or both. Successful Thoroughbreds commonly are referred to as "stakes winners." Highly successful Thoroughbreds are referred to as "grade-one stakes winners." The value of a "stakes winner" increases dramatically.

[11] Multiple ownership of horses can be structured as tenancies-in-common, joint ventures, general partnerships, limited partnerships, or corporations. Multiple ownership permits the owner of a horse to spread the risks of breeding, training, and racing the horse, while retaining control. From the investor's standpoint, multiple ownership allows investment in high-quality horses that otherwise would be out of the investor's price range. Additionally, multiple ownership vehicles permit the acquitision of several horses, thereby increasing the chance of success in the investment.

knowledge in three distinct areas of the law: equine law, tax law, and securities law. This Article discusses the tax and securities law considerations of multiple ownership of Thoroughbreds as well as state law considerations under the Bill.[12]

II. The Bill

To promote the breeding, raising, and racing of Alabama-Bred[13] Thoroughbred and standardbred horses, the horse-racing bill provides for the establishment of a breeding and development fund.[14] Each race track operator is required to pay a monthly breeding fund fee in an amount equal to one-half of one percent of the operator's monthly handle.[15] The operator's monthly handle is the total amount deposited in all of the pari-mutuel pools originated by the operator during the month. The horse-racing commission is required to adopt rules and regulations governing the maintenance and disbursement of the breeding fund.[16] Twenty percent of the annual breeding fund is to be set aside and distributed to the schools of veterinary medicine at Auburn University and Tuskegee Institute for use in equine research.[17] The balance of the fund is to be used:

(1) To provide awards to breeders[18] and owners of Ala-

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[12] A complete discussion of all the tax and securities law considerations is beyond the scope of this Article. No attempt is made to cover all the issues conceivably arising in an equine investment. Nevertheless, this Article does analyze the primary factors to be considered in structuring or investing in Thoroughbreds.

[13] The term "Alabama-Bred" is defined in the Bill as a horse registered in the registry designated and administered by the Birmingham Racing Commission in accordance with such rules concerning domicile and registration requirements as may be established by that commission and which is either (1) foaled from a mare domiciled in Alabama during the seven-year period beginning with the effective date of the Act, or (2) sired by an Alabama Stallion and foaled from a mare domiciled in Alabama at any time after the expiration of such seven-year period. Bill § 2(a).

[14] Bill § 34.

[15] *Id.*

[16] These rules presumably will address such issues as qualifications for disbursements under the fund, allocations of the fund to the various purposes, and investment of the fund pending disbursement.

[17] One of the principal objectives of the Birmingham Racing Commission should be to promote the development of high quality horses. This will require research and development in the areas of genetics, breeding, and disease prevention. Bill § 34.

[18] The term "Breeder" is defined in the Bill as the owner of a mare at the time such mare gives birth to an Alabama-Bred Thoroughbred or standardbred foal. Bill § 2(a).

bama-Bred thoroughbred and standardbred horses finishing first, second, third, or fourth in pari-mutuel races run in the state;

(2) To provide awards to Stallion Owners[19] whose Alabama Stallions[20] have sired Alabama-Bred thoroughbred or standardbred horses finishing first, second, third, or fourth in pari-mutuel races run in the state;

(3) To provide purse monies for races conducted exclusively for Alabama-Bred thoroughbred or standardbred horses;

(4) To advance and promote the breeding and raising of thoroughbred and standardbred horses in the state by the publication and dissemination of information relating thereto;

(5) To promote equine research through grants to universities within the state; and

(6) To provide for the administration and management of the breeding Fund.[21]

III. Form of Ownership

There are essentially two basic types of Thoroughbred investments: racing investments and breeding investments. Racing investments involve the ownership of racehorses and are subject to greater economic risks than breeding investments because only a small percentage of racehorses actually achieve success at the track and generate measurable

[19] The term "Stallion Owner" is defined as the owner of a stallion standing in Alabama at the time he was bred to the dam of an Alabama-Bred thoroughbred or standardbred horse. Bill § 2(a).

[20] The term "Alabama Stallion" is defined as a stallion which is standing in Alabama at the time he is bred to the dam of an Alabama-bred horse, which is registered with the Birmigham Racing Commission, and which alternatively is (1) owned by a resident of Alabama and standing the entire stud season in Alabama, (2) owned by a resident of another state but standing the entire stud season in Alabama and leased by an Alabama resident for a term of not less than two years, or (3) owned jointly by an Alabama resident together with a resident of another state and leased by an Alabama resident for a term of not less than two years. Bill § 2(a). A "resident" is defined as:

> (i) a natural person whose principal residence is located in the State; (ii) a natural person who does not maintain his or her principal residence in the State but who personally owns, singly or jointly with his or her spouse, real property located in the State that has an original cost to such person or a current fair market value of not less than $100,000; or (iii) a corporation or partnership which has its principal place of business in the State and more than fifty percent of the stock or other ownership interest in which is owned by natural persons described in clause (i) or (ii) of this sentence.

Id.

[21] *Id.*

profits. An even smaller percentage of horses is selected for breeding purposes. Breeding investments involve the ownership of either studs or broodmares. Horses selected for breeding, however, generally have had highly successful racing careers and are carefully chosen for breeding based on performance at the track and an analysis of bloodlines. This careful selection process makes the breeding investment more likely to succeed.

Investments in Thoroughbreds may be structured in several different legal forms of ownership. The most advantageous form for any individual or group depends upon many factors, including the investment goals, income tax considerations, risks and potential liability, size of the transaction, capital required, management considerations, and securities laws considerations. The most common forms of ownership are the sole proprietorship, syndicate, general partnership, and limited partnership. While sole proprietors, individual farms, and general partnerships own Thoroughbreds in great numbers, the primary focus of this Article will be the syndicate and limited partnership forms of ownership.

In recent years, Thoroughbred syndicates and limited partnerships have increased dramatically,[22] primarily because of the rising costs of quality horses. The average price for Thoroughbreds increased approximately 311% between 1970 and 1980, from an average of $8,797 in 1971 to $30,000 in 1980.[23] This price increase places quality Thoroughbreds beyond the reach of many individual investors and emphasizes the need to spread the risk of investing. Additionally, the use of limited partnerships and syndicates to aggregate capital permits the acquisition of more than one Thoroughbred, and hence, increases the chance of a successful investment.[24] Multiple ownership also permits

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[22] This is the direct result of the rapid rise in the cost of Thoroughbreds over the last 15 years, and the desire on the part of horse owners to spread the cost and risk of ownership.

[23] BARRONS NAT'L BUS. & FIN. WEEKLY, Feb. 14, 1983, at 106. *See also infra* note 28.

[24] This is particularly applicable to a racing investment because the competitive nature makes the business inherently riskier. The more horses owned and raced by the investment, the greater the chance of success and profitability of the venture. A breeding investment, by contrast, is generally more certain because the stallions and broodmares have certifiable bloodlines.

The study and analysis of the genetics of horses is a sophisticated and proven technique to breeding successful Thoroughbreds. It is not uncommon to trace a horse's

investors to acquire an interest in Thoroughbreds of higher quality with a capital investment that otherwise would purchase full ownership of lower quality Thoroughbreds. Thus, multiple ownership of Thoroughbreds, whether by syndication or limited partnership, offers the advantages of risk sharing, aggregation of capital, and diversification.[25]

A. Syndicate

The word "syndication" is thought by many outside the equine industry to be synonymous with a securities offering.[26] In the equine industry, however, and for purposes of this Article, the term refers to the ownership of horses by multiple investors, although the syndication of a horse also can involve an offering of securities.[27] The syndication of a horse permits the owner to recoup his capital investment by selling interests in the horse to investors. Stakes-winning horses can be syndicated at a substantial profit to the owner.[28]

Syndications most often are used to acquire stallions for breeding purposes.[29] Stallions with particularly successful racing careers or that have quality bloodlines, or both, frequently stand for stud after their racing careers have ended.[30] In a typical syndicate arrangement, the stallion is

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bloodlines and ancestry back as far as Man-'O-War, one of the most famous racehorses of all time.

[25] Multiple ownership permits investors to invest in more than one equine investment, which enhances their chance of success. In the absence of multiple ownership, investors would be required to tie up substantial amounts of capital in a single investment.

[26] The word "syndication" is used frequently to describe the raising of capital through the sale of limited partnership interests.

[27] *See infra* notes 326-468 and accompanying text.

[28] For example, the Thoroughbred Conquistadore Cielo was syndicated at a value of approximately $36,000,000, HORSEMEN'S J., Oct. 1982, at 5, and Seattle Slew was syndicated at a cost reportedly in excess of $100,000,000. The sale of syndicated interests in even a moderately successful stallion or a stallion with quality bloodlines can bring substantial sums to the owner of the horse.

[29] Syndicates are often formed after a stallion's racing career has ended, and he is retired to stud service. Stallions lend themselves well to syndicate arrangements because a stallion is able to service many more broodmares than any one breeder would want to make or could make available to the stallion.

[30] Not all stallions can stand for stud. There are obviously many more stallions engaged in racing than will stand for stud. In fact, a relatively small percentage of stallions have successful racing careers, and even a smaller percentage are selected for stud service. Bloodlines are extremely important in the horse industry. Some stallions with particularly good bloodlines have highly successful careers standing at stud without ever stepping on a racetrack.

treated as a commodity, such as a chattel, and is divided into multiple interests. These interests then are sold to investors, who are most likely already active in the equine industry.[31] Legally, the syndicate members own the horse as tenants-in-common, with each owning an undivided interest in the stallion. While there is no prescribed number of interests into which a stallion can be divided, most syndicates create between thirty and forty undivided interests.[32] Each interest entitles the holder to a certain number of nominations per season. Nominations are breeding rights that grant the holder the right to have a mare serviced by the stallion in the hope that the mare will conceive.[33] For example, if each holder of a syndicate interest receives two nominations, then the holder is entitled to access to the stallion's stud services twice per year. Thus, one of the principal factors in determining how many syndicate interests to create is the physiological ability of the stallion to cover mares during a breeding season.[34] If artificial insemination is permitted, then more mares can be covered, more nominations will be available, and consequently, more syndicate interests can be offered and sold. Thoroughbreds, however, are not permitted by rules of the American Jockey Club to be artificially inseminated.[35]

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[31] Because the syndicate members are free to use their interests in the stallion as they choose, investors who are actively engaged in breeding horses are better able to utilize the interest. In fact, it is unlikely that anyone not engaged in the equine industry would even be interested in purchasing an interest in a stallion. Passive investors are more likely to be interested in limited partnerships or other entities owning horses in which management of the investment is in the hands of an experienced horseman.

[32] The number of interests in which a stallion can be divided is determined, in large part, by the age and condition of the stallion. The age and condition of the stallion will determine the number of mares the stallion can cover in any one breeding season. A young, healthy stallion can cover as many as fifty or more mares per breeding season.

[33] Syndicate members usually will own a breeding farm from which they select mares to breed with the stallion acquired in the syndicate. Industry experience indicates that approximately 75% of all mares serviced by a stallion will actually conceive. The syndicate member then can raise the colt or filly for breeding or racing purposes or sell it to another farm. It is not uncommon for the syndicate member to sell the mare while it is in foal. Mares in foal sometimes bring extremely high prices, and can be sold with or without guarantees of a healthy foal.

[34] If the stallion can cover a large number of mares in a single breeding season, then the syndicate members may be given multiple nominations for each syndicate interest purchased.

[35] STANDARDS OF REGISTRATION OF FOALS, Rule 2(c) (1980). Thoroughbreds may only be bred by natural means. By contrast, standardbreds and Arabians may be

Stallion syndicates usually are structured pursuant to a rather elaborate syndicate agreement.[36] Although the holders of the interests theoretically own an undivided interest in the stallion as tenants-in-common, a syndicate agreement is necessary to govern the terms and conditions of ownership and the relative rights of the owners. Additionally, the syndicate agreement deals with such matters as risk of loss, risk of injury, infertility, sale or other disposition of excess interests or nominations, income tax considerations, selection, appointment and powers of a syndicate manager, allocation of expenses, allocation of nominations, and transfers of interest. Because each holder of an interest in the syndicate legally owns an undivided interest in the stallion, his interest is freely transferable, except as otherwise restricted by the syndicate agreement.[37]

The syndicate manager plays a crucial role in any syndicate, and therefore, he should be selected carefully. The syndicate manager should have substantial experience in raising, breeding, and caring for horses. Pursuant to the typical syndicate agreement, the syndicate manager takes physical possession of the stallion and is responsible for its boarding and care.[38] Frequently the syndicate manager is the individual owner of the stallion or the farm where the stallion stands at stud. It is not uncommon for the syndicate manager to be the syndicate promoter who organizes the syndicate and structures the terms and conditions of the sale and ownership of the syndicate interests. Sometimes the

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bred by artificial insemination and may therefore service from 125 to 225 mares during each breeding season.

[36] A well-drafted syndicate agreement is essential to any successful stallion syndicate. The typical syndicate agreement will address such issues as risk of loss, injury, infertility, transferability of interest, assessment of stallion expenses, tax considerations, and selection and duties of the syndicate manager.

[37] It is not uncommon to find provisions in a syndicate agreement restricting the transferability of the syndicate interest. These provisions can include rights of first refusal, rights of first option, or mandatory buy-backs. Restrictions on the transferability of interest permit the syndicater to select future syndicate members and keep undesirable persons out of the syndicate. To develop and maintain quality Thoroughbreds in Alabama, the breeding of stallions to broodmares must be carefully controlled. If breeding is permitted to get out of control, as it has in some states, then the quality of Thoroughbreds will necessarily decline.

[38] The importance of the syndicate manager to the syndicate cannot be over-emphasized. Potential investors in a stallion syndicate should investigate thoroughly the background, experience, and track record of the syndicate manager. Of equal importance is the particular stallion being syndicated. The stallion's bloodlines and heritage should be carefully checked and verified.

syndicate manager is the former owner who sponsored the stallion's racing career. The syndicate manager's duties can range from simple ministerial duties, such as recordkeeping and caring for the horse, to managing the investments of the syndicate interest owners. One of the most important responsibilities of the syndicate manager under the latter structure is the marketing and selling of excess nominations attributable to unsold interests or attributable to syndicate members who cannot use all the nominations available.[39] Pursuant to the syndicate agreement, the syndicate manager will be entitled to certain compensation for his services, typically free nominations or cash management fees or a combination of both.[40]

One of the most distinctive characteristics of syndicate ownership is the freedom of use of the syndicate interest by the syndicate members.[41] Each owner is free to use his interest in the stallion in any manner he chooses, subject only to the terms and conditions of the syndicate agreement. It is for this reason that members of a stallion syndicate usually are knowledgeable and experienced in the horse business. This should be contrasted with the ownership of an interest in a Thoroughbred limited partnership, which constitutes an indirect ownership interest in the horse, where the activities are controlled by the general partner.[42]

Profit from the ownership of a syndicate interest depends,

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[39] If the syndicate manager has the authority to sell excess nominations on behalf of the syndicate members, the syndicate interests may constitute securities, complicating the transaction tremendously. *See infra* text accompanying notes 352-470. If excess nominations are to be sold by the syndicate manager and the proceeds distributed pro rata to the syndicate members, the syndicate interest almost always will constitute securities.

[40] There does not appear to be a common pattern with respect to compensating syndicate managers. As a general rule, syndicate managers do not receive substantial cash compensation for managing the syndicate. When the syndicate manager is the owner of the stallion, it is not uncommon for the syndicate manager to retain a number of interests in the stallion. For example, if 40 syndicate interests are created, the syndicate manager may retain 10 and sell 30. The syndicate interests retained by the owner then can be used by him as he sees fit.

[41] Ability to make a profit from an investment in a syndicate rests solely on the entrepreneurial ability of the syndicate member. This factor frequently determines whether the syndicate interest constitutes a security. The syndicate member has discretion to select the particular mares to be serviced by the stallion, the breeding facilities to be used, the types and amount of insurance to be obtained, how to dispose of excess nominations, and how to pay breeding and other expenses.

[42] In a limited partnership, the general partner is solely responsible for the day-to-day management responsibilities of the partnership's activities. Limited partners may be given limited rights to consult with the general partner on business affairs,

in large part, solely upon the use of that interest by the owners. Profit can be derived in any one of three ways. First, the owner can profit from the sale, syndication, or racing of "gets," which are the offspring of the mares that have been serviced by the stallion. Obviously, the selection of mares is very important. Second, the owner can profit from the sale of excess nominations attributable to his interest.[43] To the extent there is "pooling of income" from such sales, however, securities problems may arise.[44] The third avenue of profit for the syndicate member is from the sale of his syndicate interest if it has appreciated in value. The potential appreciation in value of the syndicate interest will depend primarily upon the success and value of the stallion's offspring.[45]

Each syndicate owner is responsible for his own expenses.[46] The syndicate agreement normally covers some expenses common to the syndicate, such as board, veterinary care, insurance, and administrative expenses, which are paid by the syndicate owners pro rata to the number of interests owned by each. Other expenses, such as transporting mares, are the sole responsibility of the individual syndicate members.

Another use of syndicate ownership of horses is the ownership of a weanling or yearling colt.[47] This type of syndicate is substantially similar in many respects to a stallion

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but one of the principal characteristics of limited partnerships is the prohibition against the limited partners participating in the management of the business.

[43] The syndicate member necessarily may be limited in the number of mares he has available, therefore, some vehicle for efficiently disposing of those nominations is generally provided in the syndicate agreement. *See supra* note 32 and accompanying text.

[44] In some syndicate arrangements, proceeds from the sale of excess nominations are distributed pro rata among the syndicate members. This type of arrangement rarely is found in the typical stallion syndicate, however, because it creates problems under the securities laws. *See infra* note 391 and accompanying text.

[45] If the offspring of a syndicated stallion have successful racing careers, the stallion becomes more valuable. On the other hand, it is possible for a syndicate interest to decline in value if the stallion's offspring do not perform well at the racetrack.

[46] Some of these expenses actually may be paid by the syndicate itself, but the syndicate manager will have the right to assess each member for his pro rata share of these expenses. The expense of mortality and fertility insurance, however, generally is left to individual syndicate members. To some extent, however, a common sharing of expenses, and even losses, occurs, but this factor does not in itself cause a syndicate interest to be treated as a security.

[47] This type of ownership is used much less frequently than the breeding syndicate. Because of the necessity for centralization of management in these arrangements, the syndicate is not the preferred vehicle. In addition, these types of

syndicate. The syndicate manager trains and manages the racing of the colt. All expenses and earnings of the colt are shared or borne by the syndicate members pro rata, based on the number of interests owned by each. This type of syndication frequently grants the interest holders a right to convert their syndicate interests into an interest in a traditional stallion syndicate if the colt proves to be successful during its racing career and stands for stud after retirement.[48] A weanling or yearling colt syndicate differs from the traditional stallion syndicate in that the individual owners do not have separate, individual access to the horse for breeding or other purposes as in the case of a stallion syndicate. There is also greater centralization of management, pooling of income, and sharing of losses than in the typical stallion syndicate. This pooling of income and sharing of expenses, as well as the centralized management present in these syndications, generally will create problems under federal and state securities laws.[49]

B. *Limited Partnership*

In recent years, the use of the multiple ownership structure has spread to other areas of the equine industry, including the ownership of Thoroughbred stallions, mares, and geldings used in racing. One of the most common forms of multiple ownership of horses used in Thoroughbred racing is the limited partnership. A limited partnership, while differing significantly from the traditional syndicate structure in terms of its legal and operational considerations, lends itself to the ownership of Thoroughbred racehorses.[50] The

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syndicates generally involve pooling of income and create problems under the securities laws.

[48] If a stallion performs successfully at the racetrack, (i.e., becomes a "stakes winner"), the stallion may become a candidate for stud service, in which case the decision may be made to stand the stallion at stud and sell interests in him through the existing syndicate, or to transfer the stallion to a new syndicate created as a traditional breeding syndicate. In the latter case, the original syndicate members may be given the right to convert all or a part of their original syndicate interests into interests in the stallion syndicate.

[49] *See infra* notes 358-468 and accompanying text.

[50] A limited partnership is a single entity, whereas a syndicate involves multiple co-owners. In a syndicate, members are free to use their interests to the best of their entrepreneurial ability. In a limited partnership, the partnership owns the horse and the general partner is responsible for the management of the partnership's, and thus the horse's, activities. Syndicate members have the discretion to make independent decisions with respect to their syndicate interest. On the other hand, a general part-

substantial income tax benefits associated with the ownership of Thoroughbreds also facilitates the use of a limited partnership which, for tax purposes, allows the pass-through of the tax benefits to the individual partners.[51] The legal and practical complexities and risks inherent in Thoroughbred racing make the limited partnership, in most situations, the preferred legal structure for racing investments.[52] Although syndicates are also used to own racehorses, the need to make decisions about the training and racing of the horse makes the syndicate form of ownership more cumbersome.[53]

Partnerships, both general and limited, are used widely in the equine industry because they facilitate the raising of capital needed to defray the costs associated with the acquisition and maintenance of Thoroughbreds. One of the principal advantages of a partnership is the flexibility in allocating profits and losses among the partners pursuant to the limited partnership agreement.[54] So long as the allocation

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ner in a limited partnership makes all day-to-day decisions with respect to the property of the partnership. A limited partner's interest in the limited partnership is an intangible personal property right, whereas a syndicate member actually owns an undivided interest in the horse. Limited partnerships are subject to specific statutes governing limited partnerships. *See* ALA. CODE §§ 10-9A-1 to 203 (1975).

[51] A partnership is subject to the provisions of subchapter K of the Internal Revenue Code, which include some of its most complex and confusing provisions. A partnership itself does not pay tax as a separate entity. I.R.C. § 701. (All citations to the Internal Revenue Code are to the 1954 Code, as amended, unless otherwise indicated.) A partnership does have taxable income computed pursuant to § 703(a), but the individual partners are required to report their distributive share of the partnership's taxable income or loss, including each item of income, gain, loss, deduction, or credit thereof. I.R.C. § 702(a).

[52] One of the principal characteristics of a limited partnership under state law is the protection against loss and liability it affords limited partners. In general, a limited partner's liability is limited to his actual contributions to the limited partnership and his obligation to make future contributions to the partnership as set forth in the certificate of limited partnership. In addition, limited partners are liable to the creditors of the partnership to the extent of distributions made to such limited partner in compliance with the partnership agreement for a period of one year after the date of such distributions, and to the extent of distributions made in violation of the partnership agreement for a period of six years after the date of such distributions. ALA. CODE § 10-9A-107 (1975).

[53] Each syndicate member is a co-owner of the horse, and therefore, enjoys the right to participate in management decisions. This can be extremely cumbersome and impractical unless the syndicate has relatively few members. In a limited partnership, the general partner is solely responsible for the management of the partnership, and this centralization of management makes limited partnerships attractive vehicles for the ownership of racing Thoroughbreds.

[54] Provided the allocation has "substantial economic effect," a partner's distribu-

has "substantial economic effect,"[55] it can be designed to provide substantial tax benefits to the investors during the early years of the partnership's operation.[56] This flexibility is extremely important in limited partnerships formed to attract investors. Investors who invest in an equine limited partnership generally do so because of the projected tax benefits and other elements of return on investment.[57]

In general, the partnership form of ownership is extremely flexible.[58] A limited partnership can be formed tax-free,[59] and additional cash or property can be contributed

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tive share of income, gain, loss, deduction, or credit is determined by the partnership agreement. I.R.C. § 704(a)-(b).

[55] If the allocation under the agreement does not have substantial economic effect, then a partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances). I.R.C. § 704(b). In general, an allocation will have substantial economic effect if the allocation affects the partner's capital interests in the partnership and is not made merely for tax purposes. Orrisch v. Commissioner, 55 T.C. 395 (1970). In Prop. Reg. § 1.704-1(b), the IRS attempted to provide guidelines for determining when an allocation has substantial economic effect. These Proposed Regulations were extraordinarily complex and controversial and subsequently were withdrawn for further study.

[56] These early tax benefits are often referred to as "front-end" deductions and typically include depreciation deductions, loss allowances, interest deductions, trade or business expense deductions, and tax credits which are used to offset income derived from the investment program as well as the investor's other income.

[57] This should be contrasted with a typical stallion syndicate in which the investors frequently are interested in the particular stallion because they actively are engaged in horse breeding activities. Investors in an equine limited partnership may or may not be sophisticated with respect to the horse business. Because of the tax benefits available and the potential for substantial profits, many investors select equine investments simply because they are potentially good investments.

[58] State law imposes fewer rules on partnerships, for example, than on corporations. With some exceptions, the parties are free to structure a limited partnership in any manner they choose. A limited partnerhip is subject to more restrictions and formalities than a general partnership, but fewer than a corporation.

[59] I.R.C. § 721(a). That section provides: "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." *Id.* The receipt of a partnership interest in exchange for services, however, is not governed by § 721. Treas. Reg. § 1.721-1(b)(1) (1983). The receipt of a partnership interest in exchange for services to the partnership is a taxable event to the transferee. The transfer of a partnership interest from one partner to another partner for services rendered is a taxable event to the transferor and the transferee. *See, e.g.*, McDougal v. Commissioner, 62 T.C. 720 (1974). The regulations provide specifically under § 1.721-1(b)(1) (1960) that:

> to the extent any partner gives up his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another party's compensation for services . . . section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the party under section 61.

by one or more partners without recognition of gain.[60] Additionally, the management of the limited partnership's business activities is centralized in the general partner or partners.[61] Centralized management enables the limited partnership to operate almost like a corporation with a board of directors. Most of the day-to-day decisions are made by the general partners. Extraordinary decisions, such as liquidating the limited partnership, selling all or substantially all of the assets, or changing the nature of the partnership's business, may be subject to approval by the limited partners.[62]

From an investor's perspective, the primary disadvantage of a limited partnership is the illiquidity of his investment. Most limited partnership agreements restrict the right of the

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Id. See Diamond v. Commissioner, 56 T.C. 530 (1971) (the receipt of a profits interest in exchange for services also constitutes income to the partner under section 61), *aff'd per curiam*, 492 F.2d 286 (7th Cir. 1974). *See also* I.R.C. § 83.

[60] There is no requirement under subchapter K, as there is in the case of corporations, that the partners transferring property to the partnership in exchange for partnership interests be in control of the partnership immediately after the exchange. This makes partnerships more flexible than corporations, especially when the partners purchase their interests on an installment basis, requiring a series of annual capital contributions.

[61] In many respects, a limited partnership is a hybrid between a general partnership and a corporation. A general partner in a limited partnership acts much like the board of directors of a corporation. A limited partnership agreement can provide that the limited partners have the right to remove a general partner and select a new general partner. This right must be considered carefully in determining whether a partnership has the corporate characteristic of "centralization of management." *See infra* notes 122-25 and accompanying text.

[62] If limited partners are given too many rights such that they are deemed to be participating in the control of the business, they may be considered general partners. ALA. CODE § 10-9A-42(b) (1975) provides that limited partners will not be deemed to be participating in the control of the business of the limited partnership solely by doing one or more of the following:

> (1) being a contractor for or an agent, attorney-at-law, or employee of the limited partnership or of a general partner, or an officer, director or shareholder of a general partner; (2) consulting with and advising a general partner with respect to the business of the limited partnership or examining into the state and the progress of the partnership business; (3) acting as surety or guarantor for any liabilities for the limited partnership; (4) approving or disapproving an amendment to the partnership agreement; or (5) voting on one or more of the following matters: (i) the dissolution and winding up of the limited partnership; (ii) the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary course of its business; (iii) the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business; (iv) the change in the nature of the business; or (v) the removal of a general partner.

Id.

limited partner to demand the return of his capital contribution or to transfer his partnership interest.[63] Because of this illiquidity, a potential investor in an equine limited partnership should clearly understand the investment objectives of the limited partnership before committing capital to the venture.

A limited partnership, as defined by the Alabama Limited Partnership Act, is a partnership consisting of at least one general partner and one limited partner.[64] A limited partnership is created in Alabama by filing a certificate of limited partnership, executed by all of the partners, in the probate judge's office in the county where the partnership's registered office is located.[65] The basic terms and conditions governing the operation of the limited partnership are contained in the certificate of limited partnership. Additional terms and conditions agreed upon by the partners may be contained in the certificate or in a separate agreement of limited partnership.[66] State law dictates the minimum information that must be contained in the certificate of limited partnership. It is highly recommended, however, that the certificate or the agreement of limited partnership, or both, detail all the terms and conditions governing the ownership of Thoroughbreds and the respective rights and obligations of the partners. A well-drafted certificate and/or agreement of limited partnership should anticipate possible problems and contingencies and make provision for them to avoid conflicts among partners.[67]

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[63] These provisions are designed to prevent the disruption of the partnership's business. Restrictions on the transferability of a partnership interest also may be necessary to comply with federal or state securities laws. *See infra* text accompanying notes 415-19. ALA. CODE § 10-9A-100 (1975) (Alabama Limited Partnership Act) provides that a limited partner is only entitled to a return of his contribution to the extent and at the times or upon the happening of the events specified in the certificate of limited partnership.

[64] ALA. CODE § 10-9A-1(7) (1975).

[65] ALA. CODE § 10-9A-20 (1975).

[66] ALA. CODE § 10-9A-20(a)(13) (1975). The commentary accompanying this section allows for inclusion of the partnership agreement in the limited partnership certificate, a common practice.

[67] Some of these problems include the death, disability, retirement, or withdrawal of the general and limited partners, the transfer of partnership interests, the failure of a limited partner to meet his financial obligations to the partnership, the events causing dissolution, and the time when the limited partners can expect a return on their contributions. Notably, a limited partner may withdraw upon not less than six months' prior written notice to the general partners and may receive the fair value of his partnership interest if the limited partnership's certificate does not specify the

In a typical limited partnership, the general partner, promoter, or both will sell limited partnership interests, frequently called units or units of participation, to investors. The sale of these interests normally will involve the sale of a security and will necessitate compliance with federal and state securities laws.[68] Unlike the equine syndicate, investors in a limited partnership formed to own one or more Thoroughbreds do not have to be sophisticated or experienced in the horse business in order to invest.[69] An investor in a stallion syndicate owns an undivided interest in the horse itself and must use that ownership to the best of his ability and experience to make a profit. An investor in a limited partnership, on the other hand, is not expected to take an active role in the management, training, and racing of the Thoroughbreds; rather, he is expected to depend upon the skills and experience of the general partner or manager to make the investment successful.

Interests in the limited partnership are sold to investors to raise the capital necessary to achieve the limited partnership's investment objectives. The amount of capital required will vary with each limited partnership, and will depend, primarily, upon the number and quality of the horses to be acquired. The limited partnership may be formed to acquire one or more specifically identified Thoroughbreds, or may be formed as a "blind pool." A blind pool involves the formation of a limited partnership to raise capital for the general goal of acquiring horses unidentified at the time the capital is raised. Because no specific horse is identified, blind pools are by their very nature risky investments.[70] Partial blind pools can be structured to acquire

time or the events upon the happening of which a limited partner may withdraw or a definite time or event for the dissolution of the partnership. ALA. CODE § 10-9A-102(a) (1975).

[68] *See infra* notes 376-88 and accompanying text.

[69] Because the management of the limited partnership's business rests solely with the general partners, investors usually rely upon the sophistication and expertise of the general partners and should base their investment decisions, in part, on the prestige of the general partner. Federal or state securities laws may require the investors to be sophisticated in other respects such as in general business and financial matters. *See infra* notes 465-67 and accompanying text.

[70] Blind pools require special disclosure to investors because of the potential risks involved. The primary emphasis in blind pools is on the general partner, who has the discretion of investing all funds raised from investors. The disclosure documents furnished to investors in a blind pool should describe in detail the investment plans of the general partner.

one or more identified horses and one or more unidentified horses. A partial blind pool provides not only investment in one or more specific horses but also provides the capital to acquire additional horses, if attractive opportunities arise.

Limited partners are entitled to certain rights and privileges and are subject to certain obligations arising from their investment. These rights, privileges, and obligations should be clearly delineated in the certificate or agreement of limited partnership. Ownership of an interest in a limited partnership entitles the limited partner to a specific allocation of taxable income, loss, and cash flow from operations, as well as taxable gain, loss, and net proceeds from the sale of a horse.[71] A limited partnership agreement can grant the limited partners certain voting rights as prescribed by statute. As a general rule, however, limited partners may not actively participate in the management of a limited partnership.[72]

A well-drafted limited partnership agreement should contain provisions dealing with the death, withdrawal, or retirement of a limited partner, the disposition of a partnership interest, the admission of additional partners, the requirement, if any, to contribute additional sums to the limited partnership, and the rights of the limited partners. To ensure continuity, the limited partnership agreement should provide that the death, retirement, withdrawal, or expulsion of a partner does not terminate the partnership. The limited partnership agreement should contemplate, however, such an event and provide a mechanism for valuing and purchasing that partner's interest.[73] The agreement also should deal with the possibility of withdrawal or death of the general partner in a manner that offers the investors maximum flexibility, including the option to liquidate the partnership or to continue the partnership by selecting a new

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[71] ALA. CODE § 10-9A-82 (1975) (Alabama Limited Partnership Act) provides that profits and losses of a limited partnership must be allocated among the partners, and among classes of partners, in the manner provided in the partnership agreement.

[72] ALA. CODE § 10-9A-62 (1975) provides that except as provided in the act or in the partnership agreement, a general partner has the rights and powers, and is subject to the restrictions and liabilities, of a partner in a partnership without limited partners.

[73] There are numerous ways to value a partner's interest. The most common methods use some formula based on fair market value, appraised value, book value, or adjusted book value. To avoid unnecessary litigation, the partnership agreement should set forth in detail how a partner's interest is to be valued.

general partner.[74]

The general partner is responsible for the management of the limited partnership, and investors should be prepared to surrender management to the general partner.[75] Although the general partner has a fiduciary duty to the limited partners under state law, investors should carefully select the general partners with whom they choose to invest.[76] This is particularly true in the horse racing industry, which is new and relatively unknown to Alabama investors. The general partner, or a third-party manager hired by the general partner, will be responsible for the selection, training, and racing of the limited partnership's stable of Thoroughbreds. Investors should thoroughly investigate the background, experience, and track record of any general partner or manager. The background and experience of the general partner of a Thoroughbred limited partnership is equally as important as the horses to be acquired, especially in a blind pool limited partnership. Frequently, the horses to be acquired by the limited partnership will be acquired from the general partner or a related party. In these situations an independent appraisal should be obtained to support the purchase price of the horses.

One of the most crucial aspects of any offering of limited partnership interests is the marketing strategy to be employed to sell the interests. It is often recommended that a duly licensed broker-dealer be engaged to assist in the sale of the limited partnership interests.[77] The use of a broker-dealer will add to the complexity and expense of the offer-

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[74] ALA. CODE § 10-9A-140 (1975) provides that a limited partnership dissolves upon an event of withdrawal of a general partner unless: (a) at that time there is at least one other general partner and the certificate of limited partnership permits the business of the limited partnership to be carried on by the remaining general partner and that partner does so; or (b) within ninety days after the withdrawal, all partners agree in writing to continue the business of the limited partnership and to the appointment of one or more additional general partners, if necessary or desired, with the agreement effective as of the date of withdrawal. *Id.* Events of withdrawal are defined in ALA. CODE § 10-9A-61 (1975) and include, among other things, the death of a general partner who is a natural person, the withdrawal of a general partner, the removal of a general partner, and the dissolution of an entity general partner.

[75] ALA. CODE § 10-9A-62 (1975). *See supra* note 72 and accompanying text.

[76] In analyzing any potential investment, one of the most crucial inquiries should be to identify who will manage the investment and determine the extent of his experience and track record.

[77] Use of a broker-dealer will necessarily increase the cost of the transaction. Most broker-dealers will charge a commission ranging from seven to ten percent of the equity being raised. Nearly every state, including Alabama, prohibits the payment of

ing, but a broker-dealer may be necessary to complete the offering successfully.[78] Investors in most equine limited partnerships have little or no expertise in the horse business, and most horse promoters have little or no expertise in selling partnership interests to investors. Accordingly, bringing the horse promoter and the investor together in a successful offering may require the expertise of a broker-dealer familiar with the equine industry.[79]

IV. Thoroughbreds as Tax Shelter Investments

A. *General*

Tax shelter investments are investments designed to provide investors with current tax deductions which can be used to offset income from the investment as well as income from outside sources. These deductions are mandated by Congress and are intended to encourage investment of private capital in certain areas of the economy.[80] The most common examples of these deductions are cost recovery (depreciation) deductions,[81] interest deductions,[82] and trade and business deductions.[83] Congress further has encouraged investment by providing direct tax credits[84] for investments in specifically defined tangible personal

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commissions or any other remuneration to any person selling a security, unless that person is registered in the state. Ala. Code § 8-6-3 (1975).

[78] Small deals involving $1,000,000 or less often can be accomplished without the use of a broker-dealer, whereas, if the investment involves $1,000,000 or more, it often becomes necessary to use a broker-dealer. Without a broker-dealer, the promoter may find it exceedingly difficult and sometimes impossible to raise the necessary proceeds in a timely manner.

[79] It is important that the broker-dealer have at least a working knowledge of the investment being sold. Factors important in analyzing other traditional investments, such as occupancy rates, net operating income, and cash flow have little relevancy in equine investments, yet factors such as bloodlines, ancestry, and racing results do.

[80] Many provisions authorizing deductions are enacted by Congress to provide direct incentives in the form of tax benefits to specific sectors of the economy that are troubled or which Congress otherwise believes deserve special attention. A good example of such an incentive is the depletion allowance, permitted under certain circumstances, to the oil and gas industry. I.R.C. § 611-613.

[81] I.R.C. § 168.

[82] I.R.C. § 163.

[83] I.R.C. § 162. These expenses often include board, feed, training, travel, insurance, and veterinarian.

[84] The most widely used tax credit is the investment tax credit, I.R.C. § 38. Tax credits are much more valuable than deductions because they reduce tax liability dollar for dollar regardless of the taxpayer's marginal tax bracket. For example, a $5,000 investment tax credit would reduce the taxpayer's overall tax liability by $5,000 after application of the marginal tax rates. A $5,000 income tax deduction,

property.[85]

Most tax shelter investments contain one or more of the following characteristics: Deferral of current tax liability, conversion of ordinary income into capital gain, and leveraging of deductions against invested capital through the use of indebtedness.[86] Deferral of current tax liability is accomplished by investing in activities which generate substantial deductions to offset income from the activity and reduce income from other sources. Tax shelter investments are usually structured to generate taxable losses in the early years. In later years, the investment will usually "turn around" and begin generating taxable income.[87] The Economic Recovery Tax Act of 1981[88] makes investments in horses more attractive by assigning cost recovery periods of three and five years to horses,[89] depending upon the age and use of the horse.[90] These changes substantially enhance the deductions available from investments in horses and facilitate the ability to structure tax deferral. Although Congress recently repealed some of the cost recovery changes[91] and enacted

on the other hand, reduces a taxpayer's overall tax liability by a maximum of $2,500, provided the taxpayer is in the highest marginal federal tax bracket of 50%.

[85] I.R.C. § 46(a) provides a tax credit equal to 10% of the taxpayer's qualified investment, as defined in § 46(c), for any taxable year.

[86] The ideal tax shelter contains all three of these characteristics. An excellent example is a leveraged investment in real estate, which generates substantial ordinary deductions in the early years to reduce income from the investment and unrelated income and results in capital gain upon the sale of the property in the later years.

[87] This is commonly referred to as the "cross over" point. If the investment is highly leveraged, the investors may actually realize phantom income. Phantom income occurs under circumstances in which the cash generated from the investment must be used to service indebtedness. The repayment of the principal portion of indebtedness is not a deductible expense. Therefore, the income generated from the investment will be taxable to the investors without corresponding deductions. In later years, the substantial deductions will decrease as depreciation deductions decline or cease altogether and the interest portion of debt service declines.

[88] Pub. L. No. 97-34, 95 Stat. 172.

[89] I.R.C. § 168(h). The Economic Recovery Tax Act replaced the old system of depreciation with the accelerated cost recovery system. In general, property may be depreciated under the accelerated cost recovery system over a much shorter period of time than under the prior system.

[90] Any racehorse which is more than two years old at the time such horse is placed in service, and any other horse which is more than 12 years old at the time it is placed in service, is classified as three-year property and may be depreciated over a three-year period. I.R.C. § 168(h)(l). All other horses are classified as five-year property and may be depreciated over a five-year period. *Id.*

[91] The Economic Recovery Tax Act of 1981 contained provisions accelerating the cost recovery deductions for three-year and five-year property beginning in 1985, I.R.C. §§ 168(b)(1)(B)-168(b)(1)(C). Faced with increased budget deficits and decreased tax revenues as a result of ERTA, Congress in 1982 repealed these provi-

other provisions to limit the taxpayers' ability to accelerate deductions,[92] Thoroughbred racing and breeding investments remain excellent investment alternatives.

Two other tax shelter characteristics, conversion and leveraging, have been curtailed somewhat by recent tax law changes[93] but remain important considerations in structuring and analyzing Thoroughbred investments. Conversion exists if gain from the sale of the investment qualifies as capital gain.[94] The recapture provisions of the Internal Revenue Code of 1954, as amended (Code), now prohibit the conversion of gain attributable to depreciation deductions from ordinary income to capital gain. Gain in excess of these depreciation deductions, however, may still qualify for long-term capital gain treatment.[95]

Leveraging is an equally important characteristic of tax shelters and involves the use of indebtedness to "leverage" the allowable deductions against invested capital.[96] In 1976, Congress enacted the "at-risk" rules[97] to restrict the use of nonrecourse indebtedness in certain activities, including horse breeding and racing. The application of the at-risk rules to equine investments limits the ability of taxpayers to leverage deductions with nonrecourse financing. Neverthe-

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

[92] *See, e.g.*, I.R.C. §§ 461(h)-461(i), 467, 1274, enacted as part of the Deficit Reduction Act, Pub. L. No. 98-369, 98 Stat. 494 (1984).

[93] *See* I.R.C. §§ 46(c)(8), 465, 1274.

[94] I.R.C. §§ 1221, 1231.

[95] Horses are classified as § 1245 property, and to the extent a horse is sold at a gain, that portion of the gain attributable to the allowance for depreciation is characterized as ordinary income. For example, if a horse that originally costs $50,000 is subsequently sold for $100,000 at a time when its adjusted basis is $10,000, gain in the amount of $90,000 will be realized. Section 1245 requires the characterization of $40,000 of this gain, which is attributable to the prior depreciation deductions, as ordinary income. The remaining $50,000 of gain still may qualify for long-term capital gain.

[96] When the acquisition of property is financed, the amount of the indebtedness is included in the cost basis of the property, provided the amount of the indebtedness does not exceed the fair market value of the property. *See* Crane v. Commissioner, 331 U.S. 1 (1947); Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976). For example, assume a horse is acquired at a cost of $100,000, payable $15,000 in cash and the balance by the execution and delivery of an $85,000 promissory note. The basis in the horse for depreciation purposes is $100,000. If the horse is classified as three-year property, the first year's depreciation deduction under § 168(b)(1) is 25% or $25,000. Thus, because financing is used to acquire the property, the depreciation deductions have been "leveraged" and actually exceed the amount of the actual cash investment in the property.

[97] I.R.C. § 465. *See infra* notes 201-27 and accompanying text.

less, if structured properly, borrowed funds can be used effectively in an equine investment.

Tax shelters of all types have proliferated since the late 1970s and have caused great concern in Congress.[98] Responding to the rapid growth in the use of tax shelters, Congress enacted a number of provisions intended to restrict or eliminate certain tax shelters.[99] Thus far, Congress has been concerned primarily with so-called "abusive" tax shelters.[100] The present climate on Capitol Hill, however, seems to be in the direction of restricting all forms of tax shelters.[101] Proposals being considered by Congress would reduce substantially allowable deductions from investments in horses, as well as most other activities.[102] Unless such proposals are ultimately enacted, investments in Thoroughbreds can be structured as excellent tax shelters.

B. *Selected Tax Provisions Affecting Investments in Thoroughbreds*

Any investment in Thoroughbred syndicates and limited partnerships involves a number of complex and intricate federal income tax provisions. The following are the principal provisions affecting Thoroughbred syndicates and limited partnerships.

1. Classification of the Entity

Because different entities are taxed differently, the classification of the legal entity for tax purposes is crucial. The form of the entity for tax purposes, for example, determines the ability to allocate tax benefits,[103] how certain elections are made,[104] and whether the tax benefits will be directly

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[98] H.R. REP. No. 432, 98th Cong., 2d Sess. 1351-52 (1984) [hereinafter cited as H.R. REP. NO. 432].

[99] *See, e.g.*, I.R.C. §§ 46(c)(8), 461(h)(i), 467, 706(d), 1274, 6111-6112.

[100] *See* H.R. REP. No. 432 *supra* note 98, at 1357-58.

[101] TREAS. DEP'T REPORT TO THE PRESIDENT (Nov. 1984).

[102] Pursuant to the proposal prepared by the Treasury Department, the accelerated cost recovery system would be replaced by the real cost recovery system which provides substantially longer recovery periods. In addition, interest on loans other than for residential mortgages would be deductible only to the extent of $5,000 plus net investment income.

[103] Partners in a partnership have the flexibility of determining allocations in the partnership agreement.

[104] For example, these include selection of fiscal year, accounting method, amortization of organization and start-up costs, and recovery period.

available to investors.[105] The formal title given an entity in its organization document will not necessarily control for tax purposes. Accordingly, the form of the entity should be considered carefully and structured to ensure the intended tax consequences.

(a) Syndicates

The typical stallion syndicate creates separate legal interests in the stallion, and the syndicate members own the syndicate interest as tenants-in-common.[106] If structured properly, each ownership interest is separate and distinct from the others, and the tax consequences resulting from ownership of the interests depend solely upon the form of acquisition and use of the interest by the owner.[107] If the syndicate agreement grants the syndicate manager too much control or there is pooling of income from the use of the horse, or both, a partnership may be created for tax purposes.[108] A pure stallion breeding syndicate is more likely to be respected as an ownership of individual interests rather than a partnership.[109] In contrast, a syndicate formed to own weanling or yearling colts for racing is more likely to be classified as a joint venture or partnership, despite provisions in the syndicate agreement stating the parties intend not to create a partnership, joint venture, or other joint ownership entity. As discussed previ-

[105] Tax benefits flow through partnerships, and to some extent S corporations, and are available, subject to certain at-risk and loss limitations, to the partners or shareholders. In contrast, tax benefits do not flow through to the shareholders of subchapter C corporations.

[106] *See supra* notes 29-37 and accompanying text.

[107] *See supra* notes 41-43 and accompanying text.

[108] I.R.C. § 761(a) defines a partnership as "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, as venture is carried on . . . ." An enterprise may be classified as a partnership for tax purposes even though it is not a partnership under state law. *See, e.g.*, Rev. Rul. 64-220, 1964-2 C.B. 335. The Supreme Court stated that a partnership exists only when:

> considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested parties, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Commissioner v. Culbertson, 337 U.S. 733, 742 (1949) (footnote omitted).

[109] Traditional breeding syndicates do not involve pooling of income, sharing of profits and losses, or joint decision making. Each syndicate member owns an undivided interests in the stallion and is free to use his interest as he chooses.

ously,[110] these latter types of syndicates generally exhibit many of the characteristics of partnerships, such as pooling of income, sharing of profits and losses, common enterprise, and joint decision-making. The classification of an entity is based on the facts and circumstances of each situation and is determined by applying the income tax laws as well as state business association laws.

The classification of a syndicate as a partnership or other joint enterprise is important for several reasons. If it is determined that a syndicate is a partnership, then the partners may become liable for the acts of each other.[111] In addition, a partnership is required to file a separate information return.[112] A syndicate that is treated as a partnership for tax purposes also subjects the syndicate members to the myriad of complex partnership tax laws found in subchapter K of the Code.[113]

(b) Limited Partnerships

The principal question concerning a limited partnership is whether it will be classified as a partnership for tax purposes or as an association taxable as a corporation. If a purported partnership is classified for tax purposes as an association taxable as a corporation, the projected tax benefits will not flow through to the partners. An otherwise attractive tax shelter investment will become a disaster if the partnership is classified and taxed as a corporation.

In determining the classification of an organization formed and operated as a partnership, the regulations under section 7701 of the Code set forth certain characteristics ordinarily found in a true corporation.[114] These characteristics are: (1) Associates;

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[110] *See supra* notes 26-49 and accompanying text.

[111] ALA. CODE § 10-8-49 (1975) (Alabama General Partnership Act).

[112] I.R.C. § 6031.

[113] I.R.C. §§ 701-761. The Tax Court has described subchapter K as "distressingly complex and confusing" provisions which "present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field . . . ." Foxman v. Commissioner, 41 T.C. 535, 551 n.9 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965).

[114] Treas. Reg. § 301.7701-2 (1983). The corporate characteristics set forth in the regulations are largely a codification of the United States Supreme Court's decision in Morrissey v. Commissioner, 296 U.S. 344 (1931). In *Morrissey*, the Court faced the question of whether a trust created to develop real estate should be classified as an association taxable as a corporation. The Court weighed the characteristics of the trust in question against the characteristics of a typical corporation. The principal characteristics of a corporation noted by the Court were: (a) associates; (b) an objective to carry on a trade or business and divide the profits; (c) continuity of life of the enterprise, notwithstanding the death, disability, or withdrawal of its members; (d)

(2) an objective to carry on business and divide the gains therefrom; (3) continuity of life; (4) centralization of management; (5) limited liability; and (6) free transferability of interests.[115]

The Treasury Regulations promulgated under section 7701 provide that an unincorporated organization will not be classified as an association taxable as a corporation unless it has more corporate characteristics than noncorporate characteristics.[116] In making this determination, those characteristics which are common to both partnerships and corporations are ignored. Therefore, the characteristics of associates and an objective to carry on business and divide the gains therefrom, which are common to both partnerships and corporations, are ignored.[117] Accordingly, the four corporate characteristics to be examined are continuity of life, centralization of management, limited liability, and free transferability of interests. If the unincorporated organization has no more than two of these four corporate characteristics, it will be taxed as a partnership.[118] An organization with at least three of these characteristics will be classified as an association taxable as a corporation rather than a partnership.[119]

(i) Continuity of Life

The regulations provide that the corporate characteristic of continuity of life does not exist if the retirement, death, insanity, or bankruptcy of a general partner of a limited partnership causes the limited partnership to dissolve, unless the remaining members of the limited partnership agree to continue the partnership.[120] Furthermore, the regulations provide that continuity of life will be lacking when a general partnership is subject to a statute corresponding to the Uniform Partnership Act (UPA) or a limited partnership is subject to a statute corresponding to the Uniform Limited Partnership Act (ULPA). Limited partnerships organized under the Alabama Limited Partnership Act generally do not possess continuity of life.[121]

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the opportunity for centralized management; (e) limited liabiliity; and (f) free transferability of interest.

[115] Treas. Reg. § 301.7701-2(a)(1) (1983).

[116] Treas. Reg. § 301.7701-2(a)(3) (1983).

[117] Treas. Reg. § 301.7701-2(a)(2) (1983).

[118] Treas. Reg. § 301.7701-2(a)(3) (1983).

[119] *Id.*

[120] Treas. Reg. § 301.7701-2(b)(1) (1983).

[121] Treas. Reg. § 301.7701-2(b)(3) (1983). The cases seem to indicate a willingness to respect the written agreements of the parties. *See, e.g.*, United States v. Kintner, 216 F.2d 41 (9th Cir. 1954).

(ii) Centralization of Management

Regarding the corporate characteristic of centralization of management, the regulations provide that this characteristic is present if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed.[122] A general partnership subject to a statute corresponding to the UPA cannot possess the corporate characteristic of centralization of management. The mutual agency relationship between members of a general partnership precludes concentration of management powers.[123] Furthermore, a limited partnership subject to a statute corresponding to the ULPA generally does not possess centralized management. This corporate characteristic ordinarily will be present in such a limited partnership, however, if substantially all the interests in the partnership are owned by the limited partners.[124] Although the regulations do not define "substantially," the position of the IRS is that centralized management does not exist if the general partner owns at least a twenty-percent interest in the capital or profits of a limited partnership.[125] Accordingly, if the general partner of a Thoroughbred limited partnership does not own a sufficient interest in the partnership to avoid the conclusion that the limited partners own substantially all of the interests, the characteristic of centralization of management will exist.

(iii) Limited Liability

The regulations provide that an organization has the corporate characteristic of limited liability if, under local law, there is no member of the organization personally liable for the debts of or claims against the organization.[126] Personal liability exists if a creditor of an organization can satisfy its claims against the organization from a member of the organization if the assets of such organization are insufficient to satisfy the creditor's claim. The

122 Treas. Reg. § 301.7701-2(c)(1) (1983).

123 Treas. Reg. § 301.7701-2(c)(4) (1983). *See also* ALA. CODE § 10-8-49 (1975) (Alabama General Partnership Act).

124 The general partner in a limited partnership syndication will ordinarily retain an insubstantial interest, frequently 20% or less.

125 This is an unofficial policy and is subject to change at any time. *See* W. MCKEE, W. NELSON, & R. WHITEMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 306[4] (1977).

126 Treas. Reg. § 301.7701-2(d)(1) (1983).

regulations also provide that personal liability will exist with respect to each partner in the case of a general partnership subject to a statute corresponding to the UPA. Furthermore, a limited partnership subject to a statute corresponding to the ULPA generally does not have the corporate characteristic of limited liability, since the general partner is personally liable for the debts and obligations of the partnership to the extent that the partnership's assets are insufficient to satisfy creditor's claims.[127] The regulations further state that if the general partner has no substantial assets that can be reached by creditors of the organization and are mere "dummies" acting as agents of the limited partners, the corporate characteristic of limited liability exists.[128]

The IRS has published guidelines regarding whether a general partner has substantial assets.[129] Revenue Procedure 72-13 establishes certain conditions, including requirements concerning a general partner's net worth, which must be met before the IRS will issue a favorable advance ruling that an entity with a single corporate general partner is a partnership for tax purposes. Revenue Procedure 72-13 does not expressly state whether this net worth requirement relates only to the advance ruling, or whether the requirement is intended as a substantive rule to be applied in auditing taxpayers' returns.[130]

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[127] ALA. CODE § 10-9A-62 (1975). *See supra* note 72 and accompanying text. As a general rule, partners in a general partnership are jointly and severally liable for the debts and obligations of the general partnership.

[128] Treas. Reg. § 301.7701-2(d)(2) (1983). *See also* Treas. Reg. § 301.7701-3(b)(2) (1983) (Example 2). The corporate characteristic of limited liability will not exist unless the general partner has no substantial assets *and* is merely a dummy acting as an agent for the limited partners. The corporate characteristic of limited liability will not exist unless both these factors are present. Therefore, even if the general partner does not have substantial assets that can be reached by creditors of the partnership, the corporate characteristic of limited liability will not exist if the general partner is more than a dummy and acts for itself. *Id.* The Tax Court, in Larson v. Commissioner, 66 T.C. 159 (1976), held that a general partner is a "dummy" acting as agent for the limited partners when the general partner is under the control of the limited partners. *Accord,* Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975).

[129] Rev. Proc. 72-13, 1972-1 C.B. 735. The IRS' guidelines set forth in revenue procedures do not necessarily constitute the substantive law, but are merely the minimum guidelines which must be satisfied before the IRS will issue a favorable private ruling. An advance ruling by the Service can be attained with respect to certain issues that may apply to prospective transactions. The IRS will not rule on completed transactions. An advance ruling is insurance against audit with respect to the issues addressed in the ruling. If the transaction is subsequently audited by the IRS, an advance ruling will ordinarily preclude any adjustment, at least with respect to those issues addressed in the ruling. The fact that a particular transaction does not meet all of the guidelines set forth in a revenue procedure does not necessarily mean that the organization will not be classified as a limited partnerhip.

[130] In some cases, the guidelines set forth by the IRS in its revenue procedures,

Revenue Procedure 72-13 states, in pertinent part, that if total capital contributions to a limited partnership are less than $2,500,000, the net worth of a sole corporate general partner must at all times be at least fifteen percent of such contributions or $250,000, whichever is less; and if the total contributions to the limited partnership equal or exceed $2,500,000, the net worth of the corporate general partner at all times must be a least ten percent of such contributions.[131] In computing the net worth of the sole corporate general partner, its assets are to be valued at their fair market value, but its interest in the limited partnership and any accounts and notes receivable from and payable to the limited partnership are excluded. The revenue procedure also states that if the sole corporate general partner has an interest in more than one limited partnership, the net worth requirement is applied separately for each partnership, and the general partner must have at all times a net worth at least as great as the sum of the amounts required for each separate limited partnership.

(iv) Free Transferability of Interests

The regulations provide that an organization possesses this characteristic if each of its members or those members owning substantially all the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization another person who is not a member of the organization.[132] Thus, a partner must be free to transfer not only his right to participate in profits but also his right to participate in the control and assets of the organization. Furthermore, such a transfer must not cause the dissolution of the organization under state law. The parties may negate the corporate characteristic of free transferability of interests by restricting the partner's right to transfer his partnership interest and substitute another as a partner.

Under Revenue Procedure 74-17, the IRS will not issue an advance ruling whether an organization will be classified as a partnership unless:

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although technically aimed at qualifying for advance rulings, also constitute rules to be applied by agents auditing taxpayers' returns. For this reason, it is often recommended that transactions comply, when possible, with the minimum guidelines set forth in these revenue procedures to avoid future controversy with the IRS.

[131] The guidelines set forth in Rev. Proc. 72-13 presumably do not apply if the limited partnership has more than one general partner, especially if one of the general partners is an individual.

[132] Treas. Reg. § 301.7701-2(e)(1) (1983).

> (a) no creditor who makes a nonrecourse loan to the partnership will have or acquire at any time, as a result of making the loan, any direct or indirect interest in the profits, capital or property of the partnership, other than as a secured creditor;
>
> (b) the interests of all the general partners, taken together, in each material item of partnership income, gain, loss, deduction or credit is equal to or at least one percent of each such item at all times during the existence of the partnership . . . [and]
>
> (c) [the] aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of the operation of the limited partnership will not exceed the amount of equity capital invested in the limited partnership.[133]

Many limited partnerships' tax losses during the first two years of operation exceed the amount of the capital contributions of the partners, and thus fail to meet all of the requirements of Revenue Procedure 74-17. This procedure, however, specifically states that the rules contained therein are to be applied only in determining whether ruling and determination letters will be issued and are not intended as substantive rules for determining whether an organization should be classified as a partnership.

Certain decisions by the United States Tax Court and other federal courts have created great confusion with respect to the applicability and interpretation of regulations dealing with this characterization issue. The Tax Court, in *Larson v. Commissioner*,[134] held two limited partnerships formed under the California Limited Partnership Act were associations taxable as corporations for federal income tax purposes despite the fact that, as was later determined, the two partnerships qualified as partnerships under a literal application of the regulations.[135] The Tax Court, although examining the characteristics of corporate resemblance contained in the regulations, applied standards of its own creation and concluded that the limited partnerships should be treated as corporations. In *Zuckman v. United States*,[136] the

[133] Rev. Proc. 74-17, 1974-1 C.B. 438, 439 § 3.01 to .04.

[134] 65 T.C. 10 (1975) (withdrawn Nov. 7, 1975), *reissued*, 66 T.C. 159 (1976).

[135] The Tax Court subsequently withdrew its opinion and after a rehearing held that the two partnerships were partnerships for federal income tax purposes. *Larson*, 66 T.C. at 159.

[136] 524 F.2d 729 (Ct. Cl. 1975).

United States Court of Claims, applying the regulations literally, decided that a limited partnership formed under the Missouri Uniform Limited Partnership Act should be treated as a partnership and not as an association taxable as a corporation for federal income tax purposes. Subsequently, the Tax Court withdrew the *Larson* opinion and granted a petition for reconsideration on the merits, ultimately holding that the two purported partnerships were partnerships for federal income tax purposes.[137] Because the parties stipulated that Treasury Regulations were controlling, the court applied the tests of the regulations literally, without considering their validity. Only seven of the thirteen judges participating in the decision, however, concurred in the Tax Court's decision.[138] Unrest continues in both the Congress and Treasury with regard to this partnership/association issue.[139]

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[137] *Larson*, 66 T.C. at 159.

[138] While many practitioners believe that the IRS has, more or less, conceded the classification issue, it would appear that it merely has altered its form of attack. The Treasury Department recently has proposed that all limited partnerships with more than 35 limited partners automatically be classified as associations taxable as corporations.

[139] On January 5, 1977, the IRS issued proposed amendments to Treas. Reg. § 301.7701-2, T.D. 6797, 1965-1 C.B. 553, 554-56. These Proposed Regulations were withdrawn on the same day, with no explanation whether they would be reissued, revised, or dropped. On January 14, 1977, the Secretary of the Treasury announced that such amendments would not be reproposed by the Ford Administration. If similar amendments to the Treasury Regulations were to become law, or if certain concepts contained therein were adopted in future revenue rulings, such action could require many limited partnerships to be classified as corporations for federal income tax purposes.

On March 19, 1979, the IRS announced its acquiescence in *Larson* and issued Rev. Rul. 79-106, 1979-1 C.B. 147, which followed *Larson* in ruling that certain additional corporate characteristics discussed in *Larson* do not have independent significance in the determination of the classification of organizations formed as limited partnerships. Although these two developments provide support for the conclusion that many traditional tax shelter limited partnerships will be classified as partnerships for federal income tax purposes, the IRS, in Announcement 83-4 issued in January of 1983, stated that it is reconsidering its acquiescence in *Larson* to the extent its acquiescence is inconsistent with the minimum capitalization requirements of Rev. Proc. 72-13, 1972-1 C.B. 735.

Legislation has been introduced in Congress in the past and may be introduced in the future, and if enacted, would adversely affect the classification of partnerships for federal tax purposes. As an example, on January 21, 1978, President Carter proposed to Congress that legislation be enacted which would tax as corporations all limited partnerships (except partnerships engaged in certain low-income housing activities) having more than 15 limited partners. This proposal was incorporated in a bill that was introduced in Congress on April 12, 1978. Although the bill was not passed, there is no way to predict whether that proposal, or another proposal changing the rules for classifications of partnerships, will be introduced in another con-

2. Accelerated Cost Recovery System

The most valuable deductions allowable from investment in horses are the depreciation deductions under the accelerated cost recovery system (ACRS).[140] ACRS was added to the Code as part of the Economic Recovery Tax Act of 1981 (ERTA)[141] in an attempt to simplify and make more certain the rules regarding depreciation of property. Prior to ERTA, property was depreciated over a period of time based upon the property's useful life.[142] Useful life was a rather nebulous concept that often resulted in disputes between the IRS, which generally selected longer useful lives, and taxpayers, who generally selected shorter useful lives. In 1978, the asset depreciation range (ADR)[143] system was instituted in an attempt to reduce the areas of conflict over useful lives. The ADR system imposed ranges of useful lives for many different types of tangible property. For example, under the ADR system nonracing horses under age fourteen were assigned a useful life range of between eight and

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gresssional session and what effect, if any, such new classification rules would have on partnerships if they were adopted by Congress.

Notably, in Announcement 83-4, the IRS announced it was studying whether the partnership classification rules should be changed to place more emphasis on the net worth of the general partner. If the IRS changes the rules in a manner similar to those found in Rev. Proc. 72-13 concerning the net worth requirements of a corporation serving as the sole general partner, many general partners may not have, or be able to, maintain sufficient net worth for the limited partnerhip to be classified as a partnership, with the consequence that the organization would be taxed as an association, thus depriving investors of the tax benefits discussed herein.

Senate Finance Committee Chairman Packwood and House Ways and Means Committee Chairman Rostenkowski issued a statement on March 15, 1985, in support of the Treasury's proposal to tax as corporations all limited partnerships with more than 35 limited partners. Corporate tax treatment would apply to limited partnerships formed after January 1, 1986. The possibility of retroactive application is presently unclear.

If a purported partnership were classified as an association taxable as a corporation, then taxable losses generated by the organization would not pass through to the limited partners, and income generated by the organization would be taxed to the organization at the corporate income tax rates. Furthermore, cash could not be distributed to the partners under the favorable rules contained in subchapter K but rather would be subject to taxation as dividends pursuant to I.R.C. § 301.

[140] I.R.C. § 168.

[141] Pub. L. No. 97-34, 95 Stat. 172.

[142] I.R.C. § 167. Treas. Reg. §§ 1.167(a)-1.167(f), T.D. 7593 (amending § 1.167(a)(11)(f) (1977)).

[143] The asset depreciation range system established the useful life of 132 classes of capital assets. Under the ADR system, a taxpayer could deviate by up to 20%, higher or lower, from these guidelines.

twelve years.[144] Horses over age fourteen were assigned a two-year useful life,[145] and racehorses were assigned a five- to eight-year useful life.[146] While the ADR system did ease some of the confusion and uncertainty, it was not totally satisfactory, and in 1981 Congress went back to the drawing board. The result was ACRS.

ACRS applies to property placed in service after December 31, 1980,[147] provided the property is not acquired from a related party who owned the property at any time during 1980.[148] Recovery property is defined as tangible property used in a trade or business or held for the production of income which is eligible for depreciation.[149] Property not used in a trade or business, not held for the production of income, or held primarily for sale, does not qualify for ACRS. Furthermore, property is not eligible for ACRS deductions until it is actually placed in service. Property generally is deemed to be placed in service when it is in a condition of readiness for the purpose for which it was acquired.[150] Accordingly, a Thoroughbred does not become recovery property until it is placed in service in a trade or business or as property held for the production of income or investment.

ACRS replaces the ADR classifications with four classes of recovery property.[151] The concept of useful life, the most troublesome feature of the old system, was eliminated in favor of fixed recovery periods for each of the four classes. The four classes of recovery property created are: three-year property, five-year property, ten-year property, and fifteen-year property (changed to eighteen-year property by the Deficit Reduction Act of 1984).[152] Recovery property is

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

[145] *Id.*

[146] *Id.*

[147] I.R.C. § 168(b)(1)(A). I.R.C. § 168(e)(1) specifically excludes property placed in service by the taxpayer before January 1, 1981.

[148] I.R.C. §§ 168(e)(4)(A)-168(e)(4)(B). I.R.C. § 168(e)(4)(D) provides that a person is related to any person if the related person bears a relationship to such person specified in § 267(b) or § 707(b)(1), or the related person and such persons are engaged in trades or businesses under common control within the meaning of subsections (a) and (b) of § 52.

[149] I.R.C. § 168(c)(1).

[150] Treas. Reg. § 1.167(a)(11)(c)(l)(i); Rev. Rul. 76-238, 1976-1 C.B. 55.

[151] I.R.C. § 168(c)(2).

[152] *Id.*

assigned to one of these four classes, and its basis may be recovered (depreciated) over the period assigned to the class.[153] Racehorses over two years old and all other horses over age twelve are classified as three-year property.[154] Nonracehorses twelve years old or younger are classified as five-year property.[155] By reducing the period over which a horse's capitalized cost can be depreciated, Congress has made investments in horses as a source of tax shelter more popular than ever before.[156]

ACRS permits tangible property to be depreciated more rapidly. Furthermore, the ACRS system has eliminated the concept of salvage value.[157] A taxpayer may now recover the entire capital cost of an asset eligible for ACRS. To calculate the amount of the annual depreciation deduction, the unadjusted basis[158] of the property is multiplied by a statutorily prescribed percentage rate. The current percentages for three-year recovery property are twenty-five percent for the first recovery year, thirty-eight percent for the second recovery year, and thirty-seven percent for the third recov-

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[153] I.R.C. § 168(b).

[154] I.R.C. §§ 168(c)(2)(A), 168(h)(1).

[155] I.R.C. § 168(c)(2)(B). It makes no difference whether the horse is a mare or a stallion for purposes of determining its cost recovery period. A gelding, on the other hand, can only be classified as three-year property because it cannot be used for breeding purposes, but only for racing.

[156] For example, a five-year-old stakes-winning horse with quality bloodlines acquired for $100,000 for breeding purposes will be classified as five-year recovery property since it is a nonracehorse under 12 years of age. Pursuant to the table set forth in I.R.C. § 168(b)(1), the amount of the ACRS deduction permitted in the first year is 15% or $15,000. In the second year, the taxpayer would be entitled to an ACRS deduction equal to 22% of the cost of $22,000. In each of the last three years, the ACRS deduction would be 21% of the cost or $21,000. The full cost of the investment in the horse is recovered in five years. If the same horse had been acquired in 1979, the asset depreciation range or useful life of a five-year-old horse held for breeding purposes would have been 10 years. Thus, ACRS permits the taxpayer to recover the entire cost of his investment in half the time.

[157] I.R.C. § 167(f).

[158] I.R.C. § 168(d)(1). Unadjusted basis means the excess of the basis of the property as determined in § 101, over the sum of (1) that portion of the basis for which the taxpayer properly elects amortization in lieu of depreciation, and (2) that portion of the basis for which the taxpayer elects to treat as an expense under § 179. Section 179 permits a taxpayer to elect to treat a certain portion of the cost of any § 179 property as a currently deductible expense which is not chargeable to capital account. Section 179 property means any recovery property which is § 38 property (i.e., eligible for the investment tax credit) and which is acquired by purchase for use in a trade or business. Horses are specifically ineligible for the investment tax credit, and therefore, cannot be eligible for the § 179 cost election.

ery year.[159] The current percentages for five-year recovery property are fifteen percent for the first recovery year, twenty-two percent for the second recovery year, and twenty-one percent for each of the third, fourth, and fifth recovery years.[160] As originally enacted, ACRS provided for the phase-in of more rapid depreciation percentages in 1985 and 1986.[161] The phase-in of the more rapid percentages was repealed by TEFRA in 1982,[162] leaving intact the original ACRS recovery percentages. The length of the three-year and five-year recovery periods were unchanged, however, thereby permitting the recovery of the total cost of the property over the same period.[163]

ACRS permits taxpayers, at their election, to depreciate recovery property using the straight-line method rather than the statutory percentages.[164] The election must be made in the first year the property is placed in service,[165] and once made, is irrevocable.[166] Three-year property may be depreciated on a straight-line basis over three, five, or twelve years.[167] Five-year property may be depreciated on a straight-line basis over five, twelve, or twenty-five years.[168] Regardless of when the property is placed in service during the year, if the straight-line alternative is elected, the half-year convention applies to limit the first year's depreciation

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159 I.R.C. § 168(b)(1). The depreciation table for cost recovery property is based on a 150% declining balance depreciation schedule with a half-year convention.

160 *Id.*

161 I.R.C. §§ 168(b)(1)(B)-168(b)(1)(C) (1981), as repealed by the Tax Equity and Fiscal Responsibility Act of 1982.

162 Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324. As originally enacted, § 168(b)(1)(B) would have accelerated the cost recovery deductions for three-year property beginning in 1985 to 29% in the first year, 47% in the second year, and 24% in the third year. Beginning in 1986, these percentages would have accelerated to 33% in the first year, 45% in the second year, and 22% in the third year. Similarly, the percentages for five-year recovery property would have been accelerated in 1985 to 18% for the first year, 33% for the second year, 25% for the third year, 16% for the fourth year, and 8% for the fifth year.

163 Nothwithstanding that the more accelerated percentages for three- and five-year recovery property were repealed, the taxpayer's investment in such property may still be recovered (depreciated) over the same period. Thus, during the first three or five years of an investment, the taxpayer's overall ACRS deductions will remain the same.

164 I.R.C. § 168(b)(3)(A).

165 I.R.C. § 168(b)(3)(B).

166 *Id.*

167 I.R.C. § 168(b)(3)(A).

168 *Id.*

deduction to one-half the full amount.[169]

Under ACRS, a full year's depreciation is permitted irrespective of when the property is placed in service.[170] Thus, the placing of a racehorse in service in September entitles its owner to the full first year's ACRS deduction of twenty-five percent of its cost. Conversely, no ACRS deduction is permitted in the year the property is sold or otherwise disposed.[171] The ability to claim a full year's ACRS deduction in the year the property is placed in service depends upon whether the taxpayer has been in business for the entire year.[172] ACRS limits the first year's depreciation allowance if the taxpayer has a short fiscal year in the year the property is placed in service.[173] For example, if a calendar-year taxpayer begins business operations on September first and places a racehorse in service at the same time, the ACRS deduction will be reduced to take into account the short taxable year. Since the taxpayer has been in business for only four months during the year, the allowable ACRS deduction will be twenty-five percent multiplied by one-third. The portion of the ACRS deduction allowed in the short taxable year is recoverable in a later year.[174]

To prevent taxpayers from manipulating the ownership of property to take advantage of ACRS, section 168 contains "anti-churning" provisions.[175] Property acquired from a related person, as defined in section 168(e)(4)(D), who placed the property in service before 1981 is ineligible for ACRS treatment.[176] Such property must continue to be depreciated under section 167 and the ADR system. Property

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169 I.R.C. § 168(b)(3)(B)(iii).

170 I.R.C. § 168(b)(3)(B)(i).

171 I.R.C. § 168(b)(2)(B). Thus, to take full advantage of ACRS, a taxpayer should place a horse in service late in the year and sell or otherwise dispose of the horse early in the first year succeeding the year when the final cost recovery deductions are taken.

172 I.R.C. § 168(f)(5).

173 *Id.* Section 168(f)(5) provides in the case of a short taxable year, the amount of the deduction shall be an amount which bears the same relationship to the amount of the maximum deduction, as the number of the months in the short taxable year bears to 12.

174 *Id.* In such case, the amount of the deduction for subsequent taxable years is adjusted in accordance with regulations.

175 I.R.C. § 168(e)(4). "Churning" in this context refers to the sale or resale of property specifically for the purpose of taking advantage of accelerated cost recovery deductions.

176 I.R.C. §§ 168(e)(4)(A)-168(e)(4)(B).

never placed in service and acquired from a related party, however, may still qualify under ACRS.[177]

The anti-churning rules could come into play in an equine limited partnership if the general partner or a related party owns a horse which was placed in service before 1981, and the general partner retains more than a ten-percent interest in the limited partnership.[178] The limited partnership and the general partner (or related party) would be considered related parties for purposes of the anti-churning rules. To avoid the anti-churning rules in this situation, the general partner should retain less than a ten-percent interest in the limited partnership.

The anti-churning rules should not apply to the typical stallion syndicate because each syndicate member owns an undivided interest in the stallion, and generally there is no pooling of income or sharing of profits.[179] The syndicate ownership interests are distinct and independent from each other. If structured properly, the typical stallion syndicate will not be classified as a partnership for tax purposes.[180] If the syndicate is not a partnership, then there is no entity to which the promoter can be related.[181] In this situation, the fact that the promoter retains a more than ten-percent interest in the stallion is irrelevant because each syndicate member's ownership is legally separate. In contrast, a weanling or yearling colt syndicate, which ordinarily involves pooling of income and sharing of profit, generally will be classified as a partnership and will be subject to the anti-churning rules.[182] Accordingly, the promoters in these type syndi-

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[177] The IRS has taken a liberal view with respect to when property is placed in service. *See, e.g.*, Rev. Rul. 84-23, 1984-1 C.B. 38.

[178] I.R.C. § 168(e)(4)(D) refers to § 167(b) and § 707(b)(1) for purposes of determining related-party status. However, in applying § 267(b) and § 707(b)(1) "10%" must be substituted for "50%." This makes it much more difficult to avoid the anti-churning rules in situations when a taxpayer sells a horse to a partnership in which the taxpayer retains an ownership interest.

[179] *See supra* notes 41-46 and accompanying text.

[180] *See supra* notes 106-13 and accompanying text.

[181] The definition of related party for purposes of the anti-churning rules is predicated upon a relationship between the taxpayer and an entity (a corporation in the case of § 267(b) and a partnership in the case of § 707(b)(1)). If a stallion syndicate is structured properly, the syndicate arrangement will constitute neither a corporation nor a partnership, and therefore, the taxpayer cannot be a related party, at least with respect to the interests sold to unrelated syndicate members. This is important because in most syndicate arrangements the syndicate manager or owner will frequently retain as many as one-third of the syndicate interests.

[182] *See supra* notes 175-80 and accompanying text. In these situations, it is ex-

cates should not retain more than a ten-percent interest in the colt.

There is one situation when the parties may want to violate the anti-churning rules. The shortest recovery period under ACRS is three years for racehorses more than two years old and all other horses more than twelve years old.[183] Under the ADR system, a horse over age fourteen can be depreciated over a two-year period.[184] A limited partnership or syndicate that acquires a horse over age fourteen is permitted to recover the cost over three years under ACRS.[185] If the limited partnership or syndicate is structured so that the general partner or promoter retains more than a ten-percent interest, and the general partner or promoter owned the horse before 1981, the anti-churning rules will be violated, and the horse can be depreciated over two years under the ADR system.[186] Thus, depreciation deductions would be increased by fifty percent.[187]

In exchange for the substantial depreciation deductions permitted under ACRS, the Code exacts a tax cost if the horse is sold at a gain.[188] The adjusted basis of property, which determines the amount of depreciation deductions (and gain upon sale), is reduced by the amount of the cost recovery or depreciation deductions.[189] When property is sold, gain is measured by the difference between the amount realized[190] and the property's adjusted basis, as reduced by

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tremely difficult to avoid classification as a partnership or joint venture, despite provisions in the syndicate agreement to the contrary. *See supra* notes 106-13 and accompanying text.

183 I.R.C. § 168(h)(i).

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

185 I.R.C. § 168(h)(l).

186 I.R.C. § 167; Treas. Reg. §§ 1.167(a)-1.167(f), T.D. 7593 (amending 26 C.F.R. § 1.167(a)-(ll)(f) (1977)). A horse that does not qualify as cost recovery property whether three-year recovery property or five-year recovery property, is not eligible for ACRS. ACRS is not an elective provision. If the property constitutes recovery property, then the cost must be recovered pursuant to the ACRS tables in § 168(b) or pursuant to the straight-line method elected pursuant to § 168(b)(3).

187 The cost of the property would be recovered over a two year period rather than three years.

188 This tax cost is referred to as "recapture" and prevents the taxpayer from converting gain attributable to ordinary deductions to capital gain. *See* I.R.C. §§ 1245, 1250.

189 I.R.C. § 1016(a)(2).

190 I.R.C. § 1001(b).

cost recovery or depreciation deductions.[191] Section 1245 provides that, upon the sale of "section 1245 recovery property," the amount by which the lower of "recomputed basis" or amount realized exceeds the adjusted basis will be treated ("recaptured") as ordinary income.[192] "Recomputed basis" is defined basically as the adjusted basis of the property plus all ACRS deductions allowed with respect to the property prior to its sale.[193] "Section 1245 recovery property" means all recovery property except certain eighteen-year real property.[194] The principal thrust of the section 1245 recapture rules is to tax all gain attributable to ACRS deductions as ordinary income to prevent taxpayers from reducing ordinary income with ACRS deductions at a cost subsequently taxed as capital gain when the property is sold.[195]

Although ACRS added certainty to an uncertain area of the tax law, questions remain. The first question involves the aging of horses. Section 168 includes in the definition of three-year property any racehorse more than two years old at the time the horse is placed in service and any other horse which is more than twelve years old.[196] The equine industry ages a horse by one year at the beginning of each calendar year regardless of the horse's actual birthday.[197] Thus, a horse could be classified as a two-year old by the equine industry before it is chronologically two years old. While a technical interpretation of the definition would focus on actual physical age, a more reasonable approach would be to adopt the American Jockey Club rule.[198] Until

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[191] I.R.C. §§ 1011, 1016(a)(2).

[192] I.R.C. § 1245(a)(l). Essentially, all depreciation or ACRS deductions must be recaptured as ordinary income to the extent of gain recognized. If gain is recognized upon the sale of a horse, but the amount realized is less than the original cost of the horse, then part of the potential recapture will escape tax.

[193] I.R.C. § 1245(a)(2).

[194] I.R.C. § 1245(a)(3).

[195] Prior to the enactment of § 1245, taxpayers could invest in § 1245 property and depreciate the cost, which would generate deductions to offset income from the property as well as income from other sources. Then, when the property was sold, all of the gain, including gain attributable to the ordinary depreciation deductions, would be taxed at the preferential capital gains rates. The potential loss of revenue to the federal government from such a conversion led to the enactment of § 1245 and its counterpart, § 1250, which applies to real property.

[196] I.R.C. § 168(h)(l). *See also* H.R. REP. No. 4242, 97 Cong., 1st Sess. 208 (1981).

[197] AMERICAN JOCKEY CLUB RULE No. 5.

[198] The principal purpose for the American Jockey Club rule is to simplify administration. Because the underlying purpose for ACRS was to simplify the rules and

this issue is finally resolved, however, following the standards of the equine industry is risky.

Another area of uncertainty under ACRS is what happens when a racehorse, classified as a three-year property, is retired and converted to breeding status. Neither the Code nor the regulations address this problem. Nonracehorses twelve years old or younger are classified as five-year property.[199] Although the taxpayer may be required to recover the unrecovered basis over the remaining years in the five-year period, it is unclear whether the ACRS deductions taken in prior years must be recomputed based on the statutory percentages for five-year property. This is, however, not practical. Similar problems arise when a show horse is converted to a racehorse.[200]

3. "At-Risk" Limitation

As part of the Tax Reform Act of 1976,[201] Congress enacted, section 465. This provision is aimed at limiting loss deductions from certain activities to the amount the taxpayer has at risk.[202] A taxpayer is deemed to be at risk to the extent of (1) cash or the adjusted basis of property contributed to the activity; (2) borrowed amounts used in the activity for which the taxpayer has personal liability;[203] and (3) the net fair market value of personal assets which secure nonrecourse debt used in the activity.[204] A taxpayer is not

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ease administration with respect to depreciation deductions, the IRS should be consistent and adopt the American Jockey Club rule. The administrative and accounting problems faced by owners of horses will be enormous if the IRS rejects Rule No. 5.

199 I.R.C. § 168(c)(2)(B).

200 A nonracehorse 12 years old or younger is classified as five-year recovery property. I.R.C. § 168(c)(2)(B). If it is converted to a racehorse, then it becomes three-year recovery property pursuant to § 168(h)(l). While this situation occurs less frequently than the reverse, administrative problems of switching to the three-year tables would be enormous.

201 Pub. L. No. 94-455, 90 Stat. 1520. The principal thrust of I.R.C. § 465 is to limit the ability of taxpayers to generate substantial tax deductions with little or no out-of-pocket investment in the property due to leveraging. Congress concluded that high income taxpayers, by investing in abusive tax shelters utilizing heavy leveraging, were paying substantially less than their proportionate share of taxes.

202 H.R. REP. No. 658, 94th Cong., 2nd Sess. 3 (1976). The at-risk rules attacked this abuse by limiting the allowance of losses generated from property in which the taxpayer has little or no capital investment.

203 Loans for which a person has personal liability commonly are referred to as "recourse" loans, and loans for which no one has personal liability commonly are referred to as "nonrecourse" loans.

204 I.R.C. § 465(b).

considered at risk for recourse debt if the taxpayer is protected against loss as a result of guarantees, stop-loss agreements, or repurchase agreements.[205] Under section 465, loss from an activity is allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk for such activity at the close of the taxable year.[206] Section 465 applies only if the deductions attributable to the activity exceed the income generated by the activity during the taxable year.[207] Because of the potentially devastating tax consequences of the at-risk rules, each investment must be carefully evaluated and structured to deal with the application of the at-risk rules.[208]

Section 465 does not disallow deductions from an investment. Deductions are permitted according to the statutory provisions and accounting methods.[209] The underlying principle of the at-risk rules is that a taxpayer may not use losses from an activity unless he has a sufficient economic investment in the activity. The at-risk rules are designed to limit losses from investments that are highly leveraged with nonrecourse debt.[210]

The at-risk rules do not directly affect the adjusted basis of property used in an activity. According to the Supreme

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[205] I.R.C. § 465(b)(4). If an investor is protected against loss on his investment because of guarantees, stop-loss agreements, repurchase agreements, or is otherwise protected against personal liability, he is deemed not to be at risk for that amount. *See also* Prop. Treas. Reg. § 1.465-6 (proposed June 5, 1979).

[206] I.R.C. § 465(a)(1). For purposes of § 465, the term "loss" means "the excess of the deductions allowable under this chapter for the taxable year (determined without regard to the first sentence of subsection (a)) and allocable to an activity to which this section applies over the income received or accrued by the taxpayer during the taxable year from such activity . . . ." I.R.C. § 465(d). These deductions would include ACRS deductions pursuant to § 168, and interest deductions pursuant to § 163.

[207] If the property is highly leveraged, but neverthless generates substantial income in excess of the deductions allocable to the activity, § 465 is inapplicable.

[208] An otherwise attractive investment can be totally ruined by the unintended application of the at-risk rules. One of the principal attractions of any tax shelter is the tax losses projected to be available to the investors. If the at-risk rules apply and the tax losses are disallowed to the investor, the investment is rendered worthless and can result in serious tax consequences to the unwary investor.

[209] I.R.C. § 465(a)(1) only applies to activities for which a loss is realized for the taxable year. It is the overall loss from the activity that is disallowed under the at-risk rules and not the individual items of deduction.

[210] The at-risk rules apply to practically any activity engaged in by the taxpayer in carrying on a trade or business or for the production of income. I.R.C. § 465(c). The holding of real property is treated as a separate activity and is specifically excluded from the application of § 465. I.R.C. § 465(c)(3)(D).

Court, the basis of property includes not only indebtedness for which the taxpayer has personal liability, but also indebtedness for which the taxpayer has no personal liability.[211] Thus, accelerated cost recovery deductions may be computed against the full basis of the property, even if the property is acquired with nonrecourse debt.[212] For purposes of determining the amount at risk against which losses from the activity are allowed, however, nonrecourse debt is excluded.[213] In a partnership, the basis of the partnership's property is determined at the entity level. The determination of the amount at risk is determined at the partner level on an individual basis.

To determine the potential losses allowable from an activity, a taxpayer must first compute the extent to which he is at risk from the activity. If losses from the activity exceed the amount at risk, losses are allowed as a deduction only to the extent of the amount at risk at the end of the taxable year, and the excess losses are carried forward indefinitely to be deducted if and when the taxpayer's amount at risk increases.[214] A taxpayer's at-risk account may be increased by contributing additional cash or property to the activity, refinancing or converting nonrecourse debt into recourse debt, or pledging property unrelated to the activity as security for nonrecourse debt.[215]

If a substantial part of the acquisition cost of a horse is financed, the indebtedness must be recourse in an amount sufficient to provide investors with adequate at-risk accounts against which anticipated losses may be deducted. Similarly, if the investment is structured with deferred payments from the investors, the deferred payments should be fixed

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[211] Crane v. Commissioner, 331 U.S. 1 (1947).

[212] If the amount of indebtedness exceeds the reasonable fair market value of the property, it may be excluded, in whole or in part, from the determination of basis. *See* Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976).

[213] I.R.C. §§ 465(b)(2), 465(b)(3). In a partnership, the basis of the partnership's property is determined at the entity level. The determination of the amount at risk is determined at the partner level on an individual basis.

[214] I.R.C. § 465(b)(5) provides that the amount with respect to which a taxpayer is considered to be at risk in subsequent taxable years is reduced by disallowed losses from previous years.

[215] I.R.C. § 465(b)(2)(B) provides that a taxpayer will be considered at risk with respect to amounts borrowed for use in an activity to the extent he has pledged property, other than the property used in the activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interests in the property).

recourse obligations, preferably evidenced by full-recourse promissory notes.

Amounts borrowed from a related or interested party are excluded from the amount considered at risk.[216] A related party is defined generally as a member of the taxpayer's immediate family.[217] An interested party is one who has an interest in the activity other than as a creditor.[218] The proposed regulations further define an interested party as a person who has a capital or net profits interest in the activity.[219] The proposed regulations state that it is not necessary for a person to have any "incidents of ownership" in the acitivity to have an interest in the net profits from the activity.[220]

The amount at risk is calculated at the end of each fiscal year.[221] The at-risk account is adjusted upward or downward to reflect increases or decreases in the amounts at risk and loss deductions claimed against amounts at risk.[222] The amount at risk is never reduced below zero from allocations of losses. A negative at-risk amount is possible, however, if the elements which comprise the amount at risk are reduced. This could occur, for example, where recourse debt in excess of the current amount at risk is converted into nonrecourse debt. To eliminate this possibility, section 465 was amended in 1978[223] to provide that negative amounts at risk must be recaptured in a manner similar to recapture of depreciation.[224] The recapture of deductions subject to section 465 only applies to deductions claimed after December 31, 1978.[225] The effect of recapture is the recognition of ordinary income in the year the recapture occurs to the ex-

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216 I.R.C. § 465(b)(3)(B).

217 I.R.C. § 465(b)(3)(C) states that the term "related person" has the meaning given such term by § 168(e)(4), which refers to § 267(b) and § 707(b).

218 I.R.C. § 465(b)(3)(A).

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

220 Prop. Treas. Reg. § 1.465-8(b)(3) (proposed June 5, 1979). One reason for excluding loans from persons having an interest in the activity other than as a creditor is the fear that such loans may not be enforced by the lender, and therefore, the lender is actually at risk. *See* Gould, *Problems Encountered in Working with the At-Risk Provisions*, 58 TAXES 868 (1980).

221 I.R.C. § 465(a)(1).

222 I.R.C. § 465(b).

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

224 I.R.C. § 465(e).

225 I.R.C. § 465(e)(2)(A).

tent of ordinary tax deductions previously taken.[226] If no tax benefit was realized by the taxpayer from losses attributable to an activity subject to section 465, then no ordinary income is recaptured.[227]

The potential impact of the at-risk rules is significant and cannot be overemphasized. A seemingly attractive investment can become an utter nightmare if the at-risk rules are not clearly understood and contemplated. The economic viability of a tax shelter investment depends upon the investors' ability to deduct losses generated from the investment in the early years. To ensure that annual losses can be fully used by the investors, the investment should be structured to produce annual at-risk amounts at least equal to the amount of the losses.

4. Investment Tax Credit

Section 38 of the Code provides an investment tax credit for investments in certain types of property defined as "section 38 property."[228] "Section 38 property" generally means tangible personal property, which would normally include horses.[229] Horses, however, specifically are excluded from eligibility for the investment tax credit.[230] Nevertheless, most of the property, other than horses, used in connection with the equine industry qualifies as section 38 property and is eligible for the investment tax credit.

The investment tax credit for section 38 property, other than energy property and qualified rehabilitation expenditures, is ten percent of the "qualified investment."[231] A taxpayer's "qualified investment" in section 38 property means the aggregate of the "applicable percentage" of the basis of each new section 38 property placed in service during the

[226] I.R.C. § 465(e)(1). For example, assume the taxpayer has an amount at risk equal to $5,000 at the end of 1984. In 1985, the taxpayer claims a loss deduction of $3,000 attributable to his investment in the activity. Subsequently, in 1986, the taxpayer converts a $4,000 recourse note to nonrecourse basis. The loss claimed in 1985 will reduce the taxpayer's amount at risk from $5,000 to $2,000. The conversion of the recourse promissory note will reduce the amount at risk by $4,000. The taxpayer, however, is only at risk to the extent of $2,000 at that time. Accordingly, the taxpayer must report $2,000 as ordinary income pursuant to the recapture provisions of § 465(e).

[227] I.R.C. § 465(e)(2).

[228] I.R.C. § 38.

[229] I.R.C. § 48(a).

[230] I.R.C. § 48(a)(6).

[231] I.R.C. §§ 46(a)(1), 46(b)(1).