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

Part 2

by

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Originally published in CUMBERLAND LAW REVIEW
15 CUMB. L. REV. 251 (1985)

taxable year plus the applicable percentage of the cost of each used section 38 property placed in service during the taxable year.[232] The applicable percentage is determined by reference to the cost recovery period of the property. In the case of three-year recovery property, the applicable percentage is sixty percent.[233] In the case of all other eligible recovery property, the applicable percentage is one hundred percent.[234] Thus, five-year property acquired at a cost of $100,000 will yield a $10,000 investment tax credit (i.e., $100,000 multiplied by the one hundred percent applicable percentage, then multiplied by ten percent), provided the property qualifies as section 38 property.

Taxpayers are permitted to take into account the full cost basis of new section 38 property for purposes of determining the investment tax credit,[235] but only $125,000 of the cost of used section 38 property can be taken into account in any one taxable year.[236] If section 38 property is disposed of, or otherwise ceases to be section 38 property before the close of the recapture period, all or a part of the investment tax credit must be recaptured.[237] In the case of three-year property, "recapture period" means the first full year after the property is placed in service and the two succeeding full years, and in the case of five-year property, the first full year after the property is placed in service and the four succeeding full years.[238] If three-year section 38 recovery property is disposed of during the first year, the recapture percentage is one hundred percent; if disposed of during the second year, the recapture percentage is sixty-six percent; and if disposed of during the third year, the recapture percentage is thirty-three percent.[239] With five-year property, the recapture percentage is one hundred percent if the property is disposed of in the first year, and the recapture percentage decreases by twenty percent each year

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232 I.R.C. § 46(c)(1).

233 I.R.C. § 46(c)(7)(B).

234 I.R.C. § 46(c)(7)(A).

235 I.R.C. § 465(b)(1). "New § 38 property" means § 38 property the original use of which commences with the taxpayer. I.R.C. § 48(b)(2).

236 I.R.C. § 48(c). The term "Used § 38 property" means § 38 property acquired by purchase after December 31, 1961, which is not new § 38 property. *Id.*

237 I.R.C. § 47.

238 I.R.C. § 47(a)(5).

239 *Id.*

thereafter.[240]

If investment tax credit is taken with respect to any section 38 recovery property, then the tax basis of such property must be reduced by fifty percent of the amount of the credit.[241] Taxpayers may, in lieu of reducing the tax basis of the property, elect to reduce the investment tax credit.[242] If this election is made, then the regular percentage for three-year property will be four percent instead of ten percent.[243] The regular percentage for all other recovery property will be eight percent.[244] This election is made on the taxpayer's return for the taxable year in which the property subject to the election is placed in service, and once made the election is irrevocable.[245]

One of the most significant changes in the investment tax credit area in recent years is the application of the at-risk rules to section 38 property.[246] As discussed previously, to determine the amount of investment tax credit, the regular percentage is multiplied by the qualified investment in the property.[247] Section 46(c)(8) introduces a new term to the investment tax credit area, "credit base," and provides that the credit base of property is to be reduced by the amount of "non-qualified nonrecourse financing."[248] "Credit base" is defined as the basis of new section 38 property and the cost of used section 38 property.[249] "Nonqualified nonrecourse financing" means nonrecourse financing which is not "qualified commercial financing."[250] "Qualified commercial financing" includes any financing with respect to any property which meets the following requirements: (1) The property is acquired by the taxpayer from a person who is not a related party;[251] (2) the amount of nonrecourse financing with respect to the property does not exceed eighty percent of the credit base; and (3) the financing is borrowed from a

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240 *Id.*

241 I.R.C. § 48(q)(1).

242 I.R.C. § 48(q)(4).

243 I.R.C. § 48(q)(4)(B)(ii)(I).

244 I.R.C. § 48(q)(4)(B)(ii)(II).

245 I.R.C. § 48(q)(4)(C).

246 I.R.C. § 46(c)(8).

247 *See supra* notes 231-34 and accompanying text.

248 I.R.C. § 48(c)(8)(A).

249 I.R.C. § 48(c)(8)(C).

250 I.R.C. § 46(c)(8).

251 The term "related person" has the same meaning in § 46(c)(8) given such term by § 168(e)(4), which refers to § 267(b) and § 707(b). I.R.C. § 46(c)(8)(E).

qualified person or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government.[252] Simply stated, this provision means generally that no more than eighty percent of the cost of section 38 property can consist of nonrecourse financing. In other words, taxpayers must be at risk to the extent of at least twenty percent or the nonrecourse debt must be excluded from basis for purposes of determining the credit.

Nonrecourse financing includes any amount with respect to which the taxpayer has no personal liability or is protected against loss through guarantees, stop-loss agreements, or other arrangements and any amount borrrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used or is borrowed from a person related to such person.[253] Accordingly, to realize the full benefits of the investment tax credit, the taxpayer must be at risk in an amount equal to or in excess of twenty percent of the credit base of the property and any financing must satisfy the requirements of qualified commercial financing. If there is a decrease in any year in the amount of non-qualified nonrecourse financing, such net decrease will be considered additional qualified investment for such year for purposes of computing additional investment tax credit.[254]

5. Partner's Basis in Partnership

Section 704(d)[255] provides that a partner's distributive share[256] of partnership loss may be deducted currently only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the fiscal year in which such loss occurs. Thus, in a partnership setting, the deductibility of losses must be analyzed on two levels. First, losses realized from certain activities, such as horse racing or breeding, are allowed only to the extent the taxpayer is at risk, as determined by section 465;[257] and secondly, even if the at-risk rules are satisfied, a partner may only deduct losses to

252 I.R.C. § 46(c)(8)(B)(ii)(II).
253 I.R.C. §§ 465(c)(3)-465(c)(4).
254 I.R.C. § 46(c)(9).
255 I.R.C. § 704(d).
256 A partner's distributive share is defined in I.R.C. § 704.
257 *See infra* notes 259-78 and accompanying text.

the extent of his adjusted basis in his partnership interest. The interrelationship between sections 465 and 704(d) is very intricate and requires a thorough understanding of several complex partnership provisions.[258]

The starting point in understanding the relationship of section 465 to section 704(d) is section 705(a), which provides that a partner's initial basis in his partnership interest is increased by the sum of (1) his distributive share of partnership taxable income, as determined under section 703(a),[259] (2) tax-exempt income of the partnership, and (3) the excess of partnership deductions for depletion over the basis of the property subject to depletion.[260] In addition, a partner's basis is increased by the amount of cash and the adjusted basis of any property contributed to the partnership.[261] A partner's adjusted basis in his partnership interest is decreased (but not below zero) by (1) the amount of any cash distributed to him, (2) the adjusted basis of any property distributed to him, (3) his distributive share of losses of the partnership, and (4) expenditures of the partnership not deductible in computing taxable income and not chargeable to capital account.[262] A partner's adjusted basis in his partnership interest is further decreased (but not below zero) by the amount of his distributive share of deductions for depletion.[263] In the typical equine limited partnership, the most frequent adjustments to basis will occur as a result of partnership income, losses, and distributions. Section 704(d) limits a partner's deduction for losses to the extent of his adjusted basis at the end of the partnership's taxable year in which the loss is incurred, thereby preventing a partner's basis from becoming negative.[264]

A partner's initial basis in his partnership interest is deter-

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258 *See, e.g.*, I.R.C. §§ 705, 722, 731, 733, 752.

259 I.R.C. § 703(a) provides the manner of computing the taxable income of a partnership. In general, a partnership's taxable income is computed in the same manner as in the case of an individual except that certain items described in § 702(a) must be separately stated, and certain itemized deductions are not allowed to the partnership.

260 I.R.C. § 705(a)(1).

261 I.R.C. § 722.

262 I.R.C. § 705(a)(2).

263 I.R.C. § 705(a)(3).

264 I.R.C. § 704(d) provides that a partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of his partnership interests. Any excess of that loss over his basis is deductible at the end of the partnership year in which such excess is repaid to the partnership.

mined under section 722. This section provides that a partner's basis in his partnership interest equals the amount of money and the adjusted basis of any property contributed to the partnership increased by the amount, if any, of gain recognized to the contributing partner. Any increase in a partner's share of partnership liabilities or any increase in a partner's individual liabilities by reason of the assumption of partnership liabilities is considered a contribution of money by such partner to the partnership.[265] By treating an increase in a partner's share of liabilities or assumption of partnership liabilities as a contribution of money, a partner's basis in his partnership interest will be correspondingly increased.[266] Conversely, any decrease in a partner's share of partnership liabilities or any decrease in his individual liabilities by reason of the assumption by the partnership of such liabilities is considered a distribution of money to the partner by the partnership,[267] and will decrease his basis under section 705(a) (but not below zero).[268] The rules get increasingly more complex when a partnership that has liabilities is engaged in an activity that is also subject to the at-risk rules.[269]

The regulations under section 752 provide that a partner's share of partnership liabilities is determined in accordance with his ratio for sharing losses pursuant to the partnership agreement.[270] In the case of a limited partnership, however, a limited partner's share of partnership liabilities cannot exceed the difference between the actual contributions credited to him by the partnership and the to-

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265 I.R.C. § 752(a).

266 Treas. Reg. § 1.752-1(a)(1) (1960).

267 I.R.C. § 752(b).

268 Treas. Reg. § 1.752-1(b)(1) (1960). If a partner receives a distribution of money (whether actual or constructive) from the partnership in excess of his basis in his partnership interest, then gain is recognized to the extent of the excess. I.R.C. § 731(a)(1).

269 The relationship between the basis adjustment rules of § 752, and loss limitation rules of § 704(b) and § 465 is extraordinarily complex. A limited partner's basis in his partnership interest may be increased by his proportionate share of the limited partnership's nonrecourse indebtedness, which enhances the partner's ability to deduct losses under § 704. If the limited partnership is engaged in an activity covered by § 465, however, the limited partnership's nonrecourse liabilities are excluded from the limited partner's amount at risk, which limits the limited partner's allowable losses from the activity under § 465. In this situation, § 465 overrides § 704. Thus, it is imperative to structure the limited partnership's activities subject to § 465 to take into account loss limitation rules found in both § 704(d) and § 465.

270 Treas. Reg. § 1.752-1(e) (1960).

tal contribution which he is obligated to make pursuant to the limited partnership agreement.[271] There is an exception for nonrecourse debt. The regulations provide that where none of the partners has any personal liability with respect to a partnership liability, then all partners, including limited partners, share in the liability and may include such amount in basis in the same proportion as they share profits.[272] By negative inference, if any partner in a limited partnership has personal liability with respect to any liability of the partnership, then the limited partners may not include their pro rata share of such liability in basis, except to the extent they are required to make future contributions to the partnership.[273]

When an activity subject to the at-risk rules is conducted through a limited partnership, the complexities increase dramatically. If the partnership intends to use financing in the activity, then the transaction must be structured carefully to ensure that all losses will be allowed as deductions and will be available to the limited partners. For losses from the activity to be allowable at all, the investors must have a sufficient amount at risk in the activity.[274] To include the indebtedness in the amount deemed at risk the partners must be personally liable with respect to such indebtedness or satisfy other requirements.[275] Yet, in the typical situation when a limited partnership borrows money on a recourse basis, only the general partner is personally liable for the debt.[276] In that case, the amount each limited partner would be deemed to be at risk would only include the amount of money or other property actually contributed to the partnership. Each partner's basis in his partnership interest, however, would include not only the amount of money and other property actually contributed to the partnership but also, to the extent of recourse financing, the amount of money or other property each partner is obligated to con-

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271 *Id.*

272 *Id.*

273 *Id. See* Rev. Rul. 83-151, 1983-1 C.B. 105; Pvt. Ltr. Rul. 8404012, Oct. 13, 1982.

274 I.R.C. § 465(b). *See supra* notes 201-27 and accompanying text.

275 I.R.C. § 465(b). *See supra* note 215 and accompanying text.

276 ALA. CODE § 10-9A-62 (1985) (Alabama Limited Partnership Act). Limited partners are only liable for the amount of their actual contributions and obligations to make future contributions to the limited partnership. ALA. CODE § 10-9A-42 (1975) (Alabama Limited Partnership Act).

tribute to the partnership in the future.[277]

Taxpayers have attempted to solve this problem by a number of techniques, including guarantees of otherwise nonrecourse debt. This problem has been the subject of recent judicial, administrative and legislative action. In *Raphan v. United States*,[278] the United States Court of Claims held that otherwise nonrecourse indebtedness was not converted to recourse indebtedness as a result of the personal guarantee of such indebtedness by the general partners when they guaranteed the debt in their capacity other than as a general partner.[279] Even though the general partners had guaranteed a construction loan, the court found that they did not do so in their capacity as partners. According to the court, "the test is whether in assuming such liability the partner is securing rights and assuming responsibilities which are separate from, and independent of his role as a partner."[280]

Three weeks after the *Raphan* decision was announced, the IRS issued Revenue Ruling 83-151,[281] reaching an opposite conclusion on almost identical facts. Revenue Ruling 83-151 renders the general partner personally liable when it guarantees an otherwise nonrecourse loan, and accordingly, for purposes of section 1.752-1(e) of the regulations, the loan must be treated as an obligation of the limited partnership for which a partner is personally liable. If any partner has personal liability on the loan, then the liablity does not increase the adjusted basis of the partnership interests held by limited partners except to the extent they are obligated to contribute money or property to the partnership in the future.

Notwithstanding Revenue Ruling 83-151, a guarantee of otherwise nonrecourse debt may not amount to an assumption of the debt for purposes of section 752. This complicates the problem. A number of different techniques have been attempted to assure that liabilities satisfy the requirements of both sections 704(d) and 465. Difficulties arise be-

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277 Treas. Reg. § 1.752-1(e) (1960).

278 52 A.F.T.R.2d (P-H) ¶ 83-5987 (Ct. Cl. 1983).

279 In *Raphan*, the general partners guaranteed an otherwise nonrecourse debt of the limited partnership. *Id.* at ¶ 83-5992.

280 *Id.* at 83-5993. The decision of the Court of Claims was reversed by the Court of Appeals for the Federal Circuit, — F.2d — (Fed. Cir. 1985).

281 1983-1 C.B. 105.

cause the requirements under sections 752 and 465 are not consistent. The regulations under section 752 provide that a limited partner's basis in his partnership interest may be increased by such partner's share of partnership recourse debt to the extent the partner is obligated to make additional contributions to the partnership.[282] The proposed regulations under section 465, however, provide that the amount a partner is deemed at risk will not be increased by the amounts a partner is required to contribute to the partnership until such time as the contributions actually are made.[283] The foregoing illustrate the difficulties encountered in obtaining positive basis adjustments for limited partners under section 752, while simultaneously complying with the at-risk rules.

Unfortunately, the IRS and the Tax Court have interpreted the statute and regulations narrowly under section 752. Limited partners have been denied basis increases despite personal guarantees of recourse debt or indemnification of the general partner's obligations under the debt.[284] When a limited partner guarantees recourse debt, it would appear he has assumed all or a part of the economic risk in the transaction. However, the general partners would still have primary liability on the debt, and this result appears consistent with the current regulations. With respect to otherwise recourse debt, a partner's basis may be increased to the extent he is obligated to make additional capital contributions to the partnership pursuant to the limited partnership agreement, or he assumes personal liability for the indebtedness by contractually agreeing with the lender to assume the debt and release the partnership and general partner.[285]

Nonrecourse debt presents a little different situation. If a limited partner guarantees otherwise nonrecourse debt,

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282 Treas. Reg. § 1.752-1(e) (1960).

283 Prop. Treas. Reg. § 1.465-22(a) (proposed June 5, 1979).

284 Rev. Rul. 69-223, 1969-1 C.B. 184; Danoff v. United States, 499 F. Supp. 20 (M.D. Pa. 1980). The general partner of a limited partnership is primarily liable for the debt. Even though limited partners guarantee the indebtedness, they are only secondarily liable, and this appears to be a crucial difference.

285 This should satisfy the provisions of I.R.C. § 752(a) and Treas. Reg. § 1.752-1(e) (1960) because the partners replace the partnership as primary obligors on the debt. *See* Wallach & Heller, *Does Partner Guarantee of Nonrecourse Debt Prevent Increase in Limited Partners' Bases?*, 60 J. TAX'N 206 (1984); Volet & Millman, *Liability Assumptions under Section 752: An Analysis of the Underlying Theory*, 60 J. TAX'N 374 (1984).

then it is fairly clear that the only economic risk associated with the indebtedness is being borne by the limited partner making the guarantee. In such a situation, the limited partner should be allowed to increase his basis by the amount of the indebtedness or the amount of his guarantee, whichever is less. If all limited partners guarantee nonrecourse indebtedness, then each should be permitted to increase his basis in his partnership interest by his pro rata share of the debt. Even if the limited partners guarantee partnership indebtedness jointly and severally, no limited partner should be permitted to increase his basis in excess of his pro rata share of the debt because he is entitled to contribution from the other limited partners. If the general partner joins the limited partners in the guarantee of an otherwise nonrecourse indebtedness, the limited partners making the guarantee still should be entitled to increase their basis by their proportionate share of the debt.

In the past, one technique taxpayers have attempted to use to satisfy the rules under section 752 is the assumption of limited partnership liabilities. This technique was recently reviewed by the IRS in Tax Advice Memorandum 8404012,[286] in which limited partnership interests were sold on the following terms: twenty percent cash down payment, sixty-six percent by delivery of an irrevocable and transferrable letter of credit, and the balance in the form of a personal, full recourse promissory note. Each investor also was required to execute an assumption agreement pursuant to which the partners promised to pay the lender their proportionate share of the principal and interest due on a loan made to the partnership by the lender. The assumption agreement provided that obligations of the partners were independent of any obligations of the partnership and a separate action or actions could be brought and prosecuted against the individual partners whether action was brought against the partnership or whether the partnership was joined in any such action. Consistent with its position that a guarantee gives rise to personal liability on a loan, the IRS conceded that the limited partners had personal liability on their share of the partnership's loan by virtue of the assumption agreements. The IRS concluded, nevertheless, that the limited partners were not permitted to increase the basis of

[286] Tax Advice Memorandum 8404012 (Oct. 13, 1982).

their partnership interests by the amount of the letters of credit and assumption agreements.

In Tax Advice Memorandum 8404012, the IRS identified four alternative ways of analyzing the issues: (1) Did the limited partners assume a share of the partnership liability within the meaning of section 752(a)?; (2) Did the limited partners in effect borrow the money from the lender and contribute it to the partnership?; (3) Did the limited partners acquire basis in their partnership interest as a result of their obligation to make additional contributions to the partnership pursuant to Section 1.752-1(e) of the regulations?; and, (4) Did the limited partners acquire basis in their partnership interest as a result of their sharing a liability of the partnership for which none of the members of the partnership had personal liability? According to the IRS, none of the four alternatives resulted in an increase in the limited partners' basis in this situation. In the first two alternatives, the IRS viewed the partnership as the actual borrower under the loan and, pursuant to the loan agreement, it was primarily liable for the loan and its assets could be attached by the lender to satisfy the loan. Although the limited partners executed assumption agreements, the limited partnership was not contractually released from liability and the indebtedness continued to be partnership debt. Consistent with its holding in Revenue Ruling 83-151,[287] the IRS, in Tax Advice Memorandum 8404012, stated that a guarantee of partnership indebtedness creates personal liability and therefore recourse debt. Although the limited partners had personal liability, they had not assumed the liability within the meaning of section 752(a) of the Code. With respect to the third alternative, the IRS viewed the limited partners' obligation to make additional contributions to the limited partnership pursuant to the letters of credit as too contingent and indefinite for purposes of section 1.752-1(e) of the regulations.

The IRS's findings in Tax Advice Memorandum 8404012 are consistent with the strict and literal interpretation of the regulations, but do not reflect economic realities. The real economic risks for the indebtedness under the facts in the Tax Advice Memorandum were on the limited partners. As such, they should be permitted to increase their bases in

[287] Rev. Rul. 83-151, 1983-1 C.B. 105.

their partnership interests by their share of the partnership's indebtedness. In the situation when limited partners personally guarantee an otherwise nonrecourse debt, a rather anomalous situation occurs. The IRS avers the guarantee creates personal liability. Section 1.752-1(e) of the regulations provides that limited partners share in partnership debt to the extent they share partnership profits if no partner has personal liability or to the extent they are obligated to make additional contributions to the partnership if any partner has personal liability. Thus, the situation could arise when the limited partners bear the economic risks of otherwise nonrecourse liabilities by guaranteeing their repayment, but because of the literal interpretation of section 1.752-1(e) of the regulations, the entire debt would be allocated to the general partner, who bears no economic risk.

The at-risk rules require any indebtedness used for the acquisition of property in an activity to be recourse to include it in the amount deemed at risk. The problem with recourse indebtedness in the context of a limited partnership, however, is how to increase the limited partners' amount at risk for purposes of section 465 as well as adjusted bases in their partnership interests for purposes of section 704(d).

In overruling the *Raphan* case in the Tax Reform Act of 1984,[288] Congress directed the Treasury to revise the section 752 regulations to incorporate the holding of Revenue Ruling 83-51, and to update the regulations to take into account commercial practices and arrangements, e.g., assumptions, guarantees, indemnities.[289] The House Report instructed the Treasury to specify in the regulations that indebtedness for which a general partner is primarily or secondarily liable is not nonrecourse and when a limited partner guarantees such liability, the regulations should provide that basis attributable to the liability will not be shifted away from the limited partner as a result of the guarantee. The conference committee stated that the revisions to the section 752 regulations should be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to

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288 Pub. L. No. 98-369, 98 Stat. 494.

289 H.R. REP. No. 432, 98th Cong., 2d Sess. 1236 (1984).

partnership debt.[290] The revised section 752 regulations hopefully will be drafted with section 465 in mind to make the two sections more consistent and better coordinated.

6. Premature Accruals

In the past, accrual-basis taxpayers could deduct expenses when all events occurred that determined the fact of liability, and the amount of the liability could be determined with reasonable accuracy.[291] Thus, an accrual-basis equine syndicate or limited partnership could order substantial amounts of equipment, feed, and other items near the end of the taxable year and deduct the cost for such items, even if delivery or use was scheduled to occur in a subsequent taxable year. Similarly, the syndicate or limited partnership could contract for management or other services to be provided in the future and accrue and deduct all or a substantial part of the cost of such services in the taxable year the contracts were made. The 1984 Tax Reform Act imposed a new requirement on the accrual method of accounting. In determining whether an amount has been incurred with respect to any item during the taxable year, the all-events test will not be deemed to have occurred until "economic performance" with respect to such item occurs.[292]

"Economic performance" with respect to a particular liability generally will be deemed to occur when the activities for which the taxpayer is obligated actually are performed.[293] If the liability of the taxpayer arises out of providing property to the taxpayer by another person, economic performance will be deemed to occur as the person provides such property.[294] If the liability of the taxpayer arises out of providing services to the taxpayer by another person, economic performance will be deemed to occur as such person provides such services.[295] If the liability arises out of the taxpayer providing services or property to another person, then economic performance will not be deemed to occur until the taxpayer actually provides such

290 H.R. CONF. REP. No. 861, 98th Cong., 2d Sess. 869 (1984).
291 I.R.C. § 461(a).
292 I.R.C. § 461(h)(1).
293 I.R.C. § 461(h)(2).
294 I.R.C. § 461(h)(2)(A)(ii).
295 I.R.C. § 461(h)(2)(A)(i).

property or services.[296] Under the economic performance test, items may not be deducted until services are actually rendered or property is actually delivered. This provision restricts the ability of taxpayers to accelerate deductions into an earlier taxable year.[297]

There are several exceptions to the economic performance test. These exceptions are for liabilities to provide benefits to employees pursuant to a qualified retirement plan, contributions to a funded welfare or benefit plan, deductions allowable for bad debt reserves, deductions relating to accrual of vacation pay, and qualified discount coupons.[298] In addition, an exception exists for certain recurring items even though the economic performance test may not be satisfied until the year following the year that the all-events test is satisfied.[299] This exception applies only if the following four conditions are satisfied: (1) The all-events test is satisfied with respect to the item during the taxable year; (2) economic performance occurs within a reasonable period (but in no event more than eight and one-half months) after the close of the taxable year; (3) the items are recurring in nature and the taxpayer consistently treats items of that type as incurred in the taxable year in which the all-events test is met; and (4) either (a) the item is not material[300] or (b) the accrual of the item in the year in which the all-events test is met results in a better matching of the item with the income to which it relates than would result

296 I.R.C. § 461(h)(2)(B).

297 For example, under prior law a taxpayer utilizing the accrual method of accounting could contract for property or services at the end of a taxable year and deduct currently the cost of such property or services even though the property or services were not to be provided until the following taxable year. Under current law, as enacted by the Tax Reform Act of 1984, the accrual-basis taxpayer will not be entitled to a deduction for property or services until economic performance occurs, i.e., the property or services are actually provided to the taxpayer. I.R.C. § 461(h).

298 I.R.C. § 461(h)(5).

299 I.R.C. § 461(h)(3).

300 I.R.C. § 461(h)(3)(A)(iii). The factors to be taken into account in determining the materiality of an item include its size and the treatment of the item for financial accounting purposes. If the item is considered material for financial statement purposes, then it will also be considered material for tax purposes. In the case of a partnership, an item will be considered immaterial only if it is not material when analyzed at both the partnership and the partner levels.

Thus, an item that may not be material at the partnership level may be material at the partner level and the exception will not be available. This could occur, for example, when an accrual-basis partnership makes a special allocation to a partner of an item that is not material to the partnership but is material to the partner. *Id.*

from accruing the item in the year in which economic performance occurs. In determining whether an item is recurring in nature and is consistently reported by the taxpayer, the frequency with which the item and similar items are incurred and the manner in which these items have been reported for tax purposes must be considered.[301] The conference report states that the conferees intended for the exception to be available to taxpayers starting up a trade or business as well as to taxpayers already in a trade or business.[302] Therefore, if a stallion syndicate or limited partnership has a recurring item, it might avail itself of this exception even though it has just commenced business operations.

Another change in the law as a result of the 1984 Tax Reform Act affected cash-method tax shelters.[303] Under the cash receipts and disbursement method of accounting, deductions generally are allowed in the year in which the expenditures are paid.[304] Under prior law, it was unclear whether a deduction was allowed for prepaid expenses other than interest.[305] There was no specific statutory provision expressly permitting expenses to be deducted in full or prohibiting such deductions when paid by a taxpayer using the cash receipts and disbursements method of accounting. As a result of the Tax Reform Act of 1984, a deduction will not be allowed under the cash receipts and disbursements method of accounting with respect to any amount before such amount is treated as incurred.[306] Under this test, an amount will not be treated as incurred at any time earlier

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301 H.R. CONF. REP. No. 861, 98th Cong., 2d Sess. 873 (1984).

302 *Id.*

303 I.R.C. § 461(i). For purposes of I.R.C. § 461, a tax shelter means (1) any enterprise (other than a C corporation) if at any time interest in the enterprise was offered for sale in the offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale, (2) any syndicate within the meaning of I.R.C. § 1256(e)(3)(B), which generallly means any partnership or other entity if more than 35% of the losses of the entity during the taxable year are allocable to limited partners or limited entrepreneurs, and (3) any tax shelter within the meaning of I.R.C. § 6661(b)(2)(C)(ii).

304 Treas. Reg. § 1.461-1(a)(1) (1967).

305 I.R.C. § 461(g) specifically provides that interest paid by the taxpayer, which is properly allocable to any period which is after the close of the taxable year in which paid, must be charged to capital account and treated as paid in the allocable period. Prior to the enactment of § 461(i), there was no specific statutory prohibition against deducting prepaid expenses for items other than interest.

306 I.R.C. § 461(i)(l).

than the time on which economic performance occurs.[307] Thus, a cash-basis tax shelter may not deduct an amount until both economic performance occurs and the amount is paid. For this purpose, the time at which economic performance occurs generally means when services are performed, property provided, use of property occurs, or when the liability is otherwise satisfied.[308] Accordingly, management fees will be treated as incurred when the management services are rendered and prepaid supplies will be treated as incurred when the supplies are used.

An exception to the economic performance test for cash-basis tax shelters arises when economic performance occurs within ninety days after the close of the taxable year.[309] The maximum deduction allowable for any prepaid expenses under this exception, however, is limited to the cash basis the taxpayer has in the tax shelter.[310] "Cash basis" is defined as the taxpayer's basis in the partnership determined without regard to any liabilities of the partnership and without regard to any borrowings of the partner arranged by the tax shelter.[311]

In the case of a "farming syndicate" the foregoing rules do not apply.[312] Instead, section 464 applies to such ventures. A "farming syndicate" is defined as a partnership or other enterprise, other than a corporation which is not an S corporation, engaged in the trade or business of farming if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any federal or state agency or if more than thirty-five percent of the losses during any period are allocable to limited partners.[313] For this purpose, the definition of farming includes the "raising, sharing, feeding, caring for, training, and management of animals."[314] If section 464 applies

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307 I.R.C. § 461(i)(l) refers specifically to § 461(h), which sets forth the times when economic performance is deemed to occur.

308 I.R.C. § 461(h)(2).

309 I.R.C. § 461(i)(2)(A).

310 I.R.C. § 461(i)(2)(B), which states that in applying § 704(d) to a deduction or loss for any taxable year attributable to an item for which economic performance occurs within 90 days after the close of the taxable year, the term "cash basis" is substituted for the term "adjusted basis."

311 I.R.C. § 461(i)(2)(C).

312 I.R.C. § 461(i)(4).

313 I.R.C. § 464(c).

314 I.R.C. § 464(e)(1).

to a transaction, then amounts paid for feed, seed, or similar supplies may be deducted only in the taxable year in which such feed, seed, or other supplies are actually used or consumed.[315]

7. Registration of Tax Shelters

To curtail abusive tax shelters and to provide the Treasury with information concerning tax shelters, section 6111 was enacted as a part of the Tax Reform Act of 1984.[316] It requires any tax shelter organizer to register the tax shelter with the IRS before the first offering for sale of interests in the tax shelter.[317] A tax shelter organizer is the person principally responsible for organizing the shelter, and any other person who participates in the organization of a tax shelter, and any person participating in the sale or management of the investment.[318] Once registration occurs, the IRS will issue a tax shelter registration number, which must be furnished to each investor who purchases an interest in the tax shelter.[319] Any person claiming any deduction, credit, or other benefit by reason of a tax shelter investment must include the tax shelter registration number on his return.[320] "Tax shelter" means any investment with respect to which any person could reasonably infer from the representations made or to be made in connection with the sale of the interest that the "tax shelter ratio" for any investor as of the close of any one of the first five taxable years ending after the date on which such investment is offered may be greater than two to one, and which is required to be registered under a federal or state securities law, is sold pursuant to an exemption from registration, or involves a substantial investment.[321]

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315 I.R.C. § 464(a).

316 I.R.C. § 6111.

317 I.R.C. § 6111(a).

318 I.R.C. § 6111(d)(1).

319 I.R.C. § 6111(b)(1). If a tax shelter organizer or promoter fails to furnish the registration number to an investor, it will cost the organizer $100 for each failure. The failure to register with the IRS can result in a penalty of the greater of $500 or one percent of the investment in such tax shelter, up to $10,000. If the failure is intentional, the $10,000 maximum is removed. Any investor who, without reasonable cause, fails to include a registration number on his return is subject to a $50 penalty.

320 I.R.C. § 6111(b)(2).

321 I.R.C. § 6111(c)(1).

"Tax shelter ratio" means the ratio in which the aggregate amount of deductions and two hundred percent of the credits which are represented to be potentially allowable to any investor for all periods up to the close of the taxable year bears to the "investment base" as of the close of such year.[322] An investor's investment base consists of the amount of money and the adjusted basis of other property contributed by the investor as of the close of such year, reduced by any liability to which such other property is subject.[323] If the investor borrows money to contribute to the activity, then it will be excluded if it is borrowed from any person who participates in the organization, sale, or management of the investment, or who is a related person to any such persons.[324] An investment is deemed substantial if the aggregate amount which may be offered for sale exceeds $250,000, and five or more investors are expected.[325]

The registration of the tax shelter must include information identifying and describing the tax shelter, information describing tax benefits of the tax shelter represented to be available to investors, and other information about the investment.[326] The IRS has prepared form 8264 for the purpose of registering tax shelters. The form also requires tax shelter organizers to disclose information about the acquisition of the assets of or business activity to be conducted by the tax shelter, including from whom acquired, cost and means of acquisition, the accounting method of the tax shelter, method of financing for a minimum investment unit, aggregate capital to be raised, maximum number of investors, prior registered tax shelters, and other information.

The ostensible purpose of section 6111 is to furnish the IRS with information necessary to identify abusive or potentially abusive tax shelters. The information to be disclosed to the IRS on form 8264, however, is much broader. Registration is required by many activities which have economic

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322 I.R.C. § 6111(c)(2). Notably, the amount of taxable income or loss realized from the activity is irrevelant. The tax shelter ratio focuses on the ratio of aggregate deductions to the taxpayer's investment in the activity. Thus, many bona fide investments will have to be registered as "tax shelters" under this rule.

323 I.R.C. § 6111(c)(3).

324 I.R.C. § 6111(c)(3)(B)(ii). The term "related person" for purposes of § 6111 has the same meaning given that term in § 168(e)(4).

325 I.R.C. § 6111(c)(4).

326 I.R.C. § 6111(a)(2).

substance and are clearly not abusive.[327] Nevertheless, the IRS is requesting a substantial amount of information about all types of tax shelters, perhaps for the purpose of obtaining statistics to be used to support future legislative proposals.[328]

8. Hobby Loss Rules

One of the most important considerations in any activity involving horses is whether the activity is engaged in for profit. If the activity is determined by the IRS not to be engaged in for profit, then net losses attributable to that activity may only be allowed as deductions to the extent of income generated by that activity.[329] Application of this "hobby loss rule" results in the allowance of losses to offset gross income from the activity but not income from other sources.

The rule is applicable equally to most forms of business entities,[330] and to all forms of investment.[331] Certain types of investments such as those dealing with horses, cattle, "show animals," and professionally-owned farms, have been identified as deserving special attention. Before section 183 was enacted, taxpayers could engage in farm and livestock activities as a hobby, and take advantage of the favorable tax benefits. The provision was enacted to differentiate between bona fide business and investment activities, on the one hand, and recreational entertainment and hobby activities on the other. The determination of whether an activity

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[327] For example, investments which are not highly leveraged but which generate substantial deductions may yield the prohibited "tax shelter ratio," but may not actually generate a substantial taxable loss. Nevertheless, such investments would have to be registererd as a "tax shelter" under this section.

[328] It appears that the IRS is attempting to define the universe of partnerships so as to determine specifically, in the opinion of the IRS, the areas of abuse or the areas which are in need of attention.

[329] I.R.C. § 183. Whether an activity is engaged in for profit is determined under § 162 and § 212(1),(2) except insofar as § 183(d) creates a presumption that the activity is engaged in for profit. Treas. Reg. § 1.183-1(a). The principal purpose of § 183 is to limit losses from activities conducted more as hobbies than as bona fide businesses. Accordingly, the limitation of losses rule contained in § 183 is often referred to as the "hobby loss rule."

[330] Treas. Reg. § 1.183-1(a) (1972). The rules apply generally to individuals, trusts, general partnerships, limited partnerships, and small business corporations (i.e., S corporations). The regulations, however, provide that no inference is to be drawn that any activity of a corporation is or is not a business, or is engaged in for profit.

[331] *Id.*

is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case.[332] To avoid application of section 183, an activity must be engaged in with the intent to generate a profit. The taxpayer need not have a reasonable expectation of actually realizing a profit from the activity in order to demonstrate the requisite intent.[333]

(a) Presumptions

It is extremely difficult in most situations to determine a taxpayer's intent, even after analyzing carefully all the objective facts and circumstances. This places taxpayers at a significant disadvantage, especially since the burden of proving profit motive rests with the taxpayers. To ease this problem somewhat, section 183 provides two statutory safe-harbor presumptions.[334] In general, if an activity consisting in major part of the breeding, training, showing, or racing of horses realizes a profit in any two of seven consecutive taxable years, the activity is presumed to be engaged in for profit.[335]

A taxpayer may elect under the provisions of section 183(e) to delay the determination of the for-profit question to the end of the sixth taxable year. If the activity generates a profit in any two of the seven years, the presumption will relate back to each of the seven years of the activity and cover all losses.[336] Absent such election, a taxpayer would be entitled only to the benefits of the presumption for the years after the second profitable year. This election is available only for new taxpayers, and has the practical effect of preventing an audit during the first three years of the activity.[337]

The disadvantages of making the election are: (1) It effectively invites a confrontation with the IRS (i.e., it may never raise the

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[332] Treas. Reg. § 1.183-2(a) (1972).

[333] *Id.*

[334] I.R.C. §§ 183(d),(e).

[335] *Id.* Treas. Reg. § 1.183-1(c)(3) (1972) provides:

> an activity consists in major part of the breeding, training, showing or racing of horses for the taxable year if the average of the portion of expenditures attributable to breeding, training, showing and racing of horses for the three taxable years preceding the taxable year . . . was at least 50% of the total expenditures attributable to the activity for such prior taxable years.

Id.

[336] I.R.C. § 183(e)(2). Unlike the first presumption, all losses from the activity realized in any of the first seven years are allowable under this presumption.

[337] Temp. Treas. Reg. § 12.9(a) (adopted March 14, 1974).

issue otherwise); and (2) by making the election, the taxpayer agrees to extend the statute of limitations for assessment on the first year's activity to as long as nine years.[338] The taxpayer must decide whether to make the election within three years after his first return is due (disregarding extensions), but not later than sixty days after written notice that the IRS proposes to challenge the for-profit motive of the activity.[339]

(b) Objective Factors

To overcome the IRS's challenge of profit motive, a taxpayer must demonstrate the intent to engage in the activity for profit. The facts and circumstances surrounding the activity are critical in proving a profit motive. The regulations set forth nine relevant objective factors to be used in determining whether an activity is engaged in for profit. Each factor may be analyzed in light of horse-related activities, with a view to establishing a strong for-profit motive. No one factor is determinative of the issue, and the enumerated factors are not intended to be exclusive.

First, the activity must be carried on in a business-like manner. The venture should begin with a detailed analysis of projected revenues and expenses, indicating a likelihood of profitability.[340] Complete and accurate books and records should be kept, preferably together with a budget analysis for each accounting period. Not only is this record keeping a good business practice, it essentially precludes a comparable analysis by the IRS to show no reasonable hope of realizing a profit.[341]

Second, the expertise of the taxpayer or his advisors may bear directly on the determination. Preparation for the activity by extensive study of its accepted business, economic, and scientific practices may indicate that the taxpayer has a profit motive when the activity is conducted in accordance with such practices.

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338 I.R.C. § 183(e)(4).

339 Temp. Treas. Reg. § 12.9(c)(2) (adopted March 14, 1974).

340 A projection of annual income or loss from the activity will furnish strong evidence of the taxpayer's intent to engage in the activity for profit, especially if the projections are prepared by an independent party. If the projections indicate a profit form the activity in the future and the taxpayer invests in the activity based, in part, upon the projections, a profit motive has been demonstrated, and hence, § 183 is inapplicable.

341 Treas. Reg. § 1.183-2(b)(1) (1972). The operation and management of the activity are important considerations in determining a taxpayer's profit motive. When feasible, the activity should adopt the procedures and management techniques used by similar, profitable activities. *See* Edge v. Commissioner, 32 T.C.M. (CCH) 1291 (1973).

Although rarely would anyone engage in a competitive Thoroughbred-related activity in a manner that deviates to any large extent from the accepted business, economic, and scientific practices, any such deviations must appear as attempts to develop new or superior techniques for improving the profitability of the activity.[342]

Third, the expenditure of time and effort by the taxpayers, without personal or recreational benefits, is indicative of a profit motive. Importantly, the argument is equally forceful if the taxpayer employs competent and qualified persons who spend a significant amount of time and effort conducting the activity. Obviously, the IRS will try to argue that any time the taxpayer himself spends conducting the activity is for his recreational pleasure and hence not profit motivated.[343]

Fourth, and of particular importance, is the expectation of capital appreciation. This factor is especially relevant for horse-related activities which often produce losses in early years, but generate substantial profits in later years from the sale of appreciated assets. Also, to some degree, the timing of asset sales may be made to help substantiate a for-profit motive.[344]

Fifth, a taxpayer with a history of having "the Midas touch" intentionally may seek unprofitable activities expressly intending to "turn" them around financially. This factor would help substantiate a for-profit claim even though the activity has a history of losses. This factor will, however, be generally irrelevant in the case of a limited partnership in which a limited partner/investor may not get involved in the management of the activity.[345]

Sixth, an extraordinary continuation of losses beyond that normally required to reach a profitable status, will tend to reflect negatively on the taxpayer's motive. If these losses are caused by unforeseen or fortuitous circumstances beyond the control of the taxpayer, such as acts of God or market conditions, these losses would not be an indication that the activity is not engaged in for profit. On the other hand, a series of profitable years provide strong evidence that the activity is one primarily engaged in for profit.[346]

Seventh, the amount of profits in relation to the amount of

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[342] Treas. Reg. § 1.183-2(b)(2) (1972).
[343] Treas. Reg. § 1.183-2(b)(3) (1972).
[344] Treas. Reg. § 1.183-2(b)(4) (1972).
[345] Treas. Reg. § 1.183-2(b)(5) (1972).
[346] Treas. Reg. § 1.183-2(b)(6) (1972).

losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may be used to demonstrate a profit motive or lack thereof. If in relation to a taxpayer's investment, only nominal profits are earned during a few profitable years, while substantial losses occur otherwise, this may reflect negatively on a taxpayer's intent to generate a profit over the long term.[347] Absent this factor, even the most rudimentary manipulation of expenses conceivably could create a presumption, while incurring a significant net loss for the life of the venture.

Eighth, the taxpayer's net worth and annual income are relevant factors in determining a taxpayer's intent. If the taxpayer lives primarily off his efforts with respect to the questioned activity, it will be more difficult to insist that he lacks the requisite profit motive. Conversely if the taxpayer is independently wealthy and does not rely on income from the activity to support his standard of living, a negative inference may arise that the activity is not engaged in for profit, especially if personal or recreational elements are involved.[348]

Finally, and perhaps oddly based on the idea that it is somehow unfair to mix business with pleasure, the regulations provide that "the presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved."[349] The regulations make it clear that taxpayers do not have to have the exclusive intention of deriving a profit or maximizing profits from an activity. Also, an activity will not be treated as not engaged in for profit even though the taxpayer may have other reasons for engaging in the activity other than solely to make a profit. That the taxpayer also derives personal pleasure from the activity is not, in and of itself, sufficient to cause the activity to be classified as not engaged in for profit. As a practical matter, this factor seems to recognize common sense limits to what may be considered a "business."

In conclusion, because none of the enumerated factors in the regulations are determinative of the issue raised by section 183, a potential investor or syndicator must investigate carefully the purpose of the investment and be prepared to substantiate a reasonable probability of realizing a profit. He is not precluded from

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347 Treas. Reg. § 1.183-2(b)(7) (1972).

348 Treas. Reg. § 1.183-2(b)(8) (1972).

349 Treas. Reg. § 1.183-2(b)(9) (1972).

enjoying the activities accompanying ownership, so long as there remains a profit motive for the ownership.

V. EQUINE SYNDICATES AND LIMITED PARTNERSHIPS UNDER THE SECURITIES LAWS

A. General

One of the threshold questions that must be addressed when structuring any Thoroughbred syndicate or limited partnership is whether the federal and state securities laws are applicable. The application of and compliance with the federal and state securities laws increases substantially the complexities and costs of the transaction. The time necessary to complete the transaction, marketing strategies, and complexity of legal problems all are affected directly by the potential application of the securities laws. Whenever possible, the transaction should be structured in a manner so that the interests created are not considered securities.

Section 5 of the Securities Act of 1933 (1933 Act) provides that no security may be offered for sale, sold, or otherwise transferred by means of interstate commerce unless the security is registered with the Securities and Exchange Commission (SEC), or the security or transaction is exempt from registration.[350] Failure to comply with the securities laws is extremely hazardous, especially if the transaction does not live up to expectations.[351] In addition to remedies under state law for common-law fraud, section 12(1) of the 1933 Act provides a remedy against anyone who fails to register a security or qualify the security or transaction for exemption from registration.[352] Section 12(2)[353] of the 1933 Act and

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

351 The basic thrust of the 1933 Act is to require issuers of securities to disclose to potential investors all material factors concerning the investment and to give investors the opportunity to make intelligent investment decisions. If the issuer misrepresents the facts or fails to disclose a material fact concerning the investment, the securities laws give the investors a cause of action against the issuer, as well as others participating in the sale of the security. *See, e.g.*, 15 U.S.C. §§ 77*l*(1), 77*l*(2) (1981). One of the remedies afforded investors under the 1933 Act is the opportunity to get a refund of their investment. Of course, as a practical matter, if the investment is successful, the investors ordinarily will not seek remedies under the 1933 Act. If the investment is unsuccessful, however, the investors will scrutinize the sale of the securities carefully to determine if there have been violations under the 1933 Act.

352 15 U.S.C. § 77*l*(1) (1981).

353 15 U.S.C. § 77*l*(2) (1981).

Rule 10b-5[354] of the Securities and Exchange Act of 1934[355] (1934 Act) provide additional and substantive remedies against anyone who effects a transaction in securities by means of a material misstatement or who fails to disclose a material fact.[356] The potential liability of any promoter for failure to comply with the securities laws and the necessity of complying with such laws cannot be emphasized too strongly.[357]

B. What Is a Security?

Section 2(1) of the 1933 Act defines a security as "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement . . . or, in general, any interests or instrument commonly known as a 'security' . . . ."[358] The specific examples of securities, e.g., notes, stocks, and bonds, are relatively clear and easy to understand. The more general classifications of securities including "certificates of interest or participation in any profit-sharing agreement" and "investment contracts" have resulted in the greatest interpretation problems. It often is difficult to determine whether a particular transaction involves an investment contract or certificate of participation in a profit-sharing arrangement, and thus, involves a security.[359] The interpretation of these phrases has been left largely to the courts.[360]

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354 17 C.F.R. § 240.10b(5) (1982).

355 15 U.S.C. §§ 78a-78kk (1981) [hereinafter cited as 1934 Act].

356 Liability under the securities laws arises not only from misstatements and misrepresentations, but also from failing to disclose a material fact, notwithstanding the absence of intent.

357 Because of the potential liability incurred by the issuer and because of the extremely technical aspects of the securities laws, transactions involving securities should be handled by professionals who are schooled in the intricacies and complexities of the securities laws.

358 15 U.S.C. § 77b(1) (1981).

359 These phrases are intentionally broad to cover situations which in substance involve securities but for which no specific rule or regulation is applicable. *See generally* H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).

360 *See, e.g.*, United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975) (involving the purchase of shares of common stock in a cooperative housing corporation by residents); SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (involving leasehold rights); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) (involving membership certificates in a social organiztion); SEC v. Glenn W. Turner Enters., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); United States v. Monjar, 47 F. Supp. 421 (D. Del. 1942) (involving club memberships sold to raise capital for construction). *See*

The landmark case interpreting "investment contract" is the United States Supreme Court decision in *SEC v. W.J. Howey Co.*[361] In that case, Howey sold small tracts of land to investors for growing citrus fruits and provided essential services to the investors, including the cultivation, development, harvesting, and marketing of the fruit. One of the crucial findings of the Court was that the investors were not sophisticated in the citrus business and lacked the knowledge, skill, and equipment necessary for the care and cultivation of the groves. For these and other reasons, the transaction involved the sale of an investment contract, and therefore a security. The Court defined an investment contract as a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profit solely from the efforts of the promoter or third party."[362]

Instead of settling the questions of what investment contract meant, the "*Howey* test" spawned a substantial amount of litigation.[363] The test has four elements: (1) an investment of money; (2) a common enterprise; (3) an expectation of profits or other financial benefits; and (4) the expectation of profits or other financial benefits derived solely from the efforts of the promoter or third party. It is fairly well settled that a limited partner's interest in a limited partnership constitutes a security under this test.[364] It is less certain, however, whether an interest in a stallion syndicate constitutes a security. The typical syndicate, as previously discussed,[365] contains at least two of the four elements of the *Howey* test: an investment of money and an expectation of financial benefit or profits. To constitute an investment contract under

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generally Comment, *Catch-All Investment Contracts: The Economic Realities Otherwise Require*, 14 CUM. L. REV. 135 (1984).

361 328 U.S. 293 (1946).

362 *Id.* at 298-99.

363 *See* Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981); Westchester Corp. v. Peat, Marwick, Mitchell & Co., 626 F.2d 1212 (5th Cir. 1980); Cameron v. Outdoor Resorts of Am., Inc., 608 F.2d 187 (5th Cir. 1979), *modified on reh'g*, 611 F.2d 105 (5th Cir. 1980) (remanded on other grounds); Govern Plaza Joint Venture v. First of Denver Mortgage Investors, 562 F.2d 645 (10th Cir. 1977); Bell v. Health-Mor, Inc., 549 F.2d 342 (5th Cir. 1977); 1050 Tenants Corp. v. Jakobson, 503 F.2d 1375 (2d Cir. 1974); SEC v. Glenn W. Turner Enters., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

364 Pawgan v. Silverstein, 265 F. Supp. 898 (S.D.N.Y. 1967).

365 *See supra* notes 26-49 and accompanying text.

the *Howey* test, however, the syndicate investment also must contain the elements of common enterprise and expectation of profits solely from the efforts of the promoter or third party. It is these two elements, and particularly "solely from the efforts of a third party," that has resulted in the most litigation.[366]

The Supreme Court has not addressed the issue of common enterprise directly. The leading case on this issue is *SEC v. Glenn W. Turner Enterprises*,[367] in which the Ninth Circuit interpreted the phrase "common enterprise" to mean multiple investors who pool their invested funds to generate profits or other financial benefits. The Ninth Circuit interpreted "solely" to mean "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[368] The traditional horse syndication involves the use of a syndicate manager, who has certain contractual responsibilities to the syndicate members. For this reason, the fourth element of the *Howey* test might appear to apply to stallion syndicates. This would be an unreasonable expansion of the *Howey* test. A horse syndicate involves individual co-ownership by multiple parties. Each syndicate member has the right to use his interest in any manner he chooses separate from the other members, subject to the terms of the syndicate agreement. The success or failure of each syndicate member's investment is dependent upon the experience and ability of the individual member. Accordingly, in the typical syndicate arrangement profits are derived solely from the efforts of each individual investor and not from the efforts of the promoter or third party.

Syndicate members in the average stallion syndicate rely upon the syndicate manager to perform certain duties with respect to the stallion and the syndicate pursuant to the terms of the syndicate agreement. These duties include boarding and daily care of the stallion, and supervision of the breeding operations. In addition, the syndicate man-

366 *See* SEC v. Glenn W. Turner Enters., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). *See also* United Hous. Found., Inc. v. Forman, 421 U.S. 827 (1975); Noa v. Key Futures, Inc., 638 F.2d 77 (9th Cir. 1980); Cameron v. Outdoor Resorts of Am., Inc., 608 F.2d 187 (5th Cir. 1979), *modified on reh'g*, 611 F.2d 105 (5th Cir. 1980) (remanded on other grounds).

367 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

368 *Glenn W. Turner Enters.*, 474 F.2d at 482.

ager must maintain all records and accounts for the syndicate and assess each syndicate member his pro rata share of the common syndicate expenses. In some syndicate arrangements, the syndicate manager may be given the additional responsibility of marketing and selling excess nominations on behalf of the syndicate and distributing the proceeds therefrom to the syndicate members. The syndicate manager also may serve as agent for individual syndicate members who desire to sell their nominations.

The greater the amount of participation and responsibility undertaken by the syndicate manager, the more likely it will be that the fourth element of the *Howey* test is satisfied. Because the *Howey* test involves essentially a facts and circumstance determination, it is extremely difficult, in many cases, to determine which duties and responsibilities a syndicate manager may assume without violating the "solely from the efforts of the promoter or third party" element of the *Howey* test. The failure to satisfy any one of the four elements of the *Howey* test will result in exclusion of syndicate interests from the definition of a security.

One issue arising from the *Howey* test is whether "solely" means solely. In *SEC v. Koscot Inteplanetary, Inc.*,[369] the Fifth Circuit addressed this issue. In that case, the SEC alleged that a pyramid scheme, in which investors paid a sum of money for the right to become a representative for Koscot in the sale of cosmetics, constituted a security. Each participant realized profits from the sale of cosmetics, but also had the potential to earn additional sums by recruiting other participants to become Koscot representatives. Each participant would receive a portion of the fees paid to Koscot by the new participants. Applying the *Howey* text, the Fifth Circuit concluded that the transaction involved an investment of money in a common enterprise, but the real question faced by the court was whether the original participants expected profits "solely" from the efforts of the promoter, Koscot. Clearly, the original participants could generate profits through their own efforts by selling cosmetics or by recruiting new participants. Despite this fact, the court held that the transaction constituted a security, stating the "the critical inquiry is 'whether the efforts made by those other than the investors are the undeniably significant ones, those

[369] 497 F.2d 473 (5th Cir. 1974).

essential managerial efforts which affect the failure or success of the enterprise.' "[370]

Although the Supreme Court has never squarely addressed this issue, the fourth element of the *Howey* test now apparently can be satisfied if the efforts of the promoter or third party are the "undeniably significant ones."[371] Therefore, when structuring a syndicate arrangement and considering what duties the syndicate manager may perform, it should be assumed that "solely" does not really mean solely, and the fourth element of the *Howey* test can be satisfied if the duties of the promoter or syndicate manager are merely the "undeniably significant ones."

It has been held that a transaction does not constitute a security if the efforts of the promoter are relatively insubstantial. In *United Housing Foundation, Inc. v. Forman*,[372] tenants in an apartment complex were required to purchase shares in the nonprofit cooperative housing corporation that operated the complex. Each tenant was restricted from selling his shares in the corporation, and any tenant who moved from the complex was required to offer the shares to the corporation at the original purchase price. The arrangement, the Court held, did not involve a security because the tenants did not expect to derive any profit from their investment.[373]

The subjective nature of the *Howey* test makes it extremely difficult in many close factual situations to determine whether a particular transaction constitutes a security. To avoid the potential risks of violating the securities laws, one might consider requesting a no-action letter from the SEC. A no-action letter seeks a prior ruling from the SEC that a transaction does not constitute a security and is accompanied by a detailed description of the transaction, as well as a discussion of applicable law.[374] An SEC no-action letter has the practical effect of insulating a transaction, to the extent

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[370] *Id.* at 483 (quoting *Glenn W. Turner Enters.*, 474 F.2d at 482).

[371] See *supra* note 363 for cases following the interpretation of the *Koscot* decision.

[372] 421 U.S. 837 (1975).

[373] Justice Brennan dissented, noting that the nonprofit cooperative housing corporation anticipated receiving as much as $1,000,000 per year from leasing commercial space in the complex, which would be used to reduce the rent charged to the tenants. *Id.* at 861.

[374] For an example of how to prepare a request for a No-Action Letter, see *No-Action and Interpretative Letters*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,001 (1982).

the transaction adheres to the description in the request, from legal action by the SEC. A no-action letter, concluding that a transaction does not constitute a security, avoids the costs and complexities of filing a registration statement or qualifying for an exemption. It should be noted, however, that the SEC takes the position no-action letters do not constitute legal conclusions that a syndicate arrangement does not involve the issuance of a security within the meaning of the 1933 Act.[375]

Based on a review of many no-action letters, the SEC takes the position that an interest in the typical stallion syndicate does not constitute a security, providing the syndicate manager undertakes no more responsibility than caring for, advertising and promoting the horse, and performing administrative duties for the syndicate.[376] Syndicate arrangements structured in this manner involve no expectation on the part of the syndicate members to derive profits "solely" from the efforts of the promoter or syndicate managers. In fact, the role of the syndicate manager in these situations is insignificant.[377]

Once the syndicate manager's role is expanded, however, the syndicate arrangement comes closer to meeting the fourth element of the *Howey* test. One duty nearly always undertaken by the syndicate manager is the promotion and advertising of the stallion and the syndicate.[378] It does not appear that the promotion of the stallion and the syndicate by the syndicate manager will cause the transaction to be defined as a security.[379] In almost all stallion syndicates, the syndicate manager reserves the right or is required to pro-

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375 All of the No-Action Letters reviewed by the author contained a statement that the opinions contained in the letters did not constitute legal conclusions.

376 *See, e.g.*, Himito Dancer Syndicate Agreement, SEC No-Action Letter (available Feb. 5, 1982, on WESTLAW, FSEC-NAL database); Owens, SEC No-Action Letter (available Feb. 27, 1981, on WESTLAW, FSEC-NAL database); Ariston Syndication Agreement, SEC No-Action Letter (available June 23, 1980, on WESTLAW, FSEC-NAL database).

377 The syndicate manager's role is generally limited to ministerial tasks, which are deemed insignificant for securities purposes. From a practical standpoint, however, the selection of the syndicate manager in the typical stallion syndicate is critical. *See supra* notes 38-40 and accompanying text.

378 The promotion and advertising of the stallion is frequently handled through advertisements in various trade magazines, such as *The Blood-Horse* and *The Horseman's Journal.*

379 *See, e.g.*, Ariston Syndication Agreement, SEC No-Action Letter (available June 23, 1980, on WESTLAW, FSEC-NAL database).

mote the stallion. The promotion of a stallion invariably benefits the syndicate members, who may want to sell excess nominations or their syndicate interest. Nevertheless, a syndicate manager's right to promote a stallion does not bar receipt of a no-action letter.[380] Many no-action letters specifically refer to the promotional activities of the syndicate manager or describe reimbursement to the syndicate manager for expenses incurred in promoting and advertising the stallion.[381] Although the promotion of a stallion benefits the syndicate members, the actual decisions about whether to sell nominations, breed mares, sell mares or offspring, or sell the syndicate interests rest solely with the syndicate member and not the syndicate manager.

Another situation which could cause problems is when the promoter syndicates a stallion prior to its retirement from racing. In this situation the syndicate manager will, by necessity, assume significant responsibilities. If the stallion will continue to be raced after syndication, the syndicate members, as a group, cannot, as a practical matter, make the day-to-day decisions concerning the training, development, and care of the stallion. Decisions concerning the selection of jockeys, horse tracks, and particular races will be delegated to the syndicate manager.[382] It is possible to obtain a no-action letter with respect to a syndicate arrangement involving a racehorse, provided the syndicate agreement permits the owner or promoter to retain earnings rather than distributing them pro rata among the syndicate members.[383] The owner or promoter also must be responsible for all training expenses and entry fees.[384] It may also be possible to provide that earnings will accrue to the syndicate, rather than the owner or promoter, and be used to defray syndi-

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380 *See, e.g.*, Owens, Marjorie, SEC No-Action letter (available Feb. 27, 1981, on WESTLAW, FSEC-NAL database); Stallions Unlimited, Inc., SEC No-Action Letter (available Nov. 13, 1978, on WESTLAW, FSEC-NAL database).

381 *See, e.g.*, Ariston Syndication Agreement, SEC No-Action Letter (available June 23, 1980, on WESTLAW, FSEC-NAL database).

382 It is impractical for 35 syndicate members, for example, to manage the racing career of a horse. Moreover, attempts to equalize management responsibilities among all syndicate members will not result in the SEC staff taking a no-action position. Secret Passage Syndicate Agreement, SEC No-Action Letter (available Feb. 3, 1982, on WESTLAW, FSEC-NAL database).

383 Himito Dancers Syndicate Agreement, SEC No-Action Letter (available Feb. 5, 1982, on WESTLAW, FSEC-NAL database).

384 *Id.*

cate expenses.[385] One should be skeptical about such a provision, however, in a syndicate arrangement projected to generate substantial earnings in excess of syndicate expenses.[386]

If the syndicate agreement requires or permits the syndicate manager to act as a broker or agent for any syndicate member who desires to sell his breeding rights, a more difficult question arises. When the syndicate manager acts as a broker or agent for syndicate members who desire to sell their excess nominations, or for the syndicate in the sale of excess nominations when the proceeds from such sales are to be distributed pro rata to the syndicate members, the syndicate manager's role increases significantly and causes problems under the securities laws. This is an especially troublesome provision in syndicates when the syndicate members have little or no experience in the horse industry, an unusual situation in the typical stallion syndicate.[387] Although the syndicate members have the responsibility for making all major decisions with respect to the use of the syndicate interest, a provision permitting or requiring the syndicate manager to act as broker or agent for the syndicate members apparently will prevent a favorable ruling.[388]

Pooling of income in a stallion syndicate almost always will cause the transaction to be classified as a security.[389] If

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[385] Blaze Drift Syndicate, SEC No-Action Letter (available Oct. 29, 1981, on WESTLAW, FSEC-NAL database).

[386] If the syndicate were projected to generate substantial earnings which would ultimately inure to the benefit of the syndicate members, it can be expected that the SEC staff would take a different position.

[387] Interests in the typical syndicate arrangement are specifically marketed to experienced horsemen, because potential profitability from such an investment depends almost entirely upon the use to which the syndicate member puts his interest. One of the underlying facts inherent in syndicate arrangement is that the syndicate members will not rely upon the efforts of any third party to derive a profit from their investment. If the syndicate members are not experienced horsemen, but are merely passive investors, there almost certainly will be reliance upon the promoter or syndicate manager to general profits. This situation generally will cause problems under the securities laws.

[388] *See, e.g.*, Ralph E. Jr. & Diana Schenck, SEC No-Action Letter (available Nov. 20, 1978, on WESTLAW, FSEC-NAL database).

[389] Pooling of income, especially when the efforts of the promoter are undeniably significant, will satisfy all of the elements of the *Howey* test. Every No-Action Letter reviewed by the author contained a representation that there would be no pooling of revenues and that excess nominations would be allocated by lot. *See, e.g.*, Offers & Sales of Condominiums or Units in a Real Estate Development, [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 1049 (Jan. 4, 1973) (codified at 17 C.F.R. § 231.5382 (1973)) (the SEC concluded that the offer of a condominium unit in con-

the syndicate manager has the right to sell on behalf of the syndicate excess nominations and distribute the revenues pro rata among the members of the syndicate, pooling of income exists. Such a provision is beneficial to the promoter and the syndicate because the owner can control the quality of mares bred to the stallion, and thus, the quality of the offspring. Despite the apparently bona fide business reason for permitting the syndicate manager to sell excess nominations, stallion syndicate arrangements with provisions for pooling of income will be deemed to involve a security by the SEC.

Under existing authority, interests in the traditional stallion syndicate arrangement do not constitute securities. The issue usually centers on the role of the syndicate manager. If the role of the syndicate manager becomes too significant, the syndicate interests could constitute securities. This is not ordinarily a problem in the typical stallion breeding syndicate when the syndicate manager merely performs ministerial functions. In other types of syndicate arrangements, such as racing syndicates, it is much more difficult to avoid the securities laws. The principal purpose of the securities laws is to require disclosure of all material facts about the transaction to investors to permit them to make intelligent investment decisions. In the typical syndicate this disclosure requirement is unnecessary, because the syndicate members usually are sophisticated and knowledgeable about the horse business and have access to the same kinds of information required to be disclosed under the securities laws.

C. Exemptions Under Federal Law

1. General

Once the interests in the syndicate or limited partnership are determined to be securities, it must be determined whether the security must be registered,[390] and whether the sellers of the security must be registered as broker-dealers or salesmen.[391] In general, for both federal and state purposes, no security can be offered or sold unless it has been

nection with the offering of participation in a rental pool arrangement causes the transaction to be viewed as an investment contract, and, therefore, a security).

[390] 15 U.S.C. § 77B(1) (1981).

[391] 15 U.S.C. § 780 (1981).

properly registered. Fortunately, the 1933 Act and most state securities laws contain exemptions from registration for certain classifications of securities and certain transactions.[392] The principal exemptions under the 1933 Act are: (1) Transactions by an issuer not involving any public offering pursuant to section 4(2) and rule 506[393] of Regulation D[394] promulgated thereunder; (2) limited offerings pursuant to section 3(b) and rules 504[395] and 505[396] of Regulation D promulgated thereunder; (3) sales exclusively to "accredited" investors pursuant to section 4(6); and (4) intrastate offerings pursuant to section 3(a)(11) and rule 147[397] promulgated thereunder.

Most state securities laws parallel the framework of the federal securities laws. Nearly every state prohibits the sale of unregistered securities.[398] Unless an exemption is otherwise available, broker-dealers must be registered in all states,[399] and many states prohibit persons from offering or selling securities within the state unless such persons are registered as broker-dealers in the state.[400] Many states provide an exemption for isolated sales by a non-issuer to one or two purchases whether or not made by a broker-dealer.[401] In addition, many state statutes contain a private placement exemption for the issuer similar to the federal exemption, although the specific requirements of each state vary widely.[402] Some states limit the exemption to offers, but not

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392 *See, e.g.*, 15 U.S.C. § 77(d)(2) (1981) (private placements); Securities Act Release 6389, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,106 (Mar. 8, 1982) (Rule 506); 15 U.S.C. § 77c(b) (1981) (unlimited offers); 17 C.F.R. §§ 230.251 to .264 (1984) (Rules 504 and 505); 15 U.S.C. § 77c (1970) (intrastate offerings); 17 C.F.R. § 230.147 (1984) (Rule 147 intrastate offerings); 15 U.S.C. § 77d(6) (1980); ALA. CODE § 8-6-11(a)(9) (1975) (Alabama Securities Act).

393 17 C.F.R. § 230.506 (1984).

394 Securities Act Release No. 6389, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,106 (Mar. 8, 1982).

395 17 C.F.R. § 230.504 (1984).

396 17 C.F.R. § 230.505 (1984).

397 17 C.F.R. § 230.147 (1984).

398 J. HAFT & P. FASS, 1985 TAX SHELTERED INVESTMENTS HANDBOOK § 8.01 (1985).

399 *Id.*

400 *Id.*

401 *See, e.g.*, ALA. CODE § 8-6-11(a)(1) (1975) (Alabama Securities Act).

402 *See, e.g.*, ALA. CODE § 8-6-11(a)(9) (1975) (Alabama Securities Act) (permits offers to no more than 10 persons in the state within any 12 month period, provided no commissions are paid to any person upon the sale, and the securities are purchased for investment and not with the view towards resale).

sales, to a specified number of persons within the state during a certain time period, usually twelve months, provided no commissions are paid and the purchases are made for investment.[403] Other states define the private placement exemption in terms of the number of purchasers rather than offerees.[404] Many states have adopted exemptions that correspond to rule 146 promulgated under section 4(2) of the 1933 Act or rules 505 and 506 of Regulation D.[405]

2. Regulation D

Regulation D was adopted by the SEC on March 3, 1982, and replaced entirely rules 240, 242 and 146 under the 1933 Act. Regulation D contains six new rules, rules 501-506, which encompass the current limited offering exemptions under federal law. Rule 501 contains definitions and terms applicable to all offerings made pursuant to Regulation D.[406] Rule 502 sets forth the general conditions which must be satisfied in order for the exemptions to be available.[407] Rule 503 requires the filing of notices with the SEC on form D.[408] Rules 504-06 contain the specific Regulation D exemptions. Regulation D became effective on April 15, 1982, and has become the most widely-used exemption for equity placements to noninstitutional investors.

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403 *Id.*

404 *See* RULES OF OFFICE OF SECRETARY OF STATE, COMM'R OF SECS., Rule 590-4-5-.01(h) (1983) (promulgated under the Georgia Securities Act of 1973, as amended).

405 *See, e.g.*, RULES OF ALA. SECS. COMM'N, Rule 830-6-X-.11 (1982).

406 17 C.F.R. § 230.501 (1984). These definitions include "accredited investor" (rule 501(a)); "affiliate" (rule 501(b)) "aggregate offering price" (rule 501(c)); "calculation of number of purchasers" (rule 501(e)); "issuer" (rule 501(g)); and "purchaser or representative" (rule 501(h)).

407 17 C.F.R. § 230.502 (1984). Rule 502(a) provides that all sales part of the same Reg. D offering must meet all the terms and conditions of Reg. D, and offers and sales made more than six months before the start of a Reg. D offering or are made more than six months after completion of a Reg. D offering will not be considered part of the same Reg. D offering. Otherwise, in determining whether offers and sales of securities must be integrated for purposes of Reg. D, a number of factors must be taken into account including: (a) whether the sales are part of a single plan of financing; (b) whether the sales involve issuance of the same class of securities; (c) whether the sales have been made at or about the same time; (d) whether the same type of consideration is received; and (e) whether the sales are made for the same general purpose.

Rule 502 also contains general rules regarding information to be furnished to investors, limitations on the manner of the offering, and a general limitation on resale of the securities.

408 17 C.F.R. § 230.503 (1984). Form D is the standardized form prepared and adopted by the SEC for compliance with the Reg. D notification requirements.

(a) Rule 504

Rule 504 replaced rule 240 and was adopted pursuant to section 3(b) of the 1933 Act. Under rule 504, offers and sales of up to $500,000 of securities during a twelve-month period by an issuer which is not a reporting company nor an investment company are exempt, provided no general advertising or solicitation is used and notices of sales on form D are filed with the SEC.[409] Sales may be made to an unlimited number of purchasers under this rule.[410] In calculating the maximum $500,000 offering price permitted under rule 504, the issuer must aggregate (1) the gross proceeds from sales of securities during the preceding twelve months made pursuant to rule 504; (2) sales made in transactions exempt under section 3(b); and (3) sales made in violation of the registration requirements of section 5(a) of the 1933 Act.[411] If a particular transaction fails to satisfy the aggregate offering price limitation, prior transactions made in reliance on rule 504 will be unaffected.[412] Mandatory, noncontingent installments and assessments for which the investor is personally liable must be included in computing the aggregate offering price.[413]

Rule 504 does not require the issuer to furnish any specific disclosure information to investors.[414] For the exemption under rule 504 to be available, however, the investors must purchase the securities for investment and not for resale, and the securities may not be resold, unless they are subsequently registered or an exemption is available.[415] This restriction on transferability should be disclosed to the investors. In addition, although the offer and sale of securities may be exempt from registration pursuant to rule 504, the antifraud provisions of the 1933 Act[416] and the 1934 Act[417] still apply, and the delivery of a memorandum which discloses all material facts of the offering is strongly recommended.

The restriction on the manner of offering and the limitation on

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409 17 C.F.R. § 230.504(a) (1984).

410 Because the number of purchasers is unlimited, the minimum purchase by investors may be relatively small and, thus, rule 504 offerings are similar to public offerings. For this reason, many states adopting Reg. D have excluded rule 504. *See, e.g.*, RULES OF ALA. SECS. COMM'N Rule 830-X-6-.11 (1982).

411 17 C.F.R. § 230.504(b)(2) (1984).

412 *Id.*

413 17 C.F.R. § 230.501(c) (1984).

414 17 C.F.R. § 230.502(b)(1)(i) (1984).

415 *Id. See* § 230.504(b)(1) (1984).

416 *See supra* note 353.

417 *See supra* note 359.

resale does not apply to offers and sales of securities that are made exclusively in one or more states, each of which provides for the registration of the securities and requires the delivery of a disclosure document before sale.[418] This situation could occur, for example, if an offering exempted under rule 504 for federal purposes were made in one or more states which do not have an exemption corresponding to rule 504 and no other exemptions were available.[419] Offers and sales of securities, a part of which are made in any state which does not require the registration of the security or which does not require the delivery of a disclosure document, must comply with the restrictions on the manner of offering and limitations on resale.

(b) Rule 505

Rule 505 exempts offers and sales of up to $5,000,000 of restricted securities by an issuer, which is not an investment company, during any twelve-month period, provided sales are not made to more than thirty-five nonaccredited investors and the requisite notices on form D are filed with the SEC.[420] Rule 505 replaced rule 242 and was adopted pursuant to section 3(b) of the 1933 Act. As in the case of rule 504, offers and sales made in reliance on rule 505 may not be conducted by any form of general solicitation or general advertising.[421] Unlike rule 504 offerings, however, issuers relying on rule 505 must furnish prospective purchasers with specific disclosures that correspond to the same information required by part I of form S-18.[422] All sales of securities by the issuer within the preceding twelve months pursuant to

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418 17 C.F.R. § 230.504(b)(1) (1984).

419 Alabama, for example, in adopting Reg. D specifically excludes offerings pursuant to rule 504. Therefore, in Alabama a rule 504 offering must be registered, unless it also satisfies the requirements of rule 505 or rule 506 (specifically limiting sales to no more than 35 nonaccredited investors).

420 17 C.F.R. § 230.505 (1984).

421 *Id. See* § 230.505(b)(1) (1984) (offers and sales pursuant to rule 505 must satisfy the terms and conditions of rules 501-503). Rule 502(c) prohibits the offer or sale of securities by any form of general solicitation or general advertising, including, but not limited to, any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio; and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. *Id.*

In determining whether an offering is made pursuant to general advertising, the mailing of a brochure to members of the Thoroughbred Owners and Breeders Association, distributing brochures at a horse sale, and advertising in a trade journal would violate the restrictions contained in rule 502(c). *See* Aspen Grove Brochure, SEC No-Action Letter (available Nov. 8, 1982, on WESTLAW, FSEC-NAL database).

422 17 C.F.R. § 230.502(b)(i)(A) (1984).

rule 505, sales made in reliance on the exemption provided by section 3(b) (including rule 504, Regulation A and Regulation B), and sales made in violation of section 5(a) of the 1933 Act must be aggregated to calculate the maximum offering price.[423] Securities sold pursuant to rule 505 must be purchased for investment and may not be resold unless a registration statement is in effect or an exemption is otherwise available.[424]

Securities offered pursuant to rule 505 may be sold to an unlimited number of "accredited investors," but to no more than thirty-five nonaccredited investors. Rule 501(a) defines accredited investor, including eight different exemplary categories. The principal categories of accredited investors applicable to most Thoroughbred syndicate and limited partnership offerings are:

> (1) Any director, executive officer, or general partner of the issuer, or any director, executive officer, or general partner of a general partner of the issuer;
>
> (2) Any person who purchases at least $150,000 of the securities being offered, where the purchaser's total purchase price does not exceed twenty percent of the purchaser's net worth at the time of sale, or joint net worth with that of the purchaser's spouse;
>
> (3) Any natural person whose individual net worth, or joint net worth with his spouse, at the time of purchase exceeds $1,000,000;
>
> (4) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years and who reasonably expects an income in excess of $200,000 in the current year; and
>
> (5) Any entity in which all of the equity owners are accredited investors as defined in the rule, except under paragraph 2 above.[425]

(c) Rule 506

Rule 506 replaced rule 146 and was adopted pursuant to section 4(2) of the 1933 Act. Rule 506 exempts offers and sales of an unlimited amount of restricted securities[426] by any issuer to no more than thirty-five nonaccredited investors, provided the requisite notices on form D are filed with the SEC.[427] Offers and sales

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[423] 17 C.F.R. § 230.501(c) (1984).
[424] 17 C.F.R. § 230.502(d) (1984).
[425] 17 C.F.R. § 230.501(a) (1984).
[426] 17 C.F.R. § 230.506 (1984).
[427] 17 C.F.R. § 230.503 (1984).

may not be conducted by any form of general solicitation or general advertising.[428] The issuer in a rule 506 offering must reasonably believe prior to making any sale that each nonaccredited investor either alone or with his purchaser representative has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the investment.[429] For offerings up to $5,000,000 by nonreporting companies, the issuer must furnish prospective purchasers in writing with the same kind of information contained in part I of form S-18.[430] Issuers not qualified to use form S-18, such as reporting companies, and issuers engaged in offerings in excess of $5,000,000, must furnish prospective investors in writing with the same kind of information as would be required to be included in part I of a registration statement filed under the 1933 Act.[431] Purchasers of securities sold pursuant to rule 506 must acquire the securities for investment, and the securities may not be resold except pursuant to a registration or a valid exemption.[432]

3. Section 4(6) Exemption

The Small Business Investment Incentive Act of 1980[433] created a new exemption under section 4 of the 1933 Act for transactions involving offers and sales by an issuer solely to one or more accredited investors, if the following requirements are met: (1) The aggregate offering price of an issue of securities does not exceed the amount allowed under section 3(b) of the 1933 Act (presently $5,000,000); (2) the offering and sale of the securities is not conducted by any form of public solicitation or advertising; and (3) the issuer files a notice of sales on form D with the SEC.

Section 4(6) is similar to rule 505 with respect to the maximum amount of securities permitted to be offered and the definition of an accredited investor.[434] In determining who is an accredited investor for purposes of the exemption under section 4(6), however, the issuer's reasonable belief is no defense as it is under Regulation D, if an investor is actu-

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428 17 C.F.R. § 230.502(d) (1984).
429 17 C.F.R. § 230.506(b)(2)(ii) (1984).
430 17 C.F.R. § 230.502(b)(2)(i)(A) (1984).
431 17 C.F.R. § 230.502(b)(2)(i)(B) (1984).
432 17 C.F.R. § 230.502(D) (1984).
433 Pub. L. No. 96-477, 94 Stat. 2275 (1980).
434 15 U.S.C. § 77d(6) (1981).

ally nonaccredited.[435] In addition, section 4(6) is available to investment companies. In determining the maximum offering price, other sales pursuant to section 3(b) during the prior twelve months do not have to be aggregated, unless integration applies.[436] As in the case of securities sold in reliance on the exemptions afforded by Regulation D, securities sold pursuant to section 4(6) are "restricted securities," which may not be resold except pursuant to registration or a valid exemption, such as rule 144.[437]

4. Intrastate Offering Exemption

Section 3(a)(11)[438] of the 1933 Act provides an exemption from registration for securities that are part of an issue offered and sold only to persons resident within a single state, where the issuer is a person resident and doing business within that state. The SEC promulgated rule 147[439] for the purpose of interpreting section 3(a)(11) and providing objective guidelines for determining the availability of the intrastate exemption. Rule 147 was unaffected by the adoption of Regulation D. For purposes of rule 147, an issue does not include offers or sales of securities of the issuer pursuant to the exemptions provided by section 3 or section 4(2) (and Regulation D), or pursuant to a registration statement, that take place prior to the six-month period preceding or after the six-month period following offers and sales pursuant to this rule.[440]

An issuer is deemed to be a resident of the state in which (1) it is incorporated or organized, if a corportion, limited partnership or other form of business organization that is organized under state law;[441] (2) its principal office is located, if a general partnership, or other form of business organization not required to be organized under state law;[442] or (3) where his principal residence is located if an individual.[443] An issuer is deemed to be doing business within the

435 *See* 17 C.F.R. § 230.505(b)(2)(ii) (1984).

436 *See* 17 C.F.R. § 230.502(a) (1984).

437 *See* 17 C.F.R. § 230.144(a)(3) (1984); 17 C.F.R. § 230.502(d) (1984).

438 15 U.S.C. § 77c(a)(11) (1981).

439 Securities Act Release No. 5450, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,617 (Jan. 7, 1974).

440 17 C.F.R. § 230.147(b)(2) (1984).

441 17 C.F.R. § 230.147(c) (1984).

442 *Id.*

443 *Id.*

state if (1) it derived at least eighty percent of its gross revenues and those of its subsidiaries on a consolidated basis from the operation of a business or real property located in or from the rendering of services within such state;[444] (2) it had at least eighty percent of its assets and those of its subsidiaries on a consolidated basis located within the state;[445] or (3) it intends to use and uses at least eighty percent of the net proceeds from sales of its securities in connection with the operation of its business or the purchase of real property located within the state;[446] and (4) its principal office is located within the state.[447]

Offerees and purchasers under rule 147 must be residents of a single state. An entity is deemed to be a resident of the state where its principal office is located. An individual is deemed to be a resident of the state where his principal residence is located.[448] An entity formed for the purpose of acquiring securities offered pursuant to rule 147 only will be deemed a resident of the state where its principal office is located if all of the beneficial owners are residents of that state.[449] If a person purchases securities on behalf of other persons, such other persons must also satisfy the residency requirements.[450] Issuers claiming exemption under rule 147 have the burden of providing that all of the rule's requirements have been satisfied, including the residency requirement of all offerees and purchasers. If a single offeree turns out to be a resident of another state, the exemption under rule 147 is no longer available. Because of the difficulty in determining an individual's principal residence in many situations, the intrastate offering exemption must be utilized carefully.

D. Principal Exemptions Under Alabama Law

Section 8-6-4 of the Securities Act of Alabama[451] (the Act) provides that it is unlawful for any person to offer or sell any security in Alabama unless it is registered or the security or

444 17 C.F.R. § 230.147(c)(2) (1984).
445 *Id.*
446 *Id.*
447 *Id.*
448 17 C.F.R. § 230.147(d) (1984).
449 *Id.*
450 *Id.*
451 ALA. CODE §§ 8-6-1 to 95 (1975).

transaction is exempt under the law. The Act contains a number of exempt transactions, many of which are designed for special situations. There are three statutory exemptions potentially available to offers and sales of syndicate and limited partnership interests. Section 8-6-11(a)(1)[452] exempts any isolated non-issuer transaction, whether or not effected through a dealer. This exemption presumably is available only for transactions involving the offer and sale of securities to one or two investors by a nonissuer, and therefore, has limited application.

Alabama's statutory private placement exemption is found in section 8-6-11(a)(9)[453] and exempts any transaction pursuant to an offer directed to no more than ten persons in the state during any period of twelve consecutive months, whether the offer or any of the offerees is present in the state. This exemption permits offers, and not merely sales, to no more than ten persons, and for this reason has limited use.[454] For purposes of determining the number of offerees, banks, savings institutions, credit unions, trust companies, and investment companies are excluded.[455] The exemption provided by this section is available only if the seller reasonably believes that all purchasers are acquiring the securities for investment, and no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective investor.[456] The Alabama Securities Commission recently issued a rule under this section in which it interpreted the number of offerees requirement to mean no more than ten persons wherever located.[457]

Section 8-6-11(a)(9) authorizes the Alabama Securities Commission to promulgate a rule or order to withdraw or condition the private-placement exemption or to decrease or increase the number of offerees permitted. Pursuant to this authority, the Commission promulgated rule 830-X-6-.11,[458] which became effective on November 4, 1983. Rule

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452 ALA. CODE § 8-6-11(a)(1) (1975).

453 ALA. CODE § 8-6-11(a)(9) (1975).

454 By the very nature of this exemption, it is generally utilized only for relatively small offerings. In most cases the issuer has a fairly good idea who the purchasers of the securities will be. Once 10 offers have been made pursuant to this exemption, however, the offering must cease, unless another exemption is obtained.

455 ALA. CODE § 8-6-11(a)(9) (1975).

456 *Id.*

457 RULES OF ALA. SECS. COMM'N, Rule 830-X-6-.12 (adopted Dec. 1984).

458 RULES OF ALA. SECS. COMM'N, Rule 830-X-6-.11 (1983).

830-X-6-.11 provides that offers and sales of securities made in compliance with rules 501-503, 505 and 506 of Regulation D will be deemed an exempt transaction provided the following additional conditions are satisfied:

> (1) No commission, finders fee, or other remuneration is paid or given, directly or indirectly, to any person for soliciting any prospective purchaser in the state, unless such person is registered in the state;[459]
>
> (2) The issuer is not guilty of certain "bad boy" provisions set forth in rule 252 of Regulation A and the rule;[460]
>
> (3) An application for exemption on Form D is filed with the Commission along with a $150.00 filing fee no later than five full business days prior to the commencement of the offering in the state;[461]
>
> (4) A notice of sale on Form D is filed within thirty days after the completion of the offering;[462]
>
> (5) If not otherwise available, a consent to service of process must be filed with the initial application;[463]
>
> (6) Certain suitability standards with respect to the investors are satisfied.[464]

With respect to this last requirement, the rule provides that the issuer and persons acting on its behalf must have reasonable grounds to believe, and after making reasonable inquiry, must believe that the purchaser, whether accredited, either alone or with his purchaser representative, has such knowledge and experience in financial and business matters that he or they are capable of evaluating the merits and risks of the prospective investment.[465] In addition, with respect to sales to nonaccredited investors, the issuer and persons acting on its behalf must have reasonable grounds to believe, and after reasonable inquiry, must believe that the investment is suitable for the purchaser based upon the facts, if any, disclosed by the purchaser as to other security holdings, financial situation and needs.[466] The investment is deemed suitable for this purpose if the purchase price does

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459 RULES OF ALA. SECS. COMM'N, Rule 830-X-6-.11(1)(a)(1) (1983).
460 RULES OF ALA. SECS. COMM'N, Rule 830-X-6-.11(1)(a)(2) (1983).
461 RULES OF ALA. SECS. COMM'N, Rule 830-X-6-.11(1)(a)(3)(i) (1983).
462 RULES OF ALA. SECS. COMM'N, Rule 830-X-6-.11(1)(a)(3)(ii) (1983).
463 RULES OF ALA. SECS. COMM'N, Rule 830-X-6-.11(1)(a)(3)(v) (1983).
464 RULES OF ALA. SECS. COMM'N, Rule 830-X-6-.11(1)(a)(4) (1983).
465 RULES OF ALA. SECS. COMM'N, Rule 830-X-6-.11(1)(a)(4)(ii) and (5) (1983).
466 RULES OF ALA. SECS. COMM'N, Rule 830-X-6-.11(1)(a)(4)(i) (1983).

not exceed twenty percent of the investor's net worth, excluding principal residence, furnishings, and personal automobiles.[467]

The expanded private placement exemption adopted in rule 830-X-6-.11 by the Alabama Securities Commission corresponds directly to federal Regulation D with two exceptions. First, rule 504, which permits offers and sales of up to $500,000 of restricted securities to an unlimited number of purchasers, was not adopted in Alabama. Accordingly, offerings made pursuant to rule 504 will have to be registered in Alabama if sales will be made to more than thirty-five nonaccredited purchasers.[468] Second, all investors, whether accredited, must meet minimum suitability standards under Alabama's rule, whereas only the nonaccredited investors in a rule 506 offering must satisfy suitability standards under Regulation D.

VI. Conclusion

An investment in a Thoroughbred horse can be an excellent and rewarding tax shelter investment, providing taxable losses in early years and long-term capital gain in later years. Like any other investment, however, an investment in Thoroughbreds first should make sense from a business and economic standpoint. If the investment does not make good economic sense, then the likelihood of its success (i.e., generating profits at some point in the future) will be diminished substantially. The activity should be an equally good investment for the promoter and the investors. An activity that favors one over the other too heavily may be doomed from the start. In determining whether an investment in a Thoroughbred syndicate or limited partnership is a good investment, one should consider the background and experience of the general partner, manager, or both, the track record and ancestry of the horses, the impact of the tax and securities laws, and in the case of a limited partnership, the allocation of benefits between the general partner and the limited partner investors. Each of these factors is equally important. A "can't lose" investment which owns quality Thoroughbreds can turn into a bad investment if the legal and tax considerations are not handled properly. For exam-

467 *Id.*

468 Ala. Code § 8-6-3 (1975).

ple, a seemingly good investment in a Thoroughbred limited partnership can become unattractive if the projected tax benefits are not available or are deferred, such as from the application of sections 465 or 704(d), or if the partnership is characterized as an association. Likewise, a Thoroughbred limited partnership with excellent projected tax benefits is not necessarily a good investment unless it also offers expectation for profits at some point in the future, either from racing, breeding, or selling the horses. In this regard, a careful analysis of the particular horse or horses selected for syndication or ownership by a limited partnership should be undertaken. If the investment makes good business and economic sense, and the legal and tax considerations have been carefully reviewed, then the investor's decision centers on whether he likes the particular horse or horses involved. If the investor chooses to invest in a particular horse, then he can enjoy owning a part of a stallion or watching his Thoroughbred race at the track, and can also enjoy the favorable tax benefits allowed with respect to ownership of horses. Whether the Thoroughbred investment wins, places, or shows, then depends, as it should, on the Thoroughbred.