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**Applying I.R.C. Section 1033 to  
Involuntary Conversions of  
Thoroughbred Horses**

by

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# Applying I.R.C. Section 1033 to Involuntary Conversions of Thoroughbred Horses

BY BRUCE M. REYNOLDS\*

## INTRODUCTION

Generally a taxpayer is taxed on income when realized.<sup>1</sup> The tax is owed at the time the taxpayer receives cash or property from the disposition of an asset.<sup>2</sup> However, the Internal Revenue Code (Code) provides that gain need not be recognized on the disposal of certain property in certain circumstances.

The non-recognition of gain under section 1031 of the Code when one horse is disposed of in a "like-kind exchange" for another horse was explored by this author in a prior Article, *Tax-Free Exchanges of Interests in Thoroughbred Horses*.<sup>3</sup> This Article continues the examination of non-recognition provisions in relation to the equine industry by examining the application of section 1033 relating to involuntary conversions of horses.

Section 1033 provides that no gain will be recognized when property is "involuntarily converted" if the proceeds received by the taxpayer upon the conversion of the property are reinvested in similar or related property.<sup>4</sup> For example, if a taxpayer receives insurance proceeds upon the death of a broodmare killed by lightning and the proceeds are reinvested in another broodmare of equal value, no gain would be recognized and no tax would be immediately due. Non-recognition of gain from invol-

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<sup>1</sup> See Treas. Reg. § 1.61-1(a) (1969). "Gross income includes income *realized* in any form, whether in money, property or services. Income may be *realized*, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash." *Id.* (emphasis added).

<sup>2</sup> See generally R. SOMMERFELD, H. ANDERSON & H. BROCK, AN INTRODUCTION TO TAXATION §§ 5-8 to 5-9 (1977). The mere appreciation in value of an asset does not give rise to tax liability. Gain will be recognized only on exchange or sale. *Id.*

<sup>3</sup> Reynolds, 59 TAXES 547 (1981).

<sup>4</sup> I.R.C. § 1033(a)(2)(A) (1976, Supp. III 1979 & Supp. IV 1980). Nor will gain be recognized if the taxpayer uses proceeds to purchase stock in the acquisition or control of a corporation owning similar or related property. *See id.*

untarily conversion is particularly significant to thoroughbred horse owners because thoroughbred horses have recently appreciated tremendously in value. This appreciation, and the resulting tax consequences, require a taxpayer to consider the application of section 1033 upon the receipt of insurance proceeds from the involuntary conversion of the thoroughbred if the taxpayer plans to reinvest in another thoroughbred.

In determining whether to take advantage of the non-recognition provision, a horse owner must carefully consider many factors. One of the most important is cost recovery (depreciation). In the past, depreciation on horses was attractive due to horses' relatively short useful lives and their qualification for accelerated depreciation.<sup>5</sup> The depreciation of horses, like that of other property, is affected by the new Accelerated Cost Recovery System (ACRS) which was added to the Code in 1981.<sup>6</sup> Under ACRS, the tax benefits from the cost recovery of an investment in horses have become even more attractive in many instances. These tax benefits are important in analyzing the non-recognition provisions of the Code because the new horse takes the tax basis of the horse it has replaced when section 1033 applies to the disposition and replacement of horses.<sup>7</sup> Therefore, the taxpayer must decide if the immediate avoidance under section 1033 of taxable gain on the disposition, which may be largely taxed at capital gains rates,<sup>8</sup> is worth foregoing future cost recovery de-

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<sup>5</sup> Under the law as it existed before the effective date of the Economic Recovery Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981), if the original use of a horse began with a taxpayer and the horse had a useful life of three years or more, it qualified for the double declining balance method of depreciation. *See generally* Treas. Reg. § 1.167(b)-2 (1960). This normally would have only included a yearling or a weanling which had no prior use. If the horse had been previously used, the 150% declining balance method was the most rapid available method. *See generally id.* A horse used for racing was considered used property if it was later acquired and used for breeding purposes. Treas. Reg. § 1.167(c)-1(a)(2) (1960). Industry useful life guidelines were generally accepted for depreciation purposes and they set a maximum useful life of a thoroughbred participating in racing as six years (a one-year-old gelding) and a maximum useful life of ten years for breeding stock (a three-year-old stallion or broodmare). *See generally*, Presentation by Rex B. Potter, *Seminar: Accounting and Taxation in the Horse Industry* 4-6 (Oct. 6, 1981).

<sup>6</sup> *See* I.R.C. § 168 (West Supp. 1982).

<sup>7</sup> *See* I.R.C. § 1033(b) (1976, Supp. III 1979 & Supp. IV 1980).

<sup>8</sup> Thoroughbreds held for sporting or breeding purposes for 24 months will be treated as § 1231 property and therefore be subject, in part, to capital gains rates on disposition. Section 1245 also applies to dispositions and depreciation which may be recaptured. *See* I.R.C. § 1245(b)(4) (1976).

ductions from ordinary income.<sup>9</sup>

Other factors the taxpayer must consider in deciding whether to use section 1033 include the holding period of the horse to be disposed of, the cost recovery period of the thoroughbreds, the amount of depreciation recapture and the tax bracket of the taxpayer for current and future years. Clearly, the greater the after-tax value of the cost recovery deductions in the years immediately following the disposition, the easier it is to decide to forego the use of the non-recognition provisions.

### I. GENERAL CONSIDERATIONS

Section 1033 of the Code provides rules regarding non-recognition of gain upon the involuntary conversion of property.<sup>10</sup> The non-recognition treatment allowed by this section is elective so that a taxpayer has the option of choosing whether or not to recognize gain. Section 1033 applies when property is involuntarily converted as the result of destruction (in whole or in part), theft, seizure or condemnation.<sup>11</sup> Livestock (including horses) destroyed or sold because of disease are considered involuntarily converted.<sup>12</sup> When property is involuntarily converted, no gain

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<sup>9</sup> These considerations are illustrated by the following example:

A, a 50% taxpayer, owned a five-year-old broodmare, Bluebell, which was purchased for \$100,000, had a current basis of \$40,000 and was insured for \$500,000. Bluebell was killed by lightning, and A collected the full insurance proceeds. A used the proceeds to purchase another five-year-old broodmare, Snowdrop, which will be considered five-year property under the Accelerated Cost Recovery System in the hands of A. A is now considering whether to elect the application of the involuntary conversion provisions and thereby defer the gain on the death of Bluebell.

By electing the application of involuntary conversion provisions, A will avoid an immediate tax of \$110,000 that would have been recognized on Bluebell's death, but will have only a \$40,000 basis in Snowdrop that may be recovered in the following years. If A does not elect to defer the gain, he will owe tax in the amount of \$110,000, but Snowdrop will have a \$500,000 basis. However, the after-tax benefits of the higher cost recovery deductions on the higher basis will not exceed the tax immediately deferred (\$110,000), and the lower cost recovery deductions taken on the \$40,000 substituted basis until the third year. If A decides not to defer gain and thereby receives a \$500,000 basis in Snowdrop, the total cost recovery deductions over a five-year period will be worth \$250,000 in after-tax deductions. The taxpayer must decide if the \$110,000 avoided in immediate tax and therefore continued in the investment in other thoroughbreds, is more desirable than the future greater tax benefit of the cost recovery deductions.

<sup>10</sup> See text accompanying note 4 *supra* for a brief explanation of I.R.C. § 1033.

<sup>11</sup> I.R.C. § 1033(a) (1976).

<sup>12</sup> I.R.C. § 1033(d) (1976).

will be recognized if it is converted into similar or related property or if the proceeds received upon its conversion are reinvested in similar or related property within two years after the close of the taxable year in which any part of the gain upon conversion is realized.<sup>13</sup> If gain is not recognized, the newly acquired property assumes the tax basis of the involuntarily converted property.<sup>14</sup> Proceeds received on an involuntary conversion that are not reinvested in similar or related property are taxable.<sup>15</sup> The tax holding period of the converted property may be tacked onto that of the newly acquired property.<sup>16</sup>

Often it is difficult to apply the rules of section 1033 to thoroughbred horses because of the scarcity of authority regarding the involuntary conversion of animals. Most of the authority under section 1033 has developed regarding real property and often one must draw analogies to reach a conclusion as to animals.

## II. WHAT IS INVOLUNTARY CONVERSION?

Before the non-recognition provisions of section 1033 will apply, a determination must be made that property has been involuntarily converted.<sup>17</sup> In practice, the relevant determination is whether the event that results in the payment of insurance proceeds can be considered an involuntary conversion within the meaning of section 1033(a).

Numerous types of insurance policies are written on horses. The events that many of the policies insure against are clearly considered involuntary conversions. For example, proceeds collected upon the theft of a horse will certainly be deemed received upon its involuntary conversion. Likewise, when a horse dies because of accident or disease the proceeds received under a mortality policy will be covered under section 1033. However, the tax treatment of proceeds payable under other types of insurance is not as clear.

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<sup>13</sup> I.R.C. § 1033(a) (1976 & Supp. IV 1980).

<sup>14</sup> I.R.C. § 1033(b) (1976).

<sup>15</sup> I.R.C. § 1033(a)(2) (1976 & Supp. 1980).

<sup>16</sup> See I.R.C. § 1223(2) (1976).

<sup>17</sup> For a discussion of the Code's definition of involuntary conversion see notes 10 and 11 *supra* and accompanying text.

### A. Foal Insurance

Insurance may be obtained against loss resulting from a foal being born dead (as a result of being aborted, stillborn) or dying within a specified period after birth as a result of accident, illness or disease.<sup>18</sup> Normally, if a pregnant mare dies, the insurance will cover the loss of the unborn foal.

Foal insurance may be carried by a horse owner to guard, in part, against the loss of stud fees if a foal is not born alive or dies shortly after birth.<sup>19</sup> Normally, stud fees are deductible in the year of payment,<sup>20</sup> and, because of the eleven-month gestation period of horses, it is entirely possible that a stud fee may be paid and deducted in one year and insurance proceeds collected in the succeeding year when the foal is aborted, stillborn or dies within the specified period after birth set forth in the insurance policy. In such event, if the stud fee is not refundable, the question arises whether all or a portion of the insurance proceeds may be subject to the tax benefit rule.<sup>21</sup> Recently, a United States district court held in *Mager v. United States*,<sup>22</sup> that when a taxpayer received a payment for property for which a tax loss had been previously taken, the tax benefit rule caused the payment to be taxable even though the amount received on condemnation was reinvested in similar or related property within the meaning of section 1033.<sup>23</sup> In other words, the court determined that the tax benefit rule overrode the non-recognition provisions of section

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<sup>18</sup> See generally K. WOOD, LAW FOR THE HORSE BREEDER 9-7-1, at 5-1 to 5-28 (1981).

<sup>19</sup> Some contracts for the services of a stud do not guarantee impregnation or a live foal. Therefore, the fees are payable and non-refundable after the stud service without regard to whether the mare becomes impregnated or bears a live foal. Other stud services guarantee a live foal. These fees are payable after a mare becomes impregnated and are refundable if the mare does not bear a live foal.

<sup>20</sup> See Treas. Reg. § 1.162-12(a), T. D. 7198, 1972-2 C.B. 166-67 (1972).

<sup>21</sup> This rule, applied under I.R.C. § 337 regarding non-recognition of gain on the sale of corporate assets, requires income allocated to previously expensed property to be recognized by a corporation on the sale of such property, despite the section's non-recognition provisions. See *Commissioner v. Anders*, 414 F.2d 1283 (10th Cir. 1969), *rev'g* 48 T.C. 815 (1967). The tax benefit rule also has been applied to I.R.C. § 336. See *Tennessee Carolina Transp., Inc. v. Commissioner*, 65 T.C. 440 (1976), *aff'd*, 582 F.2d 378 (6th Cir. 1978).

<sup>22</sup> 499 F. Supp. 37 (M.D. Pa. 1980).

<sup>23</sup> *Id.* at 39.

1033. Although the opinion is somewhat deficient in relevant analysis,<sup>24</sup> it still is the only authority applying the tax benefit rule to section 1033, and a taxpayer must therefore consider it carefully.

However, to the extent that insurance proceeds collected exceed the amount of the stud fee previously deducted, there is authority indicating that the excess is entitled to reinvestment without taxation under section 1033. In *Bishop v. United States*,<sup>25</sup> chickens were sold as part of a sale and subsequent complete liquidation of a corporation under section 337. Because of the inventory method used to account for the chickens, a portion of their cost had already been deducted by the corporation prior to their sale. The portion of the sales price allocated to the chickens in the sale exceeded the sum of the chickens' remaining tax basis and the amount previously deducted under the inventory method.<sup>26</sup> The court held that under the tax benefit rule, the amount previously deducted must be realized in spite of the provisions of section 337.<sup>27</sup> However, the court treated the amount of the sales price allocated to the chickens in excess of their remaining basis and the amount previously deducted as being covered by section 337 and thus not taxable at the corporate level. The holding in *Bishop*, therefore, indicates that only an amount equal to previously deducted stud fees would be subject to taxation at the time of receipt of insurance proceeds even if the tax benefit rule properly applies to section 1033. This is important because foal insurance often exceeds the amount of the stud fee.<sup>28</sup>

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<sup>24</sup> The court in *Mager* said the logic used in *Commissioner v. Anders*, 414 F.2d at 1283, in which the Tenth Circuit Court of Appeals held that the tax benefit rule overrode the non-recognition provision of I.R.C. § 337, should apply to a case involving the non-recognition provision of § 1033. However, the *Mager* court failed to consider the dissimilar legislative purposes of the two sections—avoidance of double taxation under § 337 compared with the deferral of gain and loss as long as investment in the same type of property continues under § 1033. See S. REP. NO. 1622, 83d Cong., 2d Sess. 258 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. A106 (1954). The Tenth Circuit considered the legislative intent of § 337 to be central to its decision. However, even though the *Mager* court's failure to consider the different legislative intent behind § 1033 makes its precedential value questionable, the decision is still important because it is the only decision applying the tax benefit rule to § 1033.

<sup>25</sup> 324 F. Supp. 1105 (M.D. Ga. 1971).

<sup>26</sup> *Id.* at 1106-07.

<sup>27</sup> *Id.* at 1111.

<sup>28</sup> The amount of the foal insurance is generally determined by combining the

## B. *Accident, Disease and Sickness*

It is possible to insure against a horse being unable to continue racing or breeding because of accident, disease or sickness. It also is possible to get insurance to protect against a horse being unable to *commence* a breeding career due to these causes. Such insurance is designed to cover the situation where an accident, disease or sickness may not be so severe as to require the humane destruction of a horse (covered by mortality insurance), but does practically impair future racing or breeding of the horse.

A taxpayer receiving such insurance proceeds must ask whether the event causing the payment of the proceeds constitutes an involuntary conversion. In determining whether the event making the proceeds payable constitutes an involuntary conversion, it is helpful to consider proceeds payable because of accidents separately from those payable because of sickness and disease.

### 1. *Accident*

Insurance for accident, disease and sickness covers, in part, against an accidental injury preventing a horse from either racing or breeding. The obvious question is whether accidental injury not resulting in death can be considered involuntary conversion for tax purposes. Section 1033(a) defines an involuntary conversion, among other circumstances, as "destruction . . . in part."<sup>29</sup> Can an accidental injury that does not terminate the life of a horse be considered "destruction in part"? The available authority indicates yes.

In *C.G. Willis, Inc. v. Commissioner*,<sup>30</sup> the Tax Court considered whether a ship used as a transport freighter and damaged in a collision but repairable, had suffered "destruction in part." After the collision, the ship owner was faced with the choice of making major repairs and keeping the ship or making minor repairs and selling the ship "as is, where is." The taxpayer, believing the ship would never be as seaworthy as it was before the col-

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amount of the stud fee together with an estimate of the actual economic depreciation of the mare for the lost breeding year.

<sup>29</sup> I.R.C. § 1033(a) (1976 & Supp. IV 1980).

<sup>30</sup> 41 T.C. 468 (1964).



lision, decided to sell it. Before the ship was sold, the taxpayer collected \$100,000 in insurance proceeds which reduced the ship's tax basis to approximately \$8,000. The sale brought \$100,000 in proceeds. The issue confronting the Tax Court was whether the sale proceeds were subject to reinvestment without taxation under section 1033. The Tax Court ruled that the sale proceeds were not subject to reinvestment.<sup>31</sup> However, in considering the issue, the Tax Court said that the repairable damage qualified as "destruction in part" for purposes of section 1033.<sup>32</sup>

In Revenue Ruling 72-433,<sup>33</sup> the Internal Revenue Service (IRS or Service) applied the rules of section 1033 to the loss of property due to a flood easement. In the facts of the ruling, the government obtained a perpetual overflow easement that gave it the right to flood the taxpayer's farm when necessary as part of a flood control project. The taxpayer retained title to the land and could continue to plant and harvest crops, but he could have no buildings on the land. It was estimated that flooding would occur only once every six years. The taxpayer used the proceeds from the easement to pay for other farm land.

Although the ruling did not involve the definition of "destruction in part," it did apply section 1033 to a situation where the taxpayer continued to retain and use the property after collecting the condemnation proceeds. In so doing the Service specifically modified a prior ruling's statement that the application of section 1033 is "limited to a situation in which the taxpayer is deprived of practically all his beneficial rights in property."<sup>34</sup> In other words, the Service recognized that section 1033 will apply when damage to property is serious enough to impair its value and use, even though the property may continue to have some usefulness to the taxpayer.

Thus, when applied to horses, it appears reasonable to conclude that damage serious enough to terminate either a breeding or racing career will be sufficient to constitute "destruction in

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<sup>31</sup> *Id.* at 476.

<sup>32</sup> *See id.* at 474. "There was an involuntary conversion here in that there was an 'impact' destruction of the property." *Id.*

<sup>33</sup> 1972-2 C.B. 470.

<sup>34</sup> *Id.* at 471 (modifying Revenue Ruling 54-575).

part.”<sup>35</sup> The holdings and the language of the various authorities discussed so far indicate that condemnation proceeds collected by a taxpayer may be reinvested under section 1033 without recognition of gain even though the taxpayer continues to hold title to the property and the property continues to have a residual value to the taxpayer. As applied to the ownership of horses, the authorities indicate that section 1033 should apply to insurance proceeds collected on the termination of a horse's racing career even though the taxpayer may use the horse for breeding purposes later. However, one must bear in mind that there is an apparent limit to the application of section 1033 in this area.

This limit was demonstrated by the Tax Court's holding in *Willis*. Although the court in *Willis* held that proceeds received from the sale of a severely damaged ship were not subject to reinvestment under section 1033,<sup>36</sup> it noted that “[t]he wording of the statute makes it plain that [the statute] does not include conversion or sale of property where the owner had a choice of keeping the property, or converting it or selling it.”<sup>37</sup> Accordingly, the court held that section 1033 will not apply to sale proceeds on the disposition of property where the taxpayer has the option of keeping the property and using it or selling it. Therefore, under the *Willis* decision it appears that the fact that a race horse may have future breeding value will not necessarily subject *insurance* proceeds to tax under section 1033, but *sale* proceeds from the later sale of the injured animal held for breeding purposes will be taxable since section 1033 will not apply.

## 2. *Sickness and Disease*

Many thoroughbred insurance policies, as part of their usual horse insurance package, also provide benefits if a horse is unable to commence or continue either a racing or breeding career be-

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<sup>35</sup> See *Marcalus Mfg. Co. v. Commissioner*, 30 T.C. 1345 (1958), *aff'd per curiam*, *sub nom* *Marcal Pulp & Paper, Inc. v. Commissioner*, 268 F.2d 739 (3d Cir. 1959), for another example of what is considered “partially destroyed.” See also *Isabelle Krome*, 19 T.C.M. (P-H) ¶ 50,063 (1950) for a case demonstrating how substantial the damages must be to constitute “destruction in part.”

<sup>36</sup> See text accompanying notes 30-32 *supra* for a brief summary of the facts of *Willis*.

<sup>37</sup> 41 T.C. at 474.

cause of disease or sickness. The statute makes it clear that the taxpayer must show both that the horse was diseased within the meaning of section 1033(d) and that the horse was sold or exchanged because of such disease.

The term "disease" as used in section 1033(d) has been defined in several instances and appears to be broadly interpreted. The IRS in Revenue Ruling 61-216<sup>38</sup> ruled that the disease does not have to be of epidemic proportion to qualify as "disease" under section 1033(d). Revenue Ruling 54-395,<sup>39</sup> held that illness from contaminated feed pellets was a "disease." A similar result was reached in Revenue Ruling 75-381 in regard to bees killed by pesticides.<sup>40</sup> On the other hand, in Revenue Ruling 59-174,<sup>41</sup> dwarfism in cattle was not considered a disease within the meaning of section 1033(d) where it developed from a dwarf gene in the cattle. As the holdings in the above rulings indicate, the definition of "disease" appears broad and would cover illness due not only to bacteriological causes but also to chemical causes. However, as indicated by Revenue Ruling 59-174, not every abnormality will be considered a "disease."

Once a taxpayer demonstrates that the proceeds of the insurance are collected because of disease within the meaning of section 1033(d), the taxpayer must sell the diseased animal and show that the sale was a result of the disease. Treasury Regulation section 1.1033(d)-1(a) states these requirements as follows: "Livestock which are sold or exchanged because they are diseased or have been exposed to disease, *and* would not otherwise have been sold or exchanged at that particular time shall be considered sold or exchanged because of disease."<sup>42</sup>

Applying this regulation to diseased horses can often be difficult. The difficulty arises from the fact that section 1033(d) apparently was not enacted with thoroughbred horses in mind. Rather, the statute contemplates the distress sale of livestock held

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<sup>38</sup> 1961-2 C.B. 134. "Losses due to the death of livestock from disease, whether or not of epidemic proportions, come within the provisions of section 1033(3) . . . and will be treated as resulting from involuntary conversion under section 1231(a) . . ." *Id.*

<sup>39</sup> 1954-2 C.B. 143, *modified*, Rev. Rul. 59-102, 1959-1 C.B. 200.

<sup>40</sup> 1975-2 C.B. 25, 26-27.

<sup>41</sup> 1959-1 C.B. 203.

<sup>42</sup> Treas. Reg. § 1033(d)-1(a) (1960) (emphasis added).

for sale as food and does not contemplate the sale of a diseased horse with a potential residual value as a breeding animal.<sup>43</sup> For example, if a horse, because of disease, cannot continue racing but could commence a breeding career is sold for that purpose, it appears that at least one of the tests set forth in the regulations may not be satisfied. Although the horse's racing career may be terminated because of the disease at that particular time, it may be difficult to prove that the horse was sold because of the disease. The regulation apparently contemplates a sale taking place so that the diseased animal may be slaughtered and does not contemplate the sale of a diseased animal that may have a continuing useful purpose.

### 3. *Loss of Property*

Even if it can be established that a horse has been involuntarily converted within the meaning of section 1033, a taxpayer may have an additional burden of showing the nature of the loss for which the insurance proceeds are payable. Insurance policies covering accident, disease and sickness generally are written so that the loss of use of the animal is being insured against instead of the loss of the animal itself. If a policy insures against loss of use of a horse, certain problems arise. One problem occurs if the loss of use of the horse is defined in terms of lost profits. Insurance proceeds for lost profits are not subject to reinvestment without taxation under section 1033.<sup>44</sup> In addition, a revenue ruling, discussed later, creates doubt whether proceeds payable for loss of use of property are subject to reinvestment even if such loss of use is not defined in terms of lost profits.<sup>45</sup>

In considering the application of section 1033 to accident, disease and sickness insurance, one must begin by reviewing the actual terms of an insurance policy to determine the actual loss

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<sup>43</sup> The legislative history of section 1033(d) is not helpful in interpreting legislative intent. See Conference Report accompanying H.R. No. 2543, 83d Cong., 2d Sess. (1954), reprinted in 1954 U.S. CODE CONG. & AD. NEWS 5330.

<sup>44</sup> Any payment for lost profits must be taxed as income under I.R.C. § 61 (1976). See also text accompanying notes 46-60 *infra* for a discussion of when insurance proceeds are considered payment for lost profit.

<sup>45</sup> See text accompanying note 61 *infra* for a discussion of Revenue Ruling 74-444.

for which the insurance is being paid. It is helpful to know that several cases have established rules as to which insurance policy terms are fatal to the proceeds being subject to reinvestment without taxation under section 1033.

In *Miller v. Hocking Glass Company*,<sup>46</sup> the United States Court of Appeals for the Sixth Circuit considered whether certain proceeds payable under a policy were subject to reinvestment under section 203(b)(5) of the Revenue Act of 1924, a predecessor of section 1033. The court concluded that they were *not*. In the case, the taxpayer, a manufacturer of glass, obtained fire insurance upon its buildings and equipment and also insurance "for the actual loss sustained consisting of net profits on the business" and for fixed charges and expenses, if the property was destroyed because of fire. "Net profits" were defined as the taxpayer's net profits for the prior year. A fire destroyed substantially all of the taxpayer's business, and the taxpayer used the proceeds of all insurance policies to buy new plant and equipment. The new plant was larger than the old and the production capacity was substantially increased.<sup>47</sup>

The taxpayer paid taxes on the proceeds and filed a claim for a refund. The district court held that the insurance proceeds were payable for the right to use and occupancy, a property right, and the proceeds had been reinvested in similar or related property so no gain need be recognized.<sup>48</sup> The court of appeals likewise held that the insurance on the property itself could be reinvested without tax liability; however, it reversed the lower court with regard to the proceeds paid for loss of net profits because the profits, if earned by the operation of the business, would have been subject to tax.<sup>49</sup> In reaching this result the court analyzed the insurance policy and said:

The insurers agreed to be liable for the actual loss sustained "consisting of net profits" measured by the profits of the preceding year. The purpose expressly stated was to insure anticipated earnings which might be interrupted by the destruction

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<sup>46</sup> 80 F.2d 436 (6th Cir. 1935), *rev'g* 5 F. Supp. 355 (S.D. Ohio 1933).

<sup>47</sup> 80 F.2d at 436-37.

<sup>48</sup> 5 F. Supp. at 358.

<sup>49</sup> 80 F.2d at 437.

of the plant, earnings to arise out of "the business which is thereby prevented."<sup>50</sup>

Therefore, the court in *Hocking Glass* clearly held that if the insurance policy expressly insures against lost profits the proceeds will not be subject to reinvestment without taxation under section 1033.

A different result was reached in *Williams Furniture Corporation*.<sup>51</sup> There, the Board of Tax Appeals held that certain insurance proceeds were for loss of use and occupancy and could be reinvested without recognition of gain under section 112(f) of the Revenue Acts of 1934 and 1936,<sup>52</sup> forerunners to section 1033. In *Williams* the taxpayer's plant and equipment were destroyed by fire. The taxpayer had two forms of insurance coverage—the standard fire insurance on the buildings, stock and machinery, and three use and occupancy insurance policies totalling \$200,000. All insurance proceeds were used to rebuild the plant and equipment.<sup>53</sup>

The taxpayer's first policy insured against loss of net profits and certain fixed expenses. The second policy had identical provisions. Both policies called for a per diem allocation of the coverage; however, both were later amended by an endorsement that removed the lost profits language and provided instead that the insurance was for use and occupancy of buildings. The third insurance policy from its inception was in the same form as the two amended policies.<sup>54</sup>

The Board of Tax Appeals held that the policies were not for lost profits but were "contract[s] to pay the insured a flat per diem allowance for the loss of use and occupancy of the property."<sup>55</sup> The Board was not bothered by the fact that two of the policies originally insured against lost profits and pointed to the fact that no financial statements were required before damages were paid. *Williams*, therefore, holds that if insurance is paid for loss

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<sup>50</sup> *Id.*

<sup>51</sup> 45 B. T. A. 928 (1941).

<sup>52</sup> *Id.* at 937.

<sup>53</sup> *Id.* at 929-35.

<sup>54</sup> *Id.* at 931-33.

<sup>55</sup> *Id.* at 936.

of use and not for lost profits, section 1033 will apply to allow the insurance proceeds to be reinvested without recognition of gain.

In *Shakertown Corp. v. Commissioner*,<sup>56</sup> the Sixth Circuit, faced with a case similar to both *Hocking Glass* and *Williams*, held for the taxpayer. The insurance policies in *Shakertown* called for a weekly per diem amount which would be decreased by the percentage of manufacturing output the insured could continue to maintain in spite of a fire. However, the weekly amount also would be limited to lost profits. The court did not find this limitation fatal to the taxpayer's position and noted that it was contained in the separate paragraph entitled "Conditions."<sup>57</sup> The court interpreted the overall policy to be for loss of use and not for lost profits.<sup>58</sup>

*Hocking Glass*, *Williams* and *Shakertown* provide excellent insight into what provisions in an insurance policy will incur recognition of gain on reinvested proceeds under section 1033. Although *Shakertown* demonstrates that certain lost profits provisions may be included despite a later determination that the insurance actually is for loss of use of property, it is clear that such language is troublesome and should not be included in the policy if possible. However, the actual terms of the insurance policy may not control if certain other facts are present.

The importance of facts, other than the provisions of the insurance policies, was demonstrated in *Marshall Foods, Inc. v. United States*.<sup>59</sup> The court, applying the principle of tax law that the substance of the transaction, rather than its form, determines its nature for tax purposes, held that a policy covering loss of use and providing for a flat per diem amount was actually for lost profits.<sup>60</sup> The following items of evidence apparently impressed the court: (1) other fire insurance was carried on the property so the court could not understand how the policy in issue could be for loss of use; (2) the only loss that could be insured against was a loss of profits; (3) correspondence justifying the amount of

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<sup>56</sup> 277 F.2d 625 (6th Cir. 1960).

<sup>57</sup> *Id.* at 629.

<sup>58</sup> *Id.* at 630.

<sup>59</sup> 393 F. Supp. 1097 (D. Minn. 1974), *aff'd per curiam*, 75-2 U.S. TAX CAS. ¶ 9536 (8th Cir. 1975).

<sup>60</sup> 393 F. Supp. at 1100.

coverage referred to gross earnings only; (4) the application forms referred to loss of profits, and (5) the taxpayer admitted that lost profits were the basis for arriving at the amount of coverage. Thus, the *Marshall Foods* case cautions that, in considering the application of section 1033 to accident, disease and sickness insurance, one must be careful to review more than the terms of the policies. The economic basis for the insurance, the insurance applications and the other documents may assume paramount importance.

The case law in this area is important in helping a taxpayer plan. It is clear from the cases that certain policy language should be avoided. In addition, a taxpayer must be careful not to act in such a way as to cause an insurance policy to be construed to be for lost profits in spite of the express language of the policy itself. Nevertheless, in spite of all of the guidance provided in the case law, there is now concern that proceeds from such policies cannot escape recognition under section 1033 even if the proceeds are deemed payable for loss of use and not for lost profits.

In Revenue Ruling 74-444,<sup>61</sup> the IRS ruled that proceeds paid under a "loss of use and occupancy" policy were not entitled to treatment as long term capital gain under section 1231 because the insurance was not for the loss of property, but instead was for the loss of use of property.<sup>62</sup> The ruling relied on language in *Commissioner v. Gillette Motor Transp., Inc.*,<sup>63</sup> stating that use of property was not considered section 1231 property.<sup>64</sup> Because the language in the case relied on is so broad and the holding is that of the United States Supreme Court, there is concern about the impact of the case on other sections of the Code. If the *Gillette Motor* holding applies to section 1033, only insurance proceeds paid for the loss of property itself would qualify for tax-free reinvestment under section 1033. This would reverse the substantial body of law holding that insurance proceeds for loss of use of property are subject to reinvestment under section 1033.

It may be noted that there is only one case on point as to whether insurance proceeds collected for loss of use of property may

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<sup>61</sup> 1974-2 C.B. 271.

<sup>62</sup> *Id.* at 272.

<sup>63</sup> 364 U.S. 130 (1960), *rev'g* 256 F.2d 648 (5th Cir. 1959).

<sup>64</sup> 364 U.S. at 135.



be deemed to be for lost "property" within the meaning of section 1033. As mentioned above, the district court in *Hocking Glass* ruled that loss of use was loss of property for purposes of section 1033. The court stated:

In the first place, the right to the use and occupancy is property, or rather a property right. Whether it is to be classified as tangible or intangible, corporeal or uncorporeal, is perhaps not so important in this case. The conclusion that it is property, or a property right, cannot be gainsaid, in view of the manifest intention of the contracting parties. Without doubt, they so considered it. The contracts insure "against all direct loss or damage by fire \* \* \*, on the use and occupancy of its (property)."<sup>65</sup>

Although the lower court's language is forceful, it must be remembered that the lower court in *Hocking Glass* was reversed on other grounds. That fact, along with the fear that the language from *Gillette Motor* may have broad application, creates great uncertainty as to whether accident, disease and sickness insurance which is actually for loss of use of property can be subject to section 1033.

### C. *Fertility Insurance*

Fertility insurance is obtained by an owner of a horse or the owner of an interest in a horse against the horse being infertile, regardless of cause. The policy covers a particular breeding year, and infertility is based upon the inability of the stallion to get a certain percentage of the mares he services in foal during the year.<sup>66</sup> Proceeds are payable if the horse does not meet the required percentage. If the stallion does not meet the required percentage of mares he services, the owner has the option of holding onto the interest in the horse and asserting no claim or collecting under the policy. However, if a claim is asserted, the underwriter has the option to take title to the insured's interest in the horse upon payments under the policy.

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<sup>65</sup> 5 F. Supp. at 357.

<sup>66</sup> The current required percentage of mares in foal is 60% .

In analyzing whether payments under a fertility policy qualify for reinvestment without recognition of gain under section 1033 of the Code, many of the considerations applicable to payments under accident, disease and sickness insurance are relevant. If a horse is infertile due to accidental injury, it appears that the proceeds payable under the fertility policy would be subject to tax-free reinvestment under section 1033. As in the case of payment under an accident, disease and sickness policy, accidental injury rendering a horse infertile would appear to qualify as "destruction in part."<sup>67</sup> In addition, it would seem more difficult for the Service to characterize the payment under a fertility insurance policy to be either for lost profits or for loss of use of property. Under fertility policies, the underwriters actually have the option of taking title to the horse when payments are made. Thus, a fertility policy would seem to be more like a policy for loss of property rather than for loss of use, and proceeds payable under a fertility policy could more readily avoid adverse tax treatment than proceeds from an accident, disease and sickness policy.<sup>68</sup>

If infertility is the result of disease as that term is used in section 1033(d),<sup>69</sup> the proceeds would appear to qualify for reinvestment without gain recognition under section 1033. However, the animal must be sold as a result of the disease. This is not a problem if the insurance underwriter elects to take title to the horse upon payment of the insurance proceeds. On the other hand, if the horse is not taken by the underwriter, the necessity of selling the horse may present practical problems.<sup>70</sup>

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<sup>67</sup> See text accompanying notes 29-37 *supra* for a thorough discussion of reinvestment under I.R.C. § 1033 of accident, disease and sickness insurance proceeds received due to injury.

<sup>68</sup> This same observation applies where fertility insurance proceeds are payable because of sickness or disease.

<sup>69</sup> See text accompanying notes 38-41 *supra* for a discussion of revenue rulings interpreting the term "disease" as it is found in § 1033(d). Infertility caused by a genetic deficiency apparently would not qualify as a disease. See Rev. Rul. 59-174, 1959-1 C.B. 203 (dwarfism in cattle resulting from dwarf gene not considered a disease).

<sup>70</sup> Selling a well-known stallion merely for a tax advantage may very well result in bad publicity.

### III. WHAT IS SIMILAR OR RELATED PROPERTY?

Section 1033 requires the proceeds from converted property to be reinvested in "other property similar or related in service or use to the property so converted."<sup>71</sup> It is often difficult to determine what constitutes similar or related property in a given instance. Treasury Regulations are of little use. They only define such property by what it is not and give few examples: unimproved and improved real estate are not similar; the use of proceeds from conversion of real property to reduce debt on a previously purchased leasehold is not similar, and a tug boat and barges are not similar.<sup>72</sup> Although the regulations are not informative, they do indicate that similar or related property is defined much more narrowly than "like kind" property.<sup>73</sup>

Case law and revenue rulings have developed basic principles for determining whether property is similar or related in use or service. One must determine if the character of the service or use of the property is replaced.<sup>74</sup> Exact duplication is not required.<sup>75</sup> Replacement property can be of a different size, specification or capacity,<sup>76</sup> and several pieces of property may replace a larger piece.<sup>77</sup>

In determining what is similar or related property, the owner of the property must determine whether he or she is an investor or an owner-user of both the converted property and the replacement property. If a person holds property as an investor, the replacement property must be held as such for it to qualify as similar or related property. The same is true for property the owner holds as an owner-user. Separate legal tests are used to determine what is similar or related property for investors and owner-users. Thus, investors use the "same general class test," and owner-users apply the "functional use test."<sup>78</sup>

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<sup>71</sup> I.R.C. § 1033(a)(2) (Supp. IV 1980).

<sup>72</sup> Treas. Reg. § 1.1033(a)-2(c)(9) (1960).

<sup>73</sup> See Reynolds, *supra* note 3, for a discussion of non-recognition of "like-kind" exchanges.

<sup>74</sup> See *Washington Market Co. v. Commissioner*, 25 B.T.A. 576 (1932).

<sup>75</sup> 3 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 20,171 (1981).

<sup>76</sup> *Id.*

<sup>77</sup> See *Wilmore S.S. Co. v. Commissioner*, 78 F.2d 667 (2d Cir. 1935).

<sup>78</sup> For a discussion of both tests, see text accompanying notes 82-97 *infra*.

### A. *Investor v. Owner-User*

Revenue Ruling 70-399<sup>79</sup> provides factors to consider in determining whether a person is an investor or owner-user of a particular piece of property. In the ruling, a taxpayer owned a resort hotel which was leased to and operated by another taxpayer under a net lease agreement. The hotel was destroyed by fire and the taxpayer used the insurance proceeds to buy a new resort hotel. Instead of leasing the property, however, he operated it himself. In ruling that the reinvestment was not in similar or related property, the Service noted that the net lease on the first hotel required no management or services to be given to the hotel guests by the lessor. The income was therefore passive. It also noted a substantial difference in business risk between leasing and operating a hotel. A lessor under a net lease has a fixed return with none of the risks associated with economic fluctuations and liability to guests, while the opposite is true for the hotel operator.<sup>80</sup>

These factors can aid taxpayers who are deciding whether they are owner-users or investors. However, the factors are enumerated in terms of real property ownership and may be somewhat less applicable to horse ownership. The only clear situation for a horse owner is when the owner leases a horse for a flat rental. For example, if a broodmare is leased under a net lease for a fixed return, the taxpayer would be an investor under the factors set forth in Revenue Ruling 70-399. The taxpayer would not be involved in the control or management of the horse, except as a lessor, and would not have the financial risk associated with the economic fluctuations of breeding the mare.

On the other hand, even under certain horse leases, it is possible to have rental payments tied to the profits of a horse. For example, the lease on a race horse could call for payments based upon the earnings of the horse. A leased mare could have rental payments based upon the sale price of the mare's foals. In such cases, the factors stated in Revenue Ruling 70-399 would not clarify whether the taxpayer would be an investor or owner-user because the return to the taxpayer would vary with the profit-

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<sup>79</sup> 1970-2 C.B. 164.

<sup>80</sup> *Id.* at 165.

ability of the use of the horse. Although valid real property leases often have provisions calling for variable rent based upon the economic success of the lessee, it is unclear what effect such provisions would have under the rationale of Revenue Ruling 70-399.

Characterization of an owner as an investor or an owner-user may be especially important in regard to stallion shares. Although there are incentives for a syndicator to sell stallion shares only to users,<sup>81</sup> a person might purchase a stallion share for investment purposes only. For example, one purchasing a share could have the syndicate manager sell the season due that share each year. In such a case, the taxpayer would not be using an interest in the horse and would not be involved in the management of the horse. Likewise, the share owner would not have the same financial risk that an owner-user would have and would probably be deemed an investor. The owner of a share might be both an investor and an owner-user (a user of the share for some years and an investor other years). Such a change of share use would be important because, as Revenue Ruling 70-399 emphasizes, one who is an investor in regard to the replacement property must have been an investor as to the converted property. In such cases, it may be difficult for owners to determine if they are investors or owner-users at any given time.

## B. "Same General Class" v. "Functional Use" Tests

If the owner is an investor, the "same general class test" will apply in determining whether replacement property is similar or related to the converted property. If the owner is an owner-user the "functional use test" will apply.

### 1. *Same General Class Test*

In Revenue Ruling 64-237,<sup>82</sup> the IRS announced that it would apply the "same general class" test to determine if investors had

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<sup>81</sup> Under applicable securities law a sale of a stallion share to one other than an owner-user may result in the share being deemed a "security."

<sup>82</sup> 1964-2 C.B. 319.

reinvested in similar or related property. The Service described the test as follows:

In applying this test, a determination will be made as to whether the properties are of a similar service to the taxpayer, the nature of the business risks connected with the properties, and what such properties demand of the taxpayer in the way of management, services and relations to his tenants . . . [T]he Service will continue to adhere to the functional test in the case of owner-users of property.<sup>83</sup>

As stated by the ruling, the same general class test will focus on the taxpayer's relationships to the property itself and the property's actual users. The test will not focus on the actual use of the property. In applying this test to investors in horses, attention must be directed to the form of ownership, the legal relationship the owner has with the users of the horse, the method of calculating the return on the owner's investment, the business risk and any management duties of the owner in order to assure their similarity before and after the conversion.

## 2. *Functional Use Test*

Whereas the same general class test focuses on the taxpayer's relationship to the property and its users and ignores its actual use, the "functional use" test concentrates on the actual physical use of the property.<sup>84</sup> This test considers the service or use the property was designed to afford and the actual physical characteristics of the property.<sup>85</sup> It has been used to hold the following

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<sup>83</sup> *Id.* at 320. The Service gave the example of a lessor who rented out the converted property as a light manufacturing plant and the replacement property as a wholesale grocery warehouse. The court noted that "the nature of the taxpayer-owner's service or use of the properties may be similar although that of the end users may change [in the case of investors under the 'same general class' test]." Thus, as long as both properties are rented and are similar in the "extent and type of . . . management activities, the amount and kind of services [to the tenants], and the nature of his business risks connected with the properties" the converted and replacement properties satisfy the "same general class" test.

On the contrary, in the example, if the taxpayer is subject to the "functional use test," then, according to the Service, by changing the use from a light manufacturing plant to a wholesale grocery warehouse "he has so changed the nature of his relationship to the property as to be outside the nonrecognition of gain provisions." *Id.*

<sup>84</sup> 3 J. MERTENS, *supra* note 75, at § 20.171.

<sup>85</sup> *Id.*

examples to be dissimilar: a car wash and a printing company;<sup>86</sup> a billiard center and bowling center;<sup>87</sup> a mobile home park and motel;<sup>88</sup> and a land-based seafood processing plant and a ship used as a seafood processing plant.<sup>89</sup> Conversely, the test has been used to hold the property in the following examples to be similar or related: two buildings replacing one building, all with the same purpose;<sup>90</sup> a farm with one rental residence and a farm with one rental and one personal residence;<sup>91</sup> and farm land for growing crops and farm land for raising cattle and growing fruit.<sup>92</sup>

In applying the functional use test to thoroughbred horses, those held for different purposes will not be considered to have similar or related uses.<sup>93</sup> For example, a racing animal will not be considered as similar or related property to either a breeding animal or an animal held for sale. Likewise, a breeding animal will not be considered similar or related to animals held for sale. Therefore, an *owner-user* of a thoroughbred must always replace a converted animal with an animal held for the same purpose.

Although replacing property with property held for the same purpose should not normally present a problem, one must bear in mind that the ultimate purpose for which property is held will determine its purpose under section 1033. For example, in *S.H. Kress and Co. v. Commissioner*,<sup>94</sup> the Tax Court ruled that where property was held for a future store building site, its actual use as a parking lot in the meantime did not render it dissimilar to another store building site.<sup>95</sup> Likewise, in *William A. Scheuber*,<sup>96</sup> the Tax Court ruled that real property improved with shoddy and insignificant rental structures but held for future appreciation and sale was similar property to unimproved real estate held for sale even though the rental structures on the

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<sup>86</sup> Santucci, 42 T.C.M. (P-H) ¶ 73,178 (1973).

<sup>87</sup> 1976-2 C.B. 242.

<sup>88</sup> Rev. Rul. 76-390, 1976-2 C.B. 243.

<sup>89</sup> Rev. Rul. 77-192, 1977-1 C.B. 249.

<sup>90</sup> Cotton Concentration Co., 4 B.T.A. 121 (1926).

<sup>91</sup> Rev. Rul. 54-569, 1954-2 C.B. 144.

<sup>92</sup> SENATE FIN. COMM. REP. NO. 1052, 82d Cong., 1st Sess. (1951).

<sup>93</sup> I.R.S. Field Release No. 121.

<sup>94</sup> 40 T.C. 142 (1963).

<sup>95</sup> *Id.* at 154.

<sup>96</sup> 35 T.C.M. (P-H) ¶ 66,107 (1966).

improved property were rented in the meantime.<sup>97</sup>

Determining the ultimate purpose for any horse may be difficult. Race horses are often purchased with an eye to eventual conversion to a breeding career. Other race horses are purchased by potential syndicators for the purpose of syndication and sale. Some yearlings may be held for sale while other yearlings are held for racing. Because of the ultimate purpose rule, a taxpayer seeking to invoke section 1033 must be careful in establishing both the ultimate purpose of the converted horse and the ultimate purpose of the replacement horse.

### C. *Opposite Sex*

Section 1031 governing "like kind" exchanges, contains a statutory provision that requires livestock to be of the same sex to be eligible for non-recognition.<sup>98</sup> Section 1033 does not contain such a requirement. Nevertheless, the Service has taken the position in a private letter ruling that breeding cattle of opposite sexes are not similar or related property when held by owner-users.<sup>99</sup> The ruling applied the functional use test, stating:

Although bulls and cows may both be viewed as being used for breeding purposes, the specific function of bulls and cows in the breeding process are sufficiently dissimilar as to cause us to view the end uses made of each sex as dissimilar. Once impregnated, the role of the cow in the breeding process is essentially a completely passive one, i.e., to carry the unborn calf over the gestation period. On the other hand, the bull maintains an active role in the process as it is continuously used to impregnate other cows. Because a bull is not connected with only one gestating calf during the gestation period, as in the case of the cow, few bulls are needed in a breeding herd while many cows are required.<sup>100</sup>

Although the rationale of the letter ruling would surely apply to horses, one must bear in mind its specific facts.

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<sup>97</sup> *Id.* at 66-635.

<sup>98</sup> I.R.C. § 1031(3) (1976). For a discussion of the non-recognition of income on like kind exchanges, see Reynolds, *supra* note 3.

<sup>99</sup> I.R.S. Letter Ruling No. 7903064 (Oct. 18, 1979).

<sup>100</sup> *Id.*



For example, if A is an investor in regard to thoroughbreds and therefore the same general class test is applied to A's horses, an entirely different conclusion may be reached. In such a case, the basis of A's economic return, the legal relationship to the user of the animal and A's control and management of the horse would be considered. If these factors are similar in regard to the converted horse and the replacement horse, the sex of the horses used for breeding should not be a factor.

Likewise, if the horse is an animal that is racing or training to race the sex of the animal would not appear to be an important factor. Sex does not dictate a dissimilarity of the specific functions of racing colts and fillies. Rather, colts and fillies are basically trained and raced in the same way, and any differences would seem unimportant. Duplication of the converted property is not required. However, once again the taxpayer must be aware that the ultimate purpose for which an animal is held is the real test. If breeding is the ultimate purpose for which a horse is held then the sex of the animal will be important.

#### D. *Yearlings and Weanlings*

Although property held for sale cannot be considered like kind property under section 1031,<sup>101</sup> no such prohibition applies under section 1033.<sup>102</sup> Therefore, an animal held for sale may be converted and replaced by another horse held for sale. Because horses held for sale have the same basic functions regardless of sex, the sex of the replacement horse should not be a factor. Difficulties arise in proving the purpose for which a particular converted horse is held. For example, if a taxpayer generally sells yearlings and a particular yearling is killed, difficulty arises when a replacement is acquired with an intent to race it. Since horses held for sale will not be similar or related property to horses held for racing, the taxpayer must show that the dead

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<sup>101</sup> For a discussion of property qualifying as like-kind property, see Reynolds, *supra* note 3.

<sup>102</sup> Section 1031 requires that for property to be "like-kind," it must be held for either business or investment purposes. There is no such requirement for similar property under § 1033.

horse was held for the purpose of racing and not for purposes of sale.

## E. *Specific Situations*

### 1. *Syndicate Shares*

The owner of an insured syndicate share must determine what type of property in which insurance proceeds must be reinvested to qualify under section 1033. Clearly, another stallion share would be most like a converted stallion share. However, one who was an owner-user of the first share must continue to be an owner-user of the replacement share. Conversely, one who was an investor in the first share should continue to be an investor as to the second share. These determinations, of course, must be made by every owner-user or investor regardless of the type of property involved.

An additional set of pitfalls apply to certain horse syndicates. These problems develop from the fact that a particular horse syndicate may be deemed a partnership under both local law and tax law. If a syndicate is deemed a partnership, recent case law indicates that the election to reinvest proceeds from an involuntary conversion of a stallion must be made by the syndicate itself (the partnership) and not by the shareholder (the partner).<sup>103</sup> This requirement causes obvious problems when the insurance proceeds have been collected by the shareholder. If the syndicate shareholder contributes the proceeds to the partnership for its reinvestment, a question would arise as to whether the proceeds would be deemed conversion proceeds in the hands of the syndicate (partnership) since the proceeds were originally paid to the shareholder. A strong argument could be made that the proceeds constituted a capital contribution to the syndicate and not a payment of proceeds from an involuntary conversion.

If the shareholder tries to reinvest the proceeds alone, by the purchase of a new syndicate share, there are additional prob-

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<sup>103</sup> See *Demirjian v. Commissioner*, 54 T.C. 1691 (1970), *aff'd* 457 F.2d 1 (3d Cir. 1972) in which condemnation proceeds received and reinvested by partners acting as individuals did not qualify for non-recognition under § 1033. Only the partnership as former owner could take advantage of the condemned property non-recognition provisions.

lems. In light of recent authority indicating that reinvestment must be made by a partnership when partnership property has been involuntarily converted, one may be forced to argue that the shareholder's partnership interest (syndicate share) has actually been converted. Because the stallion itself will have been actually converted and the shareholder only owns an interest in a partnership that owns a horse, the shareholder may face problems in making this argument.<sup>104</sup>

In light of all these problems, it is important for it to be established that at the time of conversion the shareholder owned an undivided fractional interest in a thoroughbred instead of a partnership interest. However, establishing that the syndicate is not a partnership may be difficult. Although horse syndicates generally elect against partnership treatment pursuant to the provisions of section 761, there is some question of the effectiveness of that election for purposes of making a reinvestment under section 1033.<sup>105</sup> In addition, many syndicates, in spite of an election under section 761, may be deemed to be a partnership due to invalidity of the election. An election under section 761 is valid only if the entity is formed for one of the following purposes:

- (1) for investment purposes only and not for the active conduct of a business, or
- (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or
- (3) by dealers in securities for a short period for the purpose of underwriting, selling or distributing a particular issue of securities.<sup>106</sup>

Although use of a horse by a breeding syndicate normally qualifies as "joint . . . use of property," and the syndicate there-

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<sup>104</sup> In Harmelink & Vignes, *Tax Aspects of Baseball Player Contracts and Planning Opportunities*, 59 TAXES 543, 543-45 (1981), the authors discuss the possible application of the involuntary conversion rules to baseball player contracts when the players die. The authors argue that, under a destruction of the "economic unit" theory, upon the death of the player a contract may be considered converted for purposes of § 1033. Although a contract for services differs substantially from a partnership owning property, it is possible that a shareholder could make a similar argument upon the death of a stallion owned by a syndicate that is deemed a partnership.

<sup>105</sup> See Whitaker, *Involuntary Conversions*, 33-6th TAX MGMT. A-30 (BNA) (1975).

<sup>106</sup> I.R.C. § 761(a) (1976 & Supp. IV 1980).

fore is eligible to elect out of partnership treatment, section 761 makes it clear that the election will not be effective if the syndicate sells services or property. Often syndicate agreements call for the sale of excess stallion seasons. If such sales are made, a section 761 election seems invalid. The result of an invalid election is that the syndicate will be deemed a partnership.

Finally, where it can be established that a shareholder's interest constitutes an undivided fractional interest in the horse and not a partnership interest, the shareholder must be careful that the new stallion share that is acquired does not constitute an interest in a partnership. An undivided interest in tangible personal property and a partnership interest will not be deemed similar property.<sup>107</sup> Therefore, a taxpayer should carefully review the tax status of both the old syndicate and the new.

## 2. *Proceeds Reinvested in a Thoroughbred Horse*

The question sometimes arises as to whether proceeds from a converted stallion share can be reinvested in outright purchase of a stallion. Because no authoritative answer exists to this question, one must approach such an investment cautiously.

Assuming all proper elections have been made, a syndicate share will be deemed an undivided interest in tangible personal property. The ownership of the stallion obviously will be total ownership of tangible personal property. The fact that an owner can increase an ownership interest from a partial interest in one horse to a total interest in another horse does not by itself cause a problem. The reverse situation, replacing a total interest with a partial interest, has qualified for section 1033 treatment. In Revenue Ruling 57-154,<sup>108</sup> a taxpayer was allowed to replace total ownership in a farm with a tenancy-in-common in a second farm.

One dissimilarity between the use of a stallion share and the use of a stallion may prove troublesome. An owner's use of and relationship to a stallion may be very different from that to a stallion share. One who owns a stallion has possession and complete

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<sup>107</sup> See Rev. Rul. 57-154, 1957-1 C.B. 262; Rev. Rul. 55-351, 1955-1 C.B. 343.

<sup>108</sup> 1957-1 C.B. 262.

control of management. Certain of the stallion's seasons may be sold to others, and the management and sales of seasons may even constitute a business. On the other hand, a syndicate member does not have possession of the stallion and generally has little voice, if any, in management. The syndicate share owner basically has a right to one free season per year which may be used or sold.

*Fred Maloof v. Commissioner*<sup>109</sup> provides guidance when stallion syndicate share owners reinvest in their own stallions. In *Maloof*, the taxpayer had been involved in importing, exporting and contracting for the manufacturing of linens and other goods in China in 1941. The business assets consisted largely of inventory upon which he sustained losses. He received compensation for his losses and established a manufacturing business producing the same sort of goods. The assets of the new business included a complete manufacturing plant in addition to inventory. The Tax Court, applying the functional use test, ruled that only the reinvestment in inventory constituted similar or related property.<sup>110</sup>

In so ruling, the court noted specifically that the taxpayer "replaced a business involving subcontracting most of the necessary labor over which apparently he exercised little control with one which he has an integrated and mechanized operation of his own."<sup>111</sup> In other words, the court found it important under the functional use test that the property in which the taxpayer reinvested required more management involvement. The same situation arises if a holder of a syndicate share reinvests in a stallion. The shareholder's duties and management responsibility will increase dramatically and such an increase could cause the property to be considered dissimilar under section 1033.

### 3. *Mares in Foal*

Difficult questions arise under section 1033 when a mare in foal dies. Insurance coverage may dictate the applicability of the non-recognition provision. When a mare and unborn foal are covered by separate insurance policies, logic would dictate that

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<sup>109</sup> 65 T.C. 263 (1975).

<sup>110</sup> *Id.* at 272.

<sup>111</sup> *Id.* at 271.

proceeds collected under the separate policies be reinvested in property that is similar to the property for which the insurance proceeds are paid. Therefore, proceeds paid for the dead broodmare would be reinvested in another broodmare and proceeds for the unborn foal would likewise be reinvested in property that is similar to the dead unborn foal. However, one cannot ignore the possible application of the rationale of *Greer v. United States*<sup>112</sup> to section 1033. In *Greer*, the Sixth Circuit refused to consider an unborn foal as property separate from its mother for purposes of section 1231 dealing with like-kind exchanges. If the *Greer* rationale applies to section 1033, a taxpayer may be required to reinvest collected insurance proceeds in another mare in foal to be sure the reinvestment is in property that is completely similar to the converted property.

If the *Greer* rationale does not apply to section 1033, a reinvestment of the proceeds from two separate policies may cause an additional problem. The question arises as to whether the proceeds collected under the separate policies are properly allocated between the mare and foal in the purchase price. For example, a taxpayer who has collected \$100,000 under a policy on the mare and \$150,000 on the foal, and reinvesting the proceeds in a mare in foal for a purchase price of \$250,000, may find it difficult to show that \$100,000 of the purchase price was properly allocable to the mare and \$150,000 was properly allocable to the foal. A misallocation would result in tax ramifications.

Because of the uncertainty that the possible application of the *Greer* rationale brings to this area, it is important to note that Revenue Ruling 59-8<sup>113</sup> indicates that for purposes of section 1033 an unborn foal should be considered as property separate from its mare, at least when insurance proceeds are paid directly for the converted foal. In the ruling, the taxpayer owned farm land which had a crop growing on it. The crop was destroyed and insurance proceeds were collected for the destroyed crop. The ruling treated the crop as property separate from the land for pur-

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<sup>112</sup> 408 F.2d 631 (6th Cir. 1969). In *Greer* the court rejected the principle that the holding period of a foal under I.R.C. § 1231 could commence prior to birth. For a more detailed discussion of *Greer* and its relation to I.R.C. § 1231, see Reynolds, *supra* note 3.

<sup>113</sup> 1959-1 C.B. 202.

poses of section 1033.<sup>114</sup> Because a strong analogy may be made between a growing crop and an unborn foal, this ruling should serve as authority for treating an unborn foal and its mother as separate property when insurance coverage is provided by separate policies.

If a mare and an unborn foal are treated as separate property, a second question is relevant: What will be similar or related property to the unborn foal? Again, Revenue Ruling 59-8 appears helpful. In the ruling, the IRS held that the taxpayer may reinvest insurance proceeds collected for an unharvested crop in another unharvested crop or in a crop that had been harvested. The Service also ruled that the taxpayer, who was on a cash basis, could not reinvest the proceeds by planting a new crop.<sup>115</sup> This part of the ruling was modified recently by Revenue Ruling 81-279.<sup>116</sup>

This later ruling said that the cost of planting a new crop would qualify as a reinvestment of insurance proceeds received on the destruction of a destroyed crop under the correct circumstances. The correct circumstances, however, involved a farmer who used the crop method of accounting provided under Treasury Regulation section 1.162-12(a).<sup>117</sup> Under this accounting method, expenses of raising crops are not deducted until the crop is sold. In other words, the expenses are capitalized and considered part of the crop. Under the ruling, if the expenses incurred in raising the destroyed crop had not been capitalized they would not have been considered part of the crop, and reinvestment of insurance proceeds collected upon the destruction of a crop in planting costs of a new crop would not be permissible under section 1033.

If the analogy between unharvested crops and unborn foals is valid, these two rulings help in determining what will be considered similar or related property to an unborn foal. If insurance proceeds from the destruction of an unharvested crop may be reinvested in both unharvested and harvested crops, then insurance proceeds from the death of an unborn foal could be rein-

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<sup>114</sup> *See id.*

<sup>115</sup> *Id.*

<sup>116</sup> 1981-2 C.B. 163.

<sup>117</sup> *Id.*

vested in an unborn foal or a live foal. However, if the stud fees paid for the aborted foal had been previously deducted and not capitalized when the mare was bred, then the proceeds of the foal insurance could not be used to purchase additional stud fees to impregnate another mare. In this regard, stud fees would seem analogous to planting costs for a new crop.

In considering these issues, one should keep in mind that certain problems discussed above also apply. For example, if proceeds collected upon the death of an unborn foal are reinvested by the purchase of a live foal, the live foal must be held for the same ultimate purpose for which the unborn foal would have been held. This obviously raises the problem for the taxpayer of showing whether the ultimate purpose for the unborn foal was sale or racing. Another problem is whether the tax benefit rule will apply to subject a portion of insurance proceeds collected for the unborn foal to taxes regardless of section 1033.

When the taxpayer carries insurance solely upon the mare and does not carry foal insurance, it seems that proceeds should be reinvested solely in another mare. Only in the most extreme circumstances would it be possible to argue that a portion of the proceeds paid solely on the account of the dead mare are, in fact, allocable to the dead foal. Nevertheless, as shown by *Marshall Foods, Inc. v. United States*,<sup>118</sup> the actual terms of the insurance policy will not necessarily control if certain facts exist. If such facts do exist, the taxpayer would again be faced with the problem of determining what is similar property, as well as other problems discussed earlier.

It should be noted, however, that where insurance proceeds are payable under a single policy, the problem of allocating proceeds between mare and unborn foal on replacement is apparently eliminated. In *Evert Asjes*,<sup>119</sup> the taxpayer had his nursery property condemned. The property consisted of land, buildings and trees. In arriving at the lump sum award, the condemning authority considered the value of the land, buildings and trees separately and a portion of the award was intended to reimburse

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<sup>118</sup> 393 F. Supp. at 1097. For a discussion of this case, see text accompanying note 60 *supra*.

<sup>119</sup> 74 T.C. 1005 (1980).



the taxpayer for the loss of each of the items of property. The taxpayer reinvested the proceeds in land and building, but not in trees. The IRS argued that the portion of the proceeds not reinvested in trees must be recognized as a gain. The court disposed of the government's argument by noting that under local law the trees were considered part of the land and that under the Code, the trees would be considered part of the land or a crop. As such, the court held that no allocation to trees or property separate from the land was required.<sup>120</sup> In other words, the court held that although the trees were considered separately in making the award, a separate reinvestment in trees is not necessary.

Other cases decided under section 1033 have similar holdings. For example, in *Massillon-Cleveland-Akron Sign Company v. Commissioner*,<sup>121</sup> insurance proceeds were paid for buildings, machinery and equipment destroyed by fire. The insurance company paid a total of \$99,764.42 (\$60,711 for buildings and \$39,053.42 for machinery and equipment destroyed). The taxpayer reinvested \$20,208.50 in replacement machinery and equipment and \$79,556.02 in buildings. The Service argued that to the extent that part of the proceeds received for machinery and equipment was not reinvested in machinery and equipment but in buildings, a gain had to be recognized. The court rejected the argument and ruled that the statute did not require specific allocation when assets were destroyed together and the insurance is paid in a lump sum.<sup>122</sup>

#### CONCLUSION

Because of rampant economic appreciation in the thoroughbred horse industry, the well-informed taxpayer often will want to consider application of the non-recognition provisions upon the disposition of a horse. Unfortunately, the lack of determinative authority under section 1033 in regard to horses leaves great uncertainty as to when a taxpayer may qualify a transaction under the section. This lack of authority prevents even the most

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<sup>120</sup> *Id.* at 1011.

<sup>121</sup> 15 T.C. 79 (1950).

<sup>122</sup> *Id.* at 83.

well-informed taxpayer from being fully comfortable as to the exact tax consequences of many transactions. Traps abound for both the wary and the unwary. In taxes, as in life, horses are a gamble.