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Taxation of Equine Sales and Exchanges

Part 1 of 2

by

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INTRODUCTION

Thoroughbred horse breeding and racing is big business, involving big money. Furthermore, the industry has an important, relatively unique aspect other than the legal gambling associated with horse racing. Its major tangible product and productive asset, the horse, is subject to rapid and phenomenal appreciation. Spend a Buck, winner of the 1985 Kentucky Derby, was purchased as a yearling in March of 1983 for $12,500.[1] In late 1985, after a great racing season, an undivided one half interest in Spend a Buck sold for a reported $7,000,000.[2] Devil's Bag, an early season favorite to win the 1984 Kentucky Derby, was syndicated for $36,000,000 while still racing as a two year old in late 1983.[3] As a yearling, he had been purchased for $350,000.[4] Triple Crown winner Seattle Slew, purchased for $17,500 as a yearling in 1976, was syndicated for $12,000,000 in 1978 with a single share selling for $300,000.[5] Following the victory of Seattle Slew's son, Swale, in the 1984 Kentucky Derby, a Seattle Slew share reportedly sold for $3,000,000;[6] and in November of that year a single breeding season sold for $710,000.[7] A lifetime breeding right to Alydar sold for $1,995,000 in November of 1985.[8]

Fillies and mares, like the stallions above, can also sell for huge sums of money. The record price paid at auction for a horse in training for racing is $4,500,000, which was paid for Estrapade, a five year old filly, in November of 1985.[9] That same month Miss Oceana brought $7,000,000 at the dispersal sale of the breeding stock of Newstead Farm Trust.[10] That price was a new record; the previous record was $6,000,000, paid for Princes Fame, in foal to Alydar.[11]

Even unraced horses, if well bred, may bring extraordinary prices. At the Keeneland Select Yearling Sales in July 1985, a

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[1] Mooney, *Conditioning Spend a Buck*, 219 THOROUGHBRED REC. 4242, 4242 (Aug. 31, 1985).

[2] Mooney, *Horse of the Year—Spend a Buck*, 220 THOROUGHBRED REC. 962, 963 (Feb. 15, 1986).

[3] Heckerman, *The Big Buyers*, 219 THOROUGHBRED REC. 3322, 3328 (July 13, 1985).

[4] *Id.*

[5] *Id.*

[6] Heckerman, *Lightning in a Bottle*, 218 THOROUGHBRED REC. 5820, 5824 (Nov. 7, 1984); *Record Review*, 219 THOROUGHBRED REC. 4549, 4549 (Sept. 14, 1985).

[7] *Record Review*, 218 THOROUGHBRED REC. 6037, 6037 (Nov. 14, 1984).

[8] *Record Review*, 219 THOROUGHBRED REC. 5892, 5893 (Nov. 16, 1985).

[9] Capps, *Estrapade Sold at Keeneland*, 219 THOROUGHBRED REC. 5889, 5889 (Nov. 16, 1985).

[10] Heckerman, *Newstead Farm Trust Dispersal*, 219 THOROUGHBRED REC. 5886, 5886-87 (Nov. 16, 1985).

[11] *Id.* at 5886.

yearling colt sired by Nijinsky II sold for $13,100,000.[12] The average price paid for the 258 yearlings sold at that sale was $537,384.[13] From 1976, when the sale of a yearling for $1,000,000 was first recorded, through July 1985, one hundred and fifteen yearlings sold for $1,000,000 or more.[14]

Although these numbers are impressive, they are somewhat misleading. Only a very small percentage of thoroughbred horses ever attain the stratospheric prices described in the preceding paragraphs. Nevertheless, the value of many "ordinary" thoroughbreds is significant. At the November 1985 Keeneland September yearling sales, the largest yearling sale in the country, 1,861 yearlings sold for an average price of $33,333.[15] At the less prestigious Fasig-Tipton Kentucky yearling sale in October of that year, however, the average price for the 204 thoroughbred yearlings was only $4,804.[16] At numerous other sales around the country, similar average sales prices are recorded.[17] Every day across the country many thoroughbred horses are entered in claiming races in which they may be claimed for $10,000 or less.

The economic gains realized on the sale or exchange of thoroughbred horses can be significant. Thus, the taxes due on those gains may be correspondingly significant. Prior to the general rate reduction and the repeal of the preferential taxation of capital gains in the Tax Reform Act of 1986,[18] the taxes imposed on gain from the sale of a horse were much greater if the horse was not classified as a capital asset or section 1231 property than they were if the horse was so classified. With the repeal of the capital gains preference, the tax dollars at stake based on the characterization of the horse are not as substantial. Nevertheless, the Internal Revenue Code of 1986 continues to make all of the technical

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[12] Heckerman, *Keeneland Select Sale*, 219 THOROUGHBRED REC. 3620, 3620 (July 27, 1985).

[13] *Id.* at 3621.

[14] *Million Dollar Report*, 219 THOROUGHBRED REC. 3460, 3460 (July 20, 1985).

[15] *Keeneland September Sale*, 219 THOROUGHBRED REC. 4643, 4644 (Sept. 21, 1985).

[16] *Record Review*, 219 THOROUGHBRED REC. 5561, 5564 (Nov. 2, 1985).

[17] *E.g.*, *A Tough Sale to Figure*, 219 THOROUGHBRED REC. 5872, 5872 (Nov. 16, 1985) (Fasig Tipton Kentucky Fall Mixed Sale); *Breeders Without Buyers*, 219 THOROUGHBRED REC. 5151, 5151 (Oct. 19, 1985) (Ocala Mixed Sales); *Record Review*, *supra* note 16, at 5561 (Fasig Tipton Belmont October Sale).

[18] Pub. L. No. 99-514, §§ 301, 311, 100 Stat. 2085, 2217-19.

distinctions between capital assets, section 1231 property, and ordinary income property that were made under prior law.

This Article explores the characterization of gains realized on the sale or exchange of horses and examines the applicability of various provisions for deferring gain, such as installment sale reporting, like kind exchanges, and elective deferral of gain realized on the involuntary conversion of property. Although a few special provisions apply unique rules to horses, most issues within this topic arise because of the nature of the industry and the nature of horses. Because horses are reproducing animals and breeding is a large part of the industry, "a horse" is not simply "a horse": gender may make a difference. Futhermore, many owners are involved in all phases of the breeding and racing industry, and therefore determining the purpose for which a particular horse is held often is difficult. These factors give rise to many uncertainties in applying the general rules governing the characterization of gain and deferral of recognition-rules that may be more easily applied in other contexts.

This Article discusses tax treatment of operating expenses only to the extent that it impacts on determining the amount of gain or loss realized on a sale or exchange. Thus, problems such as the applicability of the "hobby loss" rules, partnership basis rules, the "at risk" rules, and passive loss rules limiting loss deductions to investors in horses are not discussed. Losses realized on a sale or exchange are not discussed extensively either. Because the cost of raising a horse generally is deductible and because purchased horses are subject to rapid depreciation under the Accelerated Cost Recovery System (ACRS),[19] taxable gains on the sale or exchange of horses are encountered more frequently than losses. Even if a horse's sale price is much less than the purchase price, the transaction results in a gain for tax purposes unless the horse's value declines quite rapidly and the horse sells within a relatively short time after purchase.

[19] *See* I.R.C. § 168. All citations to the Internal Revenue Code in this Article refer to both the Internal Revenue Code of 1954 and the Internal Revenue Code of 1986, except citations to §§ of the 1954 Code repealed by the Tax Reform Act of 1986 and §§ of the 1986 Code added by the Act.

I. RECOGNITION OF GAIN OR LOSS ON THE SALE OR EXCHANGE OF HORSES

For the purpose of computing federal income taxes, the seller must recognize and include in gross income gains realized on the sale of a horse.[20] A loss realized on the sale of a horse may be deducted if the horse was owned by a corporation, but if it was owned by an individual (including a partnership) the loss may be deducted only if the horse was held in connection with the taxpayer's trade or business or was acquired and sold in a transaction entered into for profit that was not connected with a trade or business.[21] This latter condition allows the deduction of losses incurred with respect to horses acquired for investment purposes. Losses incurred with respect to horses that are held primarily for pleasure may not be deducted except to the extent allowed under section 183 of the Internal Revenue Code (I.R.C.).[22]

Gain is the excess of the amount realized upon the disposition of the horse over its adjusted basis.[23] If the amount realized on disposition is less than the adjusted basis, the seller realizes a loss. Both "amount realized" and "adjusted basis" are terms of art that must be carefully defined.

A. *Determining the Amount Realized on a Sale or Exchange*

1. *Receipt of Cash or Property*

The amount realized on a sale or other disposition is the sum of the money received plus the fair market value of any other

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[20] I.R.C. § 61(a)(2)-(3) (gross income includes business income and gains from dealings in property). *See also* Treas. Reg. § 1.61-4 (1972) (gross income of farmers).

[21] I.R.C. § 165(a), (c)(1)-(2).

[22] I.R.C. § 183 deals with so-called "hobby losses" and allows the deduction of expenses incurred in an activity that is not conducted for a profit only to the extent of the gross income derived from the activity. *See* I.R.C. § 183(b)(2). The application of I.R.C. § 183 to horse breeding, racing and showing has been considered elsewhere, and this Article does not explore the issue. For discussion of the application of I.R.C. § 183 to equine activities, see, e.g., Kersten, *How To Prove a Profit Motive in Horse Breeding*, 5 J. AGRIC. TAX & L. 331 (1984); Patrick, *Business Versus Hobby: Determination of Whether a Horse Activity is Engaged in for Profit*, 70 KY. L.J. 971 (1981-82).

Although the owner of a pleasure horse may not deduct a loss on the sale of the horse, he may be able to claim a casualty loss on the death of the horse by accident, fire or other casualty. *See* I.R.C. § 165(c)(3), (h).

[23] I.R.C. § 1001(a) (computation of gain or loss).

property received by the seller.[24] In a cash sale this amount is easy to determine. In an exchange or deferred payment sale, however, the computation of the amount realized can be substantially more difficult.

If the taxpayer disposes of a horse by exchanging it for other property (including another horse), the amount realized is the fair market value of the property received in the exchange.[25] "Fair market value" is defined generally as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[26] Fair market value of property received generally should be determined by a competent appraisal. If the property received cannot be valued, it is presumed to be of a value equal to the property surrendered in the exchange, assuming the surrendered property can be valued.[27]

If the property received in exchange for a horse is another horse "of like kind," the gain realized on the exchange is not currently recognized.[28] Instead, the gain is deferred, and the horse received in the exchange takes a basis generally equal to the basis of the property surrendered. Part II of this Article discusses like kind exchanges of horses.[29]

2. *Sale for Deferred Payment*

If the seller receives a promissory note from the horse's buyer, the amount realized depends on the interrelationship of several factors. The three most significant factors are the interest rate on the note, whether the seller elects not to report the recognition of income on the installment method under section 453, and whether the seller reports his taxes on the cash or the accrual method.[30]

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[24] I.R.C. § 1001(b); Treas. Reg. § 1.1001-1(a) (1984).

[25] *See* I.R.C. § 1001(b).

[26] Treas. Reg. § 20.2031-1(b) (1958). Although this definition appears in an estate tax regulation, it is generally accepted to apply for purposes of the income tax as well.

[27] *See* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954).

[28] *See* I.R.C. § 1031.

[29] *See* notes 331-408 *infra* and accompanying text.

[30] Under the cash method of accounting "all items which constitute gross income (whether in the form of cash, property or services) are to be included for the taxable

If the seller does not elect out of the installment method of reporting and the note bears adequate interest as determined under sections 483 and 1272 through 1278,[31] the stated principal amount of the promissory note, plus any cash and the fair market value

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year in which actually or constructively received," and "[e]xpenditures are to be deducted for the taxable year in which actually made." Treas. Reg. § 1.446-1(c)(1)(i) (1984). Taxpayers using the accrual method of accounting include items in income "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.451-1(a) (1978). Accrual method taxpayers claim deductions in the "year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy," Treas. Reg. § 1.461-1(a)(2) (1967), subject to the economic performance limitations imposed on the deductions by I.R.C. § 461(h).

Most farmers elect to use the cash method of accounting. Simplicity is the primary advantage of this method, but it also may defer taxes because a farmer on the cash method of accounting is not required to maintain inventories of livestock (or crops) raised by him and may deduct as a current expense all of the expenses connected with the livestock. *See* Treas. Regs. §§ 1.61-4; 1.162-12(a) (1972); 1.47-(b)(a). Section 263A, enacted in the Tax Reform Act of 1986, requires the capitalization of the expenses of raising any livestock with a preproductive period in excess of two years. I.R.C. § 263A(d)(1)(A). This requirement does not apply, however, to certain farmers electing to recover the cost of all depreciable property placed in service in the farm business during the year under the alternative depreciation system of I.R.C. § 168(g)(2) rather than under ACRS. I.R.C. § 263A(d)(3), (e)(2). A farmer may elect to use inventories even if he is not required to do so. Treas. Reg. § 1.471-6(a) (1960). Even if the farmer uses the cash method and does not use inventories, the cost of purchased livestock may not be deducted, but must be capitalized, regardless of whether the livestock is held for resale, breeding or sporting purposes. *See* Treas. Regs. §§ 1.61-4(a)(2); 1.162-12(a); Alexander v. Commissioner, 22 T.C. 234, 238-241 (1954) (*acq.*). *See also* Hanisch, *Tax: Accounting and Inventory Valuation Methods for Farmers*, 22 WASHBURN L.J. 513 (1983); Vogel, *A Primer In The Taxation of Agricultural Transactions*, 3 TAX L.J. 61, 64-74 (1985).

Corporations engaged in farming, however, generally are limited to the accrual method. I.R.C. § 447(a). Farming syndicates using either the accrual or the cash method may not deduct feed and other supplies until they are actually consumed. I.R.C. § 464(a). This provision may apply to any breeding or racing syndicate interests which have been registered for sale with either the S.E.C. or any state agency administering a "blue sky" law. *See* I.R.C. § 464(c). *See also* Vogel *supra* at 88-92.

There is no single concise definition of "farm," "farming," or "farmer" for purposes of taxation. Different regulations and cases apply a variety of definitions. *See* Cox, *Farming and Ranching—Tax Accounting*, 413 T.M., A-1-A-2 (1980). Raising horses for breeding and racing, including the training of horses, fits within the parameters of the broad definition of farming. *See* I.R.C. § 464(e)(1); Treas. Reg. § 1.61-4(d); Priv. Ltr. Rul. 6302119340A (Feb. 11, 1963) ("The fact that the breeding activity is conducted on farms operated by others would not adversely affect the taxpayer's status as a farmer within the meaning of the 1954 Code and regulations thereunder provided she meets the other qualifications thereof as, for example, operation of the breeding activity for gain or profit.").

[31] *See* text accompanying notes 277-90 *infra*.

of other property received is the amount realized on the sale.[32] Even when the seller elects not to report on the installment method, if the seller is on the accrual method, the amount realized is not affected.[33] If, however, the seller is on the cash method and elects out of the installment method, the amount realized is the fair market value of the promissory note rather than the principal amount.[34] This is determined with reference to all of the relevant facts.[35] Treating the fair market value of the note as the amount realized does not reduce the amount of income ultimately recognized; it merely defers the recognition of the excess of the stated principal over the fair market value at the time of receipt. For years during which the capital gain preference was in effect, however, the price of this deferral was conversion of the deferred income into ordinary income.[36]

If the promissory note does not bear adequate interest under section 483 and the Original Issue Discount Rules of sections 1272 through 1278, then the sales price is recomputed to reflect adequate interest. This reduces the amount realized to something less than the stated principal of the promissory note and converts potential capital gains to certain ordinary income. The problem of unstated interest is explored more thoroughly later in this Article.[37]

B. *Computation of Basis*

1. *General Principles*

a. *Purchase Price Basis*

Gain and loss are computed with respect to the "adjusted basis" of the property sold.[38] Cost basis under section 1012 is

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[32] *See* Temp. Reg. § 15a.453-1(b)(2) (1984).

[33] *See* Temp. Reg. § 15a.453-1(d)(2)(i); Castner v. Commissioner, 30 T.C. 1061, 1069-71 (1958); First Fed. Sav. and Loan Ass'n v. Commissioner, 40 T.C. 474, 484-487 (1963).

[34] *See* Temp. Reg. § 15a.453-1(d)(2)(i); Cowden v. Commissioner, 289 F.2d 20, 24-25 (5th Cir. 1961); Warren Jones Co. v. Commissioner, 524 F.2d 788, 793-94 (9th Cir. 1975).

[35] *See* text accompanying notes 253-60 *infra*.

[36] *See* text accompanying notes 258-59 *infra*.

[37] *See* text accompanying notes 277-90 *infra*.

[38] *See* I.R.C. §§ 1001(a); 1011(a).

generally the starting point for the determining adjusted basis. The cost of purchasing a horse for breeding or sporting (racing) must be capitalized and the basis recovered through ACRS depreciation deductions.[39] The cost of horses purchased for resale may not be deducted until the year in which the animal is sold, even by a farmer who elects the cash method of reporting farm income.[40]

The horse's cost is the amount of money paid for it, including, if the stated interest is adequate, the stated principal of a promissory note given in payment of the purchase price. If the interest on the promissory note is inadequate under the unstated interest rules of the I.R.C.,[41] then the buyer's purchase price is reduced in the same manner as the amount realized was reduced for the seller of the horse.[42] If the horse was acquired in exchange for other property (including another horse, other than in a like kind exchange subject to the rules of section 1031), the purchase price is the fair market value of the horse received in the exchange.[43] If the horse was acquired in a like kind exchange, its basis is generally equal to the basis of the horse surrendered in the exchange.[44]

b. *Other Methods of Acquisition*

If the horse was acquired by a method other than purchase, the unadjusted basis must be determined under the relevant provision. For example, under section 1015, the basis of property acquired by gift generally is equal to the donor's basis.[45] Section

[39] Treas. Reg. § 1.162-12(a). *See* Duggar v. Commissioner, 71 T.C. 147, 154-55 (1978) (costs associated with weaning calves must be capitalized). Alternatively, the taxpayer may elect to include purchased livestock in inventory. Treas. Reg. § 1.162-12(a).

[40] Treas. Reg. § 1.61-4(a); *Alexander*, 22 T.C. at 239-41. *See also* Rev. Rul. 80-102, 1980-1 C.B. 108 (transportation costs involved in purchasing livestock are only deductible when livestock sold). See note 30 *supra* for a discussion of farm accounting methods.

[41] I.R.C. §§ 483; § 1274.

[42] *See* notes 277-90 *infra* and accompanying text.

[43] *See* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954).

[44] I.R.C. § 1031(d). For a discussion of the rules for computing the basis of property received in a like kind exchange, see text accompanying notes 331-39, 357-61 *infra*; 2 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 44.2.5 (1981).

[45] I.R.C. § 1015(a). If the fair market value of the horse at the time of the gift was less than the donor's adjusted basis, the donee's basis for loss purposes is limited to the fair market value. *Id.* The donee's basis can be increased, subject to the above limitation, by a portion of the gift tax, if any, incurred by the donor as a result of the gift. *Id.* at (d).

1014 provides that the basis of property acquired by inheritance is the fair market value of the property on the date of the decedent's death.[46]

The basis of a horse acquired by a partnership in exchange for a partnership interest is equal to the transferor's basis.[47] A horse acquired by a corporation in a transaction in which gain or loss was not recognized under section 351 likewise has a basis in the hands of the corporation equal to the transferor's basis.[48]

c. *Horses Raised By Owner*

Prior to the enactment of section 263A in the Tax Reform Act of 1986, if a horse was raised by the owner, the horse in most instances had an unadjusted basis of zero. No purchase price was paid for a horse foaled by an owner's broodmare that was not in foal when purchased. The stud fee paid was currently deductible,[49] so it could not have been included in basis.[50] If, however, the owner of the mare elected to capitalize the stud fee, that amount was the unadjusted basis of the foal.[51] The cost of feeding and boarding both the broodmare and the foal was deducted currently regardless of whether the taxpayer used the cash or accrual method,[52] and those expenses likewise did not increase the basis of the foal. With respect to the foal, the owner could have elected not to deduct the expenses currently. If no current deduction was

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[46] I.R.C. § 1014(a)(1).

[47] I.R.C. § 723.

[48] I.R.C. § 362. The corporation's basis is increased by any gain recognized to the transferor under I.R.C. § 356 or § 357 as a result of the transfer.

[49] *See* Ellis v. Commissioner, 47 T.C.M. (CCH) 991, 1002 (1984); Priv. Ltr. Rul. 6302119340 A (Feb. 11, 1963) (stud fees are deductible even though the fee is refundable if the mare does not produce a live foal). *But see* Rev. Rul. 79-176, 1979-1 C.B. 123; Rev. Rul. 78-411, 1978-2 C.B. 112 (both requiring capitalization of breeding and other fees where taxpayer did not have benefits and burdens of ownership of breeding stock and ownership at time expenses were incurred).

[50] *See* Treas. Reg. § 1.162-1(a); *Ellis*, 47 T.C.M. (CCH) at 1002 (disallowing addition to dead foal's basis of a portion of previously expensed feed for broodmare in computing loss deduction); Bicha v. Commissioner, 38 T.C.M. (CCH) 522 (1969) (vendor of cattle could not include in basis cost of grain previously expensed in raising cattle).

[51] *See* Welder v. United States, 329 F. Supp. 739, 751-53 (S.D. Tex. 1971), *aff'd per curiam*, 461 F.2d 1269 (5th Cir. 1972) (holding that Treas. Reg. § 1.162-12 allows cash basis farmers the option of deducting or capitalizing such expenses).

[52] *See* Treas. Reg. § 1.162-12(a); Rev. Rul. 74-527, 1974-2 C.B. 42, 43; *Ellis*, 47 T.C.M. (CCH) at 1002.

claimed, the feed and board expenses should have been capitalized into the horse's basis.[53]

Section 263A, added by the Tax Reform Act of 1986, requires the comprehensive capitalization of the costs of producing inventory and the preproductive costs of producing property to be used in the taxpayer's trade or business.[54] This rule does not apply, however, to "any animal which is produced by the taxpayer in a farming business and which as a preproductive period of two years or less, if the taxpayer uses the cash receipts and disbursements method of reporting income."[55] The legislative history indicates that the preproductive period commences at the beginning of gestation and ends when the animal is ready to perform its intended function.[56] Thus, because the period between the beginning of gestation and the sale of a yearling exceeds two years, horse breeders apparently will be required to capitalize all breeding fees, as well as the cost of raising the foals until they are sold as yearlings.[57] Similarly, because a horse generally does not enter training for racing or begin breeding within two years of the beginning of gestation, breeding fees and other expenses incurred to raise a horse for use as breeding stock or in racing must also be capitalized.[58]

In the case of horses held for breeding or racing rather than resale, a taxpayer other than a corporation, partnership, or tax shelter required to use the accrual method of accounting may elect not to capitalize these costs.[59] If such an election is made, however, the taxpayer must forgo the benefits of ACRS deductions for all property used by the taxpayer in the farming business that was placed in service in that year. Instead, the cost of all such property is recoverable under the less advantageous alternative depreciation system of section 168(g)(2).[60]

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[53] *See Welder*, 329 F. Supp. at 751-53; *Ellis*, 47 T.C.M. (CCH) 991, 996.

[54] Tax Reform Act of 1986, Pub. L. No. 99-514, § 803, 100 Stat. 2085, 2350-58.

[55] I.R.C. § 263A(d)(1).

[56] H.R. REP. No. 426, 99th Cong., 1st Sess. 628 (1985).

[57] *See* I.R.C. § 263A(e)(3)(A)(ii).

[58] *See* I.R.C. § 263A(e)(3)(A)(i).

[59] I.R.C. § 263A(d)(3).

[60] I.R.C. § 263A(e)(2). This rule also applies to the taxpayer if any related person, as defined in I.R.C. § 263A(e)(2)(B), has elected under I.R.C. § 263A(d)(3) not to capitalize preproductive period expenses.

In addition to requiring capitalization of stud fees and other cash expenses of raising horses, section 263A disallows a deduction for a portion of the interest expense incurred by the taxpayer during the preproduction period and requires the addition of that interest expense to the basis of the horse.[61] This rule requires not only the capitalization of interest on debt directly attributable to production period expenses, but also the capitalization, under the avoided cost method, of interest on debt actually incurred for other purposes.[62] Some portion of the depreciation on barns and equipment and other general expenses and overhead of the farming activity conducted by the taxpayer also is subject to capitalization under section 263A. Although the legislative history provides some guidance, specific rules have not yet been developed. In general, however, section 263A, at the very least, requires the capitalization of all expenses that are inventory costs under the principles of full absorbtion inventory accounting.[63]

d. *Miscellaneous Additions to Basis*

The normal rules for capitalization of acquisition expenses are applicable to purchased horses. Therefore, expenses such as attorney's fees and broker's fees, payable by the purchaser in connection with the acquisition of a horse, must be capitalized as part of the horse's basis.[64] This rule also extends to expenses such as the transportation of a horse from the point of delivery by the seller to the buyer's farm or stable.[65] Similar expenses incurred with respect to the sale of the horse are added to basis in computing the gain realized on the sale, rather than deducted in computing taxable income.

2. *Purchase of Mare in Foal*

The purchase of a mare in foal raises the difficult question of whether the purchase price should be apportioned between the

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[61] I.R.C. § 263A(f).

[62] I.R.C. § 263A(f)(2)(A)(ii). *See* S. REP. No. 313, 99th Cong., 2d Sess. 144 (1986); H.R. REP. No. 426, 99th Cong., 1st Sess. 626 (1985).

[63] The legislative history directs the Treasury to pattern the regulations under I.R.C. § 263A after those governing long-term contracts under Treas. Reg. § 1.451-3. S. REP. No. 313, 99th Cong., 2d Sess. 141 (1986).

[64] *See, e.g.*, Briarcliff Inv. Co. v. Commissioner, 30 B.T.A. 1269, 1270-71 (1934) (real estate commissions paid by purchaser must be capitalized).

[65] Rev. Rul. 72-113, 1972-1 C.B. 99.

mare and the foal. In *Gamble v. Commissioner*,[66] the Tax Court held that such an apportionment was proper, and the seller was permitted to allocate to the foal, which was sold when it was sixteen months old, a portion of the purchase price for the mare.[67] This case stands in apparent contrast to *Metz v. United States*,[68] in which the taxpayer successfully argued that no part of the amount realized upon the sale of a mare in foal should be allocated to the foal. The government's position was that a portion of the sales price was attributable to the foal, and that the gain attributable to that portion of the amount realized was ordinary income, not eligible for section 1231 treatment.[69] Upon instructions to the jury, a special verdict was returned finding that no part of the mare's purchase price was attributable to the unborn foal.[70] Thus, any apparent irreconcilability of these decisions is illusory. Opposite results were reached in these cases because the taxpayer in *Gamble* was able to persuade the trier of fact that he paid more for the mare in foal than he would have paid had she not been in foal. The taxpayer in *Metz*, however, was able to carry the burden of proof that no part of the purchase price was attributable to the unborn foal.

This issue is clearly a question of fact to be determined on a case by case basis. In order to allocate a portion of the purchase price to the foal, however, the enhanced price of the mare in foal must be attributable to the foal, not merely to the demonstration that the mare was fertile. In *Gamble* the court found that the taxpayer paid an increased price due to the prospect of obtaining the foal.[71] The instructions to the jury in *Metz* stated that if the increased value of the mare was "attributable merely to the fact that the mare in foal was an indication that she was a breeding mare and would be bred again, and that was the interesting point

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[66] 68 T.C. 800 (1977)(*acq.*).

[67] *Id.* at 820-21.

[68] 62-1 U.S.T.C. ¶ 9500 (E.D. Ky. 1962).

[69] *Id.* at 84,474-75. The mare was I.R.C. § 1231 property and the gain attributable to the mare would be eligible for conversion to long term capital gains. The foal on the other hand had an insufficient holding period to qualify for I.R.C. § 1231 treatment, if treated as separate property. See text accompanying notes 138-48 *infra* regarding the necessary holding period to obtain § 1231 treatment on the sale of a horse.

[70] *See id.* at 84,476-77.

[71] 68 T.C. at 821.

that the buyer was concerned with," then the jury was to return a verdict that no portion of the price was attributable to the foal.[72] Nevertheless, where a stud fee of any substance was paid and the buyer obtains foal insurance, some portion of the purchase price probably will be attributed to the foal. The stud fee and the amount of the foal insurance is highly probative evidence of the portion of the purchase price that should be allocated to the foal.[73]

If the taxpayer may apportion the purchase price of a mare in foal between the mare and the foal, how is that apportionment to be made? *Gamble* again provides guidance. Although the actual amount apportioned to the foal will be based on all facts and circumstances, in *Gamble* the Tax Court placed the greatest weight on the amount of foal insurance obtained by the taxpayer, finding the fair market value of the foal to equal the amount of the insurance.[74] Although the stud fees for the stallion that sired the foal are relevant, they do not necessarily translate dollar for dollar into basis allocated to the foal. Furthermore, if the price of the mare in foal is less than the stud fees plus the fair market value of the mare were she not in foal, *Gamble* suggests that the "discount" should be equitably apportioned between the basis allocated to the mare and the basis allocated to the foal.[75] The Internal Revenue Service (IRS), however, recently has taken the position that the proper method of allocation is to subtract from the price of the mare in foal the amount that would have been her fair market value if she were not in foal.[76] Although this might be determined by an appraisal, all of the foregoing factors might nevertheless influence such an appraisal. Thus, in practice, the apportionment method remains unclear because even the IRS "formula" requires the use of an assumed fact that is contrary to reality.

The question of whether the apportionment of basis to the foal should be made at the time of purchase or at the time of birth may be relevant when a foal is stillborn, in computing a loss deduction or, if the owner had foal insurance, in computing gain

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[72] 62-1 U.S.T.C. at 84,475.

[73] *See Gamble*, 68 T.C. at 821.

[74] *Id.*

[75] *Id.*

[76] A.O.D. 1986-024.

realized. Under the *Gamble* logic, it should be permissible to allocate a portion of the mare's purchase price to the dead foal. This conclusion, however, is by no means certain. In *Greer v. United States*[77] the Sixth Circuit Court of Appeals held that the holding period of a foal does not begin until its birth for purposes of determining if it is section 1231 property at the time of its subsequent sale.[78] If the holding period does not begin until birth, it is difficult to see how any portion of the purchase price of the mare can be allocated to the foal prior to its birth.

Logic, however, is on the side of allocating the purchase price between the mare and the unborn foal immediately upon purchase. The mare will most likely be depreciable property in the purchaser's hands.[79] Immediate apportionment of the purchase price avoids numerous computational difficulties that arise by waiting until the foal's birth to apportion. If the apportionment is delayed, the mare's unadjusted basis for purposes of computing ACRS deductions very likely will be greater in the first year than in later years. As a result, cumulative ACRS deductions will be overstated; the sum of the aggregate ACRS deductions on the Mare and the basis allocated to the foal will exceed the purchase price of the mare in foal. Complex adjustments to the ACRS formula would be necessary to avoid this result.[80] Furthermore, equity also is on

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[77] 408 F.2d 631 (6th Cir. 1969).

[78] *Id.* at 636-37.

[79] *See* note 89 *infra* and accompanying text.

[80] Under I.R.C. § 168 ACRS deductions are computed over the recovery period under the 200 percent declining balance method, switching to the straight line method in the first year in which the straight line method produces a larger deduction. Except as provided in I.R.C. § 168(e)(3) (treating any racehorse that is more than two years old when placed in service and any horse that is more than twelve years old when placed in service as 3 year property), horses are 7 year recovery property. For years prior to 1987, horses that were not assigned a 3 year recovery period were 5 year property. See Prop. Reg. § 1.168-3(c)(2) (1984).

The problem noted in the text can be demonstrated as follows using the ACRS system in effect before the Tax Reform Act of 1986. Assume that in 1986 the taxpayer purchases a five year old broodmare in foal for $50,000; $20,000 of which is allocated to the foal that will be born in 1987. If the allocation is deferred until the birth of the foal, the ACRS allowance for the broodmare in 1986 will be $50,000 x .15, or $7,500. *See* I.R.C. § 168(b)(1) as in effect prior to the Tax Reform Act of 1986. In 1987, after the foal is born, $20,000 of basis would be allocated to the foal, reducing the unadjusted basis of the broodmare to $30,000. Applying the percentages specified in I.R.C. § 168(b)(1) for years 2 through 5 to an unadjusted basis of $30,000 results in additional the side of an immediate apportionment. Failure to apportion part of the mare's purchase price to the foal prior to birth may result in an unjustifiable acceleration of the ACRS deductions on the mare because of her overstated unadjusted basis in the first year. Finally, if a portion of the purchase price is attributable to the foal, failing to allow any apportionment prior to the live birth of the foal unjustly denies the owner a deserved casualty loss (or overstates gain if the owner has foal insurance) upon the abortion or still birth of the foal.

3. *Adjustments to Basis*

The adjusted basis under section 1011, used in the computation of gain or loss on the sale or exchange of a horse, is the unadjusted basis, determined as discussed in the immediately preceding section, increased or decreased as provided in section 1016.

a. *Adjustments That Increase Basis*

All expenditures incurred with respect to a horse that are properly chargeable to a capital account should be capitalized as part of the horse's basis.[81] One of numerous expenditures in this category[82] is particularly significant with respect to horses. Expenses incurred in training a horse in preparation for a racing career are not currently deductible but must be capitalized as part of the horse's basis.[83] These expenditures are recovered through ACRS deductions when the horse begins its racing career. Only expenses actually incurred may be added to basis. If the taxpayer

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cumulative ACRS deductions of $25,500. Total ACRS deductions will be $33,000, $3,000 more than the portion of the purchase price allocable to the broodmare. The easiest solution would be to disallow the excess deductions in the last year, but would still result in an unjustifiable acceleration of the ACRS deductions.

[81] I.R.C. § 1016(a) (1984).

[82] *See* Treas. Reg. § 1.263(a)-2 (1960) (examples of expenditures).

[83] Journal Box Serv. Corp. v. United States, 9 A.F.T.R.2d (P-H) 798, 817 (S.D. Ind. 1962). For years after 1986, § 263A should compel this result. *But see* Internal Revenue Manual 45(11)I (1976) ("Consistent treatment of stud fees and training expenses [of 'raising' horses] should be accepted."). Expenses of continuing training of a horse during its racing career are currently deductible. Hill v. Commissioner, 26 T.C.M. (CCH) 1287, 1288-89 (1967).

personally trains a horse, the fair market value of the taxpayer's services may not be added to the horse's basis.[84]

Expenses to feed and care for horses held for sale, breeding or racing may be deducted currently rather than added to basis as long as the taxpayer is a "farmer" for purposes of the I.R.C.,[85] unless the taxpayer elects the inventory method of accounting for the cost of raising livestock.[86] This same rule applies to the cost of feeding and caring for a mare in foal, regardless of whether the mare was purchased in foal.[87]

b. *Adjustments That Decrease Basis*

The most significant adjustment that decreases the horse's basis is the reduction of basis by the amount of the ACRS depreciation deductions allowable with respect to the horse.[88] ACRS deductions are allowed with respect to horses held for racing (also referred to as "sporting purposes" by the I.R.C.) and breeding, but ACRS deductions are not allowed on horses held as inventory,[89] stock in trade, or primarily for sale to customers in the ordinary course of business.[90]

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[84] Miller v. Commissioner, 34 T.C.M. (CCH) 37 (1975) (disallowing capitalization of imputed expense of value of owner's services in training standardbred for computing casualty loss deduction upon horse's death).

[85] *See* Treas. Reg. § 1.162-12(a); *Duggar*, 71 T.C. at 154-55.

[86] *See* Treas. Regs. §§ 1.61-4(a), 1.162-12(a).

[87] *See* Treas. Reg. § 1.162-12(a); *Ellis*, 47 T.C.M. (CCH) at 1002.

[88] *See* I.R.C. § 1016(a)(2); Treas. Reg. § 1.1016-3(a) (1986); Sullivan v. Commissioner, 17 T.C. 1420, 1425 (1952), *aff'd*, 210 F.2d 607 (5th Cir. 1954).

[89] Horses held for breeding and racing are clearly property used in a trade or business subject to an allowance for depreciation, see Treas. Reg. § 1.162-12(a), unless the taxpayer uses the accrual method of accounting and elects to inventory livestock used for breeding purposes as permitted under Treas. Regs. §§ 1.61-4(a) and 1.162-12(a). Inventoried livestock is not depreciable, Treas. Reg. § 1.167(a)-(6)(b) (1960), and, therefore, no ACRS deductions are allowable with respect to such livestock.

Under I.R.C. § 163(e)(3) (I.R.C. § 168(h)(1) for years prior to 1987) any racehorse that is more than two years old when placed in service and any horse that is more than twelve years old when placed in service are 3 year recovery property. All other horses are 5 year recovery property. Prop. Reg. § 1.168-3(c)(2) (1984). All other horses placed in service after 1986 are 7 year recovery property.

[90] *See* 1 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 23.2.1 (1981). *Cf.* Riordan v. Commissioner, 37 T.C.M. (CCH) 839, 841 (1978) (farmer who erroneously claimed depreciation deduction on livestock sold during the year was allowed to claim same amount as cost of goods sold when depreciation deduction was disallowed).

Another less common basis adjustment is the reduction required when a horse owner receives insurance proceeds due to the horse's disability to continue either a racing or breeding career. To the extent that such insurance proceeds are not reimbursement for otherwise deductible expenses (such as veterinarian expenses) and are excluded from gross income, the horse's basis must be reduced by the amount of insurance proceeds.[91] If the insurance proceeds exceed the adjusted basis of the horse, the excess must be included in gross income,[92] unless the event constitutes an involuntary conversion and the owner elects under I.R.C. section 1033 not to recognize the gain.[93] Basis is also reduced by the amount of any unreimbursed casualty loss deduction claimed in a horse.[94] To the extent that a loss is reimbursed by insurance, however, the loss deduction is disallowed.[95] The exclusion of the insurance proceeds from gross income nevertheless requires a concomitant reduction in the horse's basis.

C. *Character of Gain or Loss*

1. *General Principles*

The character of the gain or loss recognized upon the sale or exchange of a horse depends upon the purpose for which the taxpayer held the horse. The three primary purposes for holding a horse in the breeding and racing industry are resale, racing, and breeding.[96] In some instances, a horse may be held for an

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[91] *See* C. G. Willis, Inc. v. Commissioner, 41 T.C. 468, 474 (1964), *aff'd per curiam*, 342 F.2d 996 (3d Cir. 1965) (receipt of insurance proceeds attributable to partial destruction of ship by casualty).

[92] *See* I.R.C. §§ 1033(a)(2), 1231(a)(3)(A); Central Tablet Mfg. Co. v. United States, 417 U.S. 673, 676 (1974) (gain on receipt of insurance proceeds in excess of basis of building destroyed by fire).

[93] *See* Part III *infra*.

[94] *Cf.* Rev. Rul. 71-161, 1971-1 C.B. 76, 77.

[95] I.R.C. § 165(a).

[96] A decreasing number of horses are held for draft purposes. Among the other uses of horses are rental for pleasure riding, see Campbell v. Commissioner, 20 T.C.M. (CCH) 825, 838 (1961); advertising, see, e.g., the Budwiser Clydesdales; and entertainment, see, e.g., Mr. Ed.

investment purpose that does not fit into the above categories,[97] but that generally will not be true. Horses held for resale virtually always will be categorized as stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business, and thus are excluded from the definition of capital asset.[98] Accordingly, all gain or loss recognized on the sale of such horses is taxed as ordinary income. A horse held for investment purposes is a capital asset.[99]

For years prior to 1987, the gain recognized on the sale of a capital asset may have received the advantageous treatment accorded to long term capital gains if it had been held for more than six months. Any loss recognized, however, suffered the disadvantageous treatment accorded to capital losses.[100] The Tax Reform Act of 1986 repealed the preferential treatment of long term capital gains recognized after December 31, 1986.[101] Even

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[97] This would most likely be true with respect to pleasure horses and horses held for use in activities that are subject to the limitations in I.R.C. § 183. In such a case it is probable that an attempt to deduct a capital loss would be denied by the Commissioner even though it is clear that gains recognized on the sale of such horses must be included in taxable income.

[98] I.R.C. § 1221(1). *See* Nowland v. Commissioner, 15 T.C.M. (CCH) 368, 375-76 (1956), *aff'd per curiam,* 244 F.2d 450 (4th Cir. 1957); Jewell v. Commissioner, 25 T.C. 109, 109, 117-18 (1955). *But see* Black v. Commissioner, 35 T.C. 90, 96 (1960) (taxpayer held real estate "primarily for sale" and thus could not avail herself of nonrecognition under I.R.C. § 1031 on exchange of real estate, but gain was capital gain because property was not held "primarily for sale to customers in the ordinary course of business").

[99] *See* I.R.C. § 1222.

[100] For years prior to 1987, I.R.C. § 1202(a) allowed individuals a deduction equal to sixty percent of the excess of long term capital gains over all capital losses recognized for the year. In effect this reduced the rate of tax on 100% of the gain to 40% of the rate of tax applied to ordinary income. Corporations were allowed preferential rates on long term capital gains under I.R.C. § 1201. Both of these preferences were repealed by the Tax Reform Act of 1986.

I.R.C. § 1211(b) limits indidual taxpayer's deduction for capital losses to capital gains plus an amount not to exceed $3,000, determined by formula. Under I.R.C. § 1211(a) corporations may deduct capital losses only to the extent of capital gains. Disallowed losses are carried over under I.R.C. § 1212. These limitations on the deductibility of capital losses have been continued notwithstanding the repeal of the capital gains preference.

[101] Pub. L. No. 99-514, §§ 301, 311, 100 Stat. 2085, 2217-19. For 1987 there is a limited capital gains preference for taxpayers in a marginal tax rate bracket above 28%. Section 1(j) limits the maximum rate of tax on net long term capital gains to 28%. This limitation is not effective, however, with respect to the 5% surtax imposed on certain taxpayers under I.R.C. § 1(g) for years after 1987.

though the preferential treatment of capital gains has been eliminated, section 1211 continues to limit to $3,000 per year the amount of capital losses that may be deducted against ordinary income. Thus, the characterization of both gain and loss as ordinary or capital continues to be relevant, although of diminished significance.

Horses held for breeding and racing purposes are depreciable property used in a trade or business, [102] and as such are excluded from the ambit of capital assets.[103] For the same reason that they are excluded from the definition of capital asset, however, such horses are "section 1231 property" if held for more than twenty four months.[104] Thus, the gains and losses recognized on the sale of horses used for breeding and racing may enter into the section 1231 hotchpot, with the resultant possibility that gains may be treated as long term capital gains and losses may be treated as ordinary losses, depending on whether the taxpayer recognized an overall gain or loss on the sale of section 1231 property during the year.[105] Section 1231 gains, however, are subject to a major limitation. Under section 1245 any gains realized on the sale are treated as ordinary income to the extent that the seller claimed ACRS (or depreciation) deductions with respect to the horse.[106] Only gains in excess of "depreciation

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[102] *See* I.R.C. § 1231(b)(3)(A). *See also* Kirk v. Commissioner, 47 T.C. 177, 187 (1966).

[103] I.R.C. § 1221(2); Gamble v. Commissioner, 68 T.C. 800, 810 (1977) (*acq.*).

[104] I.R.C. § 1231(b)(3)(A). This rule stands in stark contrast to the six month holding period that is generally required to attain the status of I.R.C. § 1231 property. For the possibility that a horse held for less than twenty four months may nevertheless be I.R.C. § 1231 property, see *Gamble*, 68 T.C. 800, discussed at notes 157-73 *infra*.

[105] A discussion of the mechanics of the operation of the I.R.C. § 1231 hotchpot is beyond the scope of this Article. For a detailed explanation, see 2 B. BITTKER, *supra* note 44, at ¶ 54.1-54.2 (1981).

[106] Treas. Reg. § 1.1245-3(a)(4), provides that I.R.C. § 1245 (1981) property "includes livestock . . . with respect to taxable years beginning after December 31, 1969. . . . [T]he term 'livestock' includes horses . . . irrespective of the . . . purpose for which they are held." The amount of gain subject to depreciation recapture is not limited to the depreciation previously claimed by the taxpayer if his basis is determined with reference to his transferor's basis. In such a case all of the depreciation claimed by the taxpayer and his transferor is taken into account in measuring the amount of the gain subject to recapture under § 1245. *See* Treas. Regs. §§ 1.1245-2(a)(4), -2(c)(2), -4(c)(1)-(2). See also Treas. Reg. § 1.1245-2(c)(4) (1965) regarding depreciation recapture on property acquired in an exchange subject to I.R.C. § 1031.

recapture" under section 1245 are treated as section 1231 gains.

Because different treatment is accorded gains and losses on a sale depending on the purpose for which the horse was held, it is crucial to determine whether a horse was held primarily for "sale to customers in the ordinary course of business" or for breeding or racing. On occasion, it may be necessary to determine if the horse was held for some other purpose, which may result in both gains and losses being treated as capital gains and losses. If the horse was held for use in the taxpayer's trade or business but not for resale, racing or breeding, the holding period prerequisite for section 1231 treatment is reduced to six months.[107] Unfortunately, due to the nature of the industry, categorizing the purpose for which a horse was held is frequently a difficult task.

2. *Distinguishing Horses Held Primarily for Sale to Customers From Horses Held for Breeding and Racing Purposes*

Whether a horse is held primarily for sale to customers in the ordinary course of business or for use in the taxpayer's trade or business is a question of fact.[108] A horse is not held primarily for sale to customers in the ordinary course of business, however, unless that purpose predominates over all other purposes.[109] This standard frequently helps taxpayers engaged in the breeding and racing industry to establish that a horse that has been sold was not held primarily for sale to customers in the ordinary course of business because frequently a single horse may be held for racing, breeding, or sale, based on whichever course of action appears at the time to be most profitable. Vendors of horses do not, however, have a blank check to claim that all of the horses that they have sold were held for multiple purposes and therefore

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[107] *See Gamble*, 68 T.C. at 816-17.

[108] *See, e.g.*, Gotfredson v. Commissioner, 217 F.2d 673 (6th Cir. 1954), *cert. denied*, 350 U.S. 846 (1955) (cattle); McDonald v. Commissioner, 214 F.2d 341, 342 (2d Cir. 1954) (cattle); *Jewell*, 25 T.C. at 115.

[109] *See Kirk*, 47 T.C. at 193. This principle is not unique to the horse industry; it is merely a specific application of the general principle applicable to all types of property announced by the Supreme Court in Malat v. Riddell, 383 U.S. 569, 572 (1966).

not held primarily for sale to customers in the ordinary course of business.

Many sellers are undeniably in the trade or business of breeding or buying horses for resale. Although there is authority for the proposition that each sale by a taxpayer generally in the business of selling horses must be separately examined to determine the purpose for which the horse was held,[110] a taxpayer that maintains a farm breeding horses and customarily selling all of them as yearlings or weanlings probably will be found to hold all of his yearlings and weanlings primarily for sale to customers in the ordinary course of business.[111] This does not prevent the taxpayer, however, from establishing that other horses sold by him were held for either breeding or racing,[112] although it may be more difficult for such a taxpayer to carry the burden of proof than it would be for a taxpayer that did not generally sell horses in the ordinary course of business. Advertising horses for sale in the ordinary course of business through public media, trade journals or sales catalogues generally assures treatment of gains as profits realized from sales to customers in the ordinary course of business.[113] Furthermore, even if the taxpayer can establish that the horse was held for breeding or racing purposes rather than for sale to customers in the ordinary course of

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[110] *See Jewell*, 25 T.C. at 117; Priv. Ltr. Rul. 6302119340A (Feb. 11, 1963).

[111] *See Nowland*, 15 T.C.M. (CCH) at 372 (taxpayer annually sold entire yearling crop at auction, buying back those he wished to keep by reserved bid or through a straw bidder). *But see* Bradshaw v. United States, 72-1 U.S.T.C. ¶ 9364 (E.D. Ky. 1971) (taxpayer who sold 85% of colts foaled on his farm was found by jury to have recognized § 1231 gain, not ordinary income, on the sale of certain horses).

[112] *See Jewell*, 25 T.C. at 117.

[113] *See* Clark v. Commissioner, 27 T.C. 1006, 1007-10 (1957) (taxpayer extensively advertised cattle for sale, had substantial volume of sales, and was willing to sell any cattle on farm, not just selected head); *Nowland*, 15 T.C.M. (CCH) at 372 (taxpayer advertised horses in trade journals and sales catalogues). *See also Campbell*, 20 T.C.M. (CCH) at 838 (1961) (hackney horse held for sale to customers in the ordinary course of business despite the lack of advertising and that all sales were by word of mouth because the only manner in which taxpayer could earn a profit from breeding, training and showing hackney horses was by sale). *But see* Estate of Collings v. United States, 138 F. Supp. 837, 839, 841 (W.D. Ky. 1955) (broodmares sold by taxpayer were § 1231 property; although taxpayer advertised his stable generally and the amount of the horse's winnings advertisements did not offer particular horses for sale or state prices) and *compare with Kirk*, 47 T.C. at 193 (taxpayer's failure to advertise horses for sale at general auction was a factor in finding that they were not held for sale to customers).

business, any gain recognized is still ordinary income unless the horse was held for the twenty four month period necessary to qualify for section 1231 treatment.[114]

The amendment of section 1231(b)(3) in 1969, extended from twelve to twenty four months the holding period required for cattle and horses held for draft, breeding or dairy purposes to qualify as section 1231 assets, and added horses held for sporting purposes to the category of livestock subject to the extended holding period requirement.[115] Prior to the amendment, a number of cases arose in which the issue was whether taxpayers who regularly culled animals from their breeding herds and racing stables realized section 1231 gain or loss on such sales or whether they realized ordinary gain or loss from the sale of livestock in the ordinary course of business. Horsemen who maintained established breeding and racing operations and cattlemen who maintained breeding operations generally were found to have realized section 1231 gain or loss.[116] Most of those cases involved animals held for less than twenty four months. Therefore, the issue should arise less frequently under the current statute. Nevertheless, there may be instances in which these cases are important.

It is difficult to apply these cases to clearly determine the purpose for which a horse is held. This difficulty arises from the courts' conclusion that the actual use of the horses or cattle prior to sale was not determinative of the purpose for which the taxpayer held the animals. The taxpayer's motive was what was important; therefore, a horse that never was bred or raced nevertheless might be held for breeding or racing purposes.[117]

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[114] *See* I.R.C. § 1231(b)(3)(A); Treas. Reg. § 1.1231-2(a)(1)(i) (1986); McCarthy v. Commissioner, 22 T.C.M. (CCH) 129, 137 (1963) (sale of racehorse under pre-1969 version of I.R.C. § 1231(b)(3)); Priv. Ltr. Rul. 7410240190A (Oct. 24, 1974) (sale of racehorse under current I.R.C. § 1231(b)(3)).

[115] Tax Reform Act of 1969, Pub. L. No. 91-172, § 212(b), 83 Stat. 487, 571 (1969).

[116] *See, e.g.*, United States v. Bennett, 186 F.2d 407, 410 (5th Cir. 1951); Albright v. United States, 173 F.2d 339, 344-45 (8th Cir. 1949)(cattle); *Kirk*, 47 T.C. at 187; *McCarthy*, 22 T.C.M. (CCH) at 137; Fowler v. Commissioner, 37 T.C. 1124, 1134 (1962); Journal Box Serv. Corp. v. United States, 9 A.F.T.R.2d (P-H) 798, 817 (S.D. Ind. 1962); Jackson v. Commissioner, 11 T.C.M. (CCH) 939, 940-41 (1952).

[117] *See, e.g.*, McDonald v. Commissioner, 214 F.2d at 343; *Kirk*, 47 T.C. at 192-93. *See also* Treas. Reg. § 1.1231-2(b).

Generally, the key factor in establishing that animals were held primarily for breeding or racing was the taxpayer's practice of holding the animals until he could determine whether they were desirable for that purpose. A consistent practice of selling only those animals that were, according to the taxpayer's standards, undesirable for either breeding or racing would result in treatment of the gains and losses as section 1231 losses.[118] This would be true even if a particular animal was too young at the time of sale for actual use in the intended purpose as long as the animal already exhibited characteristics that rendered it undesirable for that purpose.[119]

In *Jewell v. Commissioner*,[120] a taxpayer who sold most, but not all, of the horses bred on his farm was found to be in the business of selling horses to customers in the ordinary course of business, even though he retained some horses to enhance the quality of his breeding stock. The court was influenced by the historical operation of the taxpayer's farm and by the fact that over a five year span he sold all but one of the colts foaled on the farm—most as yearlings. Although the court found that all of the horses foaled were to be added to the breeding herd if they were good enough, most of the horses that the taxpayer asserted were culls were found by the court to have been held primarily for sale to customers in the ordinary course of business.

In determining the purpose for which the horses were held, the *Jewell* court dealt very specifically with the factual circumstances surrounding the sale of each horse. Examining the particular defect asserted by the taxpayer to render each unfit for breeding or racing, the court concluded that those horses not sold within a reasonable time period after the defect first appeared were held primarily for sale to customers in the ordinary course of business.[121] Although they originally might have been

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[118] *See, e.g., Kirk*, 47 T.C. at 192-93; *McCarthy*, 22 T.C.M. (CCH) at 137; *Jackson*, 11 T.C.M. (CCH) at 940-41.

[119] *See* note 118 *supra*.

[120] 25 T.C. 109 (1955).

[121] *Id.* at 115-18. Compare *McCarthy*, 22 T.C.M. (CCH) 129, in which the fact that the taxpayer retained some horses for a period of time after discovery of a characteristic that rendered the horse unfit for breeding or racing was not even considered

held for breeding purposes, continuing to hold them after it was apparent that they were not suitable for breeding effected a change in the purpose for which they were held. On the other hand, those horses that initially appeared to be desirable for breeding, but were sold shortly after the discovery of an undesirable trait, were found to have been held for use in breeding and the gains recognized from the sales of those horses were accorded section 1231 treatment.[122]

In contrast to the taxpayer in *Jewell*, who raced only one horse (which was not one of those sold) during the tax years in question, taxpayers that actively train and race a very high percentage of their horses have been more successful in claiming all of the horses they sold were not held for sale to customers in the ordinary course of business.[123] Here again, however, courts generally examine the particular facts upon which the taxpayer bases his claim that the horse in question has been culled from a breeding or racing stable.[124] In *Kirk v. Commissioner*[125] the Tax Court closely examined both the training procedures followed by the taxpayer, a successful harness racing owner, and the defects asserted by the taxpayer causing the horse to be culled from his stable. Many of the horses sold during the years in question were raced by the taxpayer. Others were trained, but never raced. None were used for breeding purposes. All of the culled horses were sold at general auction as soon as feasible and without advertising.

The Tax Court rejected both of the Commissioner's arguments and concluded that the taxpayer was in the business of

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by the court as a factor in determining whether the gains realized on the sale of culls were I.R.C. § 1231 gains or gains from the sale of horses held primarily for sale to customers in the ordinary course of business.

[122] 25 T.C. at 117-18.

[123] *See Kirk*, 47 T.C. at 192-93; *McCarthy*, 22 T.C.M. (CCH) at 137; *Jackson*, 11 T.C.M. (CCH) at 940-41.

[124] *See Estate of Collings*, 138 F. Supp. at 841 (finding that broodmares sold by taxpayer in the business of breeding, training and selling saddle horses were property used in the taxpayer's trade or business, not property held primarily for sale to customers in the ordinary course of business); *Gamble*, 68 T.C. at 801-02 (culls from racing stable); *Kirk*, 47 T.C. at 193 (culls from racing stable); *Campbell*, 20 T.C.M. (CCH) at 857 (according different treatment by grouping to hackney horses and horses held for rental as riding horses); *Jackson*, 11 T.C.M. (CCH) at 940 (culls from racing stable).

[125] 47 T.C. 177 (1966).

racing horses. The Commissioner argued that the taxpayer's purpose in racing the horses was merely to increase their sale value and that the taxpayer was engaged not only in the business of racing horses, but also in the business of selling horses that were not suitable for use in racing.[126] The first argument was quickly rejected on the facts; the taxpayer was in the business of racing horses, not selling them. The second argument was rejected because the sales were "a necessary incident" to the taxpayer's principal business. The taxpayer sold only those horses that were not suitable for racing. The mere fact that he knew from the time the horses were foaled that many of them would not be suitable for racing did not mean that the horses that were sold were held primarily for sale to customers in the ordinary course of business.[127] His intent in holding the horses was deter-

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[126] *Id.* at 192-93.

[127] It does not appear that the Commissioner argued or that the Tax Court ever considered the possibility that the sales of horses could have been ordinary income under the *Corn Products* doctrine. *See* Corn Prod. Ref. Co. v. Commissioner, 350 U.S. 46 (1955), *reh'g denied,* 350 U.S. 943 (1956), which was applied to I.R.C. § 1231 property in Hollywood Baseball Ass'n v. Commissioner, 423 F.2d 494 (9th Cir.), *cert. denied,* 400 U.S. 848 (1970). In apparent reference to the *Corn Products* doctrine, the trial court in Bradshaw v. United States, 72-1 U.S.T.C. ¶ 9364 (E.D. Ky. 1971), in framing its instructions to the jury, took a somewhat different view of the significance of sales being "a necessary incident" of the conduct of the taxpayer's business than the *Kirk* court did. Bradshaw was engaged in the business of breeding, training and showing saddle horses. The court instructed the jury that even if it found that the horses in question were not held primarily for sale to customers in the ordinary course of business that it was to return a verdict for the government if it concluded that the sale of the horses was "an integral part of [the taxpayer's] business. By 'integral part of' it is meant that the sales were necessary for the conduct of his business." *Id.* at 84,260. Based on this instuction, the jury nevertheless returned a verdict for the taxpayer. *Id.* at 84,261.

In Clark v. Commissioner, 27 T.C. 1006, 1014 (1957), the Tax Court, attempting to draw the line between cattle held for sale to customers in the ordinary course of business and cattle held for breeding purposes, noted the admonition of the Supreme Court in *Corn Products* that the scope of capital assets was to be narrowly construed, but apparently had no thoughts of directly applying *Corn Products.*

The better view is that, given the congressional purpose behind I.R.C. § 1231 (whether or not one agrees with that policy), the *Corn Products* doctrine should not override I.R.C. § 1231. *See* Deltide Fishing & Rental Tools, Inc. v. United States, 279 F. Supp. 661, 665-66 (E.D. La. 1968). In Guggenheim v. Commissioner, 46 T.C. 559, 569-70 (1966), the Commissioner specifically argued that the *Corn Products* doctrine overrode I.R.C. § 1231 on the sale of syndicate shares in a stallion by the taxpayer, who prior to the syndication owned the entire interest in the stallion and used him for breeding purposes. The Tax Court quickly rejected the argument, concluding that the taxpayer was merely liquidating part of his interest in I.R.C. § 1231 property. *Id.* at minative, and on the facts, the taxpayer did not decide to sell any particular horse until it was shown that the horse was not a desirable racehorse. Accordingly, all of the taxpayer's gains were treated as section 1231 gains.

In reaching its decision in *Kirk*, the Tax Court cited its earlier memorandum decision in *McCarthy v. Commissioner*[128] as a case "in which the facts were very similar."[129] Although this is generally true, there were some differences in both facts and approach. Unlike *Kirk*, yet like *Jewell*, the taxpayer in *McCarthy* continued to hold some of the horses in training for a period following discovery of a characteristic rendering them unfit for racing. Nevertheless, the Tax Court distinguished *Jewell* as a case dealing with a seller who, on all facts, was primarily engaged in raising horses for ultimate sale rather than for racing or breeding. McCarthy, on the other hand, did not continuously sell horses as yearlings. He kept the majority of his horses for more than a year, training them and selling only those horses that proved to be unfit or too slow for racing, while also showing a profit from his racing activities.[130] These facts indicated that the horses "were not trained and raced as part of a horse selling business but as a part of the integral, indivisible business of the [taxpayer] of owning, training, racing, and breeding racehorses."[131] The court concluded, without a detailed examination of the circumstances surrounding the decision to sell each horse, that the gains realized on the sale of the horses held for more than six months were eligible for capital gains treatment under

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On the other hand, there is some authority for the proposition that property may simultaneously be I.R.C. § 1231 property and property held primarily for sale to customers in the ordinary course of business. *See* International Shoe Mach. Corp. v. United States, 491 F.2d 157, *cert. denied,* 419 U.S. 834 (1974). An argument that the gain on the sales of culls was ordinary income based on this precedent should also fail. The sale of horses determined to be unfit for racing or breeding is analogous to the sale of equipment at the end of its useful life to the taxpayer, a situation that concededly produces I.R.C. § 1231 gains, not ordinary income. *See, e.g.,* Philber Equip. Corp. v. Commissioner, 237 F.2d 129 (3d Cir. 1956).

[128] 22 T.C.M. (CCH) 129 (1963).

[129] 47 T.C. at 109 n.5.

[130] *McCarthy*, 22 T.C.M. (CCH) at 133.

[131] *Id.* at 137. *See* note 127 *supra*.

section 117(j) of the 1939 Code, the predecessor of section 1231.[132]

The factors cited by the Tax Court in *McCarthy* for identifying horse owners that are not generally in the business of selling horses to customers in the ordinary course of business are clearly the mainstream criteria. The failure of the *McCarthy* court to examine individually the circumstances surrounding the sale of each horse, however, does not appear to be in the mainstream. Perhaps this reflects *sub silentio* reasoning in *McCarthy* that taxpayers who generally do not hold horses for sale to customers in the ordinary course of business do not do so with respect to specific horses, while it is much more likely that taxpayers who hold horses for sale to customers in the ordinary course of business might not hold a particular horse for that purpose.[133] It also may simply reflect the fact that in most cases the volume of horses sold by the taxpayer is sufficient to raise the possibility of dual businesses—one of breeding, training and racing horses and another of selling horses to customers in the ordinary course of business. Courts have examined closely the facts of each sale to determine whether the sales were part of a second business or merely incidents of the breeding, training and racing business. This appears to be the reason behind the detailed factual analysis in *Kirk*. Perhaps *McCarthy* may be reconciled as a case in which the factors discussed above established so clearly that the taxpayer was not in the business of selling horses to customers in the ordinary course of business that there was no need to examine further the circumstances of each sale.

If the taxpayer is not actively engaged in racing, it may be more difficult to establish that culls are not held primarily for

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[132] 22 T.C.M. (CCH) at 135-37.

[133] *Compare Kirk*, 47 T.C. at 191 ("The fact that petitioner [who was found to be engaged in the business of breeding, training and racing horses] knew in advance that a good number of the horses would never develop into good racehorses and that he would have to sell them does not mean that the horses sold were necessarily held primarily for sale.") *with Jewell*, 25 T.C. at 115-18 (taxpayer who kept only 1 out of 23 colts foaled during 5 year span, selling 19 as yearlings, was in the business of selling horses to customers in the ordinary course of business, but sales of certain colts and fillies bred for use as breeding stock but never used as such because of unsuitability were treated as sales of property held for use in the taxpayer's business).

sale to customers in the ordinary course of business.[134] This will be particularly true with respect to colts. Before a horse commences a breeding career, he generally must first prove his value on the track.[135] It is unlikely that a breeder would retain all of the colts foaled on his farm for use in breeding operations even aside from the need to first prove them on the track. Not only does a breeding operation require fewer stallions than it does broodmares, but retention of the colts for future use as stallions would lead to undesirable inbreeding.[136] Furthermore, unless the taxpayer is engaged in racing, his activities probably will not produce a profit other than through the sale of horses bred by him.[137] If the sale of horses is the only source of profit, then the gains would arise from property held for sale to customers in the ordinary course of business and therefore would be ordinary income. The taxpayer could demonstrate, however, as in *Jewell*, that a particular horse was held for use as breeding stock and thereby have those gains accorded section 1231 treatment.

3. *Special Problems in Qualifying for Section 1231 Treatment*

a. *Section 1231(b)(3) Twenty Four Month Holding Period Requirement For Horses Held For Breeding, Draft, Or Sporting Purposes*

As noted in the previous section, to be considered section 1231 property, a horse held for draft, breeding or sporting

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[134] *See* Treas. Reg. § 1.1231-2(c)(1)(iii) ("A horse which has neither been raced at a public track nor trained for racing shall not, except in rare and unusual circumstances, be considered as held for racing purposes."); *Jewell*, 25 T.C. at 115-18 (1955). *Cf.* Treas. Reg. § 1.1231-2(b)(2), Example (2) (A taxpayer who is in the business of raising horses for sale to others for use as draft horses does not hold the horses for use as draft horses merely because he uses them on his farm as draft horses for the purpose of training them; his use of the horses for draft purposes is incidental to the sale of the horses.).

[135] *See Guggenheim*, 46 T.C. at 561; *Fowler*, 37 T.C. at 1127-29.

[136] *See Jewell*, 25 T.C. at 118 (that seller knew colts foaled on farm were related to fillies foaled on farm negated argument that colts were held for breeding). *Cf. Kirk*, 47 T.C. 177 (filly sold by taxpayer because she was product of accidental inbreeding).

[137] *See Campbell*, 20 T.C.M. (CCH) 825 (taxpayer who bred and showed hackney horses realized ordinary income from sales of horses because, although he won substantial prize money at shows, the only way in which the activity could show a profit was through the sale of horses whose value had been enhanced by good show records). *But see* Hancock v. Commissioner, 31 T.C. 752, 757-58 (1959) (taxpayer that maintained only a breeding herd and sold only culls was allowed I.R.C. § 1231 treatment on all cattle sold).

purposes (including racing) must be held for more than twenty four months.[138] A horse held for use in the taxpayer's trade or business other than for draft, breeding or sporting purposes, however, must be held for only six months in order to be section 1231 property.[139] The 24 month holding period requirement largely moots the question of whether horses that the taxpayer claims were culled from potential breeding stock or from the racing stable were in fact held for those uses rather than for sale to customers in the ordinary course of business. All gains and losses realized on the resale of horses within two years of purchase or on the sale of horses foaled by the taxpayer within two years of birth will be ordinary income or loss,[140] unless the taxpayer can show that the horse was held for a purpose other than breeding, sporting or sale to customers in the ordinary course of business. Thus, the number of instances in which the IRS and the courts must grapple with ambiguous facts to make fine distinctions, as illustrated in the cases discussed in the prior section, is significantly reduced.

The extended holding period provided in section 1231(b)(3) was enacted specifically because Congress recognized that the purpose for which young horses and cattle are held frequently may be ambiguous.[141] The one year holding period requirement previously in force was considered to be an insufficient time period for the taxpayer to determine whether cattle were suitable for breeding stock and horses were suitable for racing or breeding stock or whether the animals were held for sale. Congress also was concerned that the shorter holding period, combined with the ability of investors to utilize farm accounting methods

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[138] *See* I.R.C. § 1231(b)(3); Treas. Reg. § 1.1231-2.

[139] *See Gamble*, 68 T.C. at 820. *See also Campbell*, 20 T.C.M. (CCH) at 855-56; J. O'BYRNE & C. DAVENPORT, FARM INCOME TAX MANUAL, § 325 (6th ed. 1982).

[140] *See* Rev. Rul. 76-70, 1976-1 C.B. 225; Priv. Ltr. Rul. 7410240190A (Oct. 24, 1974). *See also* Greer v. U.S., 408 F.2d 631, 636-37 (6th Cir. 1969) (casualty gain recognized on receipt of insurance proceeds paid upon death of five day old colt was ordinary income and did not go into I.R.C. § 1231 hotchpot); *McCarthy*, 22 T.C.M. (CCH) at 137 (gain on sale of racehorses held less than six months was ordinary income under pre-1969 version of I.R.C. § 1231(b)).

[141] *See* S. REP. No. 552, 91st Cong., 1st Sess. 100-01 (1969), *reprinted in* 1969-3 C.B. 423, 488; H.R. REP. No. 413 (Part 1), 91st Cong., 1st Sess. 70 (1969), *reprinted in* 1969-3 C.B. 200, 244.

to currently deduct expenses,[142] gave rise to a large number of transactions with the solely tax motivated purpose of converting ordinary income into capital gains. Extending the holding period necessary to obtain capital gains treatment through section 1231 solved both problems.

In extending the section 1231 holding period, Congress implicitly rejected the idea from earlier cases that the taxpayer's motive in holding the animal, rather than the taxpayer's actual use of the animal, determines whether it was held for breeding.[143] This is manifested in the legislative history.[144] The House version of the amendment would not have extended the one year holding period, but would have provided that the holding period would not begin until the animal reached the age at which it normally first would be used for breeding or racing purposes.[145] The Senate believed, however, that the flexible commencement date of the holding period would present administrative difficulties and, therefore, substituted the arbitrary twenty four month holding period.[146] Because cattle normally reach breeding age within two years of birth[147] and horses generally commence training for racing within two years,[148] the purpose of the Senate amendment evidently was no different than the purpose of the House version.

b. *Identifying Horses Held For Breeding Or Racing Purposes Under The Regulations*

The Treasury Regulations promulgated under section 1231(b)(3) evidence a tightening of the test for determining

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[142] *See* note 141 supra. For a brief discussion of the peculiarities of farm tax accounting methods giving rise to the problem, see note 30 *supra*.

[143] *See* cases cited in note 117 *supra*.

[144] *See* notes 145-46 *infra*.

[145] *See* H.R. REP. No. 413 (Part 1), 91st Cong., 1st Sess. 70 (1969), *reprinted in* 1969-3 C.B. 200, 244.

[146] *See* S. REP. No. 552, 91st Cong., 1st Sess. 100-01 (1969), *reprinted in* 1969-3 C.B. 423, 488; H.R. CONF. REP. No. 782, 91st Cong., 1st Sess. 298 (1969), *reprinted in* 1969-3 C.B. 644, 656.

[147] *See McDonald*, 214 F.2d at 343-44; Fox v. Commissioner, 16 T.C. 854, 856 (1951), *aff'd*, 198 F.2d 719 (4th Cir. 1952).

[148] *See Gamble*, 68 T.C. at 802 (thoroughbreds); *Kirk*, 47 T.C. at 180 (standardbreds).

whether a horse is held for breeding or racing purposes.[149] Although the regulations provide that whether or not livestock is held for breeding or racing "depends upon all the facts and circumstances in each case," they also state that the "purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal." Actual use is not necessary, however, to show that a horse was held for breeding or racing purposes if the "animal is disposed of within a reasonable time after its intended use for such purpose is prevented or made undesirable by reason of accident, disease, drought, unfitness of the animal for such purpose, or a similar factual circumstance." Thus, the regulations allow some of the flexibility evidenced in prior case law. The regulations, however, do contain the admonishment that an animal is not held for breeding or racing purposes "merely because it is suitable for such purposes or merely because it is held by the taxpayer for sale to other persons for use by them for such purposes."[150]

The regulations go on to provide very specific rules to determine whether a horse is held for racing purposes.[151] A horse that actually was raced at a public track is considered to be held for racing purposes, "except in rare and unusual circumstances."[152] Conversely, a horse that neither was raced at a public track nor trained for racing is not considered to be held for racing purposes "except in rare and unusual circumstances."[153] No authority provides examples of "rare and unusual circumstances" in either context.

If a horse was not raced at a public track, but was trained to race, the horse may be found to be held for racing purposes if "other facts and circumstances in the particular case also indicate that the horse was held for this purpose."[154] This vague standard is clarified by the further statement that if the taxpayer "maintains a written training record on all horses he keeps in training status, which shows that a particular horse does not

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149 Treas. Reg. § 1.1231-2.
150 Treas. Reg. § 1.1231-2(b)(1).
151 Treas. Reg. § 1.1231-2(c).
152 Treas. Reg. § 1.1231-2(c)(1)(i).
153 Treas. Reg. § 1.1231-2(c)(1)(iii).
154 Treas. Reg. § 1.1231-2(c)(1)(ii).

meet objective standards (including, but not limited to, such considerations as failure to achieve predetermined standards of performance during training, or the existence of a physical or other defect) established by the taxpayer for determining the fitness and quality of horses to be retained in his racing stable, . . . [and] the taxpayer disposes of the horse within a reasonable time after he determined that it did not meet his objective standards for retention, the horse shall be considered as held for racing purposes."[155] These criteria strongly resemble the factual circumstances cited by the Tax Court in *Kirk* and other similar cases used to establish that the taxpayer was in the business of training and racing horses, not selling horses, and that the particular horse in question was held for use in racing.[156] Thus, the earlier cases continue to be important precedent under the subsequently applicable regulations, although the section 1231 holding period currently is longer.

A difficult continuing issue under the regulations involves the sale of a filly or maiden mare that has not been trained for racing and has been held for more than two years by a taxpayer generally in the business of breeding and selling horses. If the animal was not actually used for breeding, apparently the horse is not treated as section 1231 property unless the taxpayer establishes both that the particular horse was held for breeding purposes (rather than for sale to customers in the ordinary course of business) and that the horse was sold within a reasonable time after discovery that she was not suitable for breeding. This often may be a difficult or impossible burden to carry. The Tax Court's decision in *Gamble v. Commissioner*,[157] however, offers another possibility.

Gamble, who was found to be in the thoroughbred racing business and not in the business of selling thoroughbreds, purchased a mare in foal on December 20, 1969. The foal, a colt, was born on April 12, 1970. The foal neither was raced at a public track nor trained for racing, but it "was handled in a manner entirely consistent with a plan to train and race it when

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[155] *Id.*

[156] *See Kirk*, 47 T.C. at 193; *McCarthy*, 22 T.C.M. (CCH) at 137; *Jackson*, 11 T.C.M. (CCH) at 940-41.

[157] 68 T.C. 800 (1977) (*acq.*).

it reached the proper age."[158] In August 1971, as the colt approached the age at which training would normally begin, Gamble sold the colt at the Saratoga Yearling Sale. Gamble claimed that the colt was a capital asset. The Commissioner argued that the colt was property used in Gamble's business subject to section 1231 and that the twenty four month holding period requirement was not met.

Based on the evidence, the court concluded that Gamble was "holding the colt in order to exploit it through whatever course of action might appear at the time to be most profitable, either through sale, or to race it himself, or in some other manner (e.g., by syndication)."[159] Because no single purpose predominated, the court reasoned that the colt was not held primarily for sale to customers within the meaning of section 1221(1). Despite Gamble's argument that his failure to claim depreciation with respect to the colt established that it was a capital asset,[160] the court concluded that, because Gamble's business "*encompassed* holding immature foals for possible future use as race horses," the evidence established that the colt was "unmistaka-

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[158] *Id.* at 806.

[159] *Id.* at 812.

[160] *Id.* at 813. The taxpayer's failure to depreciate the colt was consistent with treating the colt as I.R.C. § 1231 property. Immature animals held for future use in draft, breeding or dairy puposes are not considered to be placed in service until they reach maturity, "the age at which they can be worked, milked, or bred." U.S. TREAS. DEPT., PUB. NO. 225, FARMER'S TAX GUIDE 16 (1981 ed.). *See also* Rev. Rul. 60-60, 1960-1 C.B. 190. *But see* Rudolph Inv. Corp. v. Commissioner, 31 T.C.M. (CCH) 573, 578 (1972) (taxpayer was allowed to depreciate yearling heifers, despite immaturity for breeding, because they became part of the breeding herd at that age). No depreciation may be claimed until the animal is placed in service. Treas. Reg. § 1.167(a)-10(b) (1960). *See, e.g.,* Piggly Wiggly Stores, Inc. v. Commissioner, 84 T.C. 739 (1985) (supermarket equipment), *aff'd,* 803 F.2d 1572 (11th Cir. 1986). If breeding stock may not be depreciated prior to the year it reaches the age at which it may be bred, by analogy, no depreciation should be allowable with respect to a racehorse prior to the year in which it enters training. Nevertheless, property that will be subject to an allowance for depreciation after it is placed in service by the taxpayer is not excluded from the ambit of I.R.C. § 1231 because the taxpayer is unable to claim depreciation deductions on the property not yet placed in service. *See* Alamo Broadcasting Co. v. Commissioner, 15 T.C. 534 (1950). Therefore, it was entirely proper to claim no depreciation on the colt even if it was property subject to an allowance for depreciation held for use in the taxpayer's business and not a capital asset. *But see* Talbot & Fehrenbach, *Thoroughbred Breeding—Tax Considerations,* 49 C.P.A. J. 11, 13 (July 1979) (table of useful lives of thoroughbred racehorses shows useful life for horse that is 1 year old when placed in service).

bly" depreciable property held in connection with Gamble's business described in sections 1221(2) and 1231(b).[161] After finding the colt to be section 1231 property, rather than a capital asset, the court turned to the question of what holding period to apply, the six month holding period of section 1231(b)(1) or the twenty four month holding period of section 1231(b)(3).

At this juncture, the *Gamble* case takes a strange twist. Because the colt neither was raced nor trained for racing, the Commissioner agreed with Gamble's contention that section 1231(b)(3), with its twenty four month holding period, was inapplicable.[162] That being so, Gamble argued that the horse was nevertheless section 1231 property meeting the section 1231(b)(1) six month holding period requirement. The government, however, argued that horses could be treated as section 1231 property only under subsection (b)(3) and that if subsection (b)(3) was inapplicable the horse could not qualify under subsection (b)(1). With what at first blush appears to be well reasoned logic, the Tax Court rejected the Commissioner's argument and allowed Gamble to treat the gain recognized as capital gain on the sale of a section 1231(b)(1) asset.

First, the court noted that subsection (b)(3) provides that the term "property used in the trade or business . . . *includes*"[163] horses held for draft, breeding and sporting purposes. Section 7701(b) specifically provides that the word "includes" does not exclude things other than the specified examples if they are independently within the meaning of the defined term. Prior to the 1969 amendment to subsection (b)(3), it was established that animals held for purposes other than those specified in subsection (b)(3) could qualify as section 1231 property under subsection (b)(1).[164] Furthermore, adopting the Commissioner's argument would not only exclude from section 1231 property horses held for breeding or racing that were not held for twenty four months, but would also exclude horses held for any purpose

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[161] 68 T.C. at 812 (emphasis in original).

[162] *Id.* at 817.

[163] *Id.* at 818 (emphasis in original).

[164] *See, e.g.*, McDougal v. Commissioner, 62 T.C. 720 (1974)(*acq.*) (racehorses were I.R.C. § 1231 property under I.R.C. § 1231(b)(1) prior to addition of "sporting" purposes to subsection (b)(3) in 1969); *Fowler*, 37 T.C. 1124 (same).

not stated in subsection (b)(3), such as horses used for advertising, entertainment, or by riding stables, regardless of the holding period.[165] Finally, the court could not find adequate support in the legislative history of the 1969 amendment to conclude that Congress intended the amendment to restrict section 1231 treatment to horses that *both* had been held for twenty four months *and* held for one of the specified purposes. Although there was some language in the Senate Committee Report supporting the Commissioner's argument,[166] other language in that report and in the Conference Report indicated that the purpose was only to extend the holding period applicable to animals held for the specified purposes.[167] The general tenor of the legislative history, reciting the problems and abuses encountered with respect to the character of gain recognized on the sale of animals that were alleged to have been held for the specified purposes, supported this analysis.[168]

It is difficult to fault this logic. But the result is unsettling, and there is language in the *Gamble* opinion that hints that the result may have disturbed the court. After reaching its conclusion, the court noted:

> We recognize that the regulations as they now exist . . . might in some cases effectively shield from the 24-month holding period requirement horses which arguably should be subjected to it. However, that problem is not presented in this case, because the Government has taken the position that the chest-

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[165] 68 T.C. at 814. *See also Campbell*, 20 T.C.M. (CCH) at 885-56 (pleasure-riding horses held for rental were I.R.C. § 1231 property).

[166] *See* S. REP. No. 552, 91st Cong., 1st Sess. 100-01 (1969), *reprinted in* 1969-3 C.B. 423, 488, *quoted in* 68 T.C. at 818-19 n.16 ("Thus, cattle and horses are not to qualify for long-term capital gains treatment unless the animal is held by the taxpayer for at least two years for one of the specified purposes.").

[167] *Id., quoted in* 68 T.C. at 819, n. 17 ("The committee amendments extend the present one-year holding period for cattle and horses, *which* are held for draft, breeding, dairy or sporting purposes, to two years." (emphasis added by Tax Court)); H.R. CONF. REP. No. 782, 91st Cong., 1st Sess. 298 (1969), *reprinted in* 1969-3 C.B. 644, 656, *quoted in Gamble*, 68 T.C. at 819 n.17 ("The Senate amendment provides that in order for any gain on the sale of horses or cattle to result in capital gain *where* the animals are held for draft, dairy, breeding, or sporting purposes, the horses or cattle must have been held for at least two years." (emphasis added by Tax Court)).

[168] *See* 68 T.C. at 819. *See also* S. REP. No. 552, 91st Cong., 1st Sess. 100-01 (1969), *reprinted in* 1969-3 C.B. 423, 488.

> nut colt was property used in the petitioner's trade or business and that it was *not* held for sporting purposes.[169]

The court was correct in noting the flaw in the regulations. Its assertion that the problem was not presented in *Gamble*, however, was correct only in the narrowest sense.

In fact, *Gamble* involved the exact fact pattern that the 1969 amendment was intended to reach. The legislative history of the amendment specifically states that the changes were necessary because of the problems encountered when "the purpose for which animals are held is ambiguous."[170] The remedy was to remove horses that might be held for racing in the future or might be held for sale from the ambit of section 1231. Yet Gamble was able to use his ambiguous purpose as a sword to gain section 1231 treatment. Moreover, the facts of the case reveal not only that the taxpayer sold either a colt or filly at about the age when training would begin in each of the preceding three years, but also that the colt in question was particularly well bred and desirable.[171] Similar facts in other cases involving sales of greater numbers of animals annually have resulted in ordinary income treatment.[172] How then, did the taxpayer prevail in *Gamble*?

The easy answer is that the Commissioner largely stipulated away his case. Because Gamble did maintain a number of horses that actively raced, his sales activities were not of the level generally necessary to find that he was holding animals for sale

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[169] 68 T.C. at 820 (emphasis in original).

[170] S. REP. No. 552, 91st Cong., 1st Sess. 100-01 (1969), *reprinted in* 1969-3 C.B. 423, 488; H.R. REP. No. 413 (Part 1), 91st Cong., 1st Sess. 70 (1969), *reprinted in* 1969-3 C.B. 200, 244.

[171] 68 T.C. at 801-09.

[172] *See* Rice v. United States, 75-1 U.S.T.C. ¶ 9207 (D. Mont. 1975) (sale of high quality, undiseased heifers rather than inferior animals demontrated a predetermined effort to hold well bred animals for sale rather than culling from breeding herd); Bandes v. Commissioner, 44 T.C.M. (CCH) 243 (1982) (over the course of several years taxpayer serially sold groups of 13 month old pregnant gilts; applying Treas. Reg. § 1.1231-2(b)(1), the court concluded that, contrary to taxpayer's testimony that he intended to hold the hogs for breeding, the facts established that he held the hogs for sale to customers in the ordinary course of business); Kline v. Commissioner, 15 T.C. 998 (1950) (taxpayer, who purchased cows in the fall, bred them and resold the cows in the spring after calving, realized ordinary income because he never intended to hold them for breeding beyond the first year).

to customers.[173] On the facts, that portion of the Commissioner's argument was unsound, and it should have been recognized as such. Similarly, the Commissioner's argument that to be section 1231 property a horse had to fall within subsection (b)(3) was very clearly destined to lose. Thus, the Commissioner lost by agreeing that the colt was not held for sporting purposes. In light of the regulations, however, the Commissioner's agreement on this point does not appear to be unreasonable. The colt was neither raced nor trained, and the regulations provide that in such a case a horse "shall not, except in rare and unusual circumstances, be considered as held for racing purposes." The regulations, therefore, led to a result contrary to the Congress's intent in enacting the 1969 amendments to section 1231(b)(3). Although holding "immature colts for possible future use as race horses" brings the animals within the meaning of property held for use in the taxpayer's business, it does not amount to a "sporting purpose." Consequently, unless the regulations are amended, the same result likely would be reached if another case similar to *Gamble* arises. It is doubtful that the *Gamble* facts present the "rare and unusual circumstances" necessary to find that a horse that neither was raced nor trained is held for racing purposes.

c. *Sale of Mares in Foal*

The sale of a mare in foal raises the question of whether the amount realized should be apportioned between the mare and the unborn foal. If the amount realized is so apportioned, only the gain attributable to the mare will be eligible for section 1231 treatment, assuming that the requirements of section 1231 are otherwise satisfied, because an embryonic foal cannot satisfy the holding period requirement of either section 1231(b)(3) or subsection (b)(1).[174]

In *Metz v. United States*,[175] the Commissioner unsuccessfully argued that part of the amount realized upon the sale of a mare

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[173] *Compare Jewell*, discussed at notes 120-22 *supra*, *with Kirk* and *McCarthy*, discussed at notes 123-33 *supra*.

[174] *See Greer*, 408 F.2d 631 (holding period of foal begins at birth).

[175] 62-1 U.S.T.C. ¶ 9500 (E.D. Ky. 1962).

in foal should be allocated to the foal and that the gain attributable to the foal, which would be the entire amount realized because the seller had no cost basis in the foal, should be taxed as ordinary income. The government contended that an amount equal to the stud fees paid with respect to each of two mares involved in the case should be treated as the amount realized on the sale of the unborn foal. This argument was based on the earlier Tax Court decision in *Gamble*,[176] which held that the buyer of a mare in foal was entitled to allocate a portion of the purchase price to the foal for purposes of computing the gain realized upon the subsequent sale of the foal. The court in *Gamble*, however, considered the stud fees as only one factor in determining the portion of the purchase price allocable to the foal.

The *Metz* court apparently accepted the government's theory that a portion of the amount realized could be attributable to the unborn foal. It submitted special interrogatories to the jury, asking first, whether the " 'purchase price was enhanced by reason of the fact that the mare was thought by the parties to the transaction to be then carrying an unborn foal, and that any part of such enhancement in price, if any, was due to a value attributed or attributable to the unborn foal,' "[177] and second, if the answer to the first interrogatory was "yes," the percentage of the amount realized attributable to the foal.[178] Although on the evidence the jury answered the first interrogatory in the negative for both foals, if the jury had answered the first interrogatory in the affirmative, whatever portion of the amount realized was allocated by the jury to the foal presumably would have been held by the court to be ordinary income. Otherwise, there was no need to submit the issues to the jury.

Thus a careful comparison of *Gamble* and *Metz* leads to the conclusion that whether a portion of the amount realized on the sale of a mare in foal is properly attributable to the unborn foal is clearly a question of fact, to be determined on a case by case basis. The same considerations that govern the allocation of a

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[176] 68 T.C. 800 (1977) (*acq.*).
[177] *Metz*, 62-1 U.S.T.C. at 84,475 (quoting the first interrogatory).
[178] *Id.*

portion of the purchase price to the buyer's basis in the foal should apply in determining whether the seller must allocate a portion of the amount realized to the unborn foal. To the extent that a portion of the amount realized is attributed to the foal, the seller generally realizes ordinary income of an equal amount, assuming that the stud fee was previously deducted. If, on the other hand, the seller elected to capitalize the stud fee or was required by section 263A to capitalize all the costs of raising the foal, including the stud fee, that would be his basis in the foal for computing ordinary gain or loss realized with reference to the allocable amount realized.[179] In the unusual instance that the seller can establish that he held the unborn foal neither for sale to customers in the ordinary course of business nor for future breeding or racing and if the mare was in foal for more than six months, the seller might have an argument, based on *Gamble*, that he was entitled to section 1231 treatment on the gain attributable to the foal. This is, however, a tenuous argument at best, and is contrary to the decision in *Greer v. United States*,[180] deciding that the holding period of a foal does not begin until its birth.

4. *Sales of Syndicate Shares*

a. *Is a Syndicate Undivided Ownership or a Partnership?*

Syndicated ownership of horses occurs in racing syndicates, broodmare syndicates, and stallion syndicates.[181] Racing syndicates and broodmare syndicates should be treated as partnerships for federal income tax purposes,[182] and the sale of a share in

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[179] *See* notes 49-51 *supra* and accompanying text.

[180] 408 F.2d 631 (6th Cir. 1969) .

[181] *See generally* Campbell, *Racing Syndicates as Securities*, 74 KY. L.J. 691 (1985-86); Campbell, *Stallion Syndicates as Securities*, 70 KY. L.J. 1131 (1981-82); Kropp, Flannagan & Kahle, *Choosing the Equine Business Form*, 70 KY. L.J. 940, 945-58 (1981-82).

[182] In determining whether the syndicate is a partnership, the standards developed under I.R.C. §§ 761 and 7701(a)(2) should be determinative, not the state law determination. *See, e.g.*, Commissioner v. Culbertson, 337 U.S. 733 (1949) (ranching partnership); Wheeler v. Commissioner, 37 T.C.M. (CCH) 883 (1978) (real estate development partnership). *But see* M.H.S. Co., Inc. v. Commissioner, 35 T.C.M. (CCH) 733 (1976),

such a syndicate should be taxed under the rules governing the sale of partnership interests.[183] A stallion syndicate, however, may or may not be a partnership for income tax purposes, depending on its organization. The rules governing taxation of the sale of a share in a stallion syndicate differ depending on how the syndicate is organized.

Reduced to its most basic elements, a stallion syndicate entails multiple ownership of a stallion in which an ownership interest (commonly termed "share") entitles the owner to certain annual breeding rights (commonly termed "nominations" or "seasons") and obligates the owner to share in the stallion's maintenance expenses. In thoroughbred syndicates each share owner typically has the right to breed one mare to the stallion annually. The syndicate manager is responsible for the daily care of the stallion and the supervision of breeding activities. He maintains records of the syndicate's activities and bills the share owners for their proportionate share of the syndicate's expenses. In some syndicates the syndicate manager may be responsible for promoting the horse through advertising, obtaining insurance on the horse, assisting share owners in selling their breeding rights, or selling extra breeding rights on behalf of the syndicate and applying the proceeds against expenses or dividing the profits between the share owners.

A syndicate structured as merely an expense sharing arrangement should not be categorized as a partnership for federal income tax purposes.[184] It is merely the co-ownership of property used by each of the co-owners in his separate business and lacks

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aff'd, 575 F.2d 1177 (6th Cir. 1978) (applying state law, but noting that same result is reached under federal law).

I.R.C. § 761(a) provides that "the term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation, trust or estate." Treas. Reg. § 1.761-1(a), in relevant part, provides that "[t]enants in common . . . may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof." In McDougal v. Commissioner, 62 T.C. 720 (1974) (*acq.*), the court found that co-owners of a horse held for racing and future use as a stud were partners. *See* text accompanying notes 186-87 *infra*. *See also* Trower, Davis & Geske, *Taxation of Equine Partnerships*, 70 KY. L.J. 1021, 1038 n.51 (1981-82).

[183] *See* text accompanying notes 196-208 *infra*.

[184] *See* Treas. Reg. § 1.761-1(a).

the joint profit motive necessary for a partnership.[185] But if the syndicate actively carries on a business or a venture with the object of making and dividing profits among the syndicate members, a joint profit motive exists and the syndicate is a partnership for tax purposes.[186] Thus, if the syndicate manager is empowered to sell seasons on behalf of the syndicate and to apply the proceeds to reduce the expenses charged to the share owners or to divide the profits among the share owners, the syndicate should be treated as a partnership for federal income tax purposes. The sale of seasons by the syndicate, as opposed to sale of seasons by individual shareholders, should be viewed as the conduct of a business regardless of whether the proceeds are used solely to offset expenses or are divided among the share owners.[187]

b. *Character of Gain on Nonpartnerhip Syndicate Shares*

If a stallion syndicate share is merely an undivided interest in the horse and not an interest in a partnership, gains and losses realized upon the sale of the share should be categorized as ordinary or section 1231 gains or losses by each individual share owner, using the same standards applicable to sales of wholly owned horses. Generally, this results in section 1231 treatment as long as the holding period requirement is met. Because each share owner characterizes the purpose for which he holds the share by looking at his own activities,[188] the holding period for section 1231 purposes normally commences when the share owner acquires his share, not when the syndicate acquired the stallion, if that occurred at an earlier date. Thus, section 1231 treatment

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[185] *See* McKEE, NELSON & WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.03[5] (1977, 1985).

[186] Treas. Reg. § 1.761-1(a). *See* McKEE, NELSON & WHITMIRE, *supra* note 185; Trower, Davis & Geske, *supra* note 182, at 1038 n.51.

[187] *See* Madison Gas & Elec. Co. v. Commissioner, 72 T.C. 521 (1979), *aff'd,* 633 F.2d 512 (7th Cir. 1980) (electric utility companies jointly operating nuclear power plant and distributing power in kind rather than jointly selling power to third parties were nevertheless partners); Estate of Levine v. Commissioner, 72 T.C. 780 (1979), *aff'd,* 634 F.2d 12 (2d Cir. 1980) (co-owners of commercial building were partners).

[188] If the syndicate were classified as a partnership, the character of the gain on the horses would be determined with respect to the partnership's activities and purpose for holding the horse. I.R.C. § 702(b); Treas. Reg. § 1.702-1(b) (1985).

is not available until the share owner has held the share for more than twenty-four months.[189] The availability of section 1231 gains, of course, is limited by section 1245. If the share owner is not a partner, but an owner of an undivided interest in the stallion, he will have claimed ACRS deductions with respect to the stallion. These deductions result in gain realized upon the sale of the share being ordinary income under section 1245 to the extent of ACRS deductions previously claimed by the share owner.[190]

The similarity of the rights of a syndicate share owner and the rights of a mere lifetime season owner led the Commissioner to assert in *Guggenheim v. Commissioner*[191] that gain realized on the initial sale of syndicate shares by the promoter was ordinary income. The Commissioner argued that the purported sale of undivided interests in the stallion was, in substance, only the sale of lifetime seasons. Focusing on the rights acquired by the purchasers, rather than the rights surrendered by the promoter, the court concluded, however, that the purchasers indeed acquired undivided ownership interests in the stallion. Unlike an owner of a lifetime season, the share owners were required to contribute to the stallion's expenses, were entitled to share in any profits from the sale of excess seasons, had the right to vote on a successor syndicate manager, and had a right of first refusal to purchase the interest of any share owner who wished to sell his share. These rights, combined with the form of the transaction, were sufficient basis to respect its form.

Alternatively, the Commissioner argued that, even if the form of the transaction was respected, the seller could not treat the transaction as a sale of section 1231 property under *Commissioner v. P.G. Lake, Inc.*,[192] *Corn Products Co. v. Commissioner*,[193] and *Commissioner v. Gillette Motor Co.*[194] All three of these cases were found to be inapplicable, however, and the

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[189] I.R.C. § 1231(b)(3); Treas. Reg. § 1.1231-2.

[190] *See* text accompanying note 106 *supra*.

[191] 46 T.C. 559 (1966). *See also* Priv. Ltr. Rul. 6302014720 (Aug. 9, 1966) (technical advice memorandum issued with respect to *Guggenheim* during audit).

[192] 356 U.S. 260 (1958).

[193] 350 U.S. 46 (1955).

[194] 364 U.S. 130 (1960).

taxpayer was permitted to treat his gains as section 1231 gains. The taxpayer in *Guggenheim* clearly had transferred the investment risks associated with three-sevenths of the stallion to the purchasers of the fifteen shares. This readily distinguished the case from *P.G. Lake*, which the Tax Court concluded involved a disguised sale of future ordinary income because the purchasers of the oil rights in that case had not really acquired any substantial investment risks or benefits. The seller in *P.G. Lake* bore the same investment risks after the transaction that he bore before the transaction. The Commissioner's attempted application of *Gillette Motor Co.* was rejected for the same reasons.

Corn Products was found by the court to be inapposite because the Commissioner's application of the case was based on his already rejected argument that Guggenheim in substance sold breeding rights, not undivided shares in the stallion. The sale of undivided interests in the stallion was a partial liquidation of the taxpayer's interest in a horse held for breeding purposes, not a transaction to further the taxpayer's business of breeding horses.

Guggenheim, decided almost thirty years ago, is the last word from either the courts or the IRS on the character of gain realized on the sale of syndicate shares. It is reasonable to conclude that the issue is settled, at least as far as traditional syndication agreements are concerned. Care must be exercised in the application of *Guggenheim*, however, because the Tax Court opinion dealt only with the character of the gain realized by Guggenheim upon sale of the undivided shares of the stallion in the syndication. Careful analysis of the facts leads to the conclusion that the syndicate, once established, should have been treated as a partnership because the syndicate manager had the power to sell excess seasons and either apply the proceeds against syndicate expenses or divide them among the share owners. Thus, any subsequent sales of shares by either Guggenheim, the promoter, out of his twenty reserved shares, or by any of the purchasers of the fifteen shares originally sold by Guggenheim, should have been analyzed as a sale of a partnership interest. This leads to the question of whether the transaction actually at issue in *Guggenheim* should have been analyzed as the formation of a partnership rather than a sale of undivided interests in the stallion. This issue is explored later in this Article.[195]

c. *Sale of Shares in a Syndicate That is a Partnership*

If, under the standards discussed previously, a syndicate is treated as a partnership for federal income tax purposes, the rules determining the character of the gain or loss realized upon the sale of a syndicate share are quite different. Sales of interests in partnerships owning horses, whether the horses are held by the partnership for breeding, racing or sale to customers in the ordinary course of business, are governed by the same provisions of Subchapter K that govern the sale of interests in partnerships holding any other type of section 1231 assets or property held for sale to customers in the ordinary course of business. Although a thorough discussion of the mechanics of Subchapter K provisions relating to the sale of partnership interests is beyond the scope of this Article, a few basic principles should be considered.

Section 741 provides that gain or loss recognized on the sale of a partnership interest is treated as long or short term capital gain or loss.[196] Except as provided in section 751, the character of the underlying assets owned by the partnership does not affect the characterization of gain or loss realized on the sale of a partnership interest.[197] Thus, for example, the gain recognized on the sale of a partnership interest is capital gain even if the entire gain is attributable to appreciated assets owned by the partnership that would produce section 1231 gain upon sale. Section 751, however, stands as a guardian to prevent recognition of capital gains on the sale of the partnership interest if the partnership assets reflect significant ordinary income potential, including depreciation recapture under I.R.C. section 1245.[198] Therefore, because every syndicate will have claimed ACRS deductions on most, if not all, of the horses held, some portion

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[195] *See* Part I.E. *infra*.

[196] *See* Treas. Reg. § 1.741-1 (1985).

[197] Prior to the enactment of I.R.C. § 751 (1954) the courts, on occasion, looked through the partnership to characterize gain on the sale of a partnership interest with reference to the underlying assets. This was the exception, however, rather than the rule. *See* MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 15.03.

[198] I.R.C. § 751(a)(1), (c); Treas. Reg. § 1.751-1(c)(4) (1985).

of the gain realized on the sale of a share in a syndicate, classified as a partnership, is treated as ordinary income. On the other hand, none of the gain or loss realized on the sale of a partnership is characterized as ordinary gain or loss under the *Corn Products*[199] doctrine or on the theory that the taxpayer is a dealer in partnership interests.[200]

In computing gain or loss on the sale of a partnership interest, the seller uses his basis determined under sections 705 and 742. This reflects prior contributions to and withdrawals from the partnership, as well as the cumulative effect of his allocable share of partnership income and losses.[201] In addition, a partner's basis includes his share of partnership liabilities, determined under Treasury Regulation 1.751-1(e). Consonantly, the amount realized on the sale of the interest includes not only the cash and fair market value of other property received but also the selling partner's share of the partnership liabilities.[202]

The greatest pitfall in properly characterizing the gain realized on the sale of a partnership interest lies in the application of section 751. This section overrides section 741 and characterizes the gain attributable to unrealized receivables and substantially appreciated inventory held by the partnership as ordinary income.[203] Not only are the computations complex, but section 751 may require the recognition of ordinary gain even if the overall transaction resulted in a sale of the partnership interest at a loss.[204] When this occurs, the capital loss attributed to the sale of the partnership interest is increased by an amount equal

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[199] *See* Pollack v. Commissioner, 69 T.C. 142, 147 n.7 (1977) (holding that I.R.C. § 741 requires capital gains treatment on the sale of partnership interest independent of I.R.C. § 1221 definition of capital asset; *Corn Products* is an exception to I.R.C. § 1221). The *Pollack* decision has been subject to scholarly criticism. *See* Note, *The Corn Products Doctrine and Its Application to Partnership Interests*, 79 COLUM. L. REV. 341 (1979); Note, *Section 741 and Corn Products: A Logical Extention?*, 31 U. FLA. L. REV. 90 (1978).

[200] *See* 3 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 87.1.3 (1981).

[201] For a general discussion of the computation of the basis of a partnership interest, see MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 6.01 - ¶ 6.05.

[202] I.R.C. § 752(d); Treas. Reg. § 1.752-1(d) (1985).

[203] *See* I.R.C. § 751(a), (c), (d); Treas. Reg. § 1.751-1(a), (c), (d).

[204] *See* Treas. Reg. § 1.751-1(g), Example (1).

to the ordinary gain; the net loss will be correctly stated, but the character is altered.

Depreciation recapture is within the definition of "unrealized receivables" for purposes of section 751.[205] Thus, whenever a syndicate taxed as a partnership holds any horses that have been depreciated and which have a fair market value in excess of their adjusted basis, the seller of a share must recognize as ordinary income his share of the potential section 1245 recapture income. In a very simplified context, this may be illustrated as follows. Assume that T owns one share in a stallion syndicate taxed as a partnership. For the sake of simplicity, assume the partnership has only ten shares. T's basis in his share is $2,100. The sole asset of the syndicate is a single stallion with an adjusted basis of $21,000. The recomputed basis of the stallion is $100,000, and his fair market value is $200,000. The syndicate has no liabilities. As the owner of a one tenth partnership interest, T sells his interest for $20,000. He must recognize an overall gain of $17,900, of which $7,900 will be treated as ordinary income under section 751 and the remaining $10,000 will be capital gain under section 741.[206]

It is important to note that section 751 is a one-way swinging door. If the partnership holds horses that have depreciated in value, and that depreciation is reflected in the price received for the partnership interest, section 751 does not operate to recharacterize as ordinary loss any part of the capital gain or loss on the sale of the partnership interest that is attributable to such horses. Furthermore, if the partnership both holds horses subject to section 1245 recapture, triggering ordinary income under section 751, and horses that would result in recognition of net section 1231 ordinary losses, the losses may not be netted out against the depreciation recapture in computing the portion of the overall gain that will be ordinary gain under section 751. The losses remain part of the computation subject to section 741,[207] decreasing the capital gain or increasing the capital loss.

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[205] I.R.C. § 751(c); Treas. Reg. § 1.751-1(c)(4)(i); -1(c)(5).

[206] For a thorough discussion of the mechanics of apportioning the gain realized on the sale of a partnership between ordinary income under I.R.C. § 751 and capital gains under I.R.C. § 741, see MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 16.02.

[207] *See id.* at ¶ 16.03[3][a]; S. Horvitz, *Depreciation Recapture—Partnership Transactions*, 289 T.M. A-55-A-58.

It is also important to remember that, although the above rules apply equally to sales of syndicate shares to new syndicate members or to other syndicate members, they do not apply to a sale of shares back to the syndicate itself. Such a transaction is described as a "liquidation" of a partnership interest and is subject to the rules governing distributions from partnerships, as modified by section 736. Because it is very rare for a syndicate to buy back a share, any discussion of liquidation of partnership interests is beyond the scope of this Article. A cautionary note is in order, however, because section 751 also reaches certain partnership distributions,[208] particularly those in which a partner's entire interest is liquidated by a cash payment (whether or not deferred), again transmuting what would otherwise be capital gain into ordinary income.

D. *Installment Sales*

1. *General Principles of Deferred Recognition Rules*

Gains realized on the sale of a horse for deferred payments may be reported on the installment method regardless of whether the seller uses the cash or accrual method of tax accounting or whether the horse is property used in the seller's business (e.g., a stallion, broodmare or racehorse) or property held for sale to customers (e.g., yearlings sold by a breeder). The installment method may also be used to report gain realized on the sale of a partnership interest or a syndicate share. Different provisions, however, govern sales of horses held for sale to customers by accrual method taxpayers who maintain inventories, than govern other deferred payment sales.

Section 453 governs installment sales of horses used in the seller's business, sales of horses held for sale to customers by cash method farmers not required to maintain inventories, and sales of partnership interests and syndicate shares.[209] This section

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[208] I.R.C. § 751(b); Treas. Reg. § 1.751-1(b).

[209] I.R.C. § 453(b); Treas. Reg. § 1.453-1(a) (1981); Temp. Reg. § 15a.453-0(a); -1(b)(4) (1981); Temp. Reg. § 15a.453-1(b)(4) specifically provides that "a farmer who is not required under his method of accounting to maintain inventories may report the gain on the installment method under section 453." A cash method farmer is not required

applies whenever at least one payment is to be received in a taxable year after the close of the taxable year in which the sale occurs.[210] It requires deferred reporting of the gain unless the seller affirmatively elects to recognize the entire gain in the year of the sale.[211] A loss is always recognized in the year of the sale.[212] Under the installment method of reporting gain, in each year in which a payment is received the seller includes in income an amount which bears the same proportion to the total gain realized on the transaction as the payments received during the year bear to the "contract price", which is defined as the total amount of payments to be received.[213] For this purpose, the assumption of a lien indebtedness by the purchaser is not considered a payment, unless the debt exceeds the seller's basis.[214] In that case, gain equal to the amount by which the debt exceeds the basis must be recognized in the year of the sale, and subsequent payments will be fully includable as gain.[215] The buyer's promissory note given to evidence the debt generally is not considered to be a payment.[216]

For example, assume that the taxpayer sold a stallion with a basis of $100,000 for $250,000, of which $100,000 was paid in cash. The balance of $150,000 was represented by a promissory note calling for payment of $50,000 of principal on each of the next three anniversary dates of the note, with adequate interest. Assume further (for reasons that will soon be explained) that none of the realized gain of $150,000 is subject to section 1245 recapture because the horse was sold in the same taxable year in which it was acquired, but that the gain is ordinary income because the horse was held for less than one year. The contract price is $250,000. Therefore sixty percent of each principal payment will be recognized as gain in the year received;

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to maintain inventories. *See* note 30 *supra*. *See* Rev. Rul. 75-323, 1975-2 C.B. 346 (applying I.R.C. § 453 to the sale of a partnership interest; particular ruling now overridden by I.R.C. § 453(i)).

[210] I.R.C. § 453(b)(1).

[211] I.R.C. § 453(d); Temp. Reg. § 15a.453-1(d).

[212] Martin v. Commissioner, 61 F.2d 942 (2d Cir. 1932); Rev. Rul. 70-430, 1970-2 C.B. 51.

[213] I.R.C. § 453(c); Temp. Reg. § 15a.453-1(b)(2).

[214] Temp. Reg. § 15a.453-1(b)(3)(i), (b)(5), Example (2).

[215] *See* Temp. Reg. § 15a.453-1(b)(5), Example (3).

[216] I.R.C. § 453(f)(3), (4); Temp. Reg. § 15a.453-1(b)(3)(i).

$60,000 of gain is recognized in the year of the sale and $30,000 of gain is recognized in each of the next three succeeding years as payments are received. All of the gain is ordinary because gain is characterized based on the holding period at the time of the sale, not at the time payment is received.

Section 453C, added by the Tax Reform Act of 1986, restricts the use of the installment method of reporting gains by dealers of real and personal property who have outstanding indebtedness in any year in which they receive an installment obligation on the sale of inventory or property held primarily for sale to customers in the ordinary course of business. Certain lessors of property are also subject to this provision. The mechanical rules of section 453C that determine the extent to which installment reporting of the gain on a particular sale is disallowed are extraordinarily complex. Fortunately for taxpayers selling horses, these rules do not apply to the disposition of "any property used or produced in the trade or business of farming (within the meaning of section 2032A(e)(4) or (5))."[217] Raising horses clearly is farming within this definition. Therefore, section 453C does not apply to sales by a taxpayer in the business of raising horses for sale. Whether this rule will be applied to dispositions of horses by subsequent owners is unclear. It very likely may not.[218] In any event, because as far as we are concerned with it here, section 453C applies only to sales by dealers of property held for sale to customers in the ordinary course of business and horses leased by the taxpayer,[219] the installment method is available without restriction for reporting gains from the sale of horses held for breeding or racing purposes. This is so even if the taxpayer is a dealer. A taxpayer who sells a horse that has been leased to another taxpayer, however, may be subject to section 453C if the sales price of the horse exceeds $150,000.[220]

a. *Treatment of Sales of Horses Subject to Liens*

The treatment of a lien indebtedness assumed by the purchaser can be illustrated by varying the facts slightly. Assume

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[217] I.R.C. § 453C(e)(1)(B)(ii).

[218] *See* H.R. REP. No. 841, 99th Cong., 2d Sess. 298 (1986) (". . . the proportionate disallowance rule does not apply . . . to installment obligations arising from the sale of crops or livestock held for slaughter.").

[219] *See* I.R.C. § 453C(e)(1)(A)(i).

[220] I.R.C. § 453C(e)(1)(A)(i)(III).

that the sale price was increased to $300,000 because the horse was subject to a $50,000 debt, which the purchaser assumed or to which he took subject. In all other details the transaction was identical. The realized gain increases to $200,000, but the contract price remains $250,000, because the loan assumption is not treated as a payment. Therefore, eighty percent of each payment will be recognized as gain; $80,000 will be recognized in the year of sale and $40,000 will be recognized in each of the next three years.

b. *Disallowance of Installment Reporting of Recapture Income*

Most installment sales are not as simple as that in the preceding examples. If the horse was held for more than one taxable year (which may be less than twelve months if the horse was purchased during the year and held on the last day of the year) the seller probably has claimed ACRS deductions with respect to the horse.[221] Therefore, a portion of the gain realized on the sale is recharacterized as ordinary income under section 1245. This complicates the installment method of reporting gains because section 1245 recapture income is not eligible for installment reporting.[222] All of the recapture income must be recognized in the year of the sale, even if the amount of recapture income exceeds the payments received in that year, even if no payments are received in that year. As a result of the recognition of recapture income without regard to the receipt of a payment, for purposes of determining the gain recognized on the receipt of payments, the seller's basis in the horse that was sold is increased by the amount of recapture income.[223]

This interaction of recapture and the installment method is illustrated as follows. Assume that the horse sold in the initial example above was originally purchased for $150,000 and that the seller had claimed ACRS deductions of $50,000, reducing the adjusted basis to $100,000. Assume further that the horse

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[221] *See* text accompanying note 88 *supra*.

[222] I.R.C. § 453(i).

[223] *See* S. REP. No. 169, 98th Cong., 2d Sess. 466 (1984); H.R. REP. No. 432, 98th Cong., 2d Sess. 1008-09 (1984).

had been held for more than twenty-four months prior to sale. In all other respects the transaction is identical to the first example. The gain realized on the transaction is $150,000, of which $50,000 is section 1245 recapture income and $100,000 is section 1231 income. The $50,000 of recapture income is recognized as ordinary income in the year of the sale. For purposes of determining the portion of each payment that is section 1231 gain, the seller's basis, which was $100,000, is increased to $150,000 by adding the recapture income to it. Using the increased basis, the amount of gain is only $100,000, and since the contract price is $250,000, forty percent of each payment will be recognized as section 1231 gain. In the first year the seller must recognize $40,000 of section 1231 gain in addition to the $50,000 of section 1245 gain. In each of the next three years he must recognize $20,000 of section 1231 gain.

Similar computations must be made if the taxpayer sells a syndicate share that is treated as undivided ownership and the seller previously claimed ACRS deductions on the horse. Such computations must also be made if the taxpayer sells a partnership interest and part of the gain is characterized as ordinary income under section 751 because there is depreciation recapture inherent in the underlying assets of the partnership.[224]

2. *Installment Reporting of Contingent Price Sales*

The Treasury Regulations provide detailed rules for computing the portion of each payment that must be treated as gain in the case of installment sales at an indefinite price.[225] These rules apply, for example, if the sales price of a horse is contingent on future racing purses or stud fees earned by the horse. If there is a stated maximum price, the gross profit ratio will be computed on the assumption that it will be paid. If less than the maximum price is paid, unless one of the specific rules permitting the seller to recompute the maximum selling price applies, the seller is allowed a loss in the final year equal to the excessive

[224] STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984, at 334 (1984). *See* text accompanying notes 271-74 *infra*.

[225] Temp. Reg. § 15a.453-1(c).

gain previously included in income.[226] If the price is open-ended, but payments are due only for a specified period, the seller's basis is recovered ratably over the period for which payments are received.[227] Finally, if both the purchase price and payment period are indefinite, the seller's basis is recovered ratably over fifteen years, unless the seller can demonstrate that recovery over fifteen years would "substantially and inappropriately defer recovery of the taxpayer's basis."[228] In order to meet this burden, the seller must demonstrate that the alternative method he proposes is reasonable and that under his method he will recover basis at least twice as quickly as under the normal method.[229] Because of the limited useful life of horses, it may be possible to meet these requirements in many instances, but an advance ruling from the IRS is always necessary.[230]

3. *Determining What Constitutes a "Payment"*

For installment method reporting of gains, some debt instruments of the buyer delivered to the seller are treated as payments in the year of delivery rather than the year of payment. Section 453 specifically provides that a bond or other evidence of indebtedness, payable on demand or issued by a corporation or government and readily tradeable, is treated as a payment.[231] The mere ability of the seller to discount the buyer's obligation, however, should not result in the promissory note being deemed a payment.[232] Similarly, a third party guarantee of the buyer's obligation does not cause delivery of the buyer's note to be deemed a payment.[233] If, however, the obligation is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, the obligation is treated as a payment.[234] A nonnegotiable, nontransferable standby

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[226] Temp. Reg. § 15a.453-1(c)(2)(i)(A), (iii), Example (5).
[227] Temp. Reg. § 15a.453-1(c)(3).
[228] Temp. Reg. § 15a.453-1(c)(4), (7).
[229] Temp. Reg. § 15a.453-1(c)(7).
[230] *Id.*
[231] I.R.C. § 453(f)(4). *See* Temp. Reg. § 15a.453-1(e).
[232] *See* Temp. Reg. § 15a.453-1(e)(1)(i), (e)(4).
[233] Temp. Reg. § 15a.453-1(b)(3)(i).
[234] *Id.*

letter of credit that may not be drawn on in the absence of the buyer's default is treated as a guarantee and not a cash equivalent security.[235] Any other obligation of a third party delivered to the seller, including a negotiable letter of credit or a letter of credit that may be drawn upon by the seller without the buyer's default, is treated as a payment.[236]

4. *Premature Dispositions of Installment Obligations*

The sale, satisfaction at less than face, or other disposition of an installment obligation results in the recognition of gain or loss.[237] For this purpose the basis of the installment obligation is the "excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full."[238] In practical application the basis of an installment promissory note usually is computed by adding to the basis of the property for which the obligation was received the amount of gain previously recognized as a result of receiving payments on the note. Thus, using the immediately preceding example of an installment sale in which $90,000 of gain was realized in the year of sale and the horse sold had a basis of $100,000, the basis of the note after the first payment is $190,000. This is the same result as is obtained using the statutory method under which the deferred gain of $60,000 recognized upon the future receipt of payments is subtracted from the $250,000 face value of the note to yield a $190,000 basis. After the second payment, the basis is increased to $210,000.

The recognition rule has a number of exceptions, but they are not extensive. If an installment obligation is transferred to a partnership in a transaction subject to section 721 or to a corporation in a section 351 transaction, the nonrecognition rules of those sections apply.[239] Distributions of installment obligations by a partnership in liquidation of the partnership or a partner-

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[235] Temp. Reg. § 15a.453-1(b)(3)(i), (iii).

[236] *Id.*

[237] I.R.C. § 453B. *See also* Emory, *Disposition of Installment Obligations: Income Deferral "Thou Art Lost and Gone Forever"*, 54 IOWA L. REV. 945 (1969) (examining former I.R.C. § 453(d), the predecessor of current I.R.C. § 453B).

[238] I.R.C. § 453(b). *See* Treas. Reg. § 1.453-9(b).

[239] Treas. Reg. § 1.453-9(c)(3); § 1.721-1(a) (1985).

ship interest do not trigger recognition under section 453B,[240] but there is only a narrow exception for certain installment notes distributed in corporate liquidations.[241] A transfer incident to a divorce, subject to section 1041, also is excluded from the recognition requirements.[242] Transmission upon death does not result in recognition,[243] but a transfer by gift results in recognition to the transferor.[244] The amount realized in such a case is the fair market value of the obligation, which may be different than its face value.[245]

A seller reporting gain on the installment method also is required to recognize gain upon the buyer's default if the seller repossesses the property.[246] The gain recognized is the excess of the fair market value of the property over the basis of the installment obligation. This computation does not merely restore the status quo ante and simply tax as gain all payments previously treated as a return of basis; the repossession is treated as a separate transaction and the reacquired property has a basis equal to the fair market value used in determining the gain realized on the installment note as a result of the repossession.

The character of the gain or loss recognized on the sale or other disposition of the installment obligation is determined with reference to the character of the asset for which it was received.[247] Thus, gain recognized on the sale of a note received for a broodmare, stallion or racehorse is section 1231 gain, but if the horse were held for sale to customers the gain is ordinary income.

5. *Installment Sales to Related Persons*

Complexities arise when an installment sale is made to a related person or entity. First, if the horse is depreciable property

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[240] Treas. Reg. § 1.453-9(c)(3).

[241] I.R.C. § 453B(d).

[242] I.R.C. § 453B(g).

[243] I.R.C. § 453B(c). The deferred income is taxed to the beneficiaries of the decedent's estate who receive the obligations under I.R.C. 691. If, however, the installment obligation passes to the obligor and is thereby discharged, I.R.C. § 691(a)(5) requires that the gain be recognized by the deceased seller's estate.

[244] *See* I.R.C. § 453(f) (gift to obligor); Rev. Rul. 67-167, 1967-1 C.B. 107 (gift to nongrantor trust); Rev. Rul. 55-157, 1955-1 C.B. 293 (gift to obligor on note).

[245] I.R.C. § 453(a)(2).

[246] *See* Treas. Reg. § 1.453-1(d).

[247] *See* Treas. Reg. § 1.453-9(a).

in the hands of the buyer, as is any racehorse, stallion or broodmare, the installment method is not available for a sale to a corporation if the seller owns (after taking into account attribution rules) eighty percent of the value of the stock. Similarly, it is not available for a sale to a partnership if the seller owns eighty percent or more of either the capital or profits interest in the partnership or to any trust of which the seller or the seller's spouse is a beneficiary.[248] Second, if the installment sale is to any person from whom stock ownership is attributed to the seller under section 318, the resale or other disposition of the horse by the related buyer within two years results in the original seller recognizing all of the deferred gain in the year of the sale by the related person.[249] Section 318 attribution is quite broad and includes, among other relationships, spouse, children, grandchildren, parents, corporations of which the taxpayer directly or indirectly owns fifty percent or more of the stock after taking into account the attribution rules, trusts of which the taxpayer or any of his relatives previously mentioned is a beneficiary, and partnerships in which the taxpayer or any such relative is a partner.[250] An exception to this recognition rule applies if the taxpayer establishes to the satisfaction of the Commissioner that neither the first nor the second disposition had as one of its principal purposes the avoidance of federal income tax,[251] but there is no guidance regarding the scope of this exception.

If the amount realized during the year by the second seller is less than the contract price on the first sale, only a portion of the deferred gain is immediately recognized. The balance

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[248] I.R.C. § 453(g). This prohibition does not apply, however, if the seller can establish to the satisfaction of the Commissioner that one of the principal purposes of the disposition was not tax avoidance. The Committee Reports indicate that this exception is available if "no significant tax deferral benefits will be derived from the sale." S. REP. No. 1000, 96th Cong., 2d Sess. 17 (1980), *reprinted in* 1980-2 C.B. 494, 503. Since significant tax benefits almost always result from such a sale, the taxpayer's burden is difficult to carry.

[249] I.R.C. § 453(e).

[250] *See* I.R.C. § 318 (1985); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.21 (4th ed. 1979).

[251] I.R.C. § 453(e)(7). This exception applies, for example, to an involuntary sale such as foreclosure under a judicial lien or to a second installment sale on terms substantially similar to the terms of the first installment sale. S. REP. No. 1000, 96th Cong., 2d Sess. 16 (1980), *reprinted in* 1980-2 C.B. 494, 502.

continues to be deferred.[252] This can be illustrated as follows. Assume that T sells a horse, which has basis of $1,000, to his son, S, for $10,000, and S pays the entire purchase price by giving T a promissory note due three years later. One year later S resells the horse, but does not pay the note. If S realized $10,000 or more on the sale, then T must recognize his $9,000 gain in the year that S sold the horse. If, however, S realized only $8,000 on the sale, then T must recognize only $7,000, the excess of S's amount realized over T's basis, in the year S sold the horse. T's basis in the note will then be $8,000, and he will recognize the remaining $2,000 gain when S pays the note. The computations are substantially more complex if there were payments made on the note and the first seller recognized a portion of his gain prior to the resale.

6. *Election Not to Report on Installment Method*

A seller is not required to use the installment method and may elect to recognize the entire gain in the year of the sale.[253] This may be desirable, for example, if the seller has net operating loss carryovers,[254] particularly if they are about to expire, or long term capital losses that will offset the inclusion of net section 1231 gains as long term capital gains.[255] If the seller does elect out of installment reporting of the gain, the proper treatment depends on whether he uses the cash or accrual method of accounting. If the seller is on the accrual method, the amount realized is the face amount of the obligation, and the entire gain is recognized.[256] If the seller uses the cash method of reporting, the amount realized on the sale is the fair market value of the note,[257] which, according to the regulations, never will be less

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[252] I.R.C. § 453(e)(1), (4).

[253] I.R.C. § 453(d); Temp. Reg. § 15a.453-1(d)(1). If the sale is by a partnership, the election must be made by the partnership. I.R.C. § 703(b). The election is binding on all of the partners; partners may not elect inconsistent treatment.

[254] *See* I.R.C. § 172.

[255] *See* I.R.C. §§ 1211, 1212.

[256] Temp. Reg. § 15a.453-1(d)(2)(ii)(A), (ii)(B), Example (1); First Fed. Sav. and Loan Ass'n v. Commissioner, 40 T.C. 474 (1963); Castner v. Commissioner, 30 T.C. 1061 (1958).

[257] Temp. Reg. § 15a.453-1(d)(2)(ii)(A), (B), Example (2); Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975); Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961).