Taxation of Equine Sales and Exchanges

Part 2 of 2

by

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than the fair market value of the property sold minus the value of other consideration received by the seller.[258] In this regard, the regulations, without any apparent support in the legislative history, attempt to overturn prior case law holding that the fair market value of the note could be more or less than its face value, even if the note bore adequate interest.[259] Apart from the regulations, if the note bears interest that is higher than the prevailing rate, its fair market value might be more than face. It is much more likely, however, that the fair market value, if different, will be less than face because of the risk of the buyer's default. In the year of the sale the seller recognizes gain equal to the fair market value of the note minus his basis in the horse. The remainder of the gain is recognized as the note is paid.

The gain recognized in the year of the sale that is attributable to the receipt of the note is categorized by reference to the character of the horse for which the note was received. The remainder of the gain, which is recognized when the note is paid, is ordinary income.[260] Thus, although the deferral obtained by valuing a note at less than face may look attractive, for years in which capital gains received preferential treatment its beauty was marred substantially by the possible conversion of capital gains into ordinary income. If the term of the note was relatively brief, the tax detriment of this "reverse conversion" outweighed the tax benefit of deferral. If the term was longer, however, the deferral may have been more advantageous. Under the Internal Revenue Code of 1986, which taxes capital gains and ordinary income at the same rate, there generally is no detriment resulting from this "reverse conversion."

7. *Accrual Basis Dealers Maintaining Inventories*

An accrual method taxpayer in the business of selling horses to customers must maintain inventories.[261] The section 453 installment method rules described in the preceding section do not

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[258] Temp. Reg. § 15a.453-1(d)(2)(ii)(A).

[259] *See* B. BITTKER, *supra* note 44, at ¶ 43.3.

[260] *See* Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962), *aff'g*, 35 T.C. 250 (1960). *But see* Riss v. Commissioner, 368 F.2d 965 (10th Cir. 1966) (taxing gain on payment by corporate obligor as capital gain under I.R.C. § 1032(a) (1985)).

[261] Treas. Reg. § 1.61-4(b).

apply to a sale of a horse by such a taxpayer or to a cash basis farmer that has elected to use inventories,[262] but installment sale reporting may be available under section 453A. In general terms, the primary difference in the sections is that under section 453A the profit ratio exclusion is not determined on an asset by asset basis, but rather on a global basis including all credit sales, although the seller, with the consent of the Commissioner, may choose among a few alternative methods.[263] For this reason, installment reporting under section 453A must be used consistently once adopted, unlike section 453, which the taxpayer may elect out of on an asset by asset basis. Installment reporting under section 453A is available, however, only to "a person who regularly sells or otherwise disposes of personal property on the installment plan."[264] Thus, it might not be available to an accrual method dealer in horses because it is unlikely that a breeder will "regularly" sell horses on the installment method. The scant case law, however, interprets "regularly" quite liberally. A few installment sales each year, even if a relatively small fraction of total sales may suffice to meet the requirement.[265] Neither the Code, the Treasury Regulations nor any Revenue Rulings, however, provide guidance on the possible application of section 453A to sales by farmers using one of the inventory methods available to farmers.

8. *Sale of Syndicate Shares and Equine Partnership Interests*

a. *Generally*

Gain realized on the sale of a partnership interest or syndicate share sold for deferred payments may be reported on the

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[262] I.R.C. § 453(b)(2)(B). *See* Rev. Rul. 68-13, 1968-1 C.B. 195 (I.R.C. § 453 is not available for a bulk sale of inventory by a sole proprietor.).

[263] *See* Treas. Reg. § 1.453-2, -7, -8.

[264] I.R.C. § 453A(a)(1).

[265] See Greenspon v. Commissioner, 23 T.C. 138 (1954) (*acq.*), *rev'd on other grounds,* 229 F.2d 947 (8th Cir. 1956); Davenport Mach. & Foundry Co. v. Commissioner, 18 T.C. 39 (1952) (*acq.*); Marshall Bros. Lumber Co. v. Commissioner, 13 B.T.A. 111 (1928), *rev'd and remanded without opinion,* 51 F.2d 1081 (6th Cir. 1931).

installment method.[266] If a syndicate share is treated as an undivided interest in the horse and not as a partnership interest, the rules discussed previously in connection with the outright sale of a horse apply. In the case of the sale of a partnership interest, including a syndicate share that constitutes a partnership interest, the operation of section 453 must be coordinated with the rules governing the sale of partnership interests. This is not an easy task.

b. *Interrelationship of Installment Reporting and the Collapsible Partnership Rules*

As long as a partnership does not hold any property that could not be sold on the installment method if the property were owned and sold directly by the partner, the gain from a deferred payment sale of the partnership interest is reportable under the installment method. On the other hand, if the partnership holds property, such as inventory, that may not be sold on the installment method under section 453, the analysis is more complex. Rather than entirely denying installment reporting, it appears that a proper coordination requires current recognition only of that portion of the gain attributable to property of the partnership not eligible for installment method reporting if sold by the partnership.[267] That portion of the gain may or may not correspond to the portion of the gain characterized as ordinary income under section 751; the proper method of fragmentation is unclear. Nevertheless, there is considerable, but by no means perfect, overlap between the categories of property ineligible for installment sale reporting and the definition of section 751 assets. For example, the sale of inventory may not be reported on the installment method,[268] while section 751 recharacterizes as ordinary income only that portion of the gain realized on the sale of a partnership interest attributable to substantially appreciated

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[266] *See* Rev. Rul. 76-483, 1976-2 C.B. 131. *See also* Rev. Rul. 75-323, 1975-2 C.B. 346; Bailey v. Commissioner, 18 B.T.A. 105 (1929)(*nonacq.*); James, *The Installment Sale of a Partnership Interest*, 43 TENN. L. REV. 306 (1976).

[267] *See* MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 16.05[2],[3].

[268] *See* Rev. Rul. 68-13, 1968-1 C.B. 195 (prohibition on installment reporting of sale of inventory extended to bulk sale).

inventory.[269] In this case, the exclusion from section 453 is a bit broader than the ambit of section 751. As far as the sale of horses is concerned, a cash basis dealer in horses may report sales under section 453. Horses held for sale to customers by a cash basis partnership, however, could be substantially appreciated inventory under section 751.[270] Section 751 recharacterizes as ordinary income some of the gain realized on the sale of a partnership interest in a cash basis partnership that is a dealer in horses, but the gain apparently is eligible for installment reporting.

Similar problems arise with respect to that portion of the gain from an installment sale of a partnership interest that is characterized as ordinary income under section 751 because it represents potential depreciation recapture attributable to partnership property. Any sale of an interest in a breeding or racing partnership is subject to section 751, except in rare circumstances, due to prior ACRS deductions claimed with respect to horses held by the partnership.[271] As previously discussed, recapture income realized on an asset that is sold directly is not eligible for installment reporting, but must be recognized in the year of the sale.[272] Thus, it appears that the portion of the gain recharacterized as section 751 ordinary income because it is attributable to depreciation recapture is not eligible for installment sale reporting.[273] Although this result is neither clearly compelled by the statutes involved nor expressly mentioned in the Committee Reports, it is consistent with the intent of both section 453(i)

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[269] *See* I.R.C. § 751(a)(2),(d). A partnership has substantially appreciated inventory if the fair market value of its inventory items exceeds both 120% of the basis of the inventory items and 10% of the fair market value of all partnership property, other than money. For this purpose the word "inventory" is expansive and includes not only inventory in the traditional sense, but all property described in I.R.C. § 1222(1); such as uninventoried property held primarily for sale to customers in the ordinary course of business, and any other property that is neither a capital asset nor property described in I.R.C. § 1231. I.R.C. § 751(d). *See generally* MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 16.04.

[270] *See* note 269 *supra*.

[271] *See* text accompanying notes 205-06 *supra*.

[272] *See* text accompanying notes 221-24 *supra*.

[273] *See* Rev. Rul. 75-323, 1975-2 C.B. 346 (applying pre I.R.C. § 461(i) rule of coordinating I.R.C. § 1245 depreciation recapture and I.R.C. § 453 installment method reporting to sale of partnership interest).

and the fragmentation theory of coordinating section 453 and sections 741 and 751. It is also the position of the Joint Committee staff regarding this particularly knotty problem.[274]

In summary, the gain realized on a deferred payment sale of an interest in an equine partnership must be fragmented into three categories:

1. Section 751 gain ineligible for installment reporting under section 453, such as gain attributable to depreciation recapture on horses held for use in the partnership's business or inventoried horses held primarily for sale to customers;
2. Section 751 gain eligible for installment reporting under section 453, such as gain on the sale of uninventoried horses by a cash basis dealer in horses;
3. Section 741 gain eligible for installment sale reporting, which is the residual gain after subtracting out the section 751 gain.

A fourth category possibly should be added: section 741 gain ineligible for installment sale reporting, such as gain attributable to inventory that is not substantially appreciated.[275] Even if this is theoretically required, however, few equine partnerships will encounter such gain,[276] and therefore, no significant practical problem is raised by this possibility.

9. *Unstated Interest*

Deferred payment sales of horses, like sales of other property, are subject to the complex imputed interest rules if any payments are due more than six months from the date of the

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[274] STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984, 334 (1984). *But see* MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 16.05[2] (asserting that the staff's logic in reaching this conclusion is "dubious at best").

[275] *But see* MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 16.05[2].

[276] This would not necessarily be true with respect to the sale of a partnership interest in a breeding farm operation. In such a case, the value of the yearlings and weanlings held for sale very well might not be more than ten percent of the value of all of the assets of the partnership, excluding cash, depending mainly on the value of the broodmare band, any stallions owned by the partnership, land, barns, and other equipment.

sale and the deferred payments do not bear adequate interest.[277] In general terms, the imputed interest rules recharacterize as "unstated interest," and therefore as ordinary income, a portion of the sales price if the deferred payments do not bear interest at the "test rate." The test rate is determined in one of two ways, depending on the principal amount of the deferred payments. If the total deferred principal payments do not exceed $2,800,000, the test rate is the lesser of nine percent, compounded semiannually, or the "applicable federal rate" compounded semiannually.[278] For any obligation in excess of $2,800,000, the applicable federal rate is the test rate.[279]

The applicable federal rate, which is determined monthly, is based on the average annual yield for Treasury obligations with a maturity comparable to the deferred payment obligation.[280] For obligations due within three years, the short term federal rate applies; the mid-term federal rate applies to obligations due more than three years but not more than nine years from date of issue; and the long term federal rate applies to obligations with a term of more than nine years.[281]

A deferred payment obligation bears inadequate interest if the discounted present value (using the applicable federal rate as the discount rate) of all payments due on the obligation, including interest, is less than the principal amount of the obligation.[282] Thus, assuming that the applicable federal rate is greater than nine percent, any deferred payment obligation bearing stated interest of less than 9.2025 percent annually (the equivalent of nine percent compounded semiannually) bears unstated interest. On the other hand, any deferred payment obligation of $2,800,000 or less that bears stated interest of at least 9.2025 percent an-

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[277] *See* I.R.C. §§ 483, 1272, 1273, 1274, 1274A, 1275. *See also* S. REP. No. 83, 99th Cong., 1st Sess. 6-9 (1985); H.R. REP. No. 87, 99th Cong., 1st Sess. 12-17 (1985); H.R. REP. No. 250, 99th Cong., 1st Sess. 12-18 (1985); STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984, 89-127 (1984); Blum, Bailey & Rosenberg, *Time Value of Money and TRA '84: Accounting Rules Turned Inside Out*, 26 TAX NOTES 933 (1985).

[278] I.R.C. §§ 1274(a), (b)(1)-(2), (c)(1)-(2); 1274A(a), (b).

[279] I.R.C. § 1274(a), (b)(1)-(2), (c)(1)-(2).

[280] I.R.C. § 1274(d).

[281] I.R.C. § 1274(d)(1)(A).

[282] I.R.C. § 1274(c)(2).

nually, regardless of the rate of principal amortization, does not bear unstated interest, and no part of the principal is recharacterized as interest.

If an obligation does not bear interest at the test rate, it is said to bear "original issue discount",[283] and the difference between the present value of the payments, determined under the method described above, is recharacterized as interest income.[284] The gain or loss on the sale of the property is recomputed using the present value of the payments as the amount realized, and the profit ratio for reporting gain on the installment method must be recomputed. Although gain recognized under the installment method and stated interest payable on an original issue discount obligation is reported under the taxpayer's usual method of accounting, any original issue discount interest income generally must be reported using the accrual method at the rate that interest economically accrues.[285] There are two exceptions to this rule.

First, if the total payments due under the instrument and all other instruments relating to the same sale do not exceed $250,000, accrual reporting of the unstated interest is not required.[286] Instead, the unstated interest portion of each payment is taxable under the seller's normal method of reporting, although the unstated interest accrues economically, not ratably.[287] The meaning of "payments" must be examined carefully to determine the availability of this exception. Only deferred payments are relevant. Both interest and principal fall within its ambit;[288] payments received at the time of the sale do not.

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[283] I.R.C. § 1273(a)(1).

[284] I.R.C. § 1272(a)(1).

[285] I.R.C. § 1272(a)(1), (3).

[286] I.R.C. § 1274(c)(3)(C).

[287] I.R.C. § 483. There appears to be a gap in the coordination of the coverage of I.R.C. § 483 and I.R.C. §§ 1272 and 1274. The original issue discount rules apply to deferred payment sales in which any payment is due more than six months from the date of the sale, but only if the total deferred payments do not exceed $250,000. I.R.C. § 453 applies to any deferrred payment sale with deferred payments of $250,000 or less, but only if some payments are due more than one year from the date of the sale. Thus, it appears that no unstated interest rules apply to deferred payment sales with total deferred payments of $250,000 or less where all of the payments are due within one year from the date of the sale.

[288] *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984, 120 (1984).

Second, if the deferred payments to be received exceed $250,000, but the stated principal amount of the obligation and all other obligations relating to the same transaction does not exceed $2,000,000, the seller may be able to elect to include the original issue discount on the cash rather than the accrual method.[289] This election is available, however, only for cash method taxpayers who are not dealers with respect to the property sold in the transaction. Any such election must be made jointly by the seller-lender and buyer-borrower whose timing of interest deductions is affected by the election.

No useful purpose would be served by numerous examples of the computation of unstated interest under the various rules. In planning a sales transaction, the usual objective is to avoid the application of the unstated interest rules. As stated previously, that is done easily by requiring stated interest on the unpaid balance at 9.2025 percent annually or the annual equivalent of the applicable federal rate, compounded semiannually, whichever is appropriate. Furthermore, except in the simplest cases, the computations generally require a computer. One simple example, under section 483, rather than the Original Issue Discount rules, suffices to illustrate the principle.

Assume that Seller (S) sells a horse held for breeding purposes for more than twenty-four months but on which no ACRS deductions have been claimed.[290] S's basis in the horse is $20,000 and the sales price is $100,000. S receives no payment at the time of sale but the buyer delivers a promissory note in the principal amount of $100,000, with five percent interest per year, payable in four annual installments of $28,201, the first installment due one year from the date of the sale. Using the nine percent test rate under I.R.C. section 1274A, the present value of the four payments would be $90,959. This then is the amount realized on the sale and S recognizes only $70,959 of section 1231 gain while receiving $21,845 of interest income. If the transaction was recognized as structured with five percent interest per year, S would recognize $80,000 of I.R.C. section 1231

[289] I.R.C. § 1274A(c).

[290] See note 160 *supra* regarding the reasons that a horse might be held for breeding purposes for two years without claiming ACRS deductions.

gain and only $12,804 of interest income. As restructured, however, instead of a profit ratio of .80 percent for purposes of installment reporting of the gain, the profit ratio is reduced to .78 percent. Furthermore, because the unstated interest is treated as accruing economically, the payments are treated as follows for tax purposes.

Table I

YEAR	PAYMENT	PRINCIPAL	INTEREST	SECTION 1231 GAIN
1	$28,201	$19,828	$8,373	$15,466
2	28,201	21,653	6,548	16,890
3	28,201	23,647	4,554	18,444
4	28,201	25,825	2,378	20,142

If the transaction could be reported for tax purposes as a sale at $100,000, with the deferred payments bearing interest at only five percent, compounded annually, the payments would be reported as follows.

YEAR	PAYMENT	PRINCIPAL	INTEREST	SECTION 1231 GAIN
1	$28,201	$23,201	$5,000	$18,561
2	28,201	24,361	3,840	19,489
3	28,201	25,579	2,622	20,463
4	28,201	26,858	1,343	21,486

Careful comparison of these tables reveals that the unstated interest rules not only recharacterize as ordinary income what would otherwise be I.R.C. section 1231 gain, but also result in an acceleration of income inclusion. After recharacterization and economic accrual of the unstated interest, a greater proportion of the total gross income to be recognized upon receipt of all of the payments is recognized as the earlier payments are received, and a relatively smaller percentage of the later payments is includable in gross income. This effect, however, is not easily avoided. In order to restructure the transaction to avoid the unstated interest rules, the payments would have to be treated expressly as the unstated interest rules require, unless the buyer is willing to increase his aggregate payments by actually paying adequate stated economic interest.

10. *Tax Finance Benefits of Installment Sales*

It is a mistake to view installment reporting merely as a method of ameliorating the impact of progressive marginal tax rates or the perceived hardship of paying taxes on a gain in a year prior to the year in which the profit is reduced to cash.[291] Deferred payment sales reported on the installment method increase the seller's after tax yield on the reinvestment of the proceeds from the sale of the property. In this context, the sales proceeds are viewed economically as received at the time of the sale and then as reinvested in a debt instrument issued by the buyer. Deferred reporting of the gain on the sale enables the seller to make a larger investment and thereby earn more interest than he could have earned had he not deferred the payment of taxes attributable to the gain. In short, the investor comes out ahead by an amount equal to the after tax interest earned during the period of deferral on the portion of the amount realized owed for the taxes due on the sale.

This may be illustrated with a simple example. Assume that Seller (S), a cash basis taxpayer, agrees to sell a horse with a zero basis to Buyer (B) for a sales price of $100,000. The horse was previously depreciated by S, and the entire gain will be ordinary income under section 1245. B offered either to pay the full $100,000 in cash at the time of the sale or to defer payment for two years, with interest compounded semiannually at nine percent, resulting in a single lump sum payment of $119,252 two years later. If S were in the thirty-three percent marginal tax bracket and he received the entire payment at the time of the sale, he would have only $66,667 to invest. If this amount were invested in an interest bearing obligation, such as a United States government security, at ten percent per year compounded annually, at the end of two years, after paying taxes on the interest,

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[291] The purpose of allowing installment reporting of gains from the sale of property has been viewed as both relief from the burden of paying taxes on the entire gain when only a small portion is received in cash and avoidance of the complexities of determining the fair market value of the buyers obligations. *See* Commissioner v. South Texas Lumber Co., 333 U.S. 496, 503 (1948); S. REP. No. 52, 69th Cong., 1st Sess. (1926), *reprinted in* 1939-1 (Part 2) C.B. 332, 346.

S would have $75,857. This reflects a six and two-thirds percent after tax yield on his investment. On the other hand, if he took the deferred payment arrangement, after paying taxes on the payment he would have $79,899.[292] The after tax yield on the investment is increased to 9.475 percent by accepting the deferred payment terms, even though the interest offered by B was only 9.2025 percent per year and S could obtain ten percent interest elsewhere.

E. *Transfer to a Partnership or Syndicate*

1. *General Principles*

A sale of a horse to a partnership or syndicate of which the seller is a member or share owner is treated the same as any other sale. Gain or loss is recognized according to the normal rules,[293] and installment reporting is allowed. If, however, the seller has more than a fifty percent interest in either the profits or capital of the partnership, no loss may be recognized.[294] If the horse is depreciable in the hands of the partnership and the seller has an eighty percent or more interest in either the partnership profits or capital, installment reporting of any gain is proscribed.[295] If the seller has more than an eighty percent interest in either capital or profits, all of the gain is recognized as ordinary income.[296] A transfer of a horse to a partnership in exchange for a partnership interest, however, generally is a non-recognition event, but there are some pitfalls.

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[292] Under the terms of this particular deferred payment sale there is no original issue discount, and because the seller is on the cash basis of reporting, the entire amount, including interest earned but not payable in earlier years, is reportable in the year received.

[293] I.R.C. § 707(a)(1); Treas. Reg. § 1.707-1(a) (1985).

[294] I.R.C. § 707(b)(1); Treas. Reg. § 1.707-1(b)(1). The attribution rules of I.R.C. § 267(c), with the exception of subsection (c)(3), are applied to determine ownership of partnership interests under this prosciption. I.R.C. § 707(b)(3); see Treas. Reg. § 1.707-1(b)(3).

[295] I.R.C. § 453(g)(1). *See* text accompanying note 248 *supra*.

[296] I.R.C. § 707(b)(2); Treas. Reg. § 1.707-1(b)(2). The attribution rules of I.R.C. § 267(c), except subsection (c)(3) apply to determine ownership. I.R.C. § 707(b)(3). Technically, the rule extends to any property that is not a capital asset in the hands of the transferee. In the context of this Article it is important only in that it includes depreciable assets.

Neither gain nor loss is recognized on the contribution of property to a partnership solely in exchange for a partnership interest.[297] This rule applies even if the contributor has claimed ACRS deductions and would otherwise recognize depreciation recapture on the disposition of the horse.[298] As a result of this nonrecognition, the contributing partner takes a basis in his partnership interest equal to the adjusted basis of the property transferred to partnership.[299] The partnership's basis in the property is equal to the transferor's adjusted basis immediately prior to the transfer.[300] Because the partnership's basis is determined with reference to the transferor's basis, any depreciation recapture potential in the property at the time of transfer carries over to the partnership.[301] The rules for allocating gain or loss among partners, however, will cause that depreciation recapture to be allocated to the transferor partner when it ultimately is recognized.[302]

If the property transferred to the partnership is encumbered by a lien in excess of the transferor's basis, the transferor may be required to recognize gain as a result of the transfer of the property and the concomitant relief from that portion of the liability that is allocated to the other partners. The rules for determining the amount of gain to be recognized are complex and fact specific and will not be examined in detail.[303] Rather, a simple example illustrates how these rules are applied to a particular set of facts.

Assume that A and B desire to form a partnership for the purpose of breeding horses. A contributes a broodmare with a basis of $20,000 and a fair market value of $110,000, subject to a lien of $80,000. The recomputed basis of the mare is $100,000. If the mare was sold, $80,000 of the gain is section 1245 recap-

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[297] I.R.C. § 721(a); Treas. Reg. § 1.721-1.

[298] I.R.C. § 1245(b)(3); Treas. Reg. § 1.1245-4(c)(1), (2)(vi).

[299] I.R.C. § 722; Treas. Reg. § 1.722-1 (1985).

[300] I.R.C. § 723; Treas. Reg. § 1.723-1 (1985).

[301] I.R.C. § 1245(A)(2); Treas. Reg. § 1.1245-2(c)(1), (2)(i), (ii)(b).

[302] I.R.C. § 704(c).

[303] *See* Treas. Reg. § 1.722-1, Example(2). This results from the complex interrelationship of I.R.C. §§ 705 (1986), 721, 722, 731 (1986), 733 (1986), 741 (1986), and 752, and Treas. Reg § 1.752-1(e). *See generally* MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 4.03-.05.

ture income and the balance is section 1231 gain. B contributes $30,000; A and B become equal partners. As a result of the contribution A is relieved of $40,000 of the lien debt on the horse; B as an equal partner is now reponsible for the other $40,000. As a result, A must recognize a gain of $20,000, the amount by which his relief from debt exceeded the basis of the property contributed to the partnership in exchange for his interest. Furthermore, the regulations provide that this gain is ordinary income because there would be $80,000 of section 1245 gain if the horse had been sold.[304] If the contributed property were not subject to depreciation recapture, the gain would have been capital gain.[305]

2. *Formation of Partnership With Services Partner*

Nonrecognition of gain on the contribution of property to a partnership in exchange for a partnership interest is not universal. The Treasury Regulations specifically provide that "[t]o the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply."[306] The application of this regulation is illustrated in *McDougal v. Commissioner.*[307]

a. *Subchapter K and the "Common Law" Approach*

McDougal purchased a racehorse named Iron Card for $10,000, and promised McClanahan that if the latter would train the horse, after McDougal had recovered the cost and expenses of acquisition, he would transfer a one-half interest in the horse to McClanahan. In addition, McClanahan would receive a trainer's fee.

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[304] Treas. Reg. § 1.1245-4(c)(1), (c)(2)(i), (c)(4), Example (3). There is a theoretical inconsistency between this result and the manner in which the mechanics of the operation of Subchapter K give rise to the gain, but the issue raised by this problem has been neither addressed nor resolved. *See* McKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 4.05.

[305] I.R.C. §§ 731(a); 741.

[306] Treas. Reg. § 1.721-1(b)(1) (1960). Identical language appears in Prop. Reg. § 1.721-1(b)(1) (1971).

[307] 62 T.C. 720 (1974)(*acq.*).

McClanahan trained Iron Card, who proved to be successful on the track, and nine months later, McDougal transferred a one half interest in Iron Card to McClanahan. Shortly thereafter, McDougal and McClanahan entered into an oral partnership to race Iron Card and later hold him as a stud. They continued to race Iron Card until he was retired to stud due to injury.

McDougal claimed that the transfer of the one-half interest in Iron Card was a recognition event and reported a $25,000 section 1231 gain, basing the amount realized on a contemporaneous third party offer to purchase Iron Card for $60,000. McDougal also claimed a $30,000 deduction as a result of the transfer. McClanahan reported the receipt of $30,000 of income, and the partnership increased its basis in Iron Card to $35,000 (minus depreciation claimed by McDougal for the period prior to the transfer). The Commissioner argued that the transaction was a nonrecognition event and that the partnership took McDougal's basis in Iron Card.

Although the oral partnership was not finalized at the time, the Tax Court agreed that for income tax purposes a partnership had been formed at the time of the transfer.[308] The court nevertheless disagreed with the Commissioner's argument and found the transfer to be a recognition event. Citing the regulation quoted above, the court found that the transfer should be taxed as if McDougal first transferred an undivided one half of the horse to McClanahan and they both then contributed their undivided one halves to form the partnership.[309] While the later transfers were nonrecognition events under section 721, the former transfer was clearly a recognition event. Under established precedent, McDougal properly recognized the gain,[310] and under the regulations, he properly claimed the deduction.[311] Consequently, McClanahan recognized $30,000 of income, and had a $30,000 basis in his

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[308] *Id.* at 724. See text accompanying notes 181-87 *supra*, regarding the standards for determining if co-ownership of a horse constitutes a partnership between the co-owners.

[309] *Id.* at 725 (citing Treas. Reg. § 1.721-1(b)(1)).

[310] *Id.* at 726 (citing United States v. Davis, 370 U.S. 65 (1962)); Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940), *aff'g*, 40 B.T.A. 824 (1939). *See also* International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943).

[311] 62 T.C. at 728 (citing Treas. Reg. § 1.721-1(b)(2)). *See also International Freighting Corp.*, 135 F.2d 310.

undivided one-half interest.[312] When he transferred that interest in Iron Card to the partnership, the partnership succeeded to his basis.[313]

b. *Section 83 Approach*

The Tax Court clearly was correct in all aspects of its *McDougal* decision. Section 83 and the Treasury Regulations implementing it express the principles applied in *McDougal* even more clearly than the court did there.[314] Under section 83 the fair market value of property transferred in consideration of services is gross income to the recipient to the extent that the value of the property exceeds any purchase price paid by the transferee.[315] Inclusion, however, may be deferred if the transferee's rights in the property are restricted by nontransferability or a substantial risk of forfeiture.[316] Concomitantly, subject to the capitalization rules of section 263, in the same year, the transferor is allowed a deduction equal to the amount included by the transferee. If the transferee paid no consideration, that amount is the fair market value of the property.[317] The transferor must, however, treat that same amount as the amount realized on the sale or exchange of the transferred property and recognize gain or loss accordingly.[318] As a result, the transferor may recognize section 1231 income and an ordinary deduction. If the transferor has any basis in the property, the deduction will be larger than the income, even before taking into account the capital gain preference attaching to net section 1231 gains. These rules apply to all transfers of property in consideration for services, whether in the context of

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[312] *See* Treas. Reg. § 1.61-2(d)(2).

[313] I.R.C. § 723.

[314] *See* Treas. Reg. §§ 1.83-1 - 1.83-2 (1978); § 1.83-3; § 1.83-8 (1978); Prop. Reg. § 1.721-1(b)(1) (1971).

[315] I.R.C. § 83(a); Treas. Reg. § 1.83-1(a)(1).

[316] I.R.C. § 83(a), (c); Treas. Reg. §§ 1.83-1(a)(1), -3(b), (c), (d). The recipient may elect to include currently the fair market value of the property even though it is nontransferable or subject to a substantial risk of forfeiture. I.R.C. § 83(b); Treas. Reg. § 1.83-2.

[317] I.R.C. § 83(h); Treas. Reg. § 1.83-6(a).

[318] Treas. Reg. § 1.83-6(b). *See* MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 13.03[5].

the formation of a partnership, an ongoing employment relationship, or the engagement of an independent contractor.[319] It is worth noting, as held in *McDougal*, in forming a partnership, both the gain and deduction should be allocated entirely to the partner or partners surrendering an interest in the property[320] and should not be allocated under the general partnership provisions otherwise applicable to income and loss.[321]

The principles applied in *McDougal*, and now expressed in section 83, are not always applied as in that case. For example, if the trainer acquired only a right to future profits, such as racing purses or stud fees rather than a capital interest, the transfer probably would not be a recognition event for the transferor of the horse. Although the trainer theoretically may have a recognition event,[322] in all likelihood it would be impossible to value his profits interest and, therefore, he would not be required to recognize any gain.[323] On the other hand, if the horse in *McDougal* had not commenced its racing career, the training expenses might have been treated as a capital expense rather than a deductible item.[324] In that case, although gain would be recognized on the first transfer, no deduction would be allowed.[325] The partnership would presumably capitalize the amount realized as an addition

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[319] Treas. Reg. § 1.83-1(a); Prop. Reg. 1.721-1(b)(1).

[320] *See* I.R.C. § 706(d)(1) (requiring that each partner's share of any item of income, gain, loss, deduction or credit of the partnership be determined in accordance with his varying interests if there was any change in any partner's interest during the year); MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 5.03[1][d], [2].

[321] See I.R.C. § 704(a), (b); I.R.C. § 704(c).

[322] *See* Diamond v. Commissioner, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974); MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 5.05 - .06.

[323] *See* Vestal v. United States, 498 F.2d 487 (8th Cir. 1974) (receipt of limited partnership interest in partnership, the sole asset of which was oil and gas rights in then unproductive, but proven, field, was not currently taxable because value of rights was speculative; on rehearing the court found no inconsistency with *Diamond*, *supra* note 322); St. John v. United States, 84-1 U.S.T.C. ¶ 9158 (C.D. Ill. 1983) (applying I.R.C. § 83, based on liquidation value of profits interest at time of receipt, the fair market value of an interest only in future partnership profits was zero). *See also* Gen. Couns. Mem. 36,346 (July 25, 1977).

[324] Journal Box Serv. Corp. v. United States, 9 A.F.T.R.2d (P-H) 798 (S.D. Ind. 1962). Expenses of continuing training of a horse during its racing career are currently deductible. *See* Hill v. Commissioner, 26 T.C.M. (CCH) 1287 (1967). *See also* text accompanying note 83 *supra*.

[325] *See* I.R.C. § 707(c); Treas. Reg. §§ 1.83-6(a)(4), 1.707-1(c). *See also* Rev. Rul. 75-214, 1975-1 C.B. 185.

to the horse's cost basis to be recovered through ACRS deductions. If the horse were transferred in consideration of services that did not relate to the horse, the amount would be capitalized or deducted using the same standards that would apply if the payment for the services were made in cash.[326]

3. *Receipt of Cash by Transferor to Partnership or Syndicate*

It should be apparent from *McDougal* that proceeds realized upon syndication of a horse should be treated as an amount realized upon the sale of the horse, regardless of the form of the transaction. This conclusion is clear, even without *McDougal*, if the syndicate is not a partnership.[327] If the syndicate is a partnership, *McDougal* makes it clear that the form of the transaction should not govern over substance. Regardless of whether the syndicator is paid directly by purchasers of shares or whether the purchasers "contribute" money to the syndicate for a share followed shortly by a partnership distribution to the syndicator, the transaction should be treated as the sale of an undivided interest in the horse by the syndicator to the shareholder, with the shareholder then contributing his undivided share to the syndicate-partnership. Although this analysis may have been called into question by the decision in *Otey v. Commissioner*,[328] the 1984 amendments to section 707 adding subsection (a)(2)(B)[329] clearly call for treatment of the transaction as a sale, if not to the shareholders, then to the partnership.[330] In any event, the syndicator recognizes gain and the syndicate-partnership steps up its basis in the horse, except with respect to the share attributable to the syndicator-seller.

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[326] *See* MCKEE, NELSON & WHITMIRE, *supra* note 185, at ¶ 13.03[4].

[327] *See* text accompanying notes 191-95 *supra*. See text accompanying notes 181-87 *supra* regarding the standards for determining whether a syndicate is co-ownership or a partnership for income tax purposes.

[328] 70 T.C. 312 (1978), *aff'd per curiam*, 634 F.2d 1046 (6th Cir. 1980).

[329] Tax Reform Act of 1984, Pub. L. No. 98-369, § 73(a), 98 Stat. 494, 591 (1984).

[330] *See* S. REP. No. 169, 98th Cong., 2d Sess. 223-32 (1984); H.R. REP. No. 432, 98th Cong., 2d Sess. 1216-21 (1984); H.R. REP. No. 861, 98th Cong., 2d Sess. 859-62 (1984); STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 223-26, 231-33.

II. LIKE KIND EXCHANGES OF HORSES

A. *General Principles*

1. *Nonrecognition of Gain and Substituted Basis*

Section 1031(a) provides that, "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." Furthermore, section 1245(b)(4) expressly subordinates depreciation recapture under section 1245 to nonrecognition under section 1031.

The nonrecognition provided by section 1031, is not permanent; recognition of gain or loss, including depreciation recapture, merely is deferred. This deferral is implemented by section 1031(d), which provides that the basis of property received in an exchange is the same as the basis of the property surrendered.[331] The deferred gain is realized either through gain recognized on the sale of the property acquired in the exchange or the increase in future taxable income, effected by the reduced ACRS allowances claimed on the section 1031(d) substituted basis, rather than a basis equal to the fair market value of the property received. Thus, for example, if a horse owner exchanges a horse with a basis of $10,000 and a fair market value of $100,000 for another horse of like kind, no gain is recognized. The basis of the horse received in the transaction, however, is only $10,000. If the second horse were sold for $100,000, the seller would recognize a gain of $90,000. In determining the character of the gain, the holding period of the first horse is tacked onto the holding period of the second horse.[332] Thus, if the first horse was held for twenty months prior to the exchange, the horse received in the exchange need only be held for more than four months prior to sale to qualify for section 1231 treatment.[333] The recomputed basis of the

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[331] *See* Treas. Reg. § 1.1031(d)-1(a) (1986).
[332] I.R.C. § 1223(1).
[333] *See* text accompanying notes 138-48 *supra*.

second horse, however, includes all ACRS deductions claimed on the first horse,[334] and to the extent of prior ACRS deductions claimed on both horses, the gain is recharacterized as ordinary income.

As a result of the tacked holding period and substituted basis assigned to the horse received in an exchange, the ACRS cost recovery period for the horse is merely a continuation of the recovery period of the horse surrendered, with cost recovery deductions continuing under the same method over the remaining recovery period.[335]

Nonrecognition also extends to an exchange in which the taxpayer surrenders property plus cash in exchange for property of like kind. In such a case the additional cash payment results in an increase in the basis of the property received.[336] Thus, if the taxpayer exchanges a horse with a basis of $10,000 plus $20,000 in cash for a horse of like kind, the basis of the horse received in the exchange is $30,000. The value of either horse is not relevant.

When section 1031 applies, nonrecognition is mandatory, not elective. Thus, if a horse with a basis of $30,000 and a fair market value of $10,000 is exchanged for a horse of like kind with a value of only $10,000, the $20,000 loss realized by the transferor may not be recognized. The horse acquired in the exchange takes a $30,000 basis and the loss is recognized on the sale of the second horse or through claiming ACRS deductions on the second horse computed on the $30,000 basis. The loss is easily recognized, however, by selling the first horse and then purchasing the second horse. Section 1031 does not apply to the sale of property followed by reinvestment of the proceeds in like kind property, even if the reinvestment is immediate.[337] If the sale and purchase are interrelated, however, the IRS may be able to apply I.R.C. section 1031 to deny a loss claimed by the taxpayer where the transaction was artificially structured to attempt to evade nonrecognition of

[334] I.R.C. § 1245(a)(2); Treas. Reg. § 1.1245-2(c)(4) (1986).

[335] *See* Prop. Reg. § 1.168-5(f)(2) (1984).

[336] Treas. Reg. § 1.1031(d)-1(a) (1956).

[337] *See* Carlton v. United States, 385 F.2d 238 (5th Cir. 1967) (gain recognized on sale of property followed by immediate prearranged reinvestment of proceeds in like kind property).

the loss.[338] Such a restructuring of the transaction should apply, however, only where the the first horse is sold to the same person from whom the second horse was purchased, and where neither transaction would have occurred in the absence of the other.[339]

2. *Eligibility for Nonrecognition*

Nonrecognition of gain on exchanges of like kind property is circumscribed by a number of restrictions. Section 1031(a)(1), in setting forth the nonrecognition rule, limits its availability to the exchange of property "held for productive use in a trade or business or for investment" for other like kind property "to be held either for productive use in a trade or business or for investment."[340] Subsection (a)(2) lists specific exclusions from the scope of section 1031. Most notable among the exclusions is "stock in trade or property held primarily for sale."[341] Thus, section 1031 generally is not available for the exchange of a yearling or weanling by a breeder. If, however, the breeder can demonstrate that the particular yearling or weanling was held for investment or for future breeding or sporting purposes, section 1031 is available. Proving such intent, however, may be difficult.[342] If the breeder holds the horse until it is two years old or older, facts may show an intent to hold the horse for breeding or racing.[343] In general, if the taxpayer would recognize ordinary income, rather than section 1231 gain (or section 1245 recapture) or capital gains if the horse were sold rather than exchanged, then nonrecognition under section 1031 is not available.[344]

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[338] Rev. Rul. 61-119, 1961-1 C.B. 395. *See* Red Wing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968) (sale of used trucks to dealer and purchase of new trucks from same dealer under separate but mutually dependent contracts). *But see* Swaim v. United States, 45 A.F.T.R.2d 1276 (N.D. Tex. 1979) (sale and purchase from buyer were separate transactions).

[339] *See* Bell Lines, Inc. v. United States, 480 F.2d 710 (4th Cir. 1973).

[340] I.R.C. § 1031(a)(1).

[341] I.R.C. § 1031(a)(2).

[342] *But see* Woodbury v. Commissioner, 49 T.C. 180 (1967) (*acq.*).

[343] *See* Margolis v. Commissioner, 337 F.2d 1001 (9th Cir. 1964) (dealer in real estate allowed I.R.C. § 1031 nonrecognition on exchange of selected properties held for rental); Wylie v. United States, 1968-1 U.S.T.C. ¶ 9286 (N.D. Tex. 1968) (exchange of breeding cattle); Jewel v. Commissioner, 25 T.C. 109 (1955) (taxpayer in business of selling horses allowed I.R.C. § 1231 gains on horses held for breeding and racing).

[344] See text accompanying notes 108-37, 157-73 *supra* for a detailed discussion of

It is worth noting that section 1031(b)(1) excludes from the ambit of nonrecognition an exchange involving property held "primarily for sale", in contrast to the language of I.R.C. section 1221(1) which excludes from the definition of capital asset property held "primarily for sale to customers in the ordinary course of business." The Tax Court has given express effect to this difference by denying to a taxpayer who was not a dealer in real estate nonrecognition on the exchange of real estate acquired for the purpose of renovation and sale.[345] The gain recognized on the exchange was, nevertheless, capital gain. In a similar vein, the limiting language in subsection (a) has been interpreted by the IRS to deny nonrecognition on a like kind exchange followed by a contribution to a corporation in a section 351 transaction of property received in the exchange.[346] In *Magneson v. Commissioner*,[347] however, nonrecognition was allowed when the property received in the like kind exchange was contributed to a partnership for a general partnership interest. A crucial factor to the result was that the other property of the partnership was predominantly like kind to the contributed property.

Simply because a horse is not held primarily for sale does not mean that it is held for one of the purposes specified in section 1031(a). A horse held for use in an activity that is not conducted for profit may not be exchanged in a like kind exchange subject to nonrecognition under section 1031.[348] These use requirements apply separately to each taxpayer involved in the exchange, and the other taxpayer's prior use of the horse previously owned by him and future use of the horse to be obtained by him are irrelevant. Only the prior use of the horse surrendered and the future use of the horse received are considered. Both taxpayers' uses, however, may bear on whether the horses are "like kind."[349] Nevertheless, in some instances, the prior use of a horse by one taxpayer could exclude that taxpayer, but not the other, from

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the factors used to determine whether horses are held primarily for sale, or for breeding or sporting purposes.

[345] Black v. Commmissioner, 35 T.C. 90 (1960).

[346] Rev. Rul. 75-292, 1975-2 C.B. 333.

[347] 81 T.C. 767 (1983), *aff'd*, 753 F.2d 1490 (9th Cir. 1985).

[348] *See* Rev. Rul. 59-229, 1959-2 C.B. 180 (exchange of real property held for personal use not within I.R.C. § 1031).

[349] *See* text accompanying notes 351-77 *infra*.

nonrecognition under section 1031. For example, if a taxpayer in the business of racing horses exchanged a three year old colt previously raced by him with a taxpayer who was a dealer in horses, for a three year old colt that would be held for racing by the first taxpayer, the taxpayer engaged in racing would have a nonrecognition transaction while the dealer would be required to recognize gain or loss on the exchange.

Section 1031(a)(2) lists a variety of other types of property which are excluded from nonrecognition under section 1031.[350] Except for the exclusion of exchanges of partnership interests, none are particularly relevant here.

B. *Identifying Horses of Like Kind*

1. *Same Sex Requirement*

Determining whether two horses are of like kind for purposes of section 1031 is difficult because there is little authority interpreting the meaning of "like kind" in this or any closely analogous context. One thing, however, is clear; section 1031(e) expressly provides that livestock of different sexes are not property of like kind. Thus, an exchange of a broodmare for a stallion or a colt for a filly can never be a like kind exchange. Although Congress may not have had the exchange of racehorses in mind when enacting this section,[351] this proscription of the Code is so clear and unambiguous that there can be no doubt that a filly and a colt, although both held for racing, are not like kind.[352]

2. *Relevance of Purpose for Which Horses of the Same Sex are Held*

The Treasury Regulations provide that the term "like kind" has "reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not

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[350] I.R.C. § 1031(a)(2) excluded property includes stocks, bonds, notes, securities, certificates of trust or beneficial interest and choses in action.

[351] *See* text accompanying note 361 *infra*.

[352] *See* Greenwood v. United States, 350 U.S. 366, 374 (1956) ("[T]his a case for applying the cannon of construction of the wag who said, when the legislative history is doubtful, go to the statute." The case involved interpretation of a criminal statute.).

. . . be exchanged for property of a different kind or class.''[353] Although this standard has been interpreted extensively relative to real estate exchanges,[354] there is sparse interpretation with respect to any livestock.[355] Any attempt to apply the standards developed with respect to real estate exchanges may be hazardous. As far as real estate is concerned, both the IRS and the courts, based on substantial support from specific examples in the Regulations,[356] generally have taken the position that "real estate is real estate." They have gone so far as to conclude that an exchange of improved urban real estate and a mineral interest, treated as real property under state law, was entitled to nonrecognition under section 1031.[357] The specific business or investment purpose for which the real property was held generally has been considered to be irrelevant.

When personal property is involved, however, the words "like kind" often have been construed more narrowly, and one cannot say confidently that "a horse is a horse." The only examples of like kind exchanges of personal property set forth in the regulations are the exchange of a used automobile for a new automobile and the exchange of a used truck for a new truck.[358] Thus it is reasonable to conclude that a difference in the ages of the horses alone will not prevent them from being like kind. A difference in the ages of horses, however, sometimes results in the horses being put to different uses. As a result, determining whether the horses are "like kind" may be more difficult. The difficulty of deter-

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[353] Treas. Reg. § 1.1031(a)-1(b).

[354] See 2 B. BITTKER, *supra* note 44, at ¶ 44.2.2 for a discussion of the principles that have evolved for identifying like kind real estate and for citations to leading cases.

[355] *See* Woodbury v. Commissioner, 49 T.C. 180 (1967); Wylie v. United States, 1968-1 U.S.T.C. ¶ 9286 (N.D. Tex. 1968) (exchange of steer calves for registered Aberdeen Angus livestock in a year prior to enactment of I.R.C. § 1031(e)); Rutherford v. Commissioner, 37 T.C.M. (CCH) 1851 (1975) (exchange of three-quarter blooded heifers for one-half blooded heifers).

[356] *See* Treas. Reg. § 1.1031(a)-1(b) ("The fact that any real estate involved is improved or unimproved is not material . . . ."); -(1)(c)(2) (exchange of city real estate for a ranch or farm, improved for unimproved real estate, or a fee interest for a leasehold with more than thirty years to run are all accorded nonrecognition).

[357] *See* Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941).

[358] Treas. Reg. § 1.1031(a)-1(c)(2). For a discussion of the cases and Revenue Rulings determining whether exchanges of personalty constitute "like kind" exchanges, see Goldstein & Lewis, *Tax Treatment of Like Kind Exchanges of Property Used in a Trade or Business or for Investment*, 5 REV. TAX. IND. 191, 221-23 (1981).

mining the scope of the term "like kind" as applied to horses, and most other personalty for that matter, is compounded by the recently developed view of the IRS that the purpose for which the taxpayer held the property surrendered and will hold the property received is relevant. This approach has been applied most notably in a series of Revenue Rulings dealing with exchanges of gold coins.[359] In these rulings the IRS has taken the position that coins, the value of which is determined by bullion content, and coins, the value of which is determined by numismatic considerations, are not like kind because they are held for different purposes. According to the rulings this logic emanates from the legislative history of section 1031(e).[360]

In enacting section 1031(e) Congress sought to halt the practice of exchanging slaughter cattle (i.e., steers) for female cattle to be held for breeding purposes.[361] Congress was concerned that the practice of exchanging steers for female breeding cattle would allow the building of a breeding herd without tax consequences. Congress sought to foreclose the avoidance of ordinary income on the sale of steers that would occur by allowing such a transaction to come within section 1031. The Committee Reports state that allowing nonrecognition for such exchanges was erroneous under then current law: "[w]hen male calves are exchanged for female calves, the exchange does not involve like-kind property since the male animals are not held for breeding purposes and, in fact are not of a 'like-kind' with females."[362]

Basing the availability of nonrecognition under section 1031 on the purpose for which the taxpayer holds the property is

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[359] *Compare* Rev. Rul. 79-143, 1979-1 C.B. 264 *and* Rev. Rul 82-96, 1982-1 C.B. 113 *and* California Fed. Life Ins. Co. v. Commissioner, 76 T.C. 107 (1981) (United States double eagle gold coins and Swiss francs are not like kind) *with* Rev. Rul. 76-214, 1976-1 C.B. 218 (exchange of peso bullion type coins for corona bullion type coins was like kind exchange).

[360] This logic has led Boris Bittker to comment, "[the] ruling does not state which type [of coins] is masculine and which feminine." 2 B. BITTKER, *supra* note 44, at ¶ 44.2.2, n.11 (1981).

[361] *See* S. REP. No. 552, 91st Cong., 1st Sess. 102 (1969), *reprinted in* 1969-3 C.B. 488-89; H.R. REP. No. 413, 91st Cong., 1st Sess. 66 (1969), *reprinted in* 1969-3 C.B. 200, 241-42.

[362] S. REP. No. 552, 91st Cong., 1st Sess. 102 (1969), *reprinted in* 1969-3 C.B. 488-89; H.R. REP. No. 413, 91st Cong., 1st Sess. 66 (1969), *reprinted in* 1969-3 C.B. 200, 241-42.

consistent with the general theory of the inclusion of nonrecognition provisions in the Code. The Treasury Regulations promulgated under section 1002 state, with respect to the nonrecognition provisions, that "[t]he underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated . . . ."[363]

Applying this to horses, the question is whether the exchange of a horse held for breeding purposes for a horse held for racing purposes is more properly described as the old investment continued or as a liquidation of the old investment and a reinvestment in the newly acquired horse. Because the risks and profit potentials of breeding and racing differ, the transaction may be said to more nearly resemble a liquidation and reinvestment. Therefore, the exchange of a horse held for racing with another horse held for breeding probably should not be treated as a like kind exchange.

Facially, however, it appears that exchanges of personalty should be judged under the same criteria as are exchanges of real estate, because the statute makes no distinction between realty and personalty. Exchanges of real estate held for different purposes and entailing substantially different risks routinely are accorded like kind exchange treatment.[364] From this perspective, against only the statute and the broad rationale for nonrecognition, one might reasonably conclude that the error lies in the latitude accorded to exchanges of real estate, not in restrictions imposed on exchanges of personalty. But we are not writing on a clean slate, and applying consistent criteria has merit. From this perspective, the gold coin rulings may be reconciled as transactions that were closer to sales since bullion coins are essentially a medium of payment. This was not, however, the logic employed in those rulings.

If this logic is accepted, the exchange of a filly held for racing for a broodmare, and the exchange of a colt held for racing for a stallion, would both qualify as like kind exchanges. There is, however, some basis for believing that the IRS may take a dif-

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[363] Treas. Reg. § 1.1002-1(c) (1960). *See also* Century Elec. Co. v. Commissioner, 192 F.2d 155, 159 (8th Cir. 1951), *cert. denied,* 342 U.S. 954 (1952).

[364] *See* Goldstein & Lewis, *supra* note 358, at 223-26.

ferent view. In a 1971 private letter ruling the IRS concluded that the exchange of two five-year-old geldings for a "one-year-old stallion" was not a like kind exchange. The stated rationale for this conclusion was, "[s]ince a gelded horse can never be used for breeding purposes an exchange of such an animal for a stallion, which is used for breeding and other purposes, does not involve property of a like kind."[365] On the other hand, this ruling might be confined to geldings on the theory that there exist three sexes of horse—male, female, and gelding. The absolute inability to use the gelding for breeding purposes renders him not like kind with any colt or stallion. A horse currently held for racing, however, can be said to be held for two purposes—current racing and future breeding.[366] Because fillies and colts have breeding potential while being held for racing, the exchange of a filly for a broodmare and the exchange of a colt for a stallion might be considered to be like kind without regard to the current use of the horse. Furthermore, because of the uncertainty surrounding when a horse will be retired from racing for breeding, administrative considerations may warrant ignoring the difference between use in racing and breeding as long as the horses are of the same sex.

3. *Horses of Different Breeds*

An exchange of horses of different breeds should not be excluded *per se* from the ambit of section 1031 nonrecognition.[367] Nevertheless, such an exchange might not qualify for nonrecognition under other applicable standards. This especially is true if the different uses of horses precludes their exchange without recognition under I.R.C. section 1031. But even if that standard did not apply, most breeds are used in activities not engaged in for profit, and section 1031 is unavailable in any event. Probably the most difficult question that arises if the exchange of horses

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[365] Priv. Ltr. Rul. 7110050290.

[366] *See* Gamble v. Commissioner, 68 T.C. 800 (1977); McDougal v. Commissioner, 62 T.C. 720 (1974).

[367] *Wylie*, 1968-1 U.S.T.C. ¶ 9286 (exchange of steer calves for registered Aberdeen Angus livestock qualified for nonrecognition in a year prior to enactment of I.R.C. § 1031(e)); *Rutherford*, 37 T.C.M. (CCH) 1851, 1851-77 (exchange of three-quarter blooded heifers for one-half blooded heifers was like kind exchange).

held for different purposes is not sheltered from recognition by section 1031 is whether a standardbred held for racing or breeding is like kind with a thoroughbred held for racing or breeding. The answer is entirely problematical, and the structure of the industry is such that the question is not likely to be answered soon.

4. *Mares in Foal*

An exchange involving a mare in foal presents difficult problems. If only one of the mares is in foal, the initial question is whether a mare in foal is like kind to a mare that is not in foal. Although there is no authority providing any guidance, logic appears to dictate that the mares themselves are like kind,[368] and the real issue concerns the treatment of the unborn foal. If this is true, then the issues generally will be the same regardless of whether one or both of the mares involved in the exchange is in foal. If the unborn foal is treated as separate from the mare carrying it, should the foal be treated as boot by the person receiving the mare in foal and as additional property transferred by the person surrendering the foal? The answer, by no means clear under any scenario, might vary with the facts. For example, if a mare in foal were exchanged for a broodmare not in foal, the foal might not be boot if, when born, it was a filly that the taxpayer planned to hold for breeding or racing. If it were a colt or a filly that the taxpayer planned to sell, however, it would be boot.

If the foal is treated as boot, the transferee of the mare in foal recognizes gain, and the foal takes a basis equal to its fair market value.[369] The basis of the mare in foal received in the transaction then equals the basis of the mare surrendered, plus the gain recognized, minus the basis assigned to the foal.[370] If the foal is not treated as boot, then no gain would be recognized and the basis of the mare and the foal received would be determined by prorating the basis of the mare surrendered between the two horses received relative to their fair market values. These alloca-

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[368] *But see* Sonneborn Bros. v. Cureton, 262 U.S. 506, 522 (1923) (McReynolds, J., concurring) ("Logic and taxation are not always the best of friends.").

[369] *See* I.R.C. § 1031(d); Treas. Reg. § 1.1031(d)-1(c), (d).

[370] *See* I.R.C. § 1031(d); Treas. Reg. § 1.1031(d)-1(c), (d).

tions, of course, will have a significant impact on basis recovery rates under ACRS, as well as on the gain to be recognized on the subsequent sale of one of the horses before it is fully depreciated.

To the extent that the foal is boot to the recipient, it may constitute additional property transferred by the transferor. As a result, the transferor would recognize gain equal to the difference between his basis in the foal and its fair market value.[371] He would also add the fair market value of the foal to the basis of the mare surrendered to determine the basis of the mare received.[372] If, however, the foal is not treated as boot, the basis of the mare surrendered will be transferred to the mare received in the exchange if the stud fee was capitalized, it would be added to the basis of the new mare.

The reciprocal exchange of two broodmares in foal is even more complicated. If both mares bear fillies, then the exchange presumably would be entirely a like kind exchange, and the only issue is apportionment of basis between the mare and the foal. If one foal is a filly and one is a colt, however, the transaction might be treated either of two ways. Simply, the transaction could be treated as a like kind exchange of mares and a taxable exchange of foals.[373] Alternatively, the transaction could be treated as a like kind exchange with boot by the person receiving the colt foal and as a like kind exchange with an additional payment made with appreciated property by the person receiving the filly foal.[374] Although both treatments result in recognition by both transferors, the details of computations of gain recognized and the resultant basis of the four horses might differ.

Whether the foals should be considered separately is not entirely clear, and drawing analogies to the few decided cases involving the treatment of unborn foals leads to differing conclusions. On one hand, the Sixth Circuit Court of Appeals, in *Greer*

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[371] United States v. Davis, 370 U.S. 65 (1962); International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943); Treas. Reg. § 1.1031(d)-1(e).

[372] Treas. Reg. § 1.1031(d)-1(e).

[373] *See* Rev. Rul. 59-229, 1959-2 C.B. 180 (in a reciprocal exchange of farms, I.R.C. § 1031 applies to property other than personal residences; gain is recognized on separate exchange of personal residences, subject to nonrecognition under I.R.C. § 1034).

[374] *See* Rev. Rul. 72-151, 1972-1 C.B. 225 (exchange of land and building for farm and farm machinery was like kind exchange as to realty; farm machinery was boot).

v. United States,[375] concluded that for purposes of determining the applicability of section 1231, the holding period of a foal does not begin until birth. This indicates that the foals should not be considered to be separate property. On the other hand, in *Gamble v. Commissioner*,[376] the Tax Court concluded that it was proper to apportion the purchase price of a mare in foal between the mare and the foal when the foal is born. This indicates that the separate existence of the foal should be recognized.

These two cases might be reconciled by concluding that *Gamble* requires that independent significance be accorded to the foals, while *Greer* dictates that we adopt a "wait and see" rule under which the final determination of the tax consequences of the exchange is suspended pending the birth of the foal.[377] This may result in some administrative difficulties, such as the problem of reporting the exchange when the taxpayer's tax return for the year in which the exchange occurs is due prior to the foal's birth. It will, however, result in taxing the transaction in the manner most consistent with the ultimate result. In absence of any clear authority in this area, however, attempting a like kind exchange of mares in foal is hazardous unless a private ruling can be obtained. Even if a ruling is available, the ultimate tax consequences would turn on a gamble on the sex of the unborn foal.

5. *Partnership Interests and Syndicate Shares*

a. *Partnerships*

Section 1031(a)(2)(D) specifically excludes partnership interests from the categories of property which may be exchanged without the recognition of gain or loss. This provision was enacted in

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[375] 408 F.2d 631 (6th Cir. 1969).

[376] 68 T.C. 800 (1977)(*acq.*).

[377] *See Rutherford*, 37 T.C.M. (CCH) 1851, in which the taxpayer was held to have acquired half blood heifers in a I.R.C. § 1031 exchange when the heifers were received in consideration of the subsequent transfer of their three quarter blood heifer offspring raised by the taxpayer. At the time the taxpayer received the half blood heifers, they were not yet in calf; they were artificially inseminated following their acquisition. Thus the property transferred by the taxpayer was not even in existence under any standard when the first transfer occurred. The transaction was held open pending the birth of the three quarter blood heifers.

1984 specifically to overrule prior court decisions holding that section 1031(a)(1) applied to the exchange of partnership interests if the underlying assets of the partnerships were substantially similar in nature.[378] Thus, gain or loss must be recognized on the exchange of an interest in one equine partnership for an interest in another equine partnership.

b. *Syndicate Shares*

The unavailabilty of section 1031 nonrecognition also extends to exchanges of interests in arrangements described as syndicates if, under the standards used to define the term partnership for tax purposes, the syndicates are partnerships.[379] An election under section 761(a) not to be taxed as a partnership, even if otherwise valid, is of no avail in this context.[380] Thus, exchanges of interests in racing syndicates and breeding syndicates holding broodmares are always recognition events.

When the syndicate shares exchanged are stallion syndicate shares, a closer examination of the organization of each syndicate is necessary to determine whether the exchange may qualify under section 1031. A stallion syndicate may or may not be a partnership. If neither syndicate is a partnership the exchange should be treated as a like kind exchange of undivided fractional interests in the stallions owned by the syndicates.[381] If both syndicates are

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[378] *See* S. REP. No. 169, 98th Cong., 2d Sess. 242-44 (1984); H.R. REP. No. 432, 98th Cong., 2d Sess. 1232-34 (1984); H.R. REP. No. 861, 98th Cong., 2d Sess. 866-67 (1984). The Committee Reports indicate that this rule does not apply to interests in the same partnership, but Estate of Meyer v. Commissioner, 58 T.C. 311 (1972), *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974), to which specific reference is made in the Committee Reports, held that an exchange of a general partnership interest for a limited partnership interest was not a like kind exchange. Therefore only an exchange of a general partnership interest for a general partnership interest or a limited partnership interest for a limited partnership interest in the same partnership can qualify under I.R.C. § 1031. Such an exchange, however, would be pointless.

[379] See text accompanying notes 181-87 *supra* regarding the factors for determining whether a syndicate is a partnership.

[380] *See* Bryant v. Commissioner, 399 F.2d 800 (5th Cir. 1968) (election under I.R.C. § 761 applies only to rules of Subchapter K; Investment Tax Credit under I.R.C. § 38 computed for partners in same manner as if subchapter K applied); Rev. Rul. 65-118, 1965-1 C.B. 30 (same).

[381] Although it might be argued that a stallion share is a "chose in action" for which nonrecognition is unavailabe under I.R.C. § 1031(a)(2)(F), under the logic of Guggenheim v. Commissioner, 46 T.C. 559 (1966), discussed in the text accompanying notes 191-95 *supra*, the stallion shares should be viewed as undivided interests in the horse owned by the syndicate if the syndicate is not a partnership.

partnerships, however, section 1031 is applicable by virtue of subsection (a)(2)(D). If one syndicate is a partnership and the other is not, gain must be recognized because the exchange simply is not one of like kind property.[382]

c. *Exchange of Syndicate Shares For A Horse*

Another area of uncertainty is whether the gain or loss realized on the exchange of a syndicate share for outright ownership of a horse will be accorded nonrecognition under section 1031. Because all syndicates other than stallion syndicates should be taxed as partnerships, this issue arises only on the exchange of a share in a stallion syndicate for a colt or stallion. Although a stallion share represents an undivided ownership interest in the stallion, the rights of the share owner with respect to the stallion are much more restricted than are the rights of the owner of the entire interest in a horse.[383] A share owner has neither possession nor control nor any management authority with respect to the horse. Furthermore, his interest generally is not freely transferable. Again, different analogies point in different directions.

On one hand, as far as real estate is concerned, the exchange of a fee interest for a long term leasehold interest is considered

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[382] This would be an exchange of a partnership interest for an undivided interest in a horse. *But see* Reynolds, *Tax-Free Exchanges of Interests in Thoroughbred Horses*, 59 TAXES 547, 553 (1981), in which it is asserted that the treatment of one of the syndicates involved in the exchange as a partnership for federal income tax purposes should not preclude the application of I.R.C. § 1031 if the syndicate would not be characterized as a partnership under state law, citing Morgan v. Commissioner, 309 U.S. 78 (1940) for the proposition that state law determines the "nature and character of the property involved in the exchange." *Id. Morgan* involved estate taxation of a power of appointment, and in that context the proposition is true. But if an organization is a partnership for tax purposes under the standards of I.R.C. § 761, that § specifically provides that it will be a partnership for "purposes of this subtitle," and "this subtitle" is Subtitle A of the I.R.C., which encompases all of the Income Tax provisions, including I.R.C. § 1031. *See also* I.R.C. § 7701(a)(2) (1986); Treas. Reg. § 301.7701-3(extending the I.R.C. § 761 definition of partnership to the entire I.R.C.). *Compare* note 380 *supra with* text accompanying notes 513-16 *infra*.

[383] *See* text accompanying notes 181-86 *supra*. The mere fact that an undivided fractional interest in one horse is exchanged for sole ownership of another horse should not present any impediment to the application of I.R.C. § 1031. *See* Rev. Rul. 79-44, 1979-1 C.B. 265 (reciprocal exchange of undivided one half interests in farms resulting in each transferor holding sole ownership of one farm was a I.R.C. § 1031 exchange).

to be a like kind exchange.[384] This supports like kind exchange treatment for an exchange of a stallion share for a horse. Section 1031 applies to "like kind" property, not just identical property. If the core rights to and fundamental use of the property, which give the property value, are essentially similar, then section 1031 arguably should apply.[385] In this case, at least as far as the exchange of a stallion share for a stallion (as contrasted to a colt to be raced) is concerned, the core interest is the right to breed the horse. Both properties derive their value from this right, and the difference between the limited legal rights attached to a stallion share and the unlimited legal rights attached to outright ownership might be said to be differences in "quality", not kind.

On the other hand, even before the enactment of section 1031(a)(2)(D), the Tax Court held in *Estate of Meyer v. Commissioner*[386] that section 1031 nonrecognition did not extend to the exchange of a general partnership interest in one partnership for a limited partnership interest in another partnership. Although both partnerships held real estate, and under the logic discussed above one might conclude that the interests were similar, the court found the legal interests of general partners and limited partners to be dissimilar. Although the rights of a stallion share owner and an outright owner of a stallion are not as dissimilar as the rights of general partners and limited partners, they may be dissimilar enough to cause an exchange of such properties to fall outside of section 1031 by analogy to *Estate of Meyer*.

C. *Receipt of Boot*

1. *Cash Boot*

The broad nonrecognition directive of section 1031(a) is subject to a number of statutory qualifications. Although section

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[384] Treas. Reg. § 1.1031(a)-1(c); *Century Elec. Co.*, 192 F.2d 155.

[385] *See* Koch v. Commissioner, 71 T.C. 54, 65 (1978). In determining that the exchange of a golf course owned and operated by the taxpayer for land subject to a 99 year ground lease qualified for nonrecognition, the Tax Court stated, "section 1031(a) requires a comparison of the exchanged properties to ascertain whether the nature of the transferred rights in and to the respective properties are substantially alike."

[386] 58 T.C. 311 (1972), *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974).

1031(a) appears to limit nonrecognition to transactions in which only like kind property is received, section 1031(b) relaxes the stricture of the "solely" qualification, by providing that if both qualified like kind property and "boot" are received in an exchange, gain is recognized, but only to the extent of the money received plus the fair market value of the other property received.[387] If gain is recognized, the computation of the basis of the property received is complicated. If only cash boot is received, then the basis of the horse received in the transaction equals the basis of the horse surrendered plus the gain recognized minus the cash received.[388] Thus, if a horse with a basis of $10,000 is exchanged for a horse of like kind worth $40,000 plus $10,000 in cash, a $10,000 gain is recognized and the basis of the horse received in the transaction is zero. If the transferor received only $4,000 of cash, he recognizes that amount as gain on the exchange of the horse surrendered and the basis of the horse received is reduced from $10,000 to $6,000. On the other hand, if a horse with a basis of $40,000 is exchanged for a horse with a fair market value of $35,000 and boot of $15,000 of cash, a gain of only $10,000 is recognized and the horse received in the exchange takes a basis of $35,000.

If gain is recognized on a like kind exchange because boot is received, the gain is subject to treatment as ordinary income under section 1245 to the extent of the depreciation recapture inherent in the property surrendered in the exchange.[389]

2. *Exchanges of Encumbered Property*

When encumbered property is surrendered in a like kind exchange, the transferor is treated as receiving cash boot equal to the amount of the debt.[390] If the property received is also subject to an encumbrance, then only the net debt relief inuring to the

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[387] *See* Treas. Reg. § 1.1031(b)-1. No loss may be recognized if boot is received. The only effect of boot in an exchange in which a loss is realized is that the basis of the like kind property received will be equal to the basis of the property surrendered minus the sum of the cash and the fair market value of other property received. Treas. Reg. § 1.1031(d)-1(d).

[388] I.R.C. § 1031(d); Treas. Reg. § 1.1031(d)-1(b).

[389] I.R.C. § 1245(a)(2); Treas. Reg. § 1.1245-2(c)(4).

[390] I.R.C. § 1031(d); Treas. Reg. § 1.1031(d)-2.

transferor is treated as boot. Similar treatment results if the transferor of the encumbered property pays cash along with the surrendered property. For example, suppose a taxpayer exchanges a horse with a basis of $15,000, subject to a lien of $12,000, for a horse of like kind with a fair market value of $30,000, subject to a lien of $10,000. The transferor is deemed to receive cash boot of $2,000. Because the transferor's gain exceeds the boot received, the entire $2,000 is recognized as gain, and the basis of the horse received is $15,000. The same result obtains if the horse received in the exchange is unencumbered, but the transferor paid $10,000 cash in addition to the horse surrendered.

From the preceding examples, it should be readily apparent that section 1031 does not shelter from recognition the gain realized on the transfer of property subject to an encumbrance in excess of basis, unless the property received is subject to an encumbrance at least equal to the amount by which the lien on the property surrendered exceeds the basis of the property surrendered or the taxpayer also pays cash equal to that amount. This problem may be encountered frequently due to the rapid depreciation allowances under the ACRS cost recovery system.[391] Because payment of boot is determined by the economics of the transaction, not tax considerations, recognizing gain may be unavoidable. For example, if a taxpayer exchanges a horse with a basis of $21,000 and a fair market value of $100,000, subject to a lien of $40,000, for a horse of like kind with a fair market value of $60,000, the exchange is equal and the taxpayer must recognize a gain of $19,000. This gain cannot be eliminated by a boot payment because to do so would render the economics of the exchange nonsensical. As a consequence of the recognition of the gain, however, the basis of the horse received is increased from $21,000 to $40,000. Although net debt relief is treated as boot for purposes of gain recognition, it is not boot for purposes of computing the basis of the property received in the transaction.

If a like kind exchange results in a net increase in the lien indebtedness of the transferor, rather than a decrease, the net increase is treated as additional cash paid for the horse received

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[391] *See* Comment, *Thoroughbred Horse Racing and Breeding as a Tax Sheltered Investment: Recent Tax Law Developments*, 13 GOLDEN GATE U.L. REV. 399 (1983).

in the exchange. As a result, the basis of the horse received equals the basis of the horse surrendered plus the net increase in indebtedness. This rule applies both when the horse received is subject to a greater lien than the horse surrendered and when only the horse received is encumbered.

3. *Receipt of Both Qualified and Nonqualified Property in an Exchange*

If both like kind property and other property are received in an exchange, the other property is treated as boot to the extent of its fair market value, and its basis is equal to its fair market value.[392] Any remaining basis is allocated to the like kind property received in the exchange. This may be illustrated as follows. Assume that the taxpayer exchanges a six year old stallion with a basis of $50,000 for a six year old stallion with a fair market value of $40,000 and a six year old broodmare with a fair market value of $60,000. Only the stallions qualify as like kind property. The transferor realizes a gain of $50,000 on the transaction. Because he received boot of $60,000, the entire gain is recognized. The broodmare has a basis of $60,000, and the stallion received in the exchange has a basis of $40,000. If the relative fair market values of the broodmare and stallion received in the exchange were reversed, only $40,000 of the gain would be recognized, and the broodmare's basis will be $40,000. Using the formula for computing the basis of the like kind property received in the exchange—(1) basis of property surrendered ($50,000), plus (2) gain recognized ($40,000), minus (3) cash and fair market value of boot received ($40,000)—the basis of the stallion received in the exchange will be $50,000.

4. *Coordination With Installment Reporting of Gain*

Section 453(f)(6) provides that, for the purpose of computing the profit ratio for reporting gain recognized under the installment method, the fair market value of property received subject to the nonrecognition rules of section 1031 is disregarded. Consonantly, the receipt of like kind property is not considered to be a payment.

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[392] I.R.C. § 1031(d); Treas. Reg. § 1.1031(d)-1(c).

Section 453(f)(6) generally applies to like kind exchanges in which boot is received in the form of an installment obligation. In its application, the gross profit on the "sale" is the amount of gain that would be recognized if the installment obligation were satisfied in full. The contract price is the sum of the cash and fair market value of other property received, plus the face amount of the installment note.

The following example illustrates the operation of this provision. Assume that the taxpayer exchanges a horse with a basis of $40,000 for a horse of like kind worth $20,000 plus an installment obligation (bearing adequate interest) for $80,000, of which $10,000 is payable in the year of the sale and the balance payable the next year. The contract price is $80,000, and the gross profit is $60,000, resulting in a profit ratio of 75%. Assuming that none of the gain is recapture income, in year 1 the taxpayer must recognize $7,500 of gain and in year 2, he must recognize $52,500 of gain. His basis in the horse received is $20,000.

D. *Multiparty Exchanges*

A horse owner seeking a like kind exchange does not need to engage in a direct exchange with the owner of the horse that he wishes to acquire. If that were required, the utility of the nonrecognition provisions of section 1031 would be greatly diminished. Like kind exchanges can be, and frequently are, effected through the use of middlemen in so called three corner exchanges.[393] In a typical three corner exchange the taxpayer locates the property he wants to acquire and then finds a middleman to purchase the target property. After the middleman has purchased the target property, the taxpayer engages in a like kind exchange with the middleman, transferring to the middleman the property that he desires to dispose of and receiving the target property. The middleman then sells the property received from the taxpayer.

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[393] *See, e.g.*, Biggs v. Commissioner, 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980); Rev. Rul. 77-297, 1977-2 C.B. 304. The actual structuring of a three cornered exchange is complex and has numerous variables and possible pitfalls. A thorough discussion of the mechanics of such exchanges is beyond the scope of this Article. For further discussion of multiparty exchanges, see Goldstein & Lewis, *supra* note 358, at 252-68; Guerin, *A Proposed Test For Evaluating Multiparty Like Kind Exchanges*, 35 TAX L. REV. 547 (1980); Levine & McCormick, *Taxfree Exchanges Under Section 1031*, 61-4th T.M. A-15-A-21 (1982).

A three corner exchange must be structured so that the middleman is not considered to be the transferor's agent. If he is the transferor's agent, then section 1031 will not apply and the gain must be recognized.[394] An examination of the cases involving three cornered exchanges, however, indicates that it is easy to avoid having the middleman treated as the transferor's agent. The taxpayer apparently may control all details of the transaction, advance the middleman funds as a loan to purchase the target property, and pay the middleman a fee as compensation for his services.[395] If, however, the transferor has the right to receive cash from the middleman at any time, then section 1031 does not apply.[396] All of the transactions that are part of the three corner exchange may occur simultaneously or there may be time delays. The taxpayer seeking the exchange may locate the buyer in advance, and the obligation to perform any one of the contracts may be conditioned on performance of all other contracts. On the other hand, the sale by the middleman might be delayed for as long as the middleman is willing. If that sale is not contemporaneous with the acquisition and exchange of the target property, however, the middleman probably will seek increased compensation for the increased risk that he incurs.

E. *Special Rules for Deferred Exchanges*

The situation may arise in which a taxpayer locates a potential buyer for a horse, and although the seller is seeking to defer recognition of the gain through a like kind exchange, he has not located the horse that he wishes to purchase. In that case, the transferor might transfer his horse to the buyer in exchange for

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[394] *See* Coupe v. Commissioner, 52 T.C. 394 (1969)(*acq.*), in which the Commissioner unsuccessfully argued that the role of the transferor's attorney as the middleman precluded the applicablility of I.R.C. § 1031 because the attorney received cash from the sale of the property as the taxpayer's agent. The court agreed that if the attorney was the taxpayer's agent, I.R.C. § 1031 would not apply, but found on the facts that the attorney was not acting as the taxpayer's agent.

[395] *See Biggs*, 69 T.C. 905; Barker v. Commissioner, 74 T.C. 555 (1980); Rutland v. Commissioner, 36 T.C.M. (CCH) 40 (1977).

[396] *See* Halpern v. United States, 286 F. Supp. 255 (N.D. Ga. 1968) (right to receive cash from escrow if no property transferred within six months precluded nonrecognition). *See also* Carlton v. United States, 385 F.2d 238 (5th Cir. 1967) (receipt of cash, even if promptly reinvested in like kind property, precludes nonrecognition).

the buyer's promise to acquire and transfer to the seller another horse to be selected by the seller at some future time. The exchange contract will specify the maximum price to be paid for the horse to be selected and call for the payment of cash boot if the price is less than a specified minimum (which might be equal to the maximum price). The contract may permit the seller to select a more expensive horse if he agrees to make an additional cash payment.

The transaction can be effected through a middleman if the buyer is unwilling to be involved in anything other than a straight purchase transaction. The taxpayer would then transfer to the middleman the horse to be sold in exchange for the middleman's promise to subsequently transfer to the taxpayer a horse to be selected by the taxpayer. The middleman would then immediately close the sale and hold the proceeds pending the selection of a horse by the taxpayer.

Regardless of whether such a deferred exchange is made directly or through a middleman, the Code restricts the period for which the final exchange may be delayed if section 1031 is to apply to the transaction.[397] First, the property to be received by the taxpayer seeking section 1031 nonrecognition must be identified no more than forty-five days after the day that the taxpayer transfers his surrendered property.[398] Second, even if the property has been identified within the requisite time limit, the second half of the exchange must be completed on or before the earlier of (1) one hundred eighty days after the date on which the initial transfer occurred, or (2) the due date for the tax return for the year in which the taxpayer transferred the surrendered property.[399] Thus, if on November 17 of Year 1, taxpayer surrenders a horse in exchange for a horse to be designated at a later time, the horse to be received must be designated before January 1 of Year 2 and must be received on or before April 15 of Year 2. If the first

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[397] I.R.C. § 1031(a)(3). This provision, enacted in 1984, was intended to limit the scope of Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). *See* S. REP. No. 169, 98th Cong., 2d Sess. 241-44 (1984); H.R. REP. No. 432, 98th Cong., 2d Sess. 1231-34 (1984).

[398] I.R.C. § 1031(a)(3)(A).

[399] I.R.C. § 1031(a)(3)(B). Extensions of the due date are taken into account, and extend the time for completing the transfer.

horse is transferred on November 15, the horse to be received must be designated before December 30 of Year 1 and received on or before April 15 of Year 2. If, however, the first horse is transferred on June 30, the horse to be received must be designated prior to August 14 of Year 1, and it must be received on or before December 27 of Year 1.

The unstated interest rules do not apply to deferred like kind exchanges meeting the requirements for nonrecognition because a deferred like kind exchange must be completed within 180 days to qualify for nonrecognition. The unstated interest rules do not apply unless a payment is due more than six months from the date of sale.[400] If, however, a deferred like kind exchange fails to qualify for nonrecognition and the property to be received by the taxpayer is not received within six months of the transfer of the property surrendered, the unstated interest rules are applicable if the deferred obligation does not bear interest, and a portion of the amount realized upon receipt of the like kind property may be recharacterized as interest.[401]

F. *Determining the Desirability of a Like Kind Exchange*

Prior to the repeal of the capital gains preference, disposing of a horse in a like kind exchange generally was not desirable. An exception was when almost all of the gain that would have been recognized on the sale of a horse would have been ordinary income, either because the twenty four month holding period for section 1231 was not met or the gain would have been subject to recapture. The tax price for nonrecognition exacted by section 1031 is a transferred basis. This reduces, or if the cost of the horse surrendered has been recovered entirely, eliminates ACRS deductions on the horse acquired. By selling the first horse and purchasing the

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[400] *See supra* note 277 and accompanying text.

[401] See Starker v. United States, 602 F.2d 1341, 1356 (9th Cir. 1979), in which the portion of the property received in the deferred exchange transaction that was attributable to a 6% per year "growth factor" in the value of the property that the taxpayer was to receive was re-characterized as interest and recognized as ordinary income outside of the nonrecognition accorded by I.R.C. § 1031.

second horse, the taxpayer obtains a cost basis for depreciation and his subsequent ACRS deductions are increased greatly. If a substantial portion of the gain realized on the sale of the first horse would have been section 1231 gain, the combination of capital gains and ordinary deductions dictated that it was more profitable after taxes to sell the first horse and buy the new one rather than engage in a like kind exchange.

Under prior law it was necessary to evaluate separately each potential transaction to determine which route was best. A number of factors had to be considered, including the amount of net section 1231 gain and section 1245 gain that would be realized on a sale, the taxpayer's marginal tax rate at which income would be included and deductions claimed, the recovery period for the horse to be obtained, and the after tax discount rate to be used by the taxpayer in valuing cash flows.

Assume, for example, that the taxpayer owned a seven year old stallion held for stud purposes that has been fully depreciated. The original cost of the stallion was $100,000 and its fair market value was $200,000. If the taxpayer was in the fifty percent tax bracket, he would have owed taxes of $70,000 on the $200,000 gain that would have been realized on the sale of the horse.[402] However, if he had purchased another stallion to be held for stud purposes for a price of $200,000, he would have had an ACRS deduction in the same year of $30,000. As a result he would have saved $15,000 of taxes and the net tax increase for the year would have been $55,000. In the next year he would have had an ACRS deduction of $44,000, saving $22,000 in taxes. In each of the next three years he would have had a deduction of $42,000, saving $21,000 of taxes in each year.[403]

Looking at the taxes paid and taxes saved, this can be viewed, entirely apart from profits generated from stud fees, as an investment of $55,000 in the first year that yields $22,000 in the second year and $21,000 in each of the next three years. Assuming the

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[402] The recomputed basis of the property under I.R.C. § 1245(a)(2) is $100,000. Therefore $100,000 of the gain is taxed as ordinary income at the fifty percent rate. The remaining $100,000 of gain is net I.R.C. § 1231 gain, of which $60,000 is deducted under I.R.C. § 1202(b). The tax on the remaining $40,000 is $20,000, and the total tax is $70,000.

[403] *See* I.R.C. § 168(b)(1).

taxpayer could have invested cash in a portfolio investment at ten percent per year, before tax, his after tax discount rate is five percent. Using a five percent after tax discount rate, the net present value of the tax detriments and benefits associated with the sale is $20,417. That sum is an additional after tax profit generated by the tax system that would not be obtained if the taxpayer utilized a like kind exchange for the disposition and acquisition.[404]

If the original cost of the first horse were $180,000, however, only $20,000 of the gain on the sale would have been section 1231 gain, and the taxes on the gain recognized on a sale would have been $94,000.[405] The same ACRS benefits could have been obtained on the new horse, and net taxes due in the year of the sale would have been $77,000. The hypothetical transaction would be an investment of $77,000 that generated a return of $22,000 the next year and $21,000 in each of the succeeding three years. Using a five percent after tax discount rate, the net present value of the after tax cash flow is negative $1,583. The taxpayer would be poorer by this amount because he sold the first horse and bought the new one rather than acquiring the new horse through a like kind exchange.

Varying any of the factors can change the result. For example, if the taxpayer used an after tax discount rate of only four percent, the net present value of the cash flows would be $189, and it would be slightly more profitable to sell the first horse and purchase the second instead of engaging in a like kind exchange.

As long as there was a capital gains preference, there was no neat, generalized rule for determining the more desirable alternative. Each fact pattern must have been specifically analyzed. There were, however, a few guidelines that held true. All other things being equal, it was more likely that a sale and reinvestment was more desirable if the horse to be acquired was three year ACRS property[406] as opposed to five year ACRS property.[407] This is because in present

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[404] For an explanation of the use of time value of money analysis of after tax cash flows generated by a potential investment, see McMahon, *Applied Tax Finance Analysis of Real Estate Tax Investments*, 27 B.C.L. REV. 721 (1986). The methodology used in that article can be applied to any type of investment.

[405] The recomputed basis of the property is $180,000, which results in $90,000 of tax under I.R.C. § 1245(a). Only $20,000 of the gain is I.R.C. § 1231 gain, on which the tax is $4,000.

[406] *See* I.R.C. § 168(h)(1).

[407] For years after 1986, horses that are not 3 year ACRS property are 7 year ACRS property. I.R.C. § 168(e)(3)(c)(iii).

value terms, the ACRS deductions for three year property are more valuable than are the deductions for five year property.[408] Furthermore, although at first blush it is counterintuitive, the higher the marginal tax bracket faced by the taxpayer, the more likely it was that a sale and reinvestment would have been more profitable than a like kind exchange. For taxpayers in higher tax brackets, the capital gains preference and the ACRS deductions were more valuable. Conversely, as the discount rate increased, the desirability of a sale and purchase decreased. The higher discount rate reduced the value of the ACRS deductions, while the tax burden in the year of the sale was unchanged. This also pointed to relatively greater desirability for taxpayers in higher tax brackets because they face lower after tax discount rates than lower bracket taxpayers facing the same before tax discount rate.

After the repeal of the preferential treatment of long term capital gains by the Tax Reform Act of 1986, it will always be more advantageous to engage in a like kind exchange than it will be to sell an appreciated horse and purchase a new horse. The gain on the sale of the horse will be taxed at the same rate as the ACRS deductions on the new horse will be allowed. Thus, absent extraordinary circumstances, the net present value of the taxes saved in future years through ACRS deductions will never exceed the taxes paid in the year of the sale.

A sale may be more desirable, however, if the taxpayer has capital losses to offset the capital gain or net operating carryforwards that could not otherwise be used, which can shelter both capital gain and recapture income. In either of these cases the taxes on the gain otherwise payable in the year of the sale will be reduced. Future taxes saved through the increased ACRS deductions may have a net present value greater than the taxes due in the year of the sale. To be completely accurate, however, the analysis must take into account future tax increases attributable to the loss of the capital loss or net operating loss carryforwards used to shelter the gain on the sale of the horse.

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[408] *See* McMahon, *Reforming Cost Recovery Allowances For Debt Financed Depreciable Property*, 29 ST. LOUIS U.L.J. 1029, 1048-49 n.99, 1051-52 n.107 (1985).

III. INVOLUNTARY CONVERSIONS

A. *Introduction*

1. *Elective Nonrecognition of Gain and Basis Rules*

Section 1033 allows a taxpayer realizing a gain on the "involuntary conversion" of property to defer recognition to the extent that the amount realized is used to purchase replacement "property similar or related in service or use to the property so converted."[409] The amount realized on a involuntary conversion most frequently is the proceeds of an insurance policy, although damage awards, settlements and, occasionally, sales proceeds may be included in the amount realized. Insurance proceeds or other amounts paid to lienholders are included in the amount realized.[410]

Unlike section 1031, section 1033 is elective and applies only to gains.[411] To benefit from section 1033, a taxpayer must replace the involuntarily converted property before the end of the second taxable year following the taxable year in which gain is first realized on the involuntary conversion.[412] The replacement property must be "purchased" for nonrecognition to apply.[413] Furthermore, it must be purchased for the specific purpose of replacing the converted property. A purchase that would have occurred in any event does not qualify the gain for nonrecognition.[414]

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[409] I.R.C. § 1033(a) (1986). *See* Treas. Reg. § 1.1033(a)-1, -2 (1986).

[410] *See* Treas. Reg. § 1.1033(a)-2(c)(11) (payment by government of portion of condemnation award); Commissioner v. Fortee Properties, Inc., 211 F.2d 915 (2d Cir.), *cert. denied,* 348 U.S. 826 (1954).

[411] I.R.C. § 1033(a)(2)(A); Treas. Reg. § 1.1033(a)-2(c). The election may be made simply by failing to report the gain. For a discussion of the collateral rules attending the making of the election, see Edwards, *Involuntary Conversions* 33-7th T.M. A-13-A-15 (1984).

I.R.C. § 1033 does not apply to losses because Congress considered recognition of losses to be "more equitable." *See* S. REP. No. 1631, 77th Cong., 2d Sess. (1942), *reprinted in* 1942-2 C.B. 504, 595.

[412] I.R.C. § 1033(a)(2)(B); Treas. Reg. § 1.1033(a)-2(c)(2), (3).

[413] I.R.C. § 1033(a)(2)(A)(ii); Treas. Reg. § 1.1033(a)-2(c)(4). "Purchase" means that the replacement property would otherwise take a cost basis under I.R.C. § 1012.

[414] *See* Rev. Rul. 59-8, 1959-1 C.B. 202, *amplified by* Rev. Rul. 62-161, 1962-2 C.B 175.

As is true with respect to section 1031, the price of nonrecognition of gain is the loss of actual cost as basis. Rather than cost, the basis of the replacement property is its cost minus the amount of unrecognized gain.[415] If the cost of the replacement property is the same as the amount realized, this is approximately equal to the basis of the property converted. Due to the manner in which the basis of the replacement property is computed, the holding period of the converted property is tacked onto the holding period of the replacement property.[416] Because section 1245 recapture is subordinated to nonrecognition under section 1033, any depreciation recapture inherent in the converted property carries over to the replacement property. The recomputed basis of the replacement property is the basis, as computed above, plus the ACRS deductions claimed with respect to the converted property.[417]

If the cost of the replacement property is less than the amount realized on the involuntary conversion, then gain is recognized to the extent of the proceeds that were not reinvested in the replacement property.[418] The basis of the replacement property, computed as described above, again equals roughly the basis used to compute gain on the disposition of the original property. On the other hand, if the cost of the replacement property is more than the amount realized on the conversion, the basis of the replacement property is greater than the basis of the converted property by an amount equal to such excess.[419]

The "reinvestment" of the proceeds from the involuntary conversion need not be literal; there is no tracing of funds.[420] If, for example, the taxpayer received $100,000 of insurance proceeds on the involuntary conversion of a horse and purchased a replacement horse for $100,000, using only $20,000 of the actual proceeds and borrowing the remaining $80,000 of the purchase price, the entire gain is entitled to nonrecognition.[421] The use to which the taxpayer

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[415] I.R.C. § 1033(b); Treas. Reg. § 1.1033(b)-1 (1986).

[416] I.R.C. § 1223(1)(A); Treas. Reg. § 1.1223-1(a) (1986).

[417] I.R.C. § 1245(a)(2); (b)(4); Treas. Reg. § 1245-2(c)(4); -4(d) (1986).

[418] I.R.C. § 1033(a)(2)(A); Treas. Reg. § 1.1033(a)-2(c)(1) (1986).

[419] *See* Rev. Rul. 73-18, 1973-1 C.B. 368 (infusion of new funds to purchase replacement land and buildings increased basis).

[420] *See* 2 B. BITTKER, *supra* note 44, at ¶ 44.3.6.

[421] *See* Harsh Inv. Corp. v. United States, 323 F. Supp. 409 (D. Or. 1970).

puts the remaining $80,000 of cash proceeds is irrelevant.

2. *Characterization of Recognized Gain*

If gain is recognized as a result of an involuntary conversion of a horse, either because the owner chose not to elect nonrecognition or because the entire amount realized as a result of the involuntary conversion was not reinvested, the character of the gain is determined with reference to the purpose for which the horse was held, just as it would be if the horse was sold. Unlike section 1031, deferred recognition is available under section 1033 for gains realized on the involuntary conversion of property held for sale to customers in the ordinary course of business.[422] Thus, the proceeds realized on an involuntary conversion of a weanling or yearling owned by a dealer in horses may be entitled to nonrecognition if the dealer reinvests the proceeds in qualified property. For purposes of qualifying the gain as section 1231 gain, the twenty four month holding period applies to horses held for breeding or sporting purposes.[423] As long as the holding period requirement is met, gains from the involuntary conversion of horses held for use in the taxpayer's trade or business are accorded section 1231 treatment, and ultimately long term capital gains treatment if section 1231 gains exceed section 1231 losses, even though there was no sale or exchange.[424]

The interrelationship of involuntary gains and losses and section 1231 gains and losses recognized on sales and exchanges is complex, and a discussion of the operation of the section 1231 hotchpot that ultimately determines characterization is beyond the scope of this Article.[425] The most important limitation on the availability of section 1231, as always, is the potential for depreciation recapture under section 1245. If gain is recognized on an involuntary conver-

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[422] *See* Westchester Dev. Co. v. Commissioner, 63 T.C. 198 (1974) (land held for sale replaced by land held for sale); Rev. Rul 59-8, 1959-1 C.B. 202, *modified by* Rev. Rul. 81-279, 1981-2 C.B. 163 (farmer may replace standing crop with standing or harvested crop).

[423] *See* text accompanying notes 138-48 *supra*.

[424] I.R.C. § 1231(a)(3)(A)(ii).

[425] *See* 2 B. BITTKER, *supra* note 44, at ¶ 54.1 (1981); Edwards, *supra* note 411, at A-3-A-4 for a discussion of the interaction of involuntary conversions, casualty losses, and the I.R.C. § 1231 main hotchpot.

sion, the gain is ordinary income to the extent of prior ACRS deductions claimed with respect to the converted property.[426] Any potential depreciation recapture not recognized at that time carries over to the replacement horse because the recomputed basis of the replacement horse includes ACRS deductions claimed with respect to the converted horse to the extent that they were not recaptured at the time the gain on the conversion was realized.[427]

3. *Meaning of Involuntary Conversion*

Strictly speaking, an involuntary conversion is not the event that deprives the taxpayer of his property, but is the sequence of events by which the old property is lost and the new property acquired.[428] Colloquially speaking, however, the phrase generally is applied to the event that deprives the owner of the enjoyment of the old property. Within that usage, section 1033 applies to destruction, in whole or in part, theft, seizure, and requisition or condemnation (or threat or imminence thereof) of the property. Among these, destruction is the most likely to apply to a horse. Occasionally, a horse owner may experience a theft loss. While a horse might be condemned, this is far more likely to occur with respect to livestock raised for food, such as cattle, and the seizure or requisitioning of a horse by the government would indeed be surprising.

Destruction by any event that constitutes a casualty within the meaning of section 165, fire, shipwreck, hail, lightning or other accident, clearly is an involuntary conversion.[429] Also included in the meaning of involuntary conversion, however, are certain other causes of destruction that are not sudden and, therefore, not casualties under section 165.[430] In addition, under section 1033(e), livestock destroyed or sold on account of disease are deemed to have been involuntarily converted.[431] Thus, gain realized upon the

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[426] Treas. Reg. § 1.1245-4(d).

[427] I.R.C. § 1245(a)(2); Treas. Reg. § 1.1245-2(c)(4).

[428] *See* 2 B. BITTKER, *supra* note 44, at ¶ 44.3 (1981).

[429] *See* S. REP No. 275, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 (Part 2) C.B. 181; H.R. REP. 486, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 (Part 2) C.B. 206.

[430] *See* Rev. Rul. 66-334, 1966-2 C.B. 302 (salt water pollution of well); Rev. Rul. 59-102, 1959-1 C.B. 200 (livestock converted by drought), *superceded by* I.R.C. § 1033(e).

[431] *See* Treas. Reg. § 1.1033(d)-1.

collection of insurance proceeds on the life of a horse that prematurely dies from sickness or disease, as well as one killed in a barn fire or struck by lightning,[432] is eligible for nonrecognition under section 1033. Normal mortality, however, does not constitute an involuntary conversion. Furthermore, despite the facial applicability of section 1033(e), if a horse is sold as a result of disease it is unclear whether nonrecognition extends to the gain realized on the sale.[433]

Although the gain recognized on the receipt of mortality insurance on the premature death of a horse clearly qualifies for nonrecognition, insurance may be payable for a number of other events not so easily categorized. There is absolutely no authority construing the possible application of section 1033 to many of these events, which are discussed in Part III.B.

4. *Property Similar or Related in Service or Use*

Nonrecognition under I.R.C. section 1033 is available only to the extent that the proceeds from the involuntary conversion are reinvested in "other property similar or related in service or use to the property so converted."[434] Neither the Code nor the Treasury Regulations provide any helpful definition of this phrase. Delineation of the scope of the phrase "similar or related in service or use" has been left to the courts and, through Revenue Rulings, to the IRS. An examination of the cases does not disclose any easily applicable definition, but rather a series of factual inquiries.[435] The replacement property need not be identical,[436] and the standard is

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[432] *See* Rev. Rul. 59-102, 1959-1 C.B. 200 (livestock poisoned by contaminated feed); Rev. Rul. 195, 1953-2 C.B. 169 (livestock struck by lightning).

[433] *See* text accompanying notes 459-63 *infra*.

[434] I.R.C. § 1033(a)(1). The replacement may be made indirectly by purchasing control of the stock of a corporation owning property that is similar or related in service or use to the converted property. I.R.C. § 1033(a)(2)(A), (E)(i); Treas. Reg. § 1.1033(a)-2(c). For this provision to apply, however, the assets of the replacement corporation must be "principally" similar property. Templeton v. Commissioner, 67 T.C. 518 (1976), *aff'd per curiam,* 573 F.2d 866 (4th Cir. 1978).

[435] For a compilation of examples of decisions determing what type of replacement meets the statutory standard, see Edwards, *supra* note 411, at A-19-A-21.

[436] *See* Priv. Ltr. Rul. 7903064 (Oct. 18, 1978) (breeding cattle replaced breeding buffalo of same sex). *But see* Treas. Reg. § 1.1033(e)-1(d) (breeding or dairy livestock is not qualified replacement for draft livestock); Rev. Rul. 76-319, 1976-2 C.B. 242 (replacement of bowling alley with billiards center was not qualified).

different than the "like kind" standard for nonrecognition under section 1031.[437] The best available general definition is that property is not "similar or related in service or use" if the taxpayer has "change[d] the character of his investment." Section 1033 "requires a reasonable degree of continuity in the nature of the assets as well as in the general character of the business." [438]

No purpose would be served by a general exposition of the application of these principles in the context of other businesses. Some analogies may be drawn between decided issues and potential issues in the horse industry, however, and a few answers are relatively clear. As far as livestock are concerned, the Regulations provide that "the new livestock must be functionally the same as the livestock involuntarily converted. This means that the new livestock must be held for the same useful purpose as the old was held."[439] Thus, for example, the replacement of a broodmare with a broodmare, a stallion with a stallion, or a yearling held for resale with a yearling held for resale, all clearly would qualify, as would the replacement of a colt held for racing with a colt held for racing or a filly held for racing with a filly held for racing. There also is no doubt that several horses could be replaced by one horse or that one horse could replace several horses.[440] The consequences attached to numerous other potential replacements are less clear. For example, may a gelding held for racing be replaced by a colt held for racing? May a broodmare be replaced by a stallion? May a foal be replaced by paying stud fees with the proceeds of foal insurance? These are all difficult questions, with no clear answers. Possible resolutions to some of these questions are discussed in Part III.C.

B. *Identifying Involuntary Conversions*

As noted above, a horse is most frequently involuntarily converted due to accident, disease or sickness. If the horse dies or is

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[437] *See* text accompanying notes 351-76 *supra* regarding the meaning of "like kind" under I.R.C. § 1031.

[438] Maloof v. Commissioner, 65 T.C. 263, 269-71 (1975).

[439] Treas. Reg. § 1.1033(e)-1(d) (replacement of breeding, draft, or dairy livestock with breeding, draft, or dairy livestock, respectively, qualifies).

[440] *See, e.g.,* Treas. Reg. § 1.1033(b)-1(b) (providing rules for allocating basis among multiple replacement properties); Cotton Concentration Co. v. Commissioner, 4 B.T.A. 121 (1926) (Acq.) (two buildings may be replaced by one).

humanely destroyed as a result of accident, disease or sickness, the gain realized upon receipt of mortality insurance proceeds generally may be deferred under section 1033. A number of situations, however, present particular problems.

1. *Collection of Foal Insurance*

The owner of a broodmare may obtain foal insurance to compensate him in the event that a foal is born dead or dies soon after birth. In large part, foal insurance protects the owner against the loss of a stud fee if the fee was not refundable, and compensates him for depreciation on the mare for the year.[441] The tax benefit rule has been applied in the past to deny nonrecognition under section 1033 to gain attributable to a basis reduction resulting from the prior deduction of a loss.[442] It has been suggested that the tax benefit rule might also preclude the applicability of section 1033 to foal insurance to the extent that the owner previously deducted the stud fees attributable to the foal.[443] This issue has been mooted for future years by the enactment of section 263A, requiring the capitalization of stud fees. It remains relevant, however, for tax years prior to 1987 not closed by the statute of limitations and during years subsequent to 1986 for replacements of involuntarily converted foals the stud fee for which was paid and properly deducted prior to 1987.

Since the Supreme Court decision in *Hillsboro National Bank v. Commissioner*,[444] the touchstone for applying the tax benefit rule is that the later "recovery" of the previously deducted item is "fundamentally inconsistent" with the earlier deduction. Applying this standard, one might reasonably conclude that to the extent that the proceeds are used to pay another stud fee there is no fundamental inconsistency. No deduction should be allowed for the second stud fee for years prior to 1987 (except to the extent that it exceeds the portion of the insurance proceeds attributable to the

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[441] *See* Reynolds, *Applying Section 1033 to Involuntary Conversions of Thoroughbred Horses*, 70 KY. L.J. 987, 991-92 (1981-82).

[442] *See* Mager v. United States, 499 F. Supp. 37 (M.D. Pa.), *aff'd*, 636 F.2d 1209 (3d Cir. 1980). *But see* Buffalo Wire Works Co., Inc v. Commissioner, 37 T.C.M. (CCH) 1775 (1978).

[443] Reynolds, *supra* note 441, at 991-92.

[444] 460 U.S. 370 (1983).

first stud fee).[445] For purposes of section 1033, the payment of a nondeductible stud fee is analogous to the payment of the purchase price of replacement property that is denied a cost basis. For years after 1986, in which stud fees must be capitalized under section 263A, the payment of a stud fee would be treated in the same manner as the purchase price for any other replacement property. The stud fee would enter into the basis of the replacement foal, but the foal's basis would be reduced by the unrecognized gain realized on the involuntary conversion.

The purchase of a horse to replace the foal, however, would appear to be fundamentally inconsistent with the earlier proper deduction of a stud fee in a year prior to 1987, because even prior to the enactment of section 263A a cash basis farmer was required to capitalize the cost of purchased livestock, including horses held for resale.[446] In this context it is important to recall that the term "conversion" technically does not refer to the event that caused the disposition of the first horse, but to the entire sequence of events that result in the acquisition of the second horse. In a Revenue Ruling issued prior to the decision in *Hillsborough National Bank*, however, the IRS ruled that section 1033 was available when a farmer reinvested crop insurance proceeds, received upon the destruction of a standing crop, in a harvested crop.[447] Although the cost of planting the destroyed crop was deducted previously, the IRS did not attempt to apply the tax benefit rule to deny nonrecognition. To the extent that this Ruling retains vitality, the tax benefit rule should not stand in the way of nonrecognition upon replacement with another foal. Acquisition of an older horse, however, might fail the "similar or related in service or use" requirement.[448]

To the extent this issue survives the enactment of section 263A, it is mooted in any event if the stud fee is paid with the insurance

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[445] *See* Rev. Rul. 59-8, 1959-1 C.B. 202, *modified by* Rev. Rul. 81-279, 1981-2 C.B. 163.

[446] *See* note 30 *supra*.

[447] *See* Rev. Rul. 81-279, 1981-2 C.B. 163 (replacement of destroyed standing crop by using crop insurance proceeds to plant new crop qualifies to extent proceeds are used to bring new crop to same level of maturity as destroyed crop).

[448] *See* Manocchio v. Commissioner, 710 F.2d 1400 (9th Cir. 1983), *aff'g*, 78 T.C. 989 (1982) (disallowing deduction for educational expenses reimbursed by tax exempt payments received from Veterans Administration). *But see* Baker v. United States, 748 F.2d 1465 (11th Cir. 1984).

proceeds in the same year that the proceeds are received. The inclusion and the deduction cancel each other out. But if the stud fee is not paid until the next year (or the one following that) then the inapplicability of section 1033 effects an acceleration of income. Inclusion of the gain attributable to the insurance proceeds in the year of receipt is not cancelled out until a future year.

To the extent that the foal insurance exceeds the previously deducted stud fee, the tax benefit rule does not present a problem, but the corollary of gain exclusion is denial of the deduction for the second stud fee. Again, if the stud fee is paid in the same year that the insurance is received, the issue is moot. If the stud fee is not payable until a later year, however, then the potential availability of section 1033 benefits the taxpayer because in present value terms the tax detriment of income in an earlier year is not entirely offset by the tax benefit of a deduction in a later year.[449]

2. *Accident, Disease or Sickness Rendering a Horse Unfit for Racing or Breeding*

Insurance sometimes is obtained to compensate a horse owner for the premature retirement of a horse from racing or breeding due to an accident or sickness that does not result in the death or destruction of the horse. The potential application of section 1033 to the receipt of such insurance proceeds and the purchase of a replacement horse is complicated by the fact that the owner may retain ownership of the horse. Accidents are treated somewhat differently than disease, therefore the two are discussed separately.

a. *Accident*

If a horse is so injured by an accident to require retirement from racing or breeding, the reinvestment of the accident insurance proceeds might qualify as an involuntary conversion arising from "destruction . . . in part"[450] of the horse. Reinvestment of insurance proceeds attributable to the partial destruction of real estate or equipment qualifies for nonrecognition as an involuntary conver-

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[449] *See* McMahon, *supra* note 404.

[450] I.R.C. § 1033(a).

sion.[451] In the usual situation, however, the insurance proceeds are used to repair the partially destroyed property. In the case of a horse retired from racing or breeding, however, not only may the partially destroyed property be retained, but the insurance proceeds are used to purchase additional property. Nevertheless, if insurance proceeds are to compensate an owner for lost value, section 1033 should apply if a horse is no longer useful in the purpose for which it was held, even though it is retained. Furthermore, the availability of section 1033 with respect to the gain attributable to the insurance proceeds should be unaffected by the taxpayer's decision to sell the horse.[452] Nonrecognition should not extend, however, to the gains from the sale of the horse.[453]

A potentially serious problem, possibly negating this analysis, is that policies insuring against the risks discussed above generally are written to insure against the loss of use of the horse, not the loss of the horse itself. The Treasury Regulations provide that the proceeds of "a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion," but are ordinary income.[454] Case law appears to establish that the proceeds of insurance for loss of use of real estate may be reinvested without recognition under section 1033 as long as the policy insures against loss of use rather than loss of profits.[455] Determining whether a policy insures against loss of use or lost profits requires an examination of all of the facts and circumstances, and where horses are concerned, the relevant factors may differ from those in real estate cases. The inquiry is not limited to the face of the policy, but

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[451] *See, e.g.*, Marcal Pulp and Paper v. Commissioner, 268 F.2d 739 (3d Cir.), *cert. denied*, 361 U.S. 924 (1959); Rev. Rul. 67-254, 1967-2 C.B. 269.

[452] *See* Reynolds, *supra* note 441, at 993-95.

[453] *See* C.G. Willis, Inc. v. Commissioner, 41 T.C. 468 (1964) (gain on sale of partially destroyed ship was not entitled to nonrecognition under I.R.C. § 1033, even though sinking was an involuntary conversion by partial destruction).

[454] Treas. Reg. § 1.1033(a)-2(c)(8) (1959).

[455] *Compare* Shakertown Corp. v. Commissioner, 277 F.2d 625 (6th Cir. 1960); Williams Furniture Corp. v. Commissioner, 45 B.T.A. 928 (1941)(*acq.*); Rev. Rul. 74-447, 1974-2 C.B. 302, *with* Marshall Foods, Inc. v. United States, 393 F. Supp. 1097 (D. Minn. 1974), *aff'd per curiam*, 75-2 U.S.T.C. ¶ 9536 (8th Cir.), *cert. denied*, 423 U.S. 928 (1975).

includes the underwriting and actuarial criteria used in writing the policy.[456]

A substance over form analysis of the risk against which the owner is protected by such insurance might point to the proceeds being treated as a substitute for lost profits. Mortality insurance protects against the loss of the horse itself. Loss of use is therefore largely a euphemism for loss of profits—racing purses and stud fees. The policies are payable with reference to the activity, or lack of activity, of the horse, not its condition. This suggests that the risk insured is loss of profits.

This analysis, however, may be more accurate with respect to insurance against termination of a racing career than with respect to a breeding career. Permanent loss of use for breeding fundamentally represents destruction of the business value of the animal, and although the policy may in form be a loss of use policy, the proceeds represent substantially all of the value that will be realized from the horse. The same would hold true with respect to insurance against the premature termination of the racing career of a gelding. As far as colts and fillies held for racing are concerned, however, unless the insurance is substantially in excess of reasonably expected purses that might be earned and therefore actually represents potential loss of value as a broodmare or stallion that might result from premature termination of a racing career, the proceeds resemble lost profits. If that is so, they should be taxable as ordinary income and not eligible for nonrecognition under section 1033. Given the dearth of authority, however, generalization is dangerous, and each case should be examined against the factors applied in the relevant cases and Revenue Rulings.

If the obstacles to the application of section 1033 discussed above can be overcome, the general rules discussed at the beginning of this section would apply as follows. Assume, for example, that the taxpayer owned a fully depreciated filly held for racing, for which he had originally paid $25,000. Due to an injury, the owner retired her from racing and collected insurance proceeds of $50,000. Because the owner was not engaged in breeding and the filly had potential as a broodmare despite her injury, he sold her for $40,000.

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[456] *See Marshall Foods, Inc.*, 393 F. Supp. 1097; Rev. Rul. 86-12, 1986-5 I.R.B. 32. *See also* Reynolds, *supra* note 441, at 997-1002.

The gain realized on the collection of the $50,000 insurance proceeds could go unrecognized if the taxpayer replaced the filly with another filly held for racing; however, the $40,000 gain realized on the sale would be recognized.

Another difficult question involves characterization of the gain that is recognized. Should the $25,000 of ACRS deductions be recaptured on the sale of the filly and the replacement filly be purged of any recapture taint, or should the recapture taint carry over to the replacement filly and all of the gain be accorded section 1231 treatment, as would be the case if the converted filly was totally destroyed? A strict reading of the Treasury Regulations appear to require transfering all of the recapture potential to the replacement property, leaving the entire gain on the sale as section 1231 gain.[457] This result is unsettling, however, and the regulations do not appear to have been written with this scenario in mind.

The alternative solution of characterizing the gain on the sale as section 1245 recapture gives rise to another issue. If all of the recapture inherent in the horse at the time of its conversion by partial destruction is not recaptured on the sale because the recomputed basis exceeds the amount realized, it seems that the remaining recapture potential should be transferred to the replacement horse. How would recapture be computed if the replacement horse was sold before the converted horse was sold? Perhaps the best solution is to give each horse a recomputed basis that includes all ACRS deductions claimed with respect to the converted horse, then subsequently reduce the recomputed basis of either by the amount of recapture income recognized on the prior sale of the other.

Another difficult question is presented in determining the respective bases of the retained partially destroyed horse and the replacement horse, if the converted horse was not fully depreciated. Section 1033(c) contemplates that the basis of destroyed property will be transferred to the replacement property. While the application of this rule may seem incongruous if the converted property is not totally destroyed and is retained or sold at a profit, it is actually entirely consistent with the theory of section 1033. Nonrecognition is permitted under section 1033 on the theory that the taxpayer's investment continues in a different form. Transferring the entire

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[457] *See* Treas. Reg. § 1.1245-2(c)(4).

basis of the converted property to the replacement property reflects that continuation of the taxpayer's original investment. The converted property no longer reflects any investment, and all the proceeds of its sale reflect gain because the original investment continues in the replacement property. The basis will be recovered through ACRS deductions on the replacement property over the remaining cost recovery period of the converted property, to the extent that the basis of the replacement property does not exceed the basis of the converted property. Any additional basis is considered separate property for purposes of computing ACRS deductions, and it has an independent cost recovery period.[458]

b. *Sickness or Disease*

If a horse is retired from or cannot commence a racing or breeding career due to sickness or disease rather than accident, the gain attributable to any insurance proceeds received on account of the sickness or disease and any proceeds from the sale of the horse may be eligible for nonrecognition.[459] Section 1033(d) treats the destruction or sale of any livestock due to sickness or disease as an involuntary conversion. Sickness or disease, not resulting in death, however, does not appear to be an involuntary conversion in the absence of the forced sale contemplated by section 1033(d).[460] Therefore, unless the horse is sold, any gain realized on the collection of insurance proceeds exceeding basis probably cannot be deferred under section 1033.

The proper application of this provision to horses is unclear. For gain from a sale to be eligible for nonrecognition the taxpayer must show that the livestock were sold "because of the disease," and that it "would not otherwise have been sold or exchanged at that particular time . . . ."[461] Although the legislative history is totally silent as to the intended scope of section 1033(d),[462] it appears

[458] Prop. Reg. § 1.168-5(f)(1) (1984).

[459] I.R.C. § 1033(d) applies regardless of whether the disease is of epidemic proportions or is isolated. Rev. Rul. 61-216, 1961-2 C.B. 134. *See generally* Reynolds, *supra* note 389, at 995-97.

[460] *See* Treas. Reg. § 1.1033(d)-1.

[461] Treas. Reg. § 1.1033(d)-1(a).

[462] *See* H.R. REP. No. 2543, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 5280.

that it contemplates a sale for slaughter, not a sale for continued use for a different purpose.[463] Under this standard it may be difficult, for example, to prove that a horse retired from racing and sold for breeding would not have been sold at that time even if the disease had not occurred. If, however, a horse previously used for breeding was sold to a purchaser for use outside the breeding and racing industry, the standard would probably be met more easily.

Not all physical infirmities qualify as sickness or disease under section 1033(d). In Revenue Ruling 59-174,[464] the IRS ruled that genetic dwarfism in cattle was not a disease. Presumably this applies to any congenital infirmity, whenever manifested. There might be some argument, however, that an involuntary conversion has occured if the congenital infirmity arose from sickness or disease of the dam. When livestock illness arises from external sources, "disease" will probably be broadly construed, and should include chemical causes, such as contaminated feed,[465] as well as infectious biological causes.

Injury to a horse from chemical causes might qualify as partial destruction by accident as well as sickness.[466] If so, nonrecognition of gain attributable to insurance proceeds might be available even though it cannot be proven that the horse was sold because of the sickness. Claiming nonrecognition under this standard, however, precludes sheltering any gain realized on the sale under section 1033.[467]

c. *Fertility Insurance Proceeds*

Eligibility for nonrecognition under section 1033 of gain realized on the collection of fertility insurance on a stallion should be

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[463] *See* Reynolds, *supra* note 441, at 996-97.

[464] 1959-1 C.B. 203.

[465] Rev. Rul. 54-395, 1954-2 C.B. 143, *modified by* Rev. Rul. 59-102, 1959-2 C.B. 200. *See also* Rev. Rul. 75-381, 1975-2 C.B. 25 (honeybees killed by pesticides).

[466] *See* Rev. Rul. 75-381, 1975-2 C.B. 25 (honeybees killed by pesticides); Rev. Rul. 54-395, 1954-2 C.B. 143 (cattle killed by disease, caused by consumption of contaminated food, were involuntarily converted through destruction for year prior to enactment of I.R.C. § 1033(e)), *modified by* Rev. Rul. 59-102, 1959-2 C.B. 200.

[467] *See* Rev. Rul. 78-337, 1978-2 C.B. 208 (nonrecognition does not extend to proceeds of sale of shopping center partially destroyed by fire, but gain realized on insurance proceeds qualified for nonrecognition to the extent reinvested in qualified property).

determined under the standards discussed in the preceding sections.[468] The cause of the infertility should determine the proper treatment of the gain attributable to the insurance proceeds. If an accident can be established as the cause of the infertility, this should pose no problem. Infertility from another cause, however, presents problems. First, the burden is on the taxpayer to prove that the infertility was caused by sickness or disease. If the infertility is genetic, section 1033 does not apply. Even if the infertility was caused by disease, the stallion must be sold. This problem cures itself if the insurance underwriter takes title to the stallion, as most fertility insurance policies provide for, but if the underwriter does not take title, this may present a problem.

C. *Identifying Horses Similar or Related in Service or Use to the Converted Horses*

As previously noted, there is no single easily applied meaning of the phrase "property similar or related in service or use."[469] The most frequently cited criteria are drawn from *Maloof v. Commissioner*,[470] in which the court set out the following four general principles: (1) the replacement property must be "substantially similar" to the converted property; (2) the replacement property must represent a "continuation of the prior commitment of capital and not a departure from it;" (3) the replacement property need not exactly duplicate the converted property; and (4) the purpose of section 1033 is to provide "a means by which a taxpayer whose enjoyment of his property is interrupted without his consent may arrange to have that interruption ignored for tax purposes, by returning as closely as possible to his original position." Actual determinations have been made on a case by case basis, taking all of the facts and circumstances into account.

Two broad tests have evolved. The first, the so-called "functional use test", looks to the physical characteristics and the taxpayer's end use of the property.[471] Because this test proved difficult to apply to passive investors, a second test, the so-called "similar

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[468] *See* Reynolds, *supra* note 441, at 1002-03.
[469] *See* text accompanying notes 434-40 *supra*.
[470] 65 T.C. 263, 269-70 (1975)(*acq.*).
[471] *See* Rev. Rul. 64-237, 1964-2 C.B. 319.

economic relationship'' test has developed and is applied to passive investors.[472] This test, primarily applicable only to real estate and equipment lessors, examines the extent and type of the owner-lessor's management activity, the services rendered by him to the users (tenants), and the nature of the business risks. The similar economic relationship test generally does not apply to horses, which usually are owned by the user. If a horse is leased either for breeding or racing purposes, however, the similar economic relationship test probably will apply to determine whether the replacement property purchased by the owner-lessor of the converted horse is qualified.

1. *Owner-Users and the "Functional Use" Test*

Application of the functional use test in the context of involuntary conversions of horses presents a number of certainties and uncertainties, and its exact scope remains unclear.

a. *Replacement With Animals of Different Sex*

As far as breeding stock is concerned, a stallion may be replaced with a stallion and a broodmare with a broodmare. But in a private letter ruling the IRS has taken the position that the the replacement of breeding cattle of one sex with breeding cattle of the opposite sex is not replacement with property that is similar or related in service or use.[473] This ruling was based on the different roles played in the overall breeding process by animals of different sexes. A male animal services numerous female animals and has no continuing connection with the gestating calf. Females, on the other hand, play a role in the gestation of a single calf. A cattle breeding herd requires many cows, but only a few bulls.

Although there may be some differences in industry operations, the fundamental roles in the breeding process of bulls and stallions and cows and broodmares, respectively, are analogous. Therefore,

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[472] This test compares "the services or uses of the original and replacement properties to the taxpayer-owner." Liant Record, Inc. v. Commissioner, 303 F.2d 326, 329 (2d Cir. 1962); Johnson v. Commissioner, 43 T.C. 736 (1965)(*acq.*); Rev. Rul. 64-237, 1964-2 C.B. 319.

[473] Priv. Ltr. Ruling 7903064 (Oct. 18, 1978). *See also* Treas. Reg. § 1.1033(e)-1(c) (livestock replacing livestock sold because of drought must "be functionally the same as the livestock involuntarily converted").

the same principles used with cattle should apply to horses held for breeding. The risks associated with deriving profits from owning a stallion differ from the risks from owning a broodmare, and the replacement of one with the other can hardly be called a continuation of the original investment.

If the converted horse was held for racing, however, there is some basis for arguing that the horse's sex should be irrelevant. Although larger purses generally are earned by colts than by fillies, and races in which they may be entered might differ slightly, they are trained and raced in the same manner, and certainly seem to qualify under the *Maloof* criteria as "substantially similar" property representing a continuation of the original investment. Nevertheless, a problem is presented by the potential dual purpose for which any racehorse capable of breeding might be held. If the taxpayer engages solely in the business of racing horses, consistently selling all horses, male or female, when retired from racing, perhaps this dual purpose problem can be overcome. For the owner who both races and breeds horses, however, it is an unsolved problem.[474]

b. *Replacement With a Horse Held For a Different Purpose*

According to the IRS, horses held for different purposes are not "similar or related in service or use."[475] Therefore, the replacement of a converted racehorse with breeding stock or the replacement of breeding stock with a racehorse, even if of the same sex, will not qualify for nonrecognition under section 1033. Analyzed against the criteria that have been applied to determine whether replacement property meets the "similar or related in service or use" standard, this conclusion is logical. Different business risks, potential profits and management skills are associated with breeding and racing. Replacing a horse used for one purpose with one used for the other can hardly be said to return the taxpayer to his original position. This is, nevertheless, a difficult rule to apply to horses.

In determining whether the replacement property is similar or related in service or use, courts have looked to the taxpayer's

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474 *See* Treas. Reg. § 1.1033(e)-1(c) (I.R.C. § 1033(e) extending involuntary conversion treatment to livestock sold because of drought extends only to sales of livestock in excess of the number of sales that would occur in any event).

475 I.R.S. Field Release No. 121. *See also* Treas. Reg. § 1.1033(e)-1(d).

ultimate use of the replacement property.[476] A transitory unrelated use is ignored. Although this test may be applied without inordinate difficulty in examining real estate, which may or may not be converted to a different use as the taxpayer chooses, it is not easily applied to horses. Except for geldings, all racehorses are held not only for racing, but also for future breeding use or for sale to another person for breeding use.[477] This different use, breeding, is preordained for racehorses. Furthermore, the exact time at which a horse will be retired from racing for breeding is unpredictable. Any workout or race might result in an injury forcing retirement.[478] Thus, if a long run perspective is adopted, it is difficult to determine, particularly for a horse nearing the end of an expected racing career, whether the horse is held primarily for racing or primarily for breeding.

In practice, consideration of the dual purposes for which horses are held may produce different results depending on the "direction" of the replacement. The replacement of a stallion with a colt (or of a broodmare with a filly) might be argued to be qualified on the theory that the colt was acquired primarily for breeding purposes, and that he was being raced only to enhance his value as a stallion.[479] Evidence indicating this would be that the colt was an older colt, and, using hindsight, that he indeed was retired to stud within some reasonable period. Sale or syndication of the horse upon retirement from racing, however, indicates that the horse was acquired for racing, not breeding, unless other evidence indicates that the sale became more desirable due to a change of circumstances arising after the replacement.

On the other hand, the replacement of a racehorse, other than a gelding, with a stallion or broodmare should be much more

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[476] *See, e.g.*, S.H. Kress and Co. v. Commissioner, 40 T.C. 142 (1963) (interim use of real estate for parking lot pending construction of building); Scheuber v. Commissioner, 25 T.C.M. (CCH) 559 (1966), *rev'd on other grounds*, 371 F.2d 996 (7th Cir. 1967) (improvements on replacement for unimproved land had no value and were held for transitory rental).

[477] *See* McDougal v. Commissioner, 62 T.C. 720 (1974); Fowler v. Commissioner, 37 T.C. 1124 (1962); Reynolds, *supra* note 441, at 1009.

[478] *See McDougal*, 62 T.C. 720; *Fowler*, 37 T.C. 1124.

[479] *See* Jewell v. Commissioner, 25 T.C. 109 (1955) (commissioner unsuccesfully argued that gain on sale of horse held for racing was not I.R.C. § 1231 gain on theory that the only purpose for racing was to enhance value on subsequent sale to customers of horse breeder and dealer); *Fowler*, 37 T.C. 1124 (same).

difficult to qualify. A taxpayer engaged in both breeding and racing might argue that the converted horse was at or close to the end of its racing career and that most of its value was derived from breeding potential, rather than from expected future purses. This might support treatment of the stallion or broodmare as qualified replacement property. If the converted racehorse is young, however, this argument loses much of its weight.

For the taxpayer engaged only in racing, replacement would seem to be limited to horses used for racing. Furthermore, if the preceding argument has any validity, the replacement racehorse's value may need to be derived primarily from its value as a racehorse, rather than its value as potential breeding stock. This often might be difficult to show given the relationship of prices of thoroughbreds with good bloodlines to the size of purses available. Most horses cannot recoup their cost in purses won. Full recovery of cost is available, if at all, only through breeding following their racing careers. In this light, perhaps it should be sufficient if the replacement horse merely has significant value as a racehorse.[480] In any event, replacement with an older racehorse that will soon be sold or syndicated for breeding may less likely qualify than would replacement with a younger horse with a longer expected racing career.

Despite the possibly sound theoretical basis for allowing some leeway in the distinction between horses held for breeding and horses held for racing, however, there is little basis for treating the replacement of yearlings, weanlings or foals held by a dealer with horses held for racing or breeding as a qualified replacement. This should not, of course, preclude a dealer from proving that a particular yearling (or younger horse) would not have been sold in the ordinary course of business, but would have been held for breeding

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[480] *Compare* Massillon-Cleveland-Akron Sign Co. v. Commissioner, 15 T.C. 79 (1950)(*acq.*) (court rejected IRS argument that on replacement of going business the amount realized must be allocated among classes of converted property and cost allocated among classes of replacement property to determine whether entire amount realized was reinvested in qualified property) *with Maloof*, 65 T.C. 263 (replacement of business, substantially all of the property of which was inventory, with manufacturing business represented too great a shift of investment from current to fixed assets, and only inventory replacement qualified under I.R.C. § 1033).

or racing.[481] If the taxpayer can meet this difficult burden, then replacement with a horse used for the purpose for which the yearling would have been used should be accorded nonrecognition.

c. *Replacements Involving Mares in Foal*

The application of I.R.C. section 1033 to mares in foal is far more complex and uncertain than in the contexts already considered. Most of the uncertainty emanates from the question of whether the unborn foal should be considered property separate from the mare.[482] If it is separate property, then on the mare's death two involuntary conversions may occur, and the replacement of each must be tested separately.[483] If the foal is not separate, then there is only one involuntary conversion, and identifying "property similar or related in service or use" becomes more difficult.

If the foal is not separate from the mare, the crucial question is whether a replacement mare must be in foal in order to be considered "similar or related in service or use." Viewed from a long term perspective, one might reasonably conclude that replacement with another broodmare, in foal or not, would be sufficient to return the taxpayer as nearly as possible to his position before the conversion. If the foal is separately insured, however, the foal insurance cannot be sheltered from recognition under section 1033 by the purchase of a mare not in foal.[484] Indeed, the foal insurance

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[481] This determination would be the same as the test employed to determine if a dealer in horses is entitled to I.R.C. § 1231 treatment with respect to the sale of a particular horse. See text accompanying notes 108-37 *supra* for a discussion of this issue.

[482] *See* Reynolds, *supra* note 441, at 1014-18.

[483] *See* Rev. Rul. 77-192, 1977-1 C.B. 249 (replacemment of seafood processing building and equipment with seagoing seafood process plant and equipment was qualified only as to equipment); Rev. Rul. 70-501, 1970-2 C.B. 163 (replacement of factory building and equipment separately tested, based on insurance proceeds attributable to building and equipment and respective replacement costs). *But see* Rev. Rul. 73-18, 1973-1 C.B. 368 (replacement of land and building with land and building does not require apportionment of proceeds between converted land and building and separate test against apportioned cost of replacement land and building); Rev. Rul. 70-465, 1970-2 C.B. 162 (same).

[484] *See* International Boiler Works Co. v. Commissioner, 3 B.T.A. 283 (1926)(*acq.*) (proceeds of settlement of single fire insurance policy separately settled as to building and equipment between insured and insurance company required reinvestment be separately tested for building and equipment); Rev. Rul. 70-501, 1970-2 C.B. 163 (same). *See* note 483 *supra*.

possibly may be reinvested only in another foal or stud fees.[485] A similar conclusion may be indicated if, for example, the mare was purchased in foal and a substantial portion of the purchase price is actually attributable to the foal, but there is a single insurance policy. This fact pattern, however, makes a good case for treating the mare and the foal as separate property. Whether an unborn foal and the mare are separate property has been discussed already in the context of allocation of purchase price and like kind exchanges, concluding that the foal generally should be recognized as separate property for those purposes.[486] In that analysis, however, the foal was always presumed to be born alive, while in this context the foal is presumed never born. Therefore, as far as the application of section 1033 is concerned, the decision in *Greer v. United States*[487] that the holding period of a foal does not begin until its birth presents a significant impediment to treating the unborn foal as separate property. In the context of apportionment of basis it was suggested previously that *Greer* might be interpreted as requiring that the tax consequences of the transaction be held open pending the birth of the foal rather than as an absolute prohibition on treating the unborn foal as separate property. Only if the foal is born alive could it be considered separate property to which basis and amount realized on the sale might be allocated.[488] This interpretation of *Greer* is not so easily applied if the foal is not born alive.

Treating a foal that is not born alive as property separate from the mare carrying it opens up difficult questions which cannot be fully answered here. For example, if a mare purchased in foal aborts, may the purchaser claim a loss deduction under I.R.C. section 165(a) for the portion of the purchase price allocable to the foal if it is not insured? If the foal is property separate from the mare for purposes of section 1033, the logical corollary is that it is also separate property for purposes of section 165. Initially, allowing a deduction upon the abortion may appear to be incorrect, but closer examination indicates that such a deduction may be proper.

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[485] See text accompanying notes 441-49 *supra* for a discussion of the replacement of a dead foal with stud fees or a live foal.

[486] *See* text accompanying notes 174-80, 368-77 *supra*.

[487] 408 F.2d 631 (6th Cir. 1969), *aff'g*, 269 F. Supp. 801 (E.D. Tenn. 1967).

[488] *Id.* at 636.

Treating the foal as separate property may find support in Revenue Ruling 86-24,[489] in which the IRS determined that purebred calf embryos, implanted in mixed breed cows, were separate property from the cows for purposes of apportioning basis. Relying on *Gamble v. Commissioner*,[490] the IRS required the purchase price of each cow to be allocated between the cow and the embryo on the basis of the fair market value of each to determine the gain realized on the sale of the cows following the birth of the purebred calves. The acquisition of the purebred embryos was treated as a separate transaction for tax purposes, and the taxpayer was required to capitalize as the basis of the embryos the portion of the acquisition costs allocable to them.

It may be significant that the Ruling, while relying on *Gamble*, at all times discussed cows and "embryos", never mentioning "calves" or giving any consideration to the possibility that the basis allocated to the cow would depend on whether the embryonic calf was born alive. This may indicate that livestock embryos should be treated as separate property from the carrying animal when the embryo has independent economic value. Although the embryonic animals in the Ruling were surgically implanted in surrogate cows, the Ruling does not appear to treat this as a significant fact that would distinguish this case from one in which embryonic calves were the natural offspring of the cows. Thus, treating an embryonic foal and the broodmare carrying it as separate property for purposes of section 1033 appears to be correct.

This conclusion is reinforced by analogizing the unborn foal to standing crops. In several Revenue Rulings, the IRS has acknowledged that standing crops are property for which insurance received on their destruction may be reinvested in similar property and the gain is entitled to nonrecognition under section 1033.[491] The analogy is best seen by comparing a mare in foal, when the owner elected to capitalize rather than deduct the stud fees, with crops grown by a farmer using the crop method of accounting. In the case of the

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[489] 1986-1 C.B. 80.

[490] 68 T.C. 800 (1977)(*acq.*). *Gamble* is discussed in detail in the text accompanying notes 157-73 *supra*.

[491] Rev. Rul. 62-161, 1962-2 C.B. 175, *amplified by* Rev. Rul. 81-279, 1981-2 C.B. 163; Rev. Rul. 59-8, 1959-1 C.B. 202, *modified by* Rev. Rul. 81-279, 1981-2 C.B. 163.

mare in foal, the capitalized stud fees become the basis of the foal when born; they are not added to the basis of the mare.[492] If the foal is stillborn or the mare aborts, the stud fees, if not refunded, clearly constitute an section 165 loss.

For a farmer using the crop method of accounting, the costs of planting a crop are not deducted, but are capitalized as the basis of the crop.[493] If the crop is destroyed, the insurance proceeds may be reinvested in either a standing or harvested crop or through the expense of planting a new crop without recognition pursuant to section 1033. A foal, therefore, should be treated as separate property upon the death of the mare in foal. Furthermore, it should not matter that the stud fees were deducted previously. If the proceeds of crop insurance received by a cash basis taxpayer are reinvested in planting a new crop or purchasing a standing or harvested crop, nonrecognition under section 1033 is available. Stud fees are deducted by a cash basis taxpayer under the same provisions that authorize the deduction of the expenses of planting crops, so the same treatment should be available.

Treating the foal as separate property is the better result when the foal was insured separately, for there would be two distinct involuntary conversions, and the proceeds of insurance received with respect to each conversion should be separately tested for nonrecognition through reinvestment in similar property. Section 1033 might apply to one, but not to the other. The proceeds from the mare could be reinvested in another mare, and the proceeds of the foal insurance could be reinvested in another foal or in stud fees.

With respect to the conversion of the foal, however, if the owner had deducted the stud fees, a reinvestment in stud fees for another mare could be neither deducted nor capitalized.[494] In addition, the taxpayer might be required to show that the "reinvestment" stud fees would not have been incurred but for the involuntary conversion. Thus, stud fees incurred in the next year for a mare already owned by the taxpayer might not qualify. Apparently the

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[492] *See* text accompanying note 51 *supra*.

[493] *See* Treas. Reg. § 1.162-12 (1986). The crop method of accounting is not widely used but provides a useful analogy. *See* J. O'BYRNE & C. DAVENPORT, *supra* note 141, at § 114.

[494] *See* text accompanying note 445 *supra*.

only unquestionably qualified replacement stud fees would be those incurred with respect to a replacement mare. Finally, if the stud fees were deducted previously, replacement for the foal might be limited to stud fees. The purchase of a foal may be "fundamentally inconsistent" with the prior deduction, and the tax benefit rule may override section 1033.[495]

When the foal is not insured separately, allocating to the foal any portion of the insurance proceeds on the mare may be difficult. If no such allocation can be made, the entire reinvestment presumably must be in another mare to avoid recognition totally. The terms of the insurance policy, however, should not be controlling.[496] If, for example, the owner purchased the mare in foal, insured her for the full purchase price or more, and was able to prove the portion of the purchase price attributable to the foal, the insurance proceeds should be apportioned between the mare and the foal. A ratable apportionment would make the most sense. In that case, separate reinvestment would be appropriate.

If the foal is separate property, may the reinvestment be in the form of another mare in foal? If so, to obtain total nonrecognition, must the purchase prices attributable to the replacement mare and foal, respectively, equal or exceed the insurance proceeds attributable to the converted mare and foal, or is it sufficient that their aggregate cost exceed the insurance proceeds, even if the portion attributable to either the mare or the foal is less than the insurance attributable to it? Logic would indicate that if the mare and foal are separate for one purpose, they must be separate for all purposes, and that the purchase price of the new mare must be allocated between the mare and the foal. To the extent that the purchase price of either is less than the amount realized on the conversion of the original counterpart, gain must be recognized. This presents no more administrative difficulty than permitting the reinvestment to qualify on an aggregate basis, because the basis of the converted mare and foal would have to be apportioned between the replacement mare and foal under such a rule.[497] On the other hand, some

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[495] *See* text accompanying notes 441-47 *supra*.

[496] *See* text accompanying note 456 *supra*.

[497] *See Maloof*, 65 T.C. 263 (replacement of business substantially all of the property of which was inventory with manufacturing business represented too great a shift of investment from current to fixed assets, and only inventory replacement

authority suggests that reinvestment on an aggregate basis would be adequate to support nonrecognition and that separate computations should not be required.[498]

2. *Investors and the "Similar Economic Relationship" Test*

Although the IRS originally applied the functional use test to replacements of property by lessors by looking to the use to which the lessee put the leased property, this analysis was rejected by a number of appellate courts[499] and the IRS finally acceded to the application of the similar economic relationship test to lessors.[500] This test has been developed primarily in the context of rental real estate owned by taxpayers who did not actively manage the property[501] and may be difficult to apply in the equine context. In an abstract sense, however, the test is no different than the test applied to owner-users. The IRS and the courts will examine the taxpayer's relationship to the property in terms of the services or management activities required of the taxpayer and the risks associated with the ownership of the respective properties.[502] Generally,

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qualified under I.R.C. § 1033); Rev. Rul. 77-192, 1977-1 C.B. 249 (replacement of seafood processing building and equipment with seagoing seafood process plant and equipment was qualified only as to equipment); Rev. Rul. 70-501, 1970-2 C.B. 163.

[498] *See Massillon-Cleveland-Akron Sign Co.*, 15 T.C. 79 (court rejected IRS argument that, on replacement of going business, the amount realized must be allocated among classes of converted property and cost allocated among classes of replacement property to determine whether entire amount realized was reinvested in qualified property); Rev. Rul. 73-18, 1973-1 C.B. 368 (replacement of land and building with land and building does not require apportionment of proceeds between converted land and building and separate test against apportioned cost of replacement land and building); Rev. Rul. 70-465, 1970-2 C.B. 162 (same). *But see* Rev. Rul. 70-501, 1970-2 C.B. 163 (replacement of factory building and equipment separately tested based on insurance proceeds attributable to building and equipment and respective replacement costs).

[499] *See, e.g., Liant Record, Inc.*, 303 F.2d 326.

[500] *Johnson*, 43 T.C. 736; Rev. Rul. 64-237, 1964-2 C.B. 319.

[501] *See generally* 2 B. BITTKER, *supra* note 44, at ¶ 44.3.3; Edwards, *supra* note 411, at 33-7th T.M. A-19-A-21.

[502] *See Liant Record, Inc.*, 303 F.2d at 328-29:

> There is, therefore, a single test to be applied to both users and investors, i.e., a comparison of the services or uses of the original and replacement properties to *the taxpayer-owner*. In applying such a test to a lessor, a court must compare, *inter alia*, the extent and type of a lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of the business risks connected with the properties.

this requires that the taxpayer not replace rental property with respect to which his role is passive management with property that requires active management.[503] It might also preclude replacement of property leased for a fixed rental with property leased for rentals that vary with the lessee's profits or vice versa.

Applying these standards, one can conclude, for example, that a broodmare net-leased for a fixed rental could be replaced with another broodmare similarly leased, but that it could not be replaced with a filly leased for a percentage share of racing purses. Whether this test would permit the replacement of a filly leased for a share of racing purses with a mare leased for a share of the sales proceeds of her foals is unclear. Although the relative risks of leasing different types of real estate for a percentage of the lessee's profits might not differ dramatically, the same cannot be said so easily for the lease of horses for different purposes. As far as equine leases are concerned, the similar economic relationship test possibly may produce results identical to the functional use test applied to owner-users.

The similar economic relationship test may apply to the replacement by a share owner of his interest in an involuntarily converted horse owned by a syndicate if the shareholder regularly sold the seasons to which he was entitled rather than using them himself.[504] This problem, however, arises only with respect to stallion syndicates, because all other syndicates should be taxed as partnerships[505] and the application of section 1033 to such syndicates is determined at the partnership level, not the investor-partner level.[506] In either case, the share owner has no management responsibilities, but the risks incurred in using a season to breed the stallion to a mare owned by the share owner are significantly different from the risks incurred in regularly selling the right to the season. The risk differential probably should be sufficient to treat the passive share owner as an investor and limit his replacement property to another stallion share held for the purpose of selling seasons or, possibly, a stallion

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[503] *See, e.g.*, Rev. Rul. 70-399, 1970-2 C.B. 164 (replacement of hotel leased to operator by taxpayer with hotel operated by taxpayer did not qualify).

[504] *See* Reynolds, *supra* note 411, at 1006.

[505] *See* text accompanying note 182 *supra*.

[506] *See* text accompanying notes 508-17 *infra*.

leased to a user.

D. *Special Problems of Syndicates*

The proper application of section 1033 to the involuntary conversion of a syndicated horse depends upon whether the syndicate is characterized as a partnership for federal income tax purposes.[507] Similar considerations govern an attempt to reinvest the proceeds of an involuntarily converted horse in a syndicate share.

1. *Syndicate Treated as a Partnership*

If a horse held by a syndicate that is a partnership for federal income tax purposes is involuntarily converted, section 1033 applies only at the partnership level.[508] The horse must be replaced by the partnership, and the election not to recognize gain must be made by the partnership. All partners are bound by the partnership choice. Thus, if the partnership replaces the horse, but elects to recognize gain, all partners must recognize gain;[509] individual nonrecognition elections are not permitted. If the partnership does not replace the horse, all partners must recognize their share of the gain. Individual replacement with another horse is not permitted. If the partnership replaces the converted horse, it must be with a horse that is similar or related in service or use.

This analysis would not differ if, as is the frequent practice, the individual shareholders separately insure their interests in the horse held by the syndicate. If the syndicate is a partnership, the horse is partnership property and must be replaced by the partnership for the gain to escape recognition under section 1033. It is not necessary,

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[507] See text accompanying notes 181-87 *supra* for a discussion of the factors governing the characterization of a syndicate as a partnership.

[508] I.R.C. § 703(b) (all elections must be made by the partnership). *E.g.*, Demirjian v. Commissioner, 54 T.C. 1691 (1970), *aff'd*, 457 F.2d 1 (3d Cir. 1972) (proceeds from condemned real estate owned by partnership reinvested by partner acting in individual capacity did not qualify for nonrecognition because both election and reinvestment must be made by partnership); Rev. Rul. 66-191, 1966-2 C.B. 300 (cattle owned by partnership and sold because of drought must be replaced by partnership, not individual partners, for I.R.C. § 1033(f) to apply).

[509] Each partner recognizes gain according to his distributive share of partnership gain determined under I.R.C. § 704. In most syndicates this is a simple proportionate part of the gain, but gains sometimes may be allocated other than on a simple percentage basis.

however, that the replacement be with funds traceable to the insurance proceeds, but that is a likely source.

Properly characterizing the receipt of the insurance proceeds by the share owners and the contribution of those proceeds back to the syndicate to purchase the replacement horse presents a formidable challenge in the application of Subchapter K of the I.R.C. Thorough analysis of this problem is beyond the scope of this paper. Note, however, that even if the gain on the horse escapes taxation under section 1033, the receipt of the insurance proceeds by the share owners might be characterized as a partnership distribution that could trigger the recognition of gain under section 731.[510] Whether the prompt contribution of the insurance proceeds to the partnership results in ignoring the transitory possession by the share owners, thereby avoiding the recognition of gain under section 731, is a difficult question.[511] As long as each share owner has the choice of contributing or not contributing, however, there is significant risk that a distribution would be deemed to have occurred, even with respect to those shareholders who contribute the insurance proceeds to the syndicate to purchase a replacement horse.[512]

These problems involving the constructive distribution might be avoided by a valid election under section 761 not to be taxed as a partnership,[513] and such an election should also permit the share owners to elect nonrecongnition and reinvest as individuals rather

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[510] *See* Rev. Rul. 81-242, 1981-2 C.B. 147 (involuntary conversion of mortgaged property effected a deemed cash distribution under I.R.C. § 752(b) resulting in recognition of gain under I.R.C. § 731, notwithstanding valid I.R.C. § 1033 election and reinvestment of amount equal to proceeds of conversion).

[511] This question should be answered by applying the familiar "step transaction doctrine." Discussion of this doctrine is beyond the scope of this Article. For a discussion of the step transaction doctrine, see, e.g., Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 How. L.J. 693, 717-23 (1978); McMahon, *Defining the "Acquisition" in B Reorganizations Through the Step Transaction Doctrine*, 67 IOWA L. REV. 31, 67-84 (1981).

[512] Application of either the "binding commitment" or "mutual interdependence" forms of the step transaction doctrine would clearly result in recognizing the constructive distribution as a separate transaction. Only the "intention of the parties" variant of the step transaction doctrine would integrate the distribution and the recontribution to treat the distribution as never having occurred. Although generalizations are hazardous in this area, this test usually is applied at the request of the IRS to prevent taxpayers from disguising the true form of a transaction.

[513] See text accompanying note 380 *supra* regarding elections not to be taxed as a partnership in the context of I.R.C. § 1031 exchanges.

than through the partnership. Although a section 761 election affects only the application of Subchapter K to the partnership and not the application of other provisions,[514] the rationale for requiring the partnership to make a section 1033 election rather than the individual partners is that section 703(b), which is part of Subchapter K, requires that all elections, with certain exceptions, be made by the partnership and not the partners individually.[515] A valid election under section 761 negates the application of section 703(b), however, and the partners are presumably free to make individual elections under section 1033 because that section, on which an section 761 election has no effect, does not address partners.[516] Therefore, for purposes of section 1033, the partners will be co-owners.

A word of caution is in order, however. In the context of equine syndications and partnerships, the discussion in the preceding paragraph may be more theoretical than practical. Because of the strict limitations on the availability of section 761 elections, it is doubtful that a syndicate that crosses the line from co-ownership to partnership generally could make a valid section 761 election not to be taxed as a partnership. In those cases in which a valid section 761 election could be made, it will not be necessary because the syndicate

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[514] *See* Bryant v. Commissioner, 399 F.2d 800 (5th Cir. 1968) (Investment Tax Credit computed without regard to election not to be taxed as partnership); Rev. Rul. 65-118, 1965-1 C.B. 30 (same).

[515] *See* Rev. Rul. 66-191, 1966-2 C.B. 300.

[516] *Compare* Rev. Rul. 83-129, 1983-2 C.B. 105 (partners in mining partnership that made valid I.R.C. § 761 election were allowed separate elections under I.R.C. § 616 dealing with capitalization and amortization of mine development expenses because I.R.C. § 761 election negates requirement of I.R.C. § 703(b) that all elections be made by partnership) *with* Rev. Rul. 65-118, 1965-1 C.B. 30 (valid I.R.C. § 761 election does not affect computation of Investment Tax Credit on partnership level because I.R.C. § 48 specifically refers to partnerships independently of Subchapter K). *See also* Madison Gas & Elec. Co. v. Commissioner, 72 T.C. 521 (1979), *aff'd,* 633 F.2d 512 (7th Cir. 1980). The Tax Court in dicta suggested that a valid I.R.C. § 761 election negates partnership status for all provisions of the Code, outside of Subchapter K, that do not specifically refer to partnerships. *Madison Gas & Elec. Co.*, 72 T.C. at 559 n.9. The Seventh Circuit Court of Appeals on the other hand, noted that I.R.C. § 7701(a)(2) defines partnerships for all sections of the Code in the same manner as I.R.C. § 761, and that the effect of an I.R.C. § 761 election is limited to Subchapter K, possibly implying a more restrictive view of the effect of an election. *Madison Gas & Elec. Co.*, 633 F.2d at 515-16 n.2.

will not be a partnership anyway.[517]

2. *Syndicate That is Co-Ownership of Undivided Shares*

If the syndicate is not a partnership, a share owner in a syndicate owning a horse that has been involuntarily converted may avail himself of nonrecognition under section 1033 by investing in another syndicate that is not a partnership. The horse held by the syndicate in which the reinvestment is made must, of course, be similar or related in service or use to the horse held by the first syndicate.

Reinvestment in a syndicate that is a partnership, however, does not qualify even if the horse held by the partnership syndicate is similar or related in service or use to the horse held by the non-partnership syndicate.[518] The syndicate share that was not a partnership was an undivided interest in the horse—tangible personalty. A share in a syndicate that is a partnership is an intangible partnership interest, and it is not similar or related in service or use to an undivided interest in a horse. Therefore, the share owner seeking the shelter of section 1033 must be certain that neither the syndicate that held the converted horse nor the syndicate that holds the replacement horse is a partnership.[519]

Another question to which the answer is unclear is whether a share owner in a syndicate that held an involuntarily converted horse may replace his undivided interest in the syndicated horse with outright ownership of another horse, otherwise meeting the similar or related in service or use standard. The IRS has ruled that

[517] *See* Reynolds, *supra* note 441, at 1012-13.

[518] *See* M.H.S. Co., Inc. v. Commissioner, 35 T.C.M. (CCH) 733 (1976), *aff'd,* 575 F.2d 1177 (6th Cir. 1978) (replacement of real estate with interest in joint venture owning real estate does not qualify under I.R.C. § 1033(g)); Rev. Rul. 57-154, 1957-1 C.B. 262 (purchase of replacement property as undivided tenant in common with other owner is qualified replacement); Rev. Rul. 55-351, 1955-1 C.B. 343 (purchase of partnership interest in partnership holding property similar to converted property is not a qualified replacement). *But see* Rev. Rul. 70-144, 1970-1 C.B. 170 (purchase by 50 percent partner of other 50 percent interest in partnership holding property similar to partner's individually converted property was a qualified replacement because purchase effected liqudation of partnership, making taxpayer the sole owner of the replacement property).

[519] In determining whether the syndicate is a partnership for these purposes, the standards developed under I.R.C. §§ 761 and 7701(a)(2) should be determinative, not the state law determination of whether the syndicate is a partnership. *See* note 182 *supra*.

a fractional undivided interest in a farm is a qualified replacement for fee ownership of a farm,[520] and the converse should also hold true. Thus, the replacement of a fractional interest in a horse with a wholly owned horse should not fail *per se* the similar or related in service or use test. But a syndicate share is not a simple fractional undivided interest in a horse. A share owner's rights with respect to the horse are much more limited than the rights of a simple co-owner. The share holder has no rights of possession or management, while a co-owner or outright owner does. This difference very well may result in any investment other than an investment in another syndicate share being treated as the purchase of property not similar or related in service or use. Once again, the question is whether the taxpayer is returning to his original position or is changing the form of his investment. Moving from an investment without active management responsibilities to one which carries management responsibilities appears to be a disqualifying change.[521]

Similar considerations may prevent the outright owner of a horse that has been involuntarily converted from using section 1033 to avoid recognition if his reinvestment is in the form of a syndicate share rather than another horse. In this case the taxpayer is moving from an investment requiring active management to one that is relatively passive.[522]

E. Determining the Desirability of a Section 1033 Election

The primary criteria governing the desirability of an election to defer gain under section 1033 are the same as the criteria used to determine if a like kind exchange is desirable. If all of the gain to be recognized will be ordinary income, it almost always is desirable to elect nonrecognition. Thus, to the extent that it is available, section 1033 may be very useful for a dealer in horses who suffers

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[520] Rev. Rul. 57-154, 1957-1 T.C. 262.

[521] *See* Clifton Investment Co. v. Commissioner, 312 F.2d 719 (6th Cir.), *cert. denied*, 373 U.S. 921 (1963) (replacement of bank office building operated for tenants by two employees with hotel requiring 130-140 employees was not qualified); Rev. Rul. 79-261, 1979-2 C.B. 295 (replacement of tenant-occupied office building with building partially tenant-occupied and partially owner-occupied qualified only to extent of tenant occupied portion).

[522] *See* Rev. Rul. 70-399, 1970-2 C.B. 164 (replacement of hotel leased to operator by taxpayer with hotel operated by taxpayer did not qualify).

an involuntary conversion of a horse held for sale to customers. An election to defer gain under section 1033 also is desirable whenever a horse, held for breeding or racing for less than the twenty four month holding period requisite for obtaining section 1231 treatment, is involuntarily converted. In both cases, all of the gain is ordinary income. For the dealer, there is no benefit gained by a step up in basis. For the owner of a horse held for breeding or racing, the step up in basis increases ACRS deductions, but in the absence of a section 1033 election, the replacement horse has its own recovery period.

Using a time value of money analysis, the present value of the tax benefit of the future ACRS deductions can never equal the tax detriment of current taxation of the gains as ordinary income, unless the taxpayer has other current deductions to offset the gain or is in a low tax bracket in the current year but expects to be in a much higher bracket in the years when the ACRS deductions are claimed. If a significant portion of the gain is taxed as capital gain, however, then for years prior to 1987 it more often was desirable to currrently recognize the gain, step up the basis of the replacement horse to its full cost, and claim ACRS deductions on the cost basis. When the gain on the sale was section 1231 gain, taxed as capital gain, the discounted value of the future ACRS deductions on the increased basis was greater than the current tax detriment.[523] Thus, for years in which the capital gains preference was in effect, section 1033 nonrecognition frequently was not desirable with respect to horses held for breeding or racing for more than twenty four months. For years after 1986, however, when section 1231 gains that are treated as capital gains are nevertheless taxed at the same rates as ordinary income, making a section 1033 election will be advisable for most involuntary conversions.

CONCLUSION

This Article has attempted to provide an encyclopedic exposition of the taxation of sales and exchanges of horses, focusing primarily on the thoroughbred breeding and racing business. Even after lengthy discourse, however, the answers to many questions remain

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[523] *See* text at Part II.F. *supra*.

clouded, and more definite answers are unlikely to be forthcoming soon. This stems not so much from ambiguity of the statutory provisions governing sales and exchanges of horses, as from difficulty in applying to horses principles that may be relatively clear when applied to other types of property.

Taxation of sales and exchanges of horses is, with a few exceptions, governed by the same statutory provisions that control taxation of the sale of property generally. When applied to horses, however, otherwise relatively clear rules may be ambiguous because of the nature of horses and the industry. Because horses are living organisms, capable of reproducing, numerous questions unique to transactions involving animals arise in applying those rules. Thus, we must grapple with difficult issues such as whether any portion of the purchase price paid or the sales proceeds received for a mare in foal should be attributed to the foal, and if so, how much, or whether for purposes of section 1033 a two year old filly is "substantially similar in service or use" to a two year old colt. The embryonic foal can be an ephemeral asset; it has value, but that value is contingent on a live birth. Both a filly and a colt may have the same use—racing—for a few years, but ultimately they fill different roles in the breeding function, and the maximum potential value of a colt far exceeds the maximum potential value of a filly.

The relative dearth of answers to the types of questions that arise in sophisticated tax planning transactions should serve as a yellow caution flag to anyone attempting to structure a complicated exchange of horses or an aquisition of a horse to replace one that has been involuntarily converted. While certain straightforward exchanges and replacements present few problems, even a significant age difference between the horses in the transaction may preclude nonrecognition. One might say that the rules of law are clear, but the facts, which are the uses for which the horses are held, are all too often ambiguous. Thus, the key to planning transactions involving the sale and exchange of horses, before attempting to apply any rule or law, is to understand that a "horse is not a horse." A horse is a horse held for a particular use, and horses held for different uses are quite different.