

The National Agricultural
Law Center



University of Arkansas School of Law
NatAgLaw@uark.edu • (479) 575-7646

An Agricultural Law Research Article

Choosing the Equine Business Form

by

John J. Kropp, John A. Flanagan and
Thomas W. Kahle

Originally published in the KENTUCKY LAW JOURNAL
70 KY.L.J. 941 (1982)

www.NationalAgLawCenter.org

Choosing the Equine Business Form

BY JOHN J. KROPP*, JOHN A. FLANAGAN**
AND THOMAS W. KAHLE***

INTRODUCTION

The equine industry can be conducted through any number of legal business forms. The determination of which form is best for an individual or group of individuals turns on many factors, including tax considerations, liability issues, capitalization requirements, management goals and state and federal securities law restrictions.

The most widely used business forms in the equine industry are the sole proprietorship, partnership and corporation, or variations of these three basic business forms. This Article will discuss the substantive aspects of several forms of business available to horse industry people and investors. Particular emphasis is placed on aspects of horse ownership rather than ownership of related assets such as a horse farm. However, the considerations discussed with respect to horse ownership are, in most cases, also applicable to ownership of other related assets.

I. SOLE PROPRIETORSHIP

A. *General Considerations*

A sole proprietorship exists when one person owns and manages an unincorporated business. This is the simplest form of doing business from both a legal and tax standpoint and, in many cases, the most advantageous. There are no formal requirements imposed upon this form of business.

The most important advantage available to a sole proprietor

* Partner in the firm of Graydon, Head & Ritchey in Cincinnati, Ohio. B.A. 1969, University of Cincinnati; J.D. 1972, Georgetown University.

** Partner in the firm of Graydon, Head & Ritchey in Cincinnati, Ohio. B.A. 1964, State University of Iowa; J.D. 1968, Georgetown University.

*** Partner in the firm of Graydon, Head & Ritchey in Cincinnati, Ohio. B.A. 1972, University of Dayton; J.D. 1975, Ohio State University.

is absolute control of business income, assets and management decisions. This is especially important in the horse industry. Many horse industry people have experienced the cumbersome nature of decision-making in joint ownership arrangements. What trainer to use, what show to attend, where to race, what stallion to breed to and whether to sell, show or race the horses produced are difficult decisions subject to controversy. Differing views concerning these matters often lead to deadlocks or disharmony among joint owners which can have disastrous consequences. For example, when an attractive stallion season (a one time, non-recurring right to breed a mare to a stallion) is available, it is available on a first-come, first-served basis. The delay resulting from efforts to obtain even one additional consent from a joint owner can result in a lost opportunity for the season.

B. *Succession*

The advantages of centralized management, however, can be lost unless adequate planning is made for the operation of the business during the disability, or after the death, of a sole proprietor. Without such planning, the business can disintegrate as a result of ineffective management during these crucial periods. Livestock must continue to receive proper care and feeding. Even if an individual owner is only a substantial investor rather than a farm operator, specific plans must be made to ensure that the individual's equine holdings are managed and sold in the most advantageous manner by a knowledgeable successor. Moreover, the proprietor also must provide adequate capital to maintain his or her holdings until the proper time for liquidation, often through insurance.

One can arrange for proper succession either by careful estate planning or by selecting and training a successor, or both. A will or trust or both should be prepared naming an executor or trustee, or an advisor to the executor or trustee, who has specific knowledge of the equine industry. In addition, the individual owner should acquaint his or her fiduciary with the business and instruct the fiduciary on how to dispose of the business assets.

C. *Capitalization and Tax Considerations*

A sole proprietor is totally responsible for the financial strength of the business. Thus, the sole proprietor must capitalize and maintain the business from his or her own resources or from third party financing for which he or she is personally liable. The cost of beginning and operating a racing, showing or breeding operation makes it difficult, if not impossible, for many individuals to participate as a sole proprietor. For example, the estimated costs to maintain a yearling thoroughbred race horse for two and one-half years through its three year old year is \$44,520, and the estimated costs to keep a thoroughbred broodmare and foal until the first foal is sold as a yearling is \$23,300. Both of these estimates are exclusive of the initial purchase price, interest and insurance.

This financial burden is often minimized by tax benefits to the sole owner. Start-up costs often produce losses which reduce the sole proprietor's overall tax liability, since those losses can be offset against the sole proprietor's income from an equine enterprise or against any other income he or she may receive during the tax year as part of his or her total income. Although other business forms also may provide significant tax benefits, a sole proprietor can accomplish his or her tax goals without having to consider the tax effect on any other co-owner.

A sole proprietor also faces certain tax disadvantages. Although the profits and losses of a sole proprietorship are included along with any other income and losses the sole proprietor may have, the income and expenses of the business must be accounted for separately and should be reported on a separate schedule. In addition, each separate asset of a sole proprietorship is treated separately for tax purposes. Thus, a sale of the entire business is treated as a sale of the various assets in determining gain or loss, and not as a sale of a single business interest, as would be the case when a partnership interest or a corporate interest is sold. Another tax disadvantage of choosing the sole proprietorship form of doing business is that the Internal Revenue Service (IRS or Service) is likely to challenge the operation as one not engaged in for profit, thereby disallowing business deductions as hobby-losses if those deductions, in total, exceed the profits from the equine business after other allowable deductions.

D. *Liability and Insurance*

Concerns, other than tax disadvantages, also face a sole proprietor. Since a sole proprietor is personally liable for all debts of the operation, all of the sole proprietor's assets, including non-horse assets, are subject to attack by creditors and other third parties. For example, if the sole proprietor has been required to obtain bank financing to support his or her endeavors and the business fails to service and retire the debt, the financial institution will look to all of the proprietor's assets. Similarly, the sole proprietor's assets are vulnerable to attack by third parties claiming property damage, or personal injury, or both.

Unless an equine sole proprietor can financially withstand claims for tortious liability, the proprietor is well advised to carry adequate liability insurance to protect assets. Even for the very wealthy adequate insurance coverage is a must, and the degree and type of one's involvement will dictate the extent of the insurance necessary.

Many individuals enter the horse business for their own pleasure or for the pleasure of their families. Under these circumstances a standard homeowners' or tenants' insurance policy that includes general liability coverage for personal injury and property damage would normally cover horse-related activities without any additional cost. But if the horse-related activities have become a business with a profit motive, then additional business liability insurance will be needed since there may be no coverage under the homeowners' policy. It is commonplace in the equine industry for one to undertake an equine endeavor for pleasure and later to expand the operation into a business. The high costs involved with owning and maintaining horses tempt individuals to defray such costs by increasing equine activity. For example, boarding the horses of other owners or taking advantage of the tax benefits of the equine industry may warrant recognition as a business. It is imperative for the sole proprietor to determine when the operation has become a business so that the necessary liability policies can be obtained.

The nature and extent of insurance required for the sole proprietor will depend upon the character of the horse operations. An individual who operates a breeding nursery, for example,

will require less insurance than an individual who operates a public riding and training stable. The operation should be periodically reviewed by the sole proprietor to determine the extent to which activities warrant insurance.

Although the standard business liability policy excludes coverage for injury to or death of horses in a person's care, insurance can be obtained to cover these situations. However, since the cost of this type of insurance can be prohibitive, a sole proprietor engaged in boarding or training horses owned by third parties may wish to have the owner execute a hold harmless agreement which, except for gross negligence on the part of the proprietor, insulates the proprietor from liability for injury or death to the horses in his or her custody. The agreement may also provide that the animal owner must carry his own insurance. In addition, a sole proprietor should give serious consideration to carrying an umbrella policy providing additional coverage.

II. JOINT OWNERSHIP AND SYNDICATION

A. *General Considerations*

Equine joint ownership occurs when two or more individuals own one or more horses and related assets as tenants in common. Each joint owner owns an undivided interest in the business assets rather than owning an interest in a third entity (such as a partnership or corporation) which in turn owns the property. The joint ownership vehicle is widely used in equine enterprises, perhaps because such arrangements may exist without any written or other formal agreements. The concept of owning an interest in horse stock without the entanglements of a more structured relationship historically has been attractive to many individuals who participate in the equine industry. When such arrangements are unstructured, however, difficulties in the decision-making process often arise.

B. *Tax Considerations*

With the exception of pure stallion breeding arrangements discussed below, most co-ownership forms of business are treated and taxed by the Internal Revenue Service (IRS) as partnerships.

Nevertheless, it is often desirable from the perspective of federal income taxation to be treated merely as a co-owner of property instead of as a partner. Co-ownership avoids the requirement of filing a partnership tax return as well as the complexity associated with statutory partnership rules. Furthermore, a co-owner may depreciate his or her interest under the depreciation method which best suits his or her needs. A partner, on the other hand, is bound by the method of depreciation adopted by the partnership, each partner reporting his or her respective share of partnership depreciation.¹ In addition, a partnership or corporation can, pursuant to tax depreciation rules, depreciate an asset only for the actual months that the partnership or corporation was in existence and operating with assets. In contrast, a co-owner of a horse who has been engaged in the horse business for a full tax year and who is currently engaged in such a business, is permitted to depreciate a new horse or other depreciable assets for the full year regardless of the actual month of purchase.

Another tax consideration is that one purchasing the interest of a co-owner receives more favorable tax treatment than one purchasing a partnership interest in the event the price of the purchased interest is greater than the seller's cost basis in that interest. Unless certain elections are provided for and taken by the partnership, the purchaser would be unable to take depreciation based upon his or her purchase price, but rather would be limited to taking depreciation based upon the seller's cost basis.²

Although the IRS has not ruled on the point, an analysis of relevant statutes and regulations indicates that a stallion syndicate is not a partnership for tax purposes where the owners of the stallion each have an undivided interest in the stallion coupled with the right to breed at least one mare to the stallion during each breeding season.³ However, if breeding services can be sold to the general public by the syndicate itself and if pooling of income from the services of the stallion is permitted, then the syndicate may be taxed as a partnership.⁴ Thus, if the stallion is ca-

¹ The rules respecting the taxation of partnerships are set out in I.R.C. Subch. K §§ 700-61 (1976 & Supp. IV 1980).

² I.R.C. §§ 743(b), 754 (1976).

³ See I.R.C. § 761 (West Supp. 1981) and regulations thereunder for a discussion of the definition of a partnership.

⁴ See I.R.C. § 761 (West Supp. 1981).

pable of servicing more mares than the number of syndicate shares outstanding, the syndicate manager should draw lots for the excess nominations rather than selling stud services to the general public and pooling the resulting income. In this way, when his or her number is drawn, each individual owner receives an extra breeding right to the stallion for that breeding year. The owner may then use that nomination or sell it and receive the proceeds from sale without causing the syndicate to be taxed as a partnership.

Joint ownership arrangements other than stallion syndications are more likely to be taxed as a partnership. For example, a syndicate which owns broodmares and sells the progeny from those mares is likely to be considered a partnership for tax purposes since the income from the sale of progeny is pooled and then divided among syndicate owners. Similar problems occur when a syndicate is formed to race or show the horses it owns.

Even if the co-ownership arrangement is determined to be a partnership, the co-owners can, in some circumstances, elect not to be taxed as a partnership. This election, however, is limited to those situations where operations are similar to a stallion syndication. Internal Revenue Code (I.R.C.) section 761 provides that such an election can be made only if the co-owners joined together for joint use of the property or joint production as opposed to selling services or products produced jointly.⁵ Thus, a syndicate set up to own broodmares and to sell the foals produced would not be eligible to elect against partnership tax treatment since the foals are being sold. It is unclear whether the sale of excess stud services by a breeding syndicate to third parties constitutes a sale of services which incurs partnership tax treatment.⁶ Whether a particular equine joint enterprise is eligible for such an election is a question of fact and difficult to predict.

C. *Management*

The use of the syndicate arrangement for owning and man-

⁵ *See id.*

⁶ Treas. Reg. § 1.761-2(a) (1972) makes it clear that "services" as used in I.R.C. § 761 (West Supp. 1981) refers to personal services. However, it is arguable that the breeding process might be considered a product when sold.

aging stallions is advantageous to both the original stallion owner and those purchasing interests in the stallion for breeding purposes. The original stallion owner is able to raise capital, spread the risk of the stallion being unsuccessful at stud among the syndicate owners, improve the quality of the mares being bred to the stallion,⁷ insure that the stallion's book remains full⁸ (at least in the early years) and, in most cases, retain a part interest in the horse. Each purchaser of an interest in the stallion will be permitted to breed one or more mares of the purchaser's choice to the stallion during each breeding season. The purchaser does not need to be involved with the complexities of management of the stallion since syndicate owners typically vest management in the hands of the syndicate manager, who characteristically has the experience needed to manage a stallion successfully.

III. JOINT VENTURE AND PARTNERSHIP

Joint venture and partnership vehicles have been widely used in the equine industry. Discussed below are various aspects of joint ventures, general partnerships and limited partnerships, both public and private.

A. *Joint Venture*

A joint venture is a business structure similar to the partnership (and taxed as such) but typically narrower in purpose and scope.⁹ This business form is often used when state statutes prohibit operation of a business as a partnership or when the parties desire something less than the mutual agency relationship between associates which is characteristic of a general partnership.¹⁰ A joint venture is formed when two or more persons or en-

⁷ No single owner or farm has a sufficient number of mares that should be bred to a certain stallion. This is especially true when a major stakes class stallion is being retired to stud. Each share owner will breed the mare which he or she believes is best suited for the stallion.

⁸ Today a stallion which is syndicated in 40 shares will have 44 mares bred to him in any breeding season. These mares constitute the stallion's book.

⁹ W. REUSCHLEIN & H. GREGORY, *HANDBOOK ON THE LAW OF AGENCY AND PARTNERSHIP* 442 (1979).

¹⁰ *Id.* at 441-42.

tities join as co-owners of a business enterprise to carry out a particular venture rather than to carry on a business as would be the case with a partnership.¹¹ Thus, a joint venture normally contemplates a single transaction or a related series of transactions and short periods of association.¹² For example, a joint venture could be used to purchase a stallion for the specific purposes of a resale through syndication.

In many cases it is difficult to distinguish between a joint venture and a partnership unless the parties state the nature of their enterprise in a written agreement. The agreement should explicitly state an intent to limit the arrangement to a certain transaction or series of transactions. Nevertheless, the following discussion relative to general partnerships will in most cases also apply to joint ventures.

B. *General Partnership*

1. *General Considerations*

A partnership has been defined as an association of two or more persons who are co-owners of a business.¹³ Partnerships are widely used in the equine industry because they enable participants to meet the high costs associated with the initial purchase of horses and related assets, as well as on-going maintenance expenses. Two or more individuals can pool resources to buy higher quality horses in greater numbers, thereby increasing chances for success.

A well drafted equine partnership agreement should provide for a division of management authority among the partners commensurate with each individual partner's talent and experience.¹⁴ For example, if one of the partners has expertise as a race horse or show horse trainer, the partnership agreement should delegate to

¹¹ 1 Z. CAVITCH, *BUSINESS ORGANIZATIONS* § 13.05[1] (1982); W. REUSCHLEIN & H. GREGORY, *supra* note 9, at 442.

¹² W. REUSCHLEIN & H. GREGORY, *supra* note 9, at 442.

¹³ Bristow, Jr., *Legal Considerations in the Incorporation Process*, 4 BLACK L.J. 59, 61 (1974).

¹⁴ See generally, 1 Z. CAVITCH, *supra* note 11, at § 14.05[2]; Bristow, Jr., *supra* note 13, at 63; O'Connor, *Selection of the Form of Business or Professional Organization: A Need for Clairvoyance*, 56 TAXES 880, 882 (1978).

that partner decision-making responsibilities relating to his or her expertise. The remaining partners should retain general decision-making authority.

2. *Advantages of the Partnership Form of Business*

The partnership form of business has many advantages. Equine partnerships can allocate profits and losses among partners, thereby creating certain tax benefits which may accrue to members of the partnership.¹⁵ The high costs incurred by the partnership in early years makes allocation particularly advantageous. A partnership may be formed by individuals having different financial needs and goals throughout the duration of the partnership. Losses in early years may be beneficial to certain partners and the partnership agreement can allocate those losses accordingly. This is often the situation in equine partnerships, which frequently attract venture capitalists both with and without horse experience because of the available tax advantages. While the horse enthusiast brings to the partnership the experience needed for the partnership's success and, in most cases, does not need the tax shelter that the business provides, the investor is enticed into providing needed capital because he or she can realize an immediate return on his or her investment as a result of tax benefits. Thus, the allocation of profits and losses is often the essential ingredient for a successful relationship. Such allocations could not be achieved through the corporate form of business.

In addition to tax benefits, a partnership typically has more flexibility than a corporation because there are fewer statutory restrictions on partnerships.¹⁶ Moreover, the formation costs for a partnership are normally lower than the costs of forming a corporation. Furthermore, a business formed as a partnership can be converted to a corporation on a tax free basis if this should become advantageous.¹⁷

¹⁵ See generally 1 Z. CAVITCH, *supra* note 11, at §§ 5.02[3], 10.02[3]; W. REUSCHLEIN & H. GREGORY, *supra* note 9, at 264-65.

¹⁶ See generally Lehrman, *Should You Incorporate?*, 4 TEX. S. U.L. REV. 66, 67 (1976); O'Connor, *supra* note 14 at 882.

¹⁷ See Lehrman, *supra* note 16, at 69-70.

3. *Disadvantages of the Partnership Form of Business*

As with the sole proprietorship and joint ownership forms of business, the major disadvantage of the partnership form is individual liability for claims against the partnership.¹⁸ Thus, the insurance needs of a partnership are greater than those of a corporation. Partners have individual, unlimited joint and several liability for tort claims against the partnership, are jointly and severally liable for the wrongful acts of co-partners committed in the course of the partnership business and are jointly liable for all other partnership debts.¹⁹ Furthermore, the dissolution of the partnership does not discharge the existing liability of any partner.²⁰

Another disadvantage to the partnership form of business is that there is often no mechanism for decision-making. Frequently, decision-making is by committee, leading to deadlocks and disharmony at crucial times when delay can have serious negative effects on the partnership.²¹ For example, if a partnership is formed to claim and race horses, the decision of which horse to claim will often have to be made immediately after notification that the horse has been entered into a race. If decision-making is by committee, the opportunity to claim a desirable horse can pass before a decision is reached by the partnership. Thus, unless the partnership agreement delegates the authority for decision-making to qualified partners, the partnership form may be too cumbersome for certain equine investments.

4. *Partnership Agreements*

In order to assure optimum benefits from the equine partnership, the partnership agreement should include certain provisions. First, the agreement should provide, if appropriate, that

¹⁸ See, e.g., Bristow, Jr., *supra* note 13, at 61; Lehrman, *supra* note 16, at 68; O'Connor, *supra* note 14, at 881.

¹⁹ O'Connor, *supra* note 14, at 881; UNIF. PARTNERSHIP ACT §§ 13-15, 6 U.L.A. 163, 173-74 (1969).

²⁰ W. REUSCHLEIN & H. GREGORY, *supra* note 9, at 357; UNIF. PARTNERSHIP ACT § 36(1), 6 U.L.A. 436 (1969).

²¹ W. REUSCHLEIN & H. GREGORY, *supra* note 9, at 275-76.

management of specialized aspects of the business should be delegated to partners with specialized knowledge or talents. In any event, the assent of all the partners should be required to contract for a sale of horses owned by that partnership. Similarly, if a partnership is in the business of racing horses, unanimous agreement of the partners should be required to enter any horse in a claiming or sellers' race unless the partnership was formed to run horses which typically would be of claiming caliber.

Second, the agreement should address what is to occur upon the death, retirement, withdrawal or expulsion of a partner from the partnership.²² The agreement should provide that under those circumstances the partnership will continue unless all remaining partners consent to termination of the partnership.²³ In the event a partner wishes to retire or withdraw from the partnership or in the event of a partner's death or expulsion, the agreement should provide a mechanism for determining the value of the partner's share at that time, and the manner in which that partnership interest will be purchased.²⁴

In an equine partnership, the value of the partner's interest will primarily be fixed by the value of the assets. These assets will often consist predominantly of horses owned by the partnership. It may be impossible to reach an agreement as to the value of the horses at the time of the death, retirement, withdrawal or expulsion of a partner. Accordingly, the partnership agreement should provide a method of ascertaining the value of the terminating partner's share. For example, the agreement could provide for appraisal of partnership assets by one or more appraisers recognized as blood stock agents or equine professionals. The agreement also should provide that the terminating partner's interest shall be purchased over a specified period of time rather than immediately. Immediate payment could force the partnership to sell its horses at a disadvantageous time.

²² The Uniform Partnership Act lists the causes of dissolution of a partnership, among which is death of any partner. UNIF. PARTNERSHIP ACT § 31(4), 6 U.L.A. 376 (1969). However, the partnership agreement may provide otherwise.

²³ See generally W. REUSCHLEIN & H. GREGORY, *supra* note 9, at 351-52.

²⁴ For a general discussion of the Uniform Partnership Act's treatment of the rights of a retiring or deceased partner, see W. REUSCHLEIN & H. GREGORY, *supra* note 9, at 361-70.

C. *Securities Law Considerations*

Many horsemen have the mistaken impression that securities laws are applicable only to the stock of publicly-traded corporations such as those listed on the national stock exchanges. However, significant securities laws issues are involved in co-ownerships, syndicates, joint ventures and general and limited partnerships. Thus, a critical element in choosing an appropriate form of equine joint ownership is whether the ownership interest constitutes a "security" for the purposes of federal and state securities laws.²⁵

The evaluation of each of the equine business forms from a securities law point of view involves a two step approach: first, a determination of whether the ownership interest involved is a "security" under the federal or state securities laws and, second, if the interest is a security, evaluation of the consequences of such a characterization. Federal and state securities laws generally prohibit the offer or sale of a security without registration under, or exemption from, such laws and (regardless of registration or exemption) impose significant and unique anti-fraud and civil liability remedies.

To the surprise of many unwary joint owners and their attorneys, various forms of business organization prevalent in the horse industry today can, if not properly structured, constitute a security under the federal or state securities laws. The Securities Act of 1933 defines a security as follows:

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the forego-

²⁵ See Campbell, *Stallion Syndicates as Securities*, 70 Ky. L.J. 1131, (1981-82) (in print) for a discussion of securities as they relate to stallion syndicates.

ing.²⁶

The definition does not contain a direct reference to a joint ownership, joint venture, syndicate or partnership interest. However, the term "investment contract" may be construed to include such ownership interests. Because the term "investment contract" is not defined in the statute, one must refer to recent decisions of the federal courts, particularly the United States Supreme Court, for guidance on the question of whether any particular relationship constitutes an "investment contract" and therefore a security.

Early court decisions grappling with the "investment contract" concept established that the term would be given a very broad reading, and that the characterization of the investment as the direct ownership of certain underlying assets, such as real estate, rather than the ownership of an interest in an entity which owns the underlying asset, was not determinative.²⁷

The United States Supreme Court, in *SEC v. W.J. Howey Co.*,²⁸ announced what has become the classic definition of an investment contract. The Court stated:

[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.²⁹

²⁶ Securities Act of 1933, § 2(1), 15 U.S.C. § 77(b)(1) (1976). The definition of "security" contained in the Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1976) (which is the definition of security generally applicable to federal securities anti-fraud matters), is very similar, and insofar as it pertains to investment contracts is "virtually identical." *Tcherepnin v. Knight*, 389 U.S. 332, 335-36 (1967). State securities statutes generally contain a similar reference to an investment contract. *See, e.g.*, KY. REV. STAT. ANN. § 292.310(13) (Bobbs-Merrill 1981) [hereinafter cited as KRS]; UNIF. SECURITIES ACT § 401(1), 7A U.L.A. 628 (1978). Indeed, many of the state securities acts predate the Securities Act of 1933 and the federal definition of "security," including its "investment contract" element, was drawn from such state statutes and the cases interpreting them. *See, e.g.*, *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

²⁷ *See, e.g.*, 320 U.S. at 352.

²⁸ 328 U.S. at 293.

²⁹ *Id.* at 298-99.

Today, almost forty years later, the *Howey* test still determines, for the most part, whether an interest is an "investment contract." Although many cases have interpreted the particular elements of the *Howey* test, a common thread running through all such decisions has been that the economic substance and reality of the transaction, rather than the form or nomenclature used, should control the determination of whether the particular investment constitutes an "investment contract."³⁰

As it applies to the forms of co-ownership prevalent in the horse industry, the critical element of the *Howey* test is the last element, that is, that the expectation of profits must come solely from the efforts of others. Based upon this aspect of the *Howey* test, a substantial amount of lore has developed suggesting that co-ownerships, syndications or general partnerships do not meet the "solely from the efforts of others" test and are thus not securities. However, a review of case law reveals that such a conclusion is seriously flawed.

Numerous cases have discussed the "solely from the efforts of others" test and have determined that the test should not be literally applied. The Ninth Circuit Court of Appeals has perhaps been most direct:

We hold, however, that in light of the remedial nature of the legislation, the statutory policy of affording broad protection to the public, and the Supreme Court's admonitions that the definition of securities should be a flexible one, the word "solely" should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not in form, securities

. . . . Rather we adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.³¹

The Fifth Circuit Court of Appeals recently afforded even

³⁰ See 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 4.6 (314) at 82.3-82.4; 4 *Id.* at NM: 25-26 (1982) and cases cited therein.

³¹ SEC v. Glenn V. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973).

more practical guidance in *Williamson v. Tucker*.³² In *Williamson*, the court considered whether an interest in a joint venture which owned real estate constituted a security under applicable federal and state law. In analyzing the *Howey* "solely" test the court focused on the power retained by the investor to exert efforts or control over the key profit-making aspects of the venture rather than the *actual* efforts or exercise of control. The court concluded that in cases where the investor held a direct fractional interest in the particular asset which is the subject of the investment, "[s]o long as the investor has the right to control the asset he has purchased, he is not dependent on the promoter or on a third party for 'those essential managerial efforts which affect the failure or success of the enterprise.'"³³ Thus, the interest is typically not a security.

The court noted that in cases involving indirect interests, such as general partnerships and joint ventures, the analysis is normally more complex. As a general rule, partnership and joint venture interests are not investment contracts because the nature of a general partnership or joint venture is one in which the parties, absent an agreement to the contrary, have equal proportionate control over the business. Mindful, however, of the Supreme Court's repeated emphasis that substance rather than form controls, the *Williamson* court qualified its broad conclusion:

[T]he mere fact that an investment takes the form of a general partnership or joint venture does not inevitably insulate it from the reach of the federal securities laws. All of these cases presume that the investor-partner is not in fact dependent on the promoter or manager for the effective exercise of his partnership powers. If, for example, the partner has irrevocably delegated his powers, or is incapable of exercising them, or is so dependent on the particular expertise of the promoter or manager that he has no reasonable alternative to reliance on that person, then his partnership powers may be inadequate to protect him from the dependence on others which is implicit in an investment contract.³⁴

³² 645 F.2d 404 (5th Cir. 1981).

³³ *Id.* at 421.

³⁴ *Id.* at 422-23.

The court emphasized several factors which would indicate that the investor is dependent on the efforts of others despite a formal agreement suggesting theoretical control or independence. But, cognizant of the practical situations in which partners or joint ventures *delegate* their management control, the court emphasized that so long as the investor can exercise ultimate control, the *actual* reliance on others for management services is not sufficient to create an investment contract. It concluded:

A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.³⁵

Application of these cases to the myriad of business forms being used in the horse industry indicates that the traditional response, that general partnerships, joint ventures and other similar forms of co-ownership are not securities, is no longer sufficient. A more detailed analysis based upon *Howey* and its progeny is required. Although the forms of co-ownership, general partnership and joint venture prevalent in the horse industry generally satisfy the initial tests of an investment contract because these forms involve the investment of money in a common enterprise with the expectation of profits, the critical element is whether such profits are to be derived from the entrepreneurial or management efforts of others. Thus, in forming a venture on behalf of an owner or promoter or in reviewing the venture on behalf of a prospective investor, it is no longer sufficient to merely note that the form of the venture is not one which has typically been characterized as a security. Particular care must be taken to

³⁵ *Id.* at 424.

insure that the venture grants to all participants the right to actively and fully co-manage the business, including ready access to key information. If any type of managing agent or managing partner is used, the controlling documents should provide that the managing agent may be easily changed and that the managing agent's responsibility is limited to day-to-day administrative matters rather than policy or managerial decisions.

As *Williamson* indicates, provisions in the agreement are not necessarily determinative of whether an ownership interest is cast as a security, but rather actual circumstances of the venture must be examined. The same documents which would not constitute a security among investors who are experienced in and knowledgeable of the horse industry (and thus capable of exercising the powers granted to them in the document) could constitute a security when the investors are, by virtue of their inexperience or lack of knowledge, unable to exercise their management right. The same business venture in which a few knowledgeable, experienced investors participate and which is properly classified as not involving a security, could, when expanded to include a larger number of knowledgeable, experienced investors, be held to be a security. The existence of multiple investors, no matter how theoretically active they might be, could force dependence on others for profit.

The practical result of the application of the securities laws to the various forms of joint activity prevalent in the horse industry is to reduce the scope of such ventures beyond that which may be desired by either the promoter or the investor. Any venture which consists of "passive" investors, inexperienced horsemen, or more than a few participants personally known by the promoter runs the risk, no matter how structured, of being recast as a security.

D. *Limited Partnership*

1. *General Considerations*

A limited partnership is a partnership composed of one or more general partners and one or more limited partners.³⁶ Lim-

³⁶ UNIF. LIMITED PARTNERSHIP ACT § 1, 6 U.L.A. 562 (1969).

ited partners are responsible for the debts of the limited partnership only to the extent of their contribution, while general partners incur unlimited liability.³⁷

The limited partnership arrangement has gained wide acceptance in the equine industry. Such an arrangement, in the form of either a private or public offering, enables a general partner to raise capital needed to purchase and maintain horses throughout their racing, showing or breeding career. At the same time, a limited partnership arrangement enables the general partner to offer one or more limited partners an interest in a higher caliber or greater number of horses than the limited partners could individually own and maintain. This ownership vehicle also lessens the risks inherent in the horse business by spreading risks over a greater number of partners and permitting partners to own more than one horse. In addition to these advantages, the limited partnership arrangement permits a limited partner to reduce his or her liability exposure from the outset.³⁸

2. State Regulation

State statutes generally afford a limited partner immunity from debt liability, at least to the extent that such liability exceeds the limited partner's capital contribution.³⁹ In return, limited partners must refrain from participation in control or management of the partnership.⁴⁰ The general partner, on the other hand, has power to manage the business but unlimited personal liability.⁴¹

In contrast to the general partnership, a limited partnership

³⁷ See, e.g., Bristow, Jr., *supra* note 13, at 61. Of course, the limited partner's liability is so limited only if proper statutory requirements are met and certain rules, such as nonparticipation in active business management, are observed. See Bristow, Jr., *supra* note 13, at 61; UNIF. PARTNERSHIP ACT § 7, 6 U.L.A. 38 (1969).

³⁸ For a discussion of limited partnerships, see W. REUSCHLEIN & H. GREGORY, *supra* note 9 at 433-38.

³⁹ See UNIF. LIMITED PARTNERSHIP ACT §§ 7, 17; 6 U.L.A. 582, 601 (1969). The Uniform Limited Partnership Act has been adopted by most states, and, therefore, limited partners in these jurisdictions are immune from debt liability in excess of their capital contribution.

⁴⁰ *Id.* § 7.

⁴¹ *Id.* § 9.

can be formed only by virtue of statutes that typically require a certificate be filed in the records of the state within which the partnership will operate.⁴² The requirements for limited partnership formation and selling of partnership interests are strictly regulated by statute, and failure to comply with any of the requirements could result in treatment as a general partnership.⁴³ All partners would then be held jointly and severally liable for the claims of partnership creditors and third parties damaged as a result of partnership conduct.⁴⁴

Although limited partnerships continue to gain acceptance in the horse industry, equine limited partnerships comprised of numerous partners, especially those partnerships structured to engage in thoroughbred racing, face several potential difficulties. Currently, several states restrict the maximum number of owners of a race horse. Other states such as Kentucky limit the number of individual owners, but allow corporations, partnerships and other multiple ownership vehicles to own and race horses provided the group designates a member to represent the entity.⁴⁵ The general mood, however, suggests that the rules will have to be relaxed to accommodate most, if not all, multiple ownership vehicles.

3. Tax Considerations

A partnership, either general or limited, is not taxed as an entity. Income deductions and other tax items are passed through to the partners, with the partnership acting as a mere conduit.⁴⁶ This is true whether or not partnership income is distributed to the partners or retained by the partnership. Nevertheless, an informational return must be filed by the partnership. The losses

⁴² *Id.* § 2.

⁴³ W. REUSCHLEIN & H. GREGORY, *supra* note 9, at 434 & n.59.

⁴⁴ See notes 18-20 and accompanying text *supra* for a discussion of the unlimited liability of the partners in a general partnership.

⁴⁵ 4 KY. ADMIN. REGS. 1.007 (1982).

⁴⁶ Losses are subject to the "at risk" rules under I.R.C. § 465 (1976 & Supp. IV 1980). They limit deductions relative to a business activity to an amount an individual has at risk, which is basically the amount he could lose. These rules apply not only to individuals but also to partnerships, Subchapter-S corporations and defined closely-held corporations.

each partner may take are limited by the basis each partner has in his partnership interest decreased by losses deducted and increased by income charged to the partner but not distributed. The "at risk" rules also apply on a partner by partner basis.⁴⁷

Special allocations of profit and loss are often set forth in limited partnership agreements. These allocations will be allowed for tax purposes provided the allocation has a "substantial economic effect" independent of tax effects.⁴⁸ Although neither the Code nor the regulations define this phrase, it would appear that if the partners' capital accounts are affected by the allocation so that one partner receives more benefit than another, the allocation will have a substantial economic effect.

4. *Securities Considerations*

Limited partnership interests, whether distributed publicly or privately, have generally been held to be investment contracts and therefore are clearly securities.⁴⁹ Thus, a promoter trying to select the proper vehicle to operate his horse venture can either structure the venture to fit into one of the exemptions from federal and state securities registration or register the offering with the Securities and Exchange Commission (SEC) and with the various states in which the offering is to be sold. While a fully registered public offering has certain advantages, the registration process is costly and time consuming and thus generally appropriate only for offerings which seek to raise larger amounts of money. Because of such costs and delays, most promoters attempt to structure the offering into one of the five exemptions from federal registrations.

a. *Intrastate Offering*

The intrastate exemption⁵⁰ exempts from registration any security which is a part of an issue offered and sold only to persons

⁴⁷ See I.R.C. §§ 701-61 (1976 & Supp. IV. 1980).

⁴⁸ I.R.C. §§ 704(b)(2) (1976).

⁴⁹ See 1A A. BROMBERG & L. LOWENFELS, *supra* note 30, at § 4.6 (330)-(332); 1 L. LOSS, *SECURITIES REGULATION* 503-06 (2d ed. 1961).

⁵⁰ Securities Act of 1933, § 3(a)(10), 15 U.S.C. § 77c(a)(11) (1976).

who are residents of the same state in which the issuer of such security resides and does business.

In 1974, the SEC promulgated Rule 147⁵¹ defining the terms used in the statute creating the intrastate exemption and creating a "safe harbor" for offerings which meet all the requirements of the rule. It is possible to conduct an offering without conforming precisely to the requirements of Rule 147 and still qualify for the intrastate exemption. However, most practitioners rely on the rule because it codifies numerous cases and releases.

A detailed analysis of Rule 147 is beyond the scope of this Article, but it should be noted that everything associated with the offering must be intrastate. The issuer must be organized and have its principal place of business in the state, derive 80% of its gross revenues, maintain 80% of its assets and use 80% of the proceeds from the offering within the state. Additionally, all of the offerees and purchasers of the securities must be residents of the state. These restrictions are generally too burdensome for most horse racing or breeding ventures which need the flexibility to race, train or sell the offspring in more than one state. Thus, the exemption generally is not available as a practical matter to most horse ventures.

b. *Private Placements*

The "private placement" exemption created by section 4(2) of the Securities Act of 1933⁵² exempts from registration those "transactions by an issuer not involving any public offering." Case law interpreting the exemption, beginning principally with *SEC v. Ralston Purina Co.*,⁵³ has placed severe limits upon the use of the exemption. These cases limited the persons to whom offers or sales could be made under the private placement exemption to persons who were able to fend for themselves and who had access to the same kind of information as would be provided by a registration statement filed with the SEC. The cases led many commentators and practitioners to conclude that reliance

⁵¹ 17 C.F.R. § 230.147 (1981).

⁵² 15 U.S.C. § 77d(2) (1976).

⁵³ 346 U.S. 119 (1953).

on the private placement exemption for anything other than corporate insiders and institutional investors was hazardous.

In an effort to provide certainty in the use of the private offering exemption, the SEC promulgated Rule 146.⁵⁴ Rule 146 limited eligible offerees to those persons meeting certain sophistication and net worth tests, required the offering to be conducted in a nonpublic manner, and required that the offerees have access to the same kind of information that would be provided under a full registration statement. Other than offerees who by the nature of their position with the issuer or who as a result of their economic bargaining power did not require such information, the information requirement could be satisfied only by furnishing the offerees with information essentially equivalent to that which would be provided under the applicable form or registration statement which the issuer would use if the offering were registered with the SEC. Additionally, the offering was restricted to no more than thirty-five purchasers; however, purchasers of more than \$150,000 of securities were not counted in determining the thirty-five purchaser requirement.⁵⁵

Rule 146 was recently rescinded and Rule 506,⁵⁶ part of new Regulation D, was substituted for it. Rule 506 exempts offerings from registration without any maximum dollar limitations, provided the offerings meet the general requirements of Regulation D, the purchasers meet certain sophistication tests, and certain informational requirements are met. Regulation D limits the manner of offering, prohibits any general solicitation, restricts resales of the securities and requires the filing of a post-sale notification form. Rule 506 additionally restricts the basic number of purchasers to thirty-five, but "accredited investors" are not counted in determining this limit. The definition of an "accredited investor" may be of particular help to the promoter since it includes not only purchasers of \$150,000 or more of the security, but also persons who meet certain net worth or income requirements.⁵⁷ Moreover, Rule 506 also requires that only purchasers,

⁵⁴ 17 C.F.R. § 230.146 (1981).

⁵⁵ *Id.*

⁵⁶ 46 Fed. Reg. 11,266 (1982) (to be codified at 17 C.F.R. § 230.506).

⁵⁷ 17 C.F.R. § 230.5 (1981).

as opposed to *both* offerees and purchasers, meet the sophistication standard.⁵⁸ The single sophistication test replaced the dual standard of sophistication and ability to withstand the economic risks of the investment required by former Rule 146. The informational requirement for new or promotional investments, typical in the horse business, has remained largely unchanged from that of Rule 146 other than the requirement for certain financial statements. Anyone other than accredited investors purchasing the offering must be furnished with the same kind of information as would be required by the applicable form of federal registration statement. Rule 506, like its predecessor, Rule 146, will be a useful exemption from registration; however, the information requirement will make the exemption costly and thus suitable only for larger offerings.

c. *Rule 505*

Rule 505,⁵⁹ recently enacted as part of Regulation D, provides an alternative exemption from registration. Unlike Rule 506 and its predecessor, Rule 505 is not a rule which interprets the private placement exemption. Rule 505 was promulgated pursuant to the SEC's authority to create exemptions for offerings up to a maximum dollar limitation set by statute, currently \$5,000,000. Rule 505 allows the issuer to sell up to \$5,000,000 in securities to a maximum of thirty-five investors plus unlimited accredited investors. The information requirements are identical to those contained in Rule 506, but unlike Rule 506, the purchasers do not have to meet any sophistication test.

Rule 505 should prove to be a useful exemption for limited partnerships engaged in various forms of equine business. The \$5,000,000 maximum limitation should be less than the maximum capitalization of many horse ventures. Of critical importance to the horse industry is the fact that unlike its predecessor, Rule 505 is available for use by a limited partnership.⁶⁰ Like Rule

⁵⁸ 46 Fed. Reg. 11,266 (1982) (to be codified at 17 C.F.R. § 230.506).

⁵⁹ 46 Fed. Reg. 11,266 (1982) (to be codified at 17 C.F.R. § 230.505).

⁶⁰ See SEC Regulation D Limited Offering Exemption, SEC Release No. 33-6389 (Mar. 8, 1982).

506, the information requirements are burdensome and thus suitable only for larger offerings.

d. *Rule 504*

Rule 504,⁶¹ also enacted as part of Regulation D, is a complete exemption from federal registration for offerings under \$500,000. Unlike Rules 505 and 506, there is no limitation on the maximum number of purchasers, nor is there a specific information requirement. Thus, the principal limitations imposed upon Rule 504 offerings are those limitations common to all Regulation D offerings.

Rule 504 could be of assistance to promoters of horse ventures, although it remains to be seen whether the maximum offering limitations are too restrictive for Rule 504 to be of practical benefit. Additionally, the lack of a strict information requirement may be advantageous. However, the antifraud requirements of all securities laws have the practical impact of imposing informational requirements which are at least analogous to, if not duplicative of, those imposed by Rules 505 and 506.

e. *Section 4(6) Placements*

In 1980, Congress amended the Securities Act of 1933 to add Section 4(6),⁶² which exempts from registration certain offerings made on a private basis only to accredited investors. While the exemption may have had some significance prior to promulgation of Regulation D, as a practical matter Rule 506 duplicates all the major requirements of Section 4(6).

It is important to note that the five major exemptions listed above are exemptions from registration with the SEC. Compliance with any of the exemptions does not constitute compliance with applicable state securities statutes nor the state and federal antifraud rules. The statutes of each state in which the offering is made must be consulted. Although there has been some effort to coordinate state and federal exemptions, particularly following

⁶¹ 46 Fed. Reg. 11,266 (1982) (to be codified at 17 C.F.R. § 230.504).

⁶² See generally Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (codified in scattered sections of 15 U.S.C.).

the promulgation of Regulation D, these efforts are just beginning. Thus, offerings which are exempt from federal registration still face a maze of various state requirements.

IV. CORPORATIONS

Whether a horse enterprise should be operated as a corporation depends largely upon its need for limited liability, access to additional capital and sophisticated management. In addition, one must determine whether the corporation should be formed as a private or public corporation and whether to elect Subchapter S tax treatment.

A. *Private Closely Held Corporations*

In closely held corporations, management is vested in the hands of beneficial owners, typically consisting of a small group of individuals.⁶³ A recent trend in state statutes has been to soften the impact on closely held corporations of the formalities and requirements which corporations must generally observe. These closed corporation statutes permit closely held corporations to operate with a limited number of directors⁶⁴ and to enter into stock transfer restriction agreements. Where multiple shareholders own the stock of a closely held corporation, the transfer of stock should be restricted so that stock can be transferred only to the corporation or the remaining stockholders. In this way the shareholders can determine with whom they desire to be in business.

The need for limited liability has traditionally been the motivating factor in the decision to incorporate a specific horse business.⁶⁵ If the particular business—a riding stable, for example—

⁶³ 5A Z. CAVITCH, *supra* note 11, at § 108A.01.

⁶⁴ See DEL. CODE ANN. tit. 8, §§ 341-56 (1974); ILL. ANN. STAT. ch. 32, §§ 1201-16 (Smith-Hurd Supp. 1981); MD. CORPS. & ASS'NS CODE ANN. §§ 4-101, -603 (1975 & Supp. 1981); 5A Z. CAVITCH, *supra* note 11, at § 108A.02[1]. Also, some states have added provisions to their existing corporation statutes which are of help to closed corporations. *E.g.*, N.J. STAT. ANN. §§ 14A: 1-1 (West 1969); N.Y. BUS. CORP. LAW § 620 (McKinney 1963 & Supp. 1981). See generally 5A Z. CAVITCH, *supra* note 11, at § 108A.02[1].

⁶⁵ 5A Z. CAVITCH, *supra* note 11, at § 108A.01; Bristow, Jr., *supra* note 13, at 61; Lehrman, *supra* note 16, at 69.

exposes the individual participants to substantial risks, then incorporation can protect the investors' personal assets by limiting owners', officers' and directors' liability. However, all applicable local, state and federal corporate laws must be complied with to insure that the corporate entity will be recognized, thus preventing actions from being brought directly against the corporate principals.⁶⁶

The corporate form of business can also be highly efficient in raising additional capital for the enterprise.⁶⁷ Although this is particularly true for public corporations, it also is true on a smaller scale with respect to closely held corporations. In contrast to a partnership, a corporation can utilize different classes of stock to assist in obtaining capital.⁶⁸ Preferred stock can be offered to attract investors without causing harm to the initial shareholders, for the interests in the corporation of those initial shareholders can be protected through the exercise of preemptive rights.⁶⁹

Corporate stock is a security for the purposes of the federal and state securities statutes. Thus securities law considerations of a non-public or closely held corporation are substantially the same as those discussed in reference to limited partnerships.

The transferability of stock is one of the most significant reasons to incorporate.⁷⁰ Yet the smaller the group of shareholders, the less likely the stock will be marketable and each shareholder may have to rely on the corporation or fellow shareholders to purchase the stock when ownership is terminated.⁷¹ Moreover, because the risks associated with the horse industry are great, the transferability of the corporate stock of a closely held corporation will nearly always be limited. Thus, the decision by one or more shareholders to offer stock for sale may force a dissolution of the corporation and the sale of its assets, since the corporation may have insufficient assets or lack necessary borrowing capacity to satisfy obligations to purchase the selling

⁶⁶ Bristow, Jr., *supra* note 13, at 61-62.

⁶⁷ *Id.* at 63. *Accord* Lehrman, *supra* note 16, at 69.

⁶⁸ 5A Z. CAVITCH, *supra* note 11, at § 108A.03[1][d].

⁶⁹ *Id.* at § 108A.03[1][e], [f].

⁷⁰ *Id.* at 108A.02[2][a].

⁷¹ *Id.* at § 108A.01.

shareholder's stock. This can be particularly bothersome and detrimental in the equine industry if such a decision is made at the wrong time, since timing of the sale of the horses themselves can play an extremely important role in whether or not the corporation realizes full value on liquidation of assets. Accordingly, the remaining shareholders may be left with only two alternatives: purchase the selling shareholder's stock or liquidate the corporation and sell its assets. Therefore, the selling shareholder should be obligated by a stock purchase agreement to wait a reasonable time to receive the proceeds from the sale of the stock.

B. *Subchapter S Corporations*

A domestic corporation, not a member of an affiliated group of corporations, with thirty-five or fewer shareholders comprised of individuals, estates or certain trusts, and with only one class of stock, can elect to be treated as a "Subchapter S" or "tax-option" corporation.⁷² Such a corporation is not subject to corporate tax and accordingly the problem of double taxation is avoided. In a Subchapter S corporation, earnings other than capital gains are taxed to the shareholders as dividends, whether distributed or not, and the tax bracket of each shareholder determines the amount of tax liability. Losses generally are passed through to the shareholders, limited only by the shareholder's basis in the stock. Like a partnership, the basis in a Subchapter S corporation is increased by earnings charged to the shareholder but not distributed, and decreased by any losses passed through to a shareholder. The "at risk" rules also apply.⁷³

In addition to the tax advantages of electing Subchapter S treatment, a Subchapter S corporation, like any other corporation, has other desirable attributes such as limited liability and centralized management. However, an electing corporation must follow numerous I.R.C. restrictions in order to continue to qualify for Subchapter S treatment. Failure to comply with those restrictions can result in unexpected and unplanned tax liability.

⁷² I.R.C. § 1371(a) (1976 & Supp. IV 1980).

⁷³ See note 45 *supra* for a discussion of the "at-risk" rules of I.R.C. § 465.

C. *Public Corporations*

Like limited partnerships, equine public corporations are gaining popularity because they are an effective capital raising mechanism, while still providing investors with limited liability.

There are, however, disadvantages to public offerings. A public corporation can face numerous licensing restrictions imposed by state racing commissions, which have not yet resolved the multiple ownership issue. Thus, current public equine proposals are concerned with breeding and selling operations rather than racing operations.

The issuance of stock of publicly held corporations requires full registration with the SEC and full compliance with applicable state blue sky securities laws. This is a complex, time-consuming and costly process and generally is cost effective only when several million dollars are being raised.⁷⁴ The periodic reporting requirement, proxy rules, short swing profit limitation and general disclosure requirements which generally result from a public offering of securities should be carefully considered prior to making any such offering.⁷⁵

Unlike a private or public limited partnership, a corporation is not a conduit of tax benefits from the corporation to the investor. Thus, a corporation, other than a Subchapter S corporation, is unable to pass through to the individual investor any losses generated by the business. Furthermore, corporate profits are subject to double taxation because those profits are taxed at the corporate level and then again after distribution to the investor.⁷⁶

⁷⁴ HALLORAN, *GOING PUBLIC* (3rd ed. 1979); Schneider, Mankō and Kant, *Going Public: Practice, Procedure and Consequences*, 27 VILLANOVA L. REV. 1 (1981).

⁷⁵ Schneider and Shargel, *Now That You Are Publicly Owned*, 36 BUS. LAWYER 1631 (1981).

⁷⁶ Another advantage prior to 1982 was that profits were taxed at the lower corporate rate and the balance used for working capital with the hope of someday getting it out at capital gain rates either through a qualified redemption, liquidation or sale. Now that the top corporate tax rate is 46% and the top individual tax rate is 50%, as opposed to 70% for years prior to 1982, this advantage is significantly reduced.

CONCLUSION

Those engaged in operating equine enterprises presently use a wide array of business forms, including sole proprietorships, joint ownership and syndication arrangements, joint ventures, general and limited partnerships and corporations. The selection of a business form through which to own and operate such an enterprise should be made only after weighing many factors, including the management characteristics of the form being considered, the ability of an enterprise using that form to raise capital, the tax characteristics desired, the applicability of state and federal securities laws and the ability to shield individual owners from liability. A sole proprietorship affords maximum control over the business to the proprietor, but places heavy financial responsibility and risk on the proprietor. And unless the proprietor has planned accordingly, succession of management and ownership can be problematic. Although joint ownership arrangements and syndications afford the co-owners informality and flexibility in operating their enterprise and permit some distribution of risks, they may be plagued by management inefficiencies and tax and securities laws complications. While partnerships offer favorable tax treatment and flexibility in management, it may be difficult to liquidate one's partnership interest due to complexities of valuing partnership assets. Although limited partnership and corporations provide limited liability, they are subject to extensive state regulation and state and federal securities laws restrictions. No one form of business is ideally suited to the equine industry; choose carefully.