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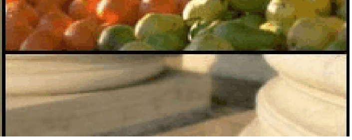

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Taxation of Equine Partnerships: Selected Problems

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Taxation of Equine Partnerships: Selected Problems

BY CHRIS TROWER,* THOMAS A. DAVIS** AND ALVIN J. GESKE***

INTRODUCTION

A partnership is a frequently used business form in the equine industry, but equine business partners generally are unaware of the significant tax planning opportunities available to partnerships. In some unfortunate situations, equine investors are unaware of their status as partners for tax purposes until an adverse audit commands their attention. This Article, therefore, focuses on the following major recurring problems involving the taxation of equine partnerships:

*depreciation and cost recovery strategies for short taxable years;

*receipt of a partnership interest in exchange for services;

*retroactive and special allocations, and

*like-kind exchanges of partnership interests.

I. A PRIMER ON PARTNERSHIP TAXATION

The Tax Court has described the partnership sections of the Internal Revenue Code (I.R.C. or Code) as a "distressingly complex and confusing" set of rules which "present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field," and as a maze whose "complex provisions may confidently be dealt with by at most only a compar-

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atively small number of specialists who have been initiated into its mysteries."[1]

A. *Basic Tax Rules*

Notwithstanding the observations of the Tax Court, some basic rules apply to partnership taxation.

1. *Entity Income: The Partnership*

A partnership itself does not pay income tax,[2] but it does have "taxable income" computed at the partnership level,[3] the character of which is determined as if the partnership were a taxpayer.[4] The partnership is treated as an entity in making these computations. For example, the partnership's holding period for a broodmare determines whether or not the broodmare is eligible for section 1231 classification; the period for which a particular partner may have held his or her partnership interest is irrelevant.[5]

2. *Separately Stated Items*

"Taxable income" of a partnership is computed in the same way an individual would compute taxable income, with appropriate exceptions to prevent double-dipping such as double deductions for charitable contributions[6] and to exclude peculiarly individual items such as the personal exemption.[7] Additionally, a large number of items which go into computing an individual's taxable income—long and short term capital gains and losses, section 1231 gains and losses and the like—must be "separately

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[1] Foxman v. Commissioner, 41 T.C. 535, 551 n.9 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1966).

[2] I.R.C. § 701 (1976).

[3] *Id.* § 703(a) (West Supp. 1982).

[4] *Id.* § 702(b) (West Supp. 1982).

[5] *Id.* § 741 (West Supp. 1982); Allen S. Lehman, 7 T.C. 1088 (1946), *aff'd*, 165 F.2d 383 (2d Cir. 1948). With proper planning, a partner can be taxed at capital gains rates on an appreciated thoroughbred held for less than two years. If he contributes the thoroughbred to an existing partnership in a non-taxable § 721 transaction, his capital account will be credited. The distributing proceeds of a subsequent sale by the partnership of a different animal held for the requisite period will be taxed at capital gains rates.

[6] I.R.C. § 703(a)(2)(C) (West Supp. 1982).

[7] *Id.* § 703(a)(2)(A).

stated" by a partnership.[8] That is, these items are separately determined at the partnership level by referring only to partnership operations and are not integrated with other items of income (such as ordinary income from partnership operations) to determine the partnership's bottom-line taxable income or loss.[9] Those items required to be separately stated generally are items which at the partner level will be aggregated with the individual partner's items of income and/or loss from other sources to determine final tax treatment.

3. *Distributive Shares: Aggregate Taxation*

Once partnership taxable income and the separately stated items are determined on an entity basis, the Code shifts by treating the partnership as an aggregate of individual taxpayers.[10] Each partner reports his or her "distributive share" of partnership taxable income or loss and of each separately stated item of income, gain, loss, deduction or credit.[11] Hence, partnership income "flows through" to the partners, and the "character" of an item at the partnership level is preserved at the partner level by the reporting of "distributive shares" of separately stated items.[12]

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[8] *Id.* § 703(a)(1).

[9] Generally speaking, those items required to be separately stated are items which at the partner level will be aggregated with the individual's partners income and/or loss from other sources to determine final tax treatment. For example, a partner's distributive share of partnership § 1231 gains (determined at the partnership level) must be aggregated at the individual level against the partner's § 1231 gains and/or losses from other ventures to determine whether or not the individual partner has a net § 1231 gain or loss, and is therefore entitled to capital gain or ordinary loss treatment, respectively, with respect to that net number.

Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974) (per curiam), is an example of a taxpayer attempting to create an unusual result, short-term capital gain, at the partnership level; his other ventures had created otherwise unusable capital losses. See notes 65-69 *infra* and accompanying text for a discussion of the *Diamond* handling of the partnership-profits-interest-for-services issue.

[10] The Uniform Partnership Act also shifts between the entity and aggregate concepts of a partnership. *See Commissioners' Prefatory Note* to UNIF. PARTNERSHIP ACT, 6 U.L.A. 5-8 (1968).

[11] I.R.C. § 702(a) (West Supp. 1982).

[12] It must be emphasized that this summary of partnership tax rules is more easily stated than applied. As recently as 1973, the United States Supreme Court decided a case wherein the fundamental dispute was whether a partnership was an entity or a conduit.

4. *Basis*

The basic rules applicable to partnerships and partners exhibit a similar entity-aggregate schizophrenia. The partnership's basis[13] is used to determine gain or loss on the sale of a partnership asset; the resulting gain or loss is then reported by each partner according to his or her distributive share. On the other hand, a partner's basis in his or her partnership interest determines whether the partner has gain or loss on the sale or exchange of his or her partnership interest or on distribution from the partnership.[14]

B. *Financial Accounting Matters*

A survey of partnership tax rules would be incomplete without a quick look at the major accounting treatments of partnerships and their relationship to partnership tax problems, although no method of financial accounting for partnership operations is universally accepted.

1. *Capital Accounts*

Most partnership agreements contain some reference to the "capital accounts" of the partners. The significance of capital accounts in analyzing partnership tax problems is often stressed, but the I.R.C., the Uniform Partnership Act (UPA) and the Uniform Limited Partnership Act (ULPA) fail to mention the concept. When tax practitioners refer to a "capital account" of a partner, they mean the account stated on the books and records of the partnership which expresses the book value of each partner's interest in the partnership. Normally, this account will be

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See United States v. Basye, 410 U.S. 441 (1973) (contributions made by employer to a retirement trust established by a medical partnership held to be taxable income to the partnership and partners required to report their distributive shares, even though payment was made directly to the trust and a partner lost his right to participate in the trust upon leaving the partnership prior to normal retirement).

[13] Partnership basis in property contributed by a partner equals the adjusted basis of such property to the contributing partner at the time of the contribution, increased by the amount (if any) of gain recognized to the contributing partner at such time. I.R.C. § 723 (West Supp. 1982).

[14] Treas. Reg. § 1.741-1(a) (1981).

the sum of the amount of cash and the agreed value of property contributed to the partnership by the partner, plus the partner's share of retained earnings, minus the partner's share of losses. As a general rule, those who prepare the partnership's books do not distinguish among these components of the capital account. The account balance is not divided into separate entries for capital contributions and for results of partnership operations. Nor does the capital account necessarily reflect the true value of a partnership interest, any more than the net book value per share of corporate stock represents the fair market value of a share. Book value can never reflect unrealized appreciation or depreciation in the value of an asset. Moreover, property may have been contributed to the partnership at an agreed value (which establishes the capital account of the contributing partner) that is more or less than its fair market value.

2. *Drawing, Profit and Retained Earnings Accounts*

While many accounting firms routinely determine the results of partnership operations for a particular fiscal period and then close the appropriate journal entries to the capital accounts, some firms do establish separately labeled accounts—variously called "drawing" accounts, "profit and loss" accounts or "retained earnings" accounts—which are used to reflect the operations of the partnership, leaving the capital accounts inviolate. Still other firms close journal entries of operations to drawing or profit/loss accounts which in turn are closed to the capital accounts. In most cases, the choice of accounting method seems to be more a matter of a firm's practice or a partnership's preference rather than adherence to any general principle of accounting theory. If the only function of accountant reports was to present the financial operations of the partnership to the partners in a comprehensive fashion, the choice of method would be of little consequence. However, because of the unique entity/aggregate nature of partnerships for both tax and substantive law purposes, failure to conform the partnership's accounting records to the partners' intentions underlying the partnership agreement can cause substantial difficulty.

The potential for such difficulty is illustrated by an arrangement where the partners intend to share operating profits and

losses equally even though the initial contributions to the partnership are uneven. An example of such a relationship in the equine industry is a partnership between an owner and a trainer where the owner contributes the horse and pays out-of-pocket expenses and the trainer contributes only services. The trainer receives no fees for his or her services except a share of the winnings. Once the owner has recovered his or her investment in the horse plus advance expenses and, in some agreements, a specified return on investment, the partnership is converted into a fifty-fifty partnership with the owner and trainer each having a fifty percent share of the winnings.[15]

If the owner/trainer partnership is dissolved prior to the return of the owner's investment, the capital account records of the partnership may be crucial in determining exactly what amounts are due each partner and in what priority the partners will share in the assets of the partnership. For example, if the capital accounts have been kept inviolate, the owner undoubtedly will argue that he or she is entitled to receive the balance of the capital account (here, the owner's original investment) before any distributions are made of "profits." Since both the UPA and ULPA treat capital contributions as debts of the partnership to be satisfied prior to any distributions to the partners,[16] the owner may prevail. Upon such a dissolution, then, the trainer will benefit if the partnership books have been kept by a firm which closes the results of operations to the capital accounts. The owner's capital account will have been reduced by depreciation deductions and other non-cash expenses, possibly resulting in some "profits" remaining to be distributed after the owner has been reimbursed to the extent of his or her capital account balance.

Suppose in a second hypothetical that our owner and trainer agree that winnings and expenses are to be shared equally, but that upon dissolution of the venture, the racing-age thoroughbred will be returned to the owner. The partnership continues

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[15] See notes 52-58 *infra* and accompanying text for a discussion of McDougal v. Commissioner, 62 T.C. 720 (1974), a case which involved an equine partnership with this type of arrangement.

[16] *See* UNIF. PARTNERSHIP ACT § 40, 6 U.L.A. 468-69 (1969); UNIF. LIMITED PARTNERSHIP ACT § 23, 6 U.L.A. 607 (1969).

for several years, and the original racehorse is claimed and replaced several times by similar claimers before the partnership is dissolved. At the owner's request, but prior to their reaching an understanding that the partnership will be dissolved, the trainer sells the horse to a third party. If the selling price is *less* than the original capital account established with respect to the owner's contribution, the trainer may owe the owner the difference under a strict reading of the UPA,[17] yet it is difficult to believe that the owner and trainer would have agreed originally to such a result had they considered the matter.

In such a situation, a court might treat inviolate capital accounts as evidence of the partners' intent that the owner should recover his or her original investment as a debt of the partnership for which the trainer is jointly responsible; the court might read changing capital accounts as evidence to the contrary. If the selling price is *greater* than the owner's original capital account and the partnership agreement is silent as to how the excess is to be distributed, the partnership's accounting records again can be crucial to resolving the issue. If the sales proceeds of previously claimed horses have been credited equally to the respective capital accounts of the owner and trainer, a court would almost certainly divide the excess of the selling price over the owner's capital contribution equally between the parties.

In this Article, the term "capital account" will be used to refer to the account or accounts established on the books and records of the partnership for each partner which equals his or her initial capital contribution and, during the term of the partnership, is increased by the amount of taxable income allocated to the partner and decreased by the amount of tax losses allocated to the partner and by the amount of any cash (or the fair market value of any property) distributions to the partner. The term "capital contribution" will be used to refer to the amount of money or the agreed value of property contributed to the partnership by a partner. The capital contribution thus initially establishes the balance in a partner's capital account, and the capital account itself thereafter reflects that value as modified by the

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[17] *See* UNIF. PARTNERSHIP ACT § 40, 6 U.L.A. 468-69 (1969).

results of partnership operations, including the tax incidents of partnership operations.

II. TAXABLE YEAR MYSTERIES

Under section 706(b)(1), "[t]he taxable year of a partnership shall be determined as though the partnership were a taxpayer."[18] A partner's distributive share of partnership income or loss is included in his or her taxable year within or with which the taxable year of the partnership ends.[19] The regulations further provide that a partnership return need not be filed before the first taxable year in which the partnership receives income or has deductions.[20]

Thus, a partnership is formed, begins business and is required to file a partnership informational return for each taxable year.[21] It sounds simple enough, but the interaction of the depreciation rules with the partnership taxable year rules has made this a controversial area in the equine industry. The controversy is exacerbated because the economic rhythms of the thoroughbred business call for purchases of horses in the second half of the taxable year, and the vast majority of horses are purchased in the final quarter of the calendar year.

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[18] I.R.C. § 706(b)(1) (1976).

[19] I.R.C. § 706(a) (1976).

[20] Treas. Reg. § 1.6031-1(a), T.D. 7564, 1978-2 C.B. 19, 66. This regulation states as follows:

> For purposes of filing a partnership return, an unincorporated organization will not be considered within the meaning of section 761(a), to carry on a business, financial operation, or venture as a partnership before the first taxable year in which such organization receives income or incurs any expenditures treated as deductions for federal income tax purposes.

Id. I.R.C. § 761(a) (Supp. IV 1980) defines a partnership as a "syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate."

[21] The adoption of a taxable year for the partnership is not necessarily a routine issue which the partners have absolute discretion to resolve. I.R.C. § 706(b)(1) (1976) states that "[a] partnership may not change to, or adopt, a taxable year other than that of all its principal partners unless it establishes, to the satisfaction of the Secretary, a business purpose therefor." A principal partner is defined as one "having an interest of five percent or more in partnership profits or capital." I.R.C. § 706(b)(3) (1976). The purpose of this rule is to prevent partnerships from choosing taxable years ending on January 31, thus produc-

A. *The Problem and the Opportunity*

From an economic standpoint, a taxpayer benefits by investing money in an income-producing enterprise for most of the calendar year, followed by a year-end investment which generates non-cash deductions such as depreciation to shelter the cash income from taxation. For example, under the law prior to the Economic Recovery Tax Act of 1981 (ERTA), a taxpayer who invested $1,000 on January 1 in a money market fund earning an annual interest rate of twelve percent could have withdrawn on November 30 the original $1,000 investment plus $110 in money market interest. The taxpayer could then have borrowed $9,000 on December 1 and invested the borrowed funds with the original $1,000 to purchase a thoroughbred stallion share for $10,000, which we will assume was being depreciated using the straight-line method over an eight-year life. The one year depreciation deduction would have been $1,250, and monthly depreciation deductions would have been $104. For the year, our hypothetical investor/horse owner would have reported a taxable income of $110 (interest income) minus $104 (depreciation deductions), or only $6. However, the strategy outlined above would have backfired economically if the earnings on the stallion share could not cover the debt service on the $9,000.

Tax planners have, therefore, strained their imaginations to develop techniques which allow the taxpayer to claim a depreciation deduction with respect to a period during which the taxpayer still had the use of his or her money. To return to our example, the idea is to permit the horse owner to keep the cash invested in money market funds through November 30, but to obtain depreciation deductions computed as if he or she had purchased the stallion share *prior* to December 1.

B. *The Averaging Conventions Under pre-1981 Law*

Before the enactment of ERTA, the depreciation regulations

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ing an 11-month deferral for their partners who will have received cash distributions during the year but who will not have to report the partnership income on their individual returns for that year. For an example of a taxpayer attempt to circumvent this rule by characterizing certain partnership payments as "guaranteed payments" under I.R.C. § 707(c) (1976), see Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977).

generally provided that depreciation of an asset begins when the asset is placed in service and that depreciation is allowable only for the proportionate part of the year during which the asset is in service.[22] Thus, in our example, the horse owner would normally be required to compute depreciation on the stallion share acquired at year-end by taking only one month of depreciation.[23]

An asset-by-asset and date-by-date computation of depreciation deductions would be unduly burdensome for any business which acquired a number of depreciable assets at different times during the calendar year. The Department of Treasury (Treasury), therefore, adopted regulations permitting taxpayers who record depreciable property in multiple asset accounts and use the Asset Depreciation Range (ADR) system to use one of two averaging conventions to determine depreciation deductions.[24]

Taxpayers electing to depreciate assets under the "half-year" convention are permitted to treat all property in an ADR account as if it had been "placed in service on the first day of the second half of the taxable year."[25] Taxpayers using the "modified half-year" convention are required to treat all property "placed in service during the first half of the taxable year as placed in service on the first day of the taxable year"[26] and all property "placed in service during the second half of the taxable year as placed in service on the first day of the succeeding taxable year."[27] As would be expected, taxpayers who generally purchased most of their depreciable property during the first six months of the calendar year elected the "modified half-year" convention, while those who generally acquired depreciable property in the latter half of the year usually elected the "half-year" convention.

Where the averaging conventions were used by existing partnerships with full taxable years or by horse owners operating as

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[22] Treas. Reg. § 1.167(a)-10(b) (1982).

[23] The method of computing depreciation is immaterial. The question is what portion of an otherwise allowable depreciation deduction for one year is permitted to a taxpayer who acquires property and places it in service for less than a full taxable year.

[24] Treas. Reg. § 1.167(a)-11(c)(2), T.D. 7272, 1973-1 C.B. 82, 95. Prior to the 1982 amendment, it came in through T.D. 6500 (1960).

[25] Treas. Reg. § 1.167(a)-11(c)(2)(iii), T.D. 7272, 1973-1 C.B. 82, 96.

[26] Treas. Reg. § 1.167(a)-11(c)(2)(ii), T.D. 7272, 1973-1 C.B. 82, 96.

[27] *Id.*

sole proprietorships, the conventions seemed no more than a reasonable compromise between theory and the exigencies of tax administration. After all, acquisitions of depreciable property should be made at all times during the calendar year so that the net effect of the use of the conventions over a number of years would approximate deductions otherwise allowable using an asset-by-asset and date-by-date method. However, taxpayers, and especially horse owners, tend to concentrate on the April 15 tax return deadline alone and to structure their business activities to avoid the leveling effect of the conventions in subsequent years. A favorite strategy in the past was to form a limited partnership and acquire depreciable assets such as broodmares at the fall bloodstock sales. The partnership then elected the "half-year" convention and claimed six months of depreciation on the broodmares, and the limited partner investors still used their funds for much more than six months of the year to produce income which would be sheltered by the non-cash depreciation deductions. Because the partnership would seldom purchase additional broodmares in subsequent years (except as replacements), the fundamental premise of the convention—regular purchases over several years at different times—failed; thus, no deductions were ever postponed by operation of the conventions.

To combat this problem, the Treasury finalized regulations in early 1981 which dealt with the use of the depreciation averaging conventions under the ADR System by entities with less than a full taxable year.[28] Those regulations provide that the averaging conventions will apply only within the particular short taxable year of an entity and that the determination of when a partnership begins will be based upon all the facts and circumstances rather than upon the organizational documents of the partnership.[29] For example, a partnership formed on December 1 which adopts the half-year convention would be entitled to only fifteen days of depreciation.[30] Additionally, a question of intent can

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[28] Treas. Reg. § 1.167(a)-11(c)(2)(iv)(c) and (d), T.D. 7763, 1981-1 C.B. 80, 81.

[29] Treas. Reg. § 1.167(a)-11(c)(2)(iv)(c), T.D. 7763, 1981-1 C.B. 80, 81.

[30] The application of these regulations to our hypothetical horse investor who purchases an interest in a broodmare partnership late in the year would be as follows. The beginning of the "taxable year" for income tax purposes will not be determined by the

arise in determining when the partnership is "formed" for taxation purposes. Suppose a partnership purchases a thoroughbred early in the year and conducts some minimal business activities, but does not commence major operations until December 1. The Internal Revenue Service (Service) may argue that the partnership did not begin until December and is thus entitled to deduct only fifteen days of depreciation. The pertinent regulation provides:

> [I]f a person engages in a small amount of trade or business activity *for the purpose* of obtaining a disproportionately large depreciation deduction for assets for the taxable year in which they are placed in service, and placing those assets in service represents a substantial increase in the person's level of business activity, then for purposes of depreciating those assets the person will not be treated as beginning a trade or business until the increased amount of business activity begins.[31]

Presumably, the focus on taxpayer "purpose" will be most easily resolved in the egregious cases. Tax shelter partnerships established and marketed for the sole purpose of using averaging conventions to produce depreciation benefits cannot expect sympathetic treatment from the Service, since it is precisely these stratagems against which the regulations are directed. On a practical level, however, it will be difficult to determine a prohibited purpose in the equine industry, and horse owners and their professional advisers should be alert to the use of the averaging conventions to maximize deductions in appropriate circumstances.[32]

C. *Short Taxable Years Under ERTA*

ERTA mandates a re-evaluation of traditional conceptual and technical approaches to depreciation questions. Under ERTA, the Accelerated Cost Recovery System (ACRS) abolishes

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state law existence *vel non* of the partnership. According to the regulations, "the taxable year of the person placing such property in service does not include any month before the month in which the person begins engaging in a trade or business or holding depreciable property for the production of income." *Id.*

[31] Treas. Reg. § 1.167(a)-11(c)(2)(iv)(d), T.D. 7763, 1981-1 C.B. 80, 81.

[32] See part IV *infra* for a discussion of the use of short taxable year strategies combined with retroactive allocation.

the useful life concept and accelerated depreciation methods which have dominated tax planning.[33] The ACRS percentages, which are multiplied by the original cost basis of property to determine the cost recovery deduction, contain built-in averaging conventions so that the cost recovery deduction is determined without regard to when property is placed in service during a taxable year.[34]

Even under ERTA, however, the taxable year problem rears its ugly head. Section 168(f)(5)[35] provides that where a taxpayer has a taxable year of less than twelve months, the amount of the cost recovery deduction otherwise available will be prorated according to the number of months in the short taxable year.[36] If a broodmare partnership operating on a calendar year basis is organized under state law on January 1, it arguably has a taxable year which is not less than twelve months. However, section 168(f)(5) states that "[t]he determination of when a taxable year begins shall be made in accordance with regulations prescribed by the Secretary."[37] No regulations have yet been promulgated, but Revenue Ruling 82-110[38] suggests that the Service will be hostile to taxpayer attempts to manipulate the taxable year for extra depreciation deductions.

The ruling involved a partnership organized on December 15, 1977, to acquire and hold title to an ocean-going oil tanker. The partnership, which used the calendar year as its taxable year, elected to claim depreciation under the ADR system and adopted the half-year convention. The partnership actually received no income and incurred no deductible expenses until it acquired the oil tanker on December 20, 1978.[39] Its attempt to take six months of depreciation for property actually in service during

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[33] *See* I.R.C. § 168 (West Supp. 1982).

[34] *See id. See also* S. REP. NO. 97-144, 97th Cong., 1st Sess. 39, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105, 145.

[35] I.R.C. § 168(f)(5) (West Supp. 1982).

[36] For example, if a partnership formed on October 1 acquires a broodmare on that date and elects the calendar year as its taxable year, the partnership would be entitled to claim a cost recovery deduction of one-fourth of the 15% deduction otherwise available under ACRS.

[37] I.R.C. § 168(f)(5) (West Supp. 1982).

[38] Rev. Rul. 82-110, 1982-22 I.R.B. 8.

[39] *Id.*

only ten days of the taxable year was disallowed in the ruling.[40] The Service held that the beginning of the partnership's initial taxable year for purposes of applying the half-year convention occurred on December 20, 1978, the date the partnership began to incur expenses and receive income.[41] Since the partnership had elected the half-year convention, it was limited by the Service to six days rather than six months of depreciation.[42] Therefore, cautious practitioners will advise their equine industry clients that an aggressive approach toward the taxable year controversy that does not reflect the substance of the partnership tax year undoubtedly will generate resistance by the Service.

D. *Planning Techniques*

Horse owners and their advisors are using a number of techniques to deal with the short taxable year question under ERTA. The success of these techniques, of course, has yet to be determined.

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[40] Athough Revenue Ruling 82-110 deals with property acquired and placed in service prior to the effective date of the Economic Recovery Tax Act of 1981 (ERTA), it provides ample evidence of the Service's predictable action under ERTA, especially since the ruling involved the acquisition of property prior to the effective date of the regulations limiting the application of the averaging conventions in situations where the taxpayer was in existence for a full year but conducted no business until the end of the year. See note 28 *supra* and accompanying text for a discussion of these regulations.

[41] Rev. Rul. 82-110, 1982-22 I.R.B. 8. The Service's analysis in this ruling leaves much to be desired. The holding is based upon Treas. Reg. § 1.603-1(a)(1), T.D. 8564, 1978-2 C.B. 19, 66, which provides: "For purposes of filing a partnership return, an unincorporated organization will not be considered . . . to carry on a business, financial operation, or venture as a partnership *before the first taxable year in which* such organization receives income or incurs any expenditures treated as deductions . . . ." *Id.* (emphasis added). However, this Regulation is not intended to advise when a partnership's taxable year begins but is designed to tell a partnership when it must file a return. The language emphasized above implies that the taxable year may begin prior to the receipt of income or the incurring of expenditures. Therefore, the Service's reliance on the Regulation appears to be misplaced, but the Service may be betting on a conceptual longshot in an attempt to discourage a perceived tax avoidance technique.

[42] It is interesting to note that the partnership would have been entitled to 11 days of depreciation under the asset-by-asset method. Treas. Reg. § 1.167(a)-10(b) (West Supp. 1982). Therefore, the partnership's attempt to use the half-year convention cost it five days of depreciation on an asset with a cost basis of $42 million. With stallions being syndicated at numbers around $20 million and with the substantial growth of publicly-financed limited partnerships in the equine industry, similarly important decisions may come from the equine industry in the next few years.

1. *Churning*

The accelerated cost recovery system established by ERTA is only available for "recovery property" as defined by section 168.[43] To prevent taxpayers from transferring record ownership of property in 1981 and succeeding years in a fashion which does not alter the basic economic relationship of the taxpayer to the property, but which would make the property eligible for faster deductions under ACRS than under pre-1981 law, section 168(e)[44] includes several anti-churning rules.[45] Perhaps because the short taxable year rules under ERTA are part of the statute, some horse owners have tried to avoid their application by intentionally failing the anti-churning tests, believing that an advantage may be gained if property is not "recovery property" subject to the short taxable year rules of the 1981 legislation.

Although failing the anti-churning tests will not result in depreciation deductions for a greater number of months (or days) than the period of ownership, in many circumstances it will provide greater depreciation deductions in the short tax year (year of acquisition) than applying ACRS with the 1981 short tax year rules. The greater deductions under pre-1981 rules stem from two factors: 1) pre-1981 law may allow use of a shorter useful life and 2) if the partnership acquires the horse at the beginning of its short taxable year, it is not disadvantaged by the ACRS rules which mandate a half-year convention (by combining a percentage based upon a half-year convention with the short tax

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[43] I.R.C. § 168(c) (West Supp. 1982). "Recovery property" is that property placed into service by the taxpayer after January 1, 1981, which is in a trade or business or held for the production of income. *Id.*

[44] I.R.C. § 168(e) (West Supp. 1982).

[45] If a taxpayer acquires property in a taxable transaction from a transferor who is a "related person," the property is not recovery property. I.R.C. § 168(e)(4)(A)(i) (West Supp. 1982). A partner and a partnership will be considered "related" if the partner has *more* than a 10% interest in the capital or profits of the partnership. I.R.C. § 168(e)(4)(D) (West Supp. 1982). The anti-churning rules also exclude from the definition of "recovery property" any property which is transferred to a partnership as a non-taxable contribution to capital under I.R.C. § 721 (1976), "to the extent that the basis of the property is determined by reference to the basis of the property in the hands of the transferor . . . ." I.R.C. § 168(e)(4)(C) (West Supp. 1982). Since I.R.C. § 723 (1976) prescribes a full carryover basis for the partnership with respect to property contributed by a partner under I.R.C. § 721 (1976), property contributed by a partner who used it prior to 1981 will not be eligible for ACRS treatment.

year rules). Of course, there are situations in which intentional failure of the anti-churning rules will not result in greater first year deductions than under ACRS. Thus, the more responsible conclusion for planning purposes is that, as long as the percentage of adjusted basis which could be taken as a depreciation deduction during a full taxable year is no greater under the old law than under the 1981 legislation,[46] intentionally failing the anti-churning rules will do nothing to help a taxpayer with a short taxable year.

2. *Early Partnership Formation; Late Admission of Investors*

A horse owner who thinks ahead can improve the chances of maximizing depreciation deductions by forming partnerships early in the year and then admitting investors and purchasing property later in the year. This technique at least permits the partnership to claim on the basis of facts and circumstances that its taxable year begins on the date of organization and should be respected for depreciation/cost recovery purposes.[47] It is important, however, that the horse owner not forget the realities of the tax world.

Whether the full year will be respected for tax purposes will

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[46] It might be possible with respect to particular thoroughbreds to produce a higher deduction under the old law than under ERTA. For example, broodmares more than 13 years old would be depreciated over three years under ERTA, I.R.C. § 168(h)(1) (West Supp. 1982), but over as little as two years under prior law, based upon industry useful life guidelines which were generally accepted by the Service for depreciation purposes. The availability of a shorter useful life would, however, offer a separate reason for transgressing the anti-churning rules and would have nothing to do with the short taxable year issue. However, the other significant factor is that, even in short tax years, ERTA *mandates* a half-year convention through the percentages selected, and prior law allows the partnership to obtain a full year's depreciation on the assets acquired at the beginning of its taxable year (short or otherwise).

[47] As far as partnership law is concerned, a partnership can be structured so its existence begins early in the year but admits investors toward the end of the year. *See* UNIF. PARTNERSHIP ACT § 17, 6 U.L.A. 207 (1969); UNIF. LIMITED PARTNERSHIP ACT § 2(XI), 6 U.L.A. 568 (1969).

"Offering" materials describing a limited partnership organized between the general partner and an initial limited partner who withdraws from the partnership upon the admission of additional limited partners are common. Typically, these deals split profits, leases and the tax incidents of partnership operations (which will by definition be fairly limited) between the general partner and the initial limited partner on a 99:1 basis. *Cf.*

probably depend upon whether or not the taxpayer had begun "engaging in a trade or business or holding depreciable property for the production of income"[48] at the time of organization. Because the Service has traditionally denied favorable treatment to a taxpayer who engages "in a small amount of trade or business activity for the purpose of obtaining a disproportionately large depreciation deduction,"[49] there can be no assurance that any particular situation will succeed. Of course, to the extent that a taxpayer acquires a substantial number of horses for the partnership early in the year, the tax shelter benefits of the technique are diminished.

Also, if a partnership if formed early in the year and anticipates acquiring substantial assets late in the year after the admission of investors, special care should be taken in determining whether the deal should be structured to violate the anti-churning rules. The regulations under section 168(f)(5)[50] have not yet been promulgated, and it may be some time before they are, but the simplicity of ERTA could well work in favor of post-1980 partnerships. As long as those partnerships simply claim the authorized ERTA percentages for a full taxable year, as opposed to the complicated red flag elections of the averaging conventions under old law, the practical dangers of such a course might be substantially limited.

3. *Co-Ownership*

One solution to the short taxable year problem may be co-ownership of the horses rather than partnership ownership. Since each individual owns an undivided interest in the property, the taxable year in question is the individual's taxable year and a full

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Rev. Proc. 74-17, 1974-1 C.B. 438. Upon the admission of the investor limited partners, the percentages switch to those called for by the deal.

It might be thought that early organization followed by late admission of investor limited partners would cause a termination of a partnership for tax purposes because of the 50% rule of I.R.C. § 708(b)(1) (1976). However, Treas. Reg. § 1.708-1(b)(ii) indicates that the 50% rule applies to a sale or exchange of partnership interests and that a contribution of property to the partnership is not a sale or exchange.

[48] See note 30 *supra* and accompanying text.

[49] Treas. Reg. § 1.167(a)-11(C)(2)(iv)(d), T.D. 7763, 1981-1 C.B. 80, 81.

[50] I.R.C. § 168(f)(5) (West Supp. 1982).

ACRS deduction would be available. This technique would work for a stallion syndicate, which usually is structured as a regime of co-ownership rather than a partnership, and it also applies to smaller partnerships where co-ownership of specific horses by a few individuals may be a realistic alternative.[51]

For partnerships involving more individuals—almost all private offerings of partnership interests to limited partner investors and public offerings—co-ownership will not be a feasible alternative from a practical standpoint even though in a properly structured deal a co-ownership will work from a tax standpoint. These partnerships typically require use of a managing agent, and the limited partners always are concerned with preserving their limited liability status. In a co-ownership arrangement, the liability of entrepreneurs would be limited only by stop-loss or indemnification agreements of the operator, and even then would depend upon the resources of the operator available to satisfy these agreements. Thus, from a marketing and logistical standpoint, co-ownership will not be a useful alternative for most partnerships.

III. RECEIPT OF A PARTNERSHIP INTEREST IN EXCHANGE FOR SERVICES

Determining the proper treatment of the receipt of a partnership interest in exchange for services is a common issue in the equine industry. This issue arises whenever an owner transfers to a trainer an interest in the earnings of one or more thoroughbreds, and whenever a stallion share owner or syndicate manager and a mare owner make an arrangement with respect to the offspring of a particular breeding. It also may arise in the receipt of

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[51] If the individuals are to own race horses or broodmares, it may be difficult to structure a co-ownership which is not treated as a partnership for federal income tax purposes. The Code provides that "the term 'partnership' includes a syndicate, group, pool, venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on and which is not, within the meaning of this title, a trust or estate or a corporation." I.R.C. § 7701(a)(2)(1976). The carrying on of racing activities and sharing of profits and losses, or the breeding of horses (including the raising of the foals) and the sharing of profits and losses, may well be treated by the IRS as the carrying on of a business or venture resulting in partnership treatment, although this result may be avoided through careful planning in some circumstances.

syndicate shares by trainers, veterinarians, syndicate promoters or other persons who will not perform substantial services for the syndicate but are in essence being rewarded for prior service, usually rendered prior to the stallion's retirement to stud. The following discussion deals primarily with two leading cases in which some of these issues arose.

A. *The Trainer's Dilemma:* McDougal

One of the cases in this area, *McDougal v. Commissioner*,[52] involved a partnership between an owner and a trainer. The owner purchased a thoroughbred named Iron Card for $10,000, a price which was depressed because the horse had a condition diagnosed as a protein allergy. The owner promised his trainer a half interest in Iron Card, once the owner recovered the costs and expenses of acquiring the colt, in exchange for the trainer's attending to the colt. Significantly, this promise was not made in lieu of payment of the standard trainer's fees, which during the course of the arrangement were paid to the trainer according to his customary charges. The trainer successfully treated the colt's condition, and within ten months from the date of its acquisition by the owner, several purchase offers were made, one of which reached $60,000. The owner decided to keep the horse, however, and, after recovering his costs of acquiring the horse, transferred a one-half interest in Iron Card to the trainer.[53]

In the Tax Court, the owner, while conceding that he had realized a gain on the transfer equal to the difference between the value of the one-half interest given up and his adjusted basis in that one-half interest, contended that he was entitled to a $30,000 business expense deduction representing the value of the property transferred to the trainer as compensation for services rendered.[54] Thus, the owner was effectively deriving a tax benefit to the extent of the difference between the taxes saved by the ordinary $30,000 deduction and the smaller amount of taxes paid on the reported capital gain.[55] In contrast, the Commissioner

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[52] 62 T.C. 720 (1974).

[53] *Id.* at 721-22.

[54] *Id.* at 723.

[55] Even with respect to the proportion of the gain attributable to previously claimed

contended that the owner and the trainer had entered into a partnership to which the owner contributed Iron Card and to which the trainer agreed to contribute his services.[56]

Thus, the owner's conveyance would have been structured as a nontaxable transfer to a partnership in exchange for an interest in the partnership, with the partnership taking a carry-over basis in the thoroughbred, limited under section 723 to the owner's adjusted basis for the horse,[57] or no more than $10,000. Under the taxpayer/owner's theory, the partnership's basis for future depreciation deductions would be $30,000 (the trainer's cost basis for his one-half interest), *plus* something a bit less than $5,000 (the owner's allocable cost basis in the retained one-half interest).

The Tax Court agreed with the owner:

> When on the formation of a joint venture a party contributing appreciated assets satisfies an obligation by granting his obligee a capital interest in the venture, he is deemed first to have transferred to the obligee an undivided interest in the assets contributed, equal in value to the amount of the obligation so satisfied. He and the obligee are deemed thereafter and in concert to have contributed those assets to the joint venture.
>
> The contributing obligor will recognize gain on the transaction to the extent that the value of the undivided interest which he is deemed to have transferred exceeds his basis therein. The obligee is considered to have realized an amount equal to the fair market value of the interest which he receives in the venture and will recognize income depending upon the character of the obligation satisfied.[58]

The *McDougal* case, standing for the proposition that the transfer of a partnership interest in exchange for services rendered is a taxable transaction both to the transferor and the

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depreciation, capital gain treatment was available because the transaction occurred prior to the enactment in 1969 of the depreciation recapture provisions. Actually, the taxpayer was not performing any magic; he could have sold a one-half interest in Iron Card for $30,000 cash, reported the capital gain, and then paid the trainer $30,000 in cash and taken a deduction. Surely the Service would not have challenged the propriety of the capital gain/ordinary loss alchemy if cash had been used rather than an in-kind payment, although the amount of the deduction could have been challenged as unreasonable.

[56] *Id.* at 724.

[57] See note 13 *supra*.

[58] 62 T.C. at 725-26 (footnotes omitted).

transferee, is not governed by the general non-recognition rule of section 721.[59] Because the specific facts of *McDougal* are unlikely to be repeated in many transactions, the case might be regarded as a judicial derelict. But *McDougal* has wide application in the equine industry, particularly to the receipt of so-called "trainer's shares" in stallion syndicates. Typically, ownership of the stallion is divided into forty equal shares or fractional interests. Each co-owner is entitled to one "free nomination"[60] to the stallion for each share owned and, additionally, is entitled to participate in drawing for excess or shortfall nominations in accordance with the procedures described in the syndication agreement. Some syndicate agreements additionally provide a nomination for the person who trained the stallion during its racing career; generally, this nomination is not contingent upon the trainer's continuing to serve in any particular capacity.

Regardless, syndicate agreements often attempt to characterize the trainer's share or nomination as being received on an annual basis in exchange for future services. A typical agreement provides that the trainer "shall during the term of this Agreement promote the value of the Stallion as a stud at thoroughbred racetracks and thoroughbred auction sales, and will upon request consult with the Syndicate Manager concerning the selection of thoroughbred mares most suitable to the Stallion."[61] Whether the trainer's nomination is actually earned on a year-to-year basis by the trainer after the syndication of the stallion or is received by the trainer as compensation for services previously rendered to the owners is a question of fact. But, under *McDougal*, if it is determined that the trainer's nomination is compensation for prior services, then its fair market value is both includable in the trainer's income in the year of receipt and deductible by the owners as an ordinary and necessary business expense.[62] Because

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[59] No gain or loss is recognized by a partnership or its partners where a contribution of property is made to a partnership in exchange for an interest in the partnership. I.R.C. § 721 (1976).

[60] A "free nomination" is generally defined in an agreement as the right to breed one mare to the stallion in a breeding season.

[61] At a seminar sponsored by Gainesway Farm in the fall of 1980, this specific language was recommended by one of Kentucky's leading equine accounting firm.

[62] See text accompanying note 59 *supra*. *Cf.* Pessin v. Commissioner, 59 T.C. 473

a syndicated stallion will almost by definition be worth considerably more than the price paid for the horse, the owners—even in a world of depreciation recapture—can still obtain a useful ordinary deduction at the price of a taxable gain, the majority of which will be capital in nature.

B. *Profits Interests*

McDougal considered the tax consequences of a transfer of an interest in partnership capital. But an agreement between an owner and trainer that, upon the owner's recovery of original investment, they will divide all future net earnings equally, with the owner receiving all proceeds upon the horse being claimed or sold, would involve the transfer of only a "profits interest" in a partnership. Until 1971, such a transfer, even when in compensation for services rendered, was considered to be a nontaxable transaction. This view was based upon a parenthetical clause contained in Treasury Regulation section 1.721-1(b)(1),[63] which provides:

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership . . . whether made at the formation of the partnership or subsequent thereto. To 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 party as compensation for services . . . section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.[64]

In *Diamond v. Commissioner*,[65] however, the Tax Court held that the parenthetical clause of the regulations did not make the receipt of a profits interest in exchange for services nontaxable. Under the partnership agreement in *Diamond*, the tax-

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(1972) (veterinarian who received lifetime breeding in stallions at time of syndication required to report fair market value as immune in year of receipt).

[63] Treas. Reg. § 1.721-1(b)(1) (1960).

[64] *Id.* (emphasis added).

[65] 56 T.C. 530 (1971), *aff'd per curiam*, 492 F.2d 286 (7th Cir. 1974).

payer had been granted a sixty percent interest in the partnership profits in exchange for his services; further, upon a sale of the partnership's sole asset, an office building, the taxpayer was entitled to sixty percent of the net proceeds after the contributing partner had been reimbursed for the funds expended by him in the acquisition of the property. Less than three weeks after execution of the partnership agreement, the taxpayer sold his interest for $40,000 in an arm's length transaction.[66] Thus, the Tax Court was presented with a set of facts which arguably involved a pure profits interest that had an ascertainable and substantial fair market value.

The Tax Court noted that the regulations make the nonrecognition provisions of section 721 inapplicable in the case of a taxpayer who has received an interest in the *capital* contribution made by another partner.[67] But the court refused to assign any significance to the parenthetical clause which consistently has been thought by practitioners to distinguish between the treatment of capital and profits interests. Terming the draftsmanship of the regulations "obscure" and "opaque," the Tax Court declared:

> [The parenthetical clause] excludes that type of situation from the rule which the regulations affirmatively set forth in respect of readjustments of capital interests; but it does not deal one way or the other with situations described in the parenthetical clause . . . . [W]hat is plain is that the regulations do not call for the applicability of section 721 where a taxpayer has performed services for someone who has compensated him therefor by giving him an interest in a partnership that came into being at a later date.[68]

On this analysis, the Tax Court held that Diamond received $40,000 in compensation income when he received the interest in the partnership.[69]

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[66] 56 T.C. at 532-39.

[67] *Id.* at 545-46.

[68] *Id.* at 546.

[69] *Id.* The Tax Court's decision has been severely criticized. *See, e.g.*, Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The* Diamond *Case*, 27 TAX L. REV. 161 (1972), but it has never been abandoned by the Service, and no contrary authority has appeared.

The trainer, therefore, who provides services in exchange for an interest in partnership profits and/or capital is faced with a potentially significant tax problem. One might argue that the *Diamond* rationale applies only in those instances where the interest received has a readily ascertainable market value.[70] Alternatively, it might be argued that *Diamond* can be distinguished as having involved the transfer of *both* a profits and a capital interest, since Diamond received, in exchange for his services, not only an interest in profits, but also an interest in the sole asset of the partnership.[71]

Either theory would allow a trainer to escape taxation at the time the interest is granted both in the situation of a racing partnership where future net winnings are to be shared and in the more difficult situation where a trainer receives a nomination in a stallion syndicate. In the first case, no transfer of a capital interest has occurred because the owner is entitled to all the proceeds of the sale of the thoroughbred. Since the future net winnings from racing are obviously totally speculative, a strong argument can be made that even if *Diamond* requires *recognition* of any income realized, no income has been *realized* because the value of the profits interest received is either nominal or not ascertainable. In the second case, the argument would be that, as the trainer is never entitled to a share of the proceeds of the sale of the stallion once he begins stud service, no capital interest has been transferred. Additionally, the value of the stallion's services as a stud *to the trainer* are quite speculative, because, at the time the nomination is received, the stallion's fertility will normally not have been established, and the future value of the stud services are uncertain; moreover, the value of the nomination may depend upon the mares available to the trainer.[72]

C. *A Practical Approach*

Section 83 of the Code,[73] which became effective after the oc-

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[70] This factor played an important role in the Seventh Circuit's opinion upholding the Tax Court's decision. 492 F.2d at 288.

[71] See note 66 *supra* and accompanying text.

[72] *But see* Pessin v. Commissioner, 59 T.C. at 473 (value of lifetime nominations to stallion being syndicated taxed to veterinarian upon receipt; value determined without regard to quality of mares but with regard to fertility of stallions).

[73] I.R.C. § 83 (1976).

currence of the transactions involved in *McDougal* and *Diamond*, arguably has rendered moot the dispute about the correctness and reach of the *Diamond* case. Section 83 provides in general that if "property" is transferred to any person "in connection with the performance of services," then the "fair market value" of the property (less any amount paid for the property) must be included in the gross income of the person who performed the services "in the first taxable year in which the rights of the person having the beneficial interest in such property are transferrable or are not subject to a substantial risk of forfeiture, whichever is applicable."[74]

Although there is some question whether section 83 was *intended* to include partnership interests (or at least profits interests) in its definition of "property,"[75] a regulation under section 83 embraces as property all "real and personal property other than money or an unfunded and unsecured promise to pay deferred compensation."[76] Undoubtedly, a partnership profits interest is personalty under section 26 of the Uniform Partnership Act,[77] and is not an unfunded, unsecured promise to pay deferred compensation. Section 83, however, was designed to respond to the use of stock options and restricted stock options as a means of converting ordinary income into capital gain. While its language is broad enough to reach partnership profits interests, nothing suggests that the section was drafted to change the basic rules governing whether a taxable event occurs (that question arguably having been settled by the regulations under section 721 promulgated after enactment of the 1954 Code) upon receipt of a partnership profits interest. Rather, section 83 was seemingly enacted to extend ordinary income treatment to transactions involving restricted property which, prior to the enactment of section 83, had offered an opportunity to transform otherwise ordinary income into capital gain. If section 83 applies to all transfers of "property," including partnership profits interests, then

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[74] I.R.C. § 83(a)(2).

[75] Section 83's provisions deal almost exclusively with the means of valuing "restricted property" and determining when the receipt of "restricted property" may be appropriately taxed.

[76] Treas. Reg. § 1.83-3(3) (1978).

[77] UNIF. PARTNERSHIP ACT § 26, 6 U.L.A. 349 (1969).

whenever an interest in a partnership is transferred under circumstances which could be interpreted as involving compensation for services, a three-step analysis seems appropriate.

The first determination is whether the transfer is in fact compensation for services. For example, suppose our trainer contributes property or money to the partnership. It could be argued that the trainer's interest in the partnership, albeit not in proportion to his or her capital investment, has been received in consideration of (1) contribution of property or money, and (2) anticipated *future* participation in partnership management which the partners expect will contribute more to the success of the partnership than the participation of the other parties. Since the trainer's receipt of any profits depends to a degree upon his or her future efforts on behalf of the partnership, that part of the interest received which is not in consideration of capital contribution arguably represents no more than an unfunded promise to pay for future services, which is not currently taxable. Under this analysis, section 83 would not apply because the profits interest received would not be transferable (in the sense that the trainer would not ordinarily be permitted to assign his or her interest to another trainer), and it would be subject to a "substantial risk of forfeiture" in that the trainer's right to receive a share of the net winnings would apparently terminate upon a cessation of trainer services.

Second, it must be determined whether the trainer has received a "capital" or a "profits" interest in the partnership. The Code and regulations do not deal directly with this distinction under either section 721 or section 83. However, a regulation under the family partnership rules of section 704(e)(3) of the Code does provide that for purposes of those rules

> a capital interest in a partnership means an interest in the assets of the partnership which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.[78]

[78] Treas. Reg. § 1.704-1(3)(1)(v), T.D. 6771, 1964-2 C.B. 177, 178.

Whether a particular interest in a partnership constitutes a "capital" interest or a "profits" interest will therefore depend upon the precise terms of the agreement between the parties.

Finally, the question of value must be addressed. It is conceptually possible for a "profits" interest to have been transferred as compensation for services, but the value of that interest might be nominal or not ascertainable; thus, although the taxpayer will have realized income that must be recognized, the amount of such income may well be negligible. This situation could apply to a trainer who receives only an interest in future net winnings, which at the time of receipt is subordinate to the recovery by the owner of substantial costs.[79] If the trainer receives, in addition to the profits interest, normal and customary charges for training the horse, the argument is made stronger because the Service will not be able to contend that the value of the profits interest should be measured by unpaid standard fees.[80] The attempt to minimize the value of what the trainer received, however, or to defer the time of taxation, will normally be at the expense of a reduction, or deferral, of the deduction for the person transferring the interest.

IV. EXOTICA: "RETROACTIVE" AND "SPECIAL" ALLOCATIONS

The natural economic rhythms of the equine industry, which traditionally call for the purchase of horses in the second half of the calendar year, and the relative simplicity of most equine partnerships, in the sense that the finite number of animals involved simplifies tax accounting problems, make equine partnerships a fertile ground for tax planning using "retroactive" and "special" allocations.

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[79] Normally, this idea would be expressed by a partnership agreement provision to the effect that cash distributions would go to the owner until he or she has recovered his costs, or if the partnership is liquidated prior to recovery of those costs, the net proceeds of the liquidation would be applied first to the owner's capital account.

[80] *Cf.* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954) (cost basis under § 1012 of property received in an exchange is fair market value of property received; if that value cannot be determined with reasonable certainty, the fair market value of the property exchanged will be presumed to be the value of the property received).

A. *"Retroactive" Allocations*

A "retroactive" allocation occurs when a partner who is admitted to the partnership subsequent to the beginning of its taxable year is allocated losses which have been economically incurred prior to his or her admission. In its most tax-aggressive posture, the retroactive allocation question concerns whether losses incurred by a partnership formed by a promoter early in the calendar year, perhaps including losses generated by use of the averaging conventions or other techniques to avoid the short taxable year limitations, can be allocated to investors admitted to the partnership in December.

1. *Early Decisions*

Although tax shelter promoters often touted retroactive allocations, judicial decisions never established the legitimacy of such allocations. In the leading case, *Rodman v. Commissioner*,[81] a partnership believed that it had a substantial tax loss for the year. A new partner, admitted in early November, purchased a two-ninths interest in the partnership from two existing partners. On the partnership return, the new partner was allocated two-ninths of the partnership's loss for the entire year. The Tax Court disallowed certain deductions, resulting in the partnership actually having a gain rather than a loss for the year.[82] Not unexpectedly, the new partner then changed his position and contended that he should be required to report only two-ninths of the profits earned from the date of his admission to the end of the year, rather than two-ninths of the entire year's profits.[83] The Tax Court, however, accepted the Commissioner's argument that the retroactive allocation should be upheld, i.e., the new partner should be taxed on two-ninths of the entire year's income.[84]

On appeal, according to leading commentators, "sanity re-

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[81] T.C.M. (CCH) 1307 (1973), *rev'd*, 542 F.2d 845 (2d Cir. 1976).
[82] 542 F.2d at 857.
[83] *Id.*
[84] *Id.*

turned,"[85] and the Second Circuit Court of Appeals held that the retroactive allocation was not permissible, relying both on policy grounds and section 706(c)(2)(B).[86] That section provides that a partner's distributive share of partnership income or loss for a taxable year in which the partner "sells or exchanges" less than his or her entire interest in the partnership "shall be determined by taking into account his varying interests in the partnership during the taxable year."[87] The appellate court reasoned that *Rodman* involved a sale or exchange of partnership interests by the two existing partners; thus, their shares of partnership profits for the year had to include the share of profits earned through October with respect to the two-ninths interest transferred to the new partner. Because the new partner could not be allocated income reported by the two existing partners, the new partner's allocation was limited to his pro rata share of profits earned after his admission to the partnership.[88]

2. *Changes Under the 1976 Tax Reform Act*

Retroactive allocations continued to be made after *Rodman* because of technical deficiencies in the relevant Code provisions. Under pre-1976 law, the "varying interests" rule of section 706(c) (as referred to in the previous paragraph), while applicable in instances where the new partner obtained an interest by *sale or exchange*, did not literally apply to the more common situation where end-of-year investors were admitted to an already formed partnership by making *contributions to capital.*[89] A second provision prior to 1976 which appeared to sanction retroactive allocations was section 704(a), under which a partner's distributive share of income or loss was determined by the partnership agreement, unless the agreement was found to be invalid[90] because it was formulated by the partners as a tax avoidance device.[91] Argu-

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[85] A. WILLIS, J. PENNEL & P. POSTLEWAITE, PARTNERSHIP TAXATION § 87.02 (3d ed. 1982).

[86] 542 F.2d at 858.

[87] I.R.C. § 706(c)(2)(B) (1976).

[88] 542 F.2d at 858-59.

[89] *See* I.R.C. § 706(c) (1954).

[90] I.R.C. § 704(b) (1954).

[91] I.R.C. § 704(a) (1954).

ably, this tax avoidance test (contained in section 704(b)) was inapplicable to retroactive allocations because the pre-1976 version of section 704(b) only applied to allocations of "items" of partnership income or loss and did not apply to allocation of so-called bottom line taxable income or loss.[92]

The Tax Reform Act of 1976 amended sections 704 and 706 to eliminate the more brazen forms of retroactive allocations.[93] Section 704(b) was amended not only to replace the "tax avoidance" test with the "substantial economic effect" test,[94] but also to extend to bottom line partnership income or loss as well as items.[95] The "varying interests" rule of section 706(c) was amended to apply not only to a sale or exchange, but also to situations where a partner's interest is reduced "by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise."[96] The legislative history of these amendments leaves absolutely no doubt that their specific intention was to prevent retroactive allocations.[97]

3. *Planning Opportunities*

The 1976 legislation has not prevented careful tax planning from achieving the same result as a retroactive allocation, as is illustrated by the recent case of *Richardson v. Commissioner.*[98] In *Richardson*, new limited partners who contributed cash and notes for the purpose of paying outstanding bills were admitted to the partnership on December 31, at which time the accrued but unpaid bills were paid with the new limited partners' funds. The partnership agreement was amended to provide that ninety-

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[92] *See* I.R.C. § 704(b) (1954). For example, a retroactive allocation of depreciation—an "item"—would have come under § 704(b).

[93] See 26 U.S.C. § 1 et. seq. (1976).

[94] *See* notes 109-112 *infra* and accompanying text for a discussion of the requirements of the "substantial economic effect" test.

[95] I.R.C. § 704(b)(2) (1976).

[96] I.R.C. § 706(c)(2)(B) (1976).

[97] *See* STAFF OF JOINT COMMITTEE ON TAXATION, 94th CONG., 2d Sess., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, p. 92-4 (1976).

[98] 76 T.C. 512 (1981). The case involved a pre-1976 fact situation, but the current provisions of § 706 were applied. The Tax Court reasoned that the 1976 amendments did not change the law, but simply codified prior law concerning the applicability of the "varying interests" rule to newly admitted partners. *Id.* at 524.

nine percent of the profits and losses for the entire year would be allocated to the new partners.[99] The Tax Court applied section 706(c)(2)(B) so that the new partners could not, by taking advantage of the economic predicament of the partnership, simply be allocated a percentage of partnership losses determined for the entire taxable year. But the Tax Court further held that, in determining losses which would have to be allocated both before and after the admission of the new partners, a partnership may use either an interim closing of the books or a proration method in which the entire year's results are prorated among the partners according to the portion of the taxable year which elapses before and after the admission date.[100]

Applied to *Richardson's* facts, the availability of the interim closing technique is critical. The Senate Financing Committee Report which accompanied the 1976 amendment to section 706 states that, once the varying interests are determined, the income and loss to be shared may be allocated by using

> the easier method of prorating items according to the portion of the year for which a partner was a partner, or the more precise method of an interim closing of books (as if the year had closed) which, in some instances, will be more advantageous where most of the deductible expenses were paid or incurred upon or subsequent to the entry of the new partners in the partnership.[101]

If the interim closing method is used by a cash-basis partnership and if the deductible expenses are paid (as they were in *Richardson*) after the admission of the new partners, then the partnership's losses will be concentrated during the period after the admission of the new partners, and the new partners will be in the same position as if a full retroactive allocation had been made.

The unresolved question is whether the holding in *Richardson* and a similar holding in a subsequent case, *Roccaforte v. Commissioner*,[102] can be extended to non-cash deductions such as depreciation, where the property generating the deduction is ac-

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[99] *Id.* at 514-20.
[100] *Id.* at 526.
[101] S. REP. NO. 938, 94th Cong., 2d Sess. 98 (1976).
[102] 77 T.C. 263 (1981).

quired after the admission of new partners with funds supplied by new partners. The use of the interim closing technique would permit such an allocation, even though the allocation may, because of the averaging conventions or because of ACRS, involve a deduction which is determined as if the property had been owned by the partnership for a period prior to its acquisition. Since the property will not have been acquired by the partnership prior to the admission of the new partners, an interim closing of the books as of the date of their admission will produce no depreciation or cost recovery deduction for the portion of the taxable year prior to the admission of the new partners. Rather, the deduction will be confined to the portion of the year subsequent to the admission of the new partners.

An alternative technique available to accrual basis partnerships where expenses have been prepaid is to select the proration method of determining the income and losses allocable in accordance with the "varying interests" rule. This will give the newly admitted partners a share of deductions attributable to expenses paid prior to their admission.[103]

B. *"Special" Allocations*

In a straightforward partnership agreement, the tax incidents of partnership operations are allocated among the partners according to their percentage interests in the partnership.[104] For

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[103] For accrual basis partnerships, the proration method will not, however, permit newly admitted partners to share in depreciation deductions economically accrued prior to their admission, i.e., incurred with respect to assets purchased prior to their admission. Use of the accrual method may be disadvantageous for equine partnerships because it may not only preclude the deduction of prepaid items, but also may require the capitalization of costs of raising horses. See Treas. Reg. §§ 1.162-12(a), 1.1251-2(d).

[104] Perhaps the most common method is simply to express the interests and percentages. One sometimes encounters partnership agreements, however, which express the partners' interests as percentages determined by dividing their capital contributions and any additional contributions by the total capital contributions and additional contributions made by all partners. This latter scheme reflects a corporate mentality inasmuch as it mirrors the fashion in which dividends are distributed based upon relative ownership of shares. The idea works well enough when current distributions are being made by a partnership, but it can cause severe difficulties upon liquidation where appreciated assets are sold for cash and the cash is distributed to the partners. If the appreciation is shared by the partners in proportion to their percentages determined by capital contributions, a relative-

example, in an equal three-person partnership, any partnership income or loss for the year for tax purposes will be reported one-third by each of the partners, and any separately stated items will also be reported one-third by each partner.

A "special" allocation occurs when the partnership agreement contains provisions that one or more partners will report items of income or loss, or perhaps bottom line loss for tax purposes, in a fashion *different* from their percentage interest in the partnership. A special allocation provision need not affect the distribution of cash to the partners during the taxable year in which the special allocation is made. Thus, it is possible for the partners to divide equally the cash flow from a partnership but to report unequally the tax losses of the partnership which may have been generated by depreciation after the cost recovery deductions or other deductions. The important point is that a "special" allocation by definition departs from a "regular" allocation, which applies to items other than the specially allocated items. Otherwise, the "special" allocation is the only allocation made by the partnership agreement.

Under section 704(a), a partner's distributive share of income (loss) *or* of any item of income (deduction) is determined "by the partnership agreement,"[105] provided the allocation of distributive shares in the partnership agreement has "substantial economic effect."[106] The partners are free to allocate the tax incidents of partnership operations between themselves in a fashion different from 1) their proportionate capital contributions, or 2) their "regular" share of partnership income or loss. Any such special allocation is separately stated and does not go into the computation of bottom line partnership taxable income or loss.[107]

1. *Use of Special Allocations*

Assume a partnership owns a number of broodmares. Nor-

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ly small capital contribution made late in the life of the partnership and perhaps after the majority of the appreciation occurred, can distort the amount of cash distributable to the partners.

[105] I.R.C. § 704(a) (1976).

[106] I.R.C. § 704(b)(2) (1976).

[107] Treas. Reg. § 1.702-1(a)(8)(i), T.D. 7728, 1980-2 C.B.

mally, partnership taxable income would be computed by subtracting out-of-pocket expenses such as board, farrier, veterinarian services and insurance, plus cost recovery deductions *from* gross receipts on the sale of the broodmares' offspring. The resulting amount would constitute partnership taxable income or loss, and each partner would report his or her distributive share of that number. The partners may agree to a different scheme which provides for a special allotment of all, or a portion, of an item to one partner, provided the "substantial economic effect" test is met.

The motive for special allocations is easy to discern: where the partners are in different tax brackets or have different individual tax profiles, the tax utility of a particular item may be greater for one partner than for another. For example, a partner may have significant short-term capital gains from other sources. A special allocation of partnership short-term capital losses reduces this partner's tax burden to a much greater extent than the shifting of short-term capital losses deprives the other partners of usable deductions, because of the limits on the application of capital losses against ordinary income under section 1211(b).[108] In a second situation, one partner may be in the highest bracket for a particular year (due to income from other sources) while another partner may have little or no income from other sources for a particular year. Under such circumstances, a special allocation of depreciation to the partner in the high bracket recommends itself.

2. *Substantial Economic Effect*

Partners do not have unlimited freedom to "specially allocate" items of income and loss among themselves without regard to economic reality. In 1976, Congress amended section 704(b)(2) to prohibit special allocations which do not "have substantial economic effect."[109] Basically, a special allocation has substantial economic effect and is respected for tax purposes if: 1) the allocation of an item of income or deduction to a particular

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[108] I.R.C. § 1211(b) (1976).
[109] I.R.C. § 704(b)(2) (1976).

partner is credited to or charged against the partner's capital account, and 2) liquidation proceeds are distributed in accordance with capital accounts. Thus, before the partners share in any liquidation proceeds according to their regular ratios, each partner's capital account must be fully adjusted.[110] The allocation must, at least potentially, affect the cash flow and property distributions from the partnership to the partners.

In *Orrisch v. Commissioner*,[111] the partners agreed that depreciation would be specially allocated to one partner, but the partnership agreement nonetheless provided that all cash and property distributions to the partners, and all distributions upon liquidation of the partnership, would be shared equally. The Tax Court accordingly held that the allocation lacked substantial economic effect because the tax allocation had no effect on the economic sharing of profits and losses.[112]

3. *An Example of a Proper Special Allocation*

Suppose *X* and *Y* own as partners a number of broodmares, stallion shares and racehorses. *X* and *Y* have previously shared all cash flow from the partnership and have allocated the tax incidents of partnership operations equally. Their initial investment in the partnership was equal, and each partner's current capital account balance is $100,000. Each partner's basis in the partnership is $100,000 and the partnership's basis for its depreciable assets is $200,000. The partnership's cash expenses are exactly matched by its cash revenues, so that for tax purposes the partnership will report a loss equal to its depreciation deduction for the year.

Because *X* has substantial taxable income from other sources and *Y* expects to have her income from other sources sheltered by deductions from other investments, it appears that *Y*'s share of the depreciation deductions will shelter income taxable at a rate much lower than *X*'s rate. Because of this, the partners agree that depreciation deductions will be allocated ninety percent to *X* and ten percent to *Y* while all other partnership taxable income/loss

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[110] *See* Magaziner v. Commissioner, 37 T.C.M. (CCH) 873 (1978).

[111] 55 T.C. 395 (1971), *aff'd per curiam* 31 A.F.T.R.2d 1069 (9th Cir. 1973).

[112] *Id.* at 399.

will be allocated equally. The partnership agreement is further amended to provide that the depreciation deductions will be charged against *X*'s capital account and that the proceeds received when the partnership sells its horses will first be applied to the extent of the capital accounts of the partners, with the remaining proceeds then divided equally. Under convenient analysis, this arrangement will pass the substantial economic effect test.

Assuming that the partnership has a depreciation deduction for the year in question of $100,000, a $90,000 deduction will be allocated to *X* and a $10,000 deduction will be allocated to *Y*. This will reduce the capital accounts of *X* and *Y* to $10,000 and $90,000 respectively. If the partnership's horses are sold on the first day of the next taxable year for $200,000, the partnership will have a gain on the sale of $100,000 ($200,000 amount realized minus adjusted basis of $100,000) which will be reported equally by the partners. This reported gain will increase the respective capital accounts of the partners to $60,000 for *X* and $140,000 for *Y*. If the partnership were then immediately liquidated, *X* would receive cash of $60,000 and *Y* would recive cash of $140,000,[113] and the special allocation would have had substantial economic effect.

4. *Planning Techniques: Gain Chargebacks*

Horse owners sometimes balk at the idea that the price of "substantial economic effect" will be that dissolution proceeds from the partnership will not be shared equally or in accordance with their "regular" percentages. This practical difficulty often is dealt with by what is known as a "gain chargeback" provision in the partnership agreement. Such a provision provides that when a special allocation has been made, any gain on the sale or other disposition of the asset with respect to which the allocation was

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[113] This distribution produces a fair result, even though *X* receives less than *Y*. *X* has already received a tax benefit as the result of the special allocation to him of $40,000 in depreciation deductions which otherwise would have been available to *Y*. At the same time, *Y* has been required to report a taxable gain of $50,000 on the sale of the thoroughbreds, $40,000 of which is directly attributable to the depreciation deductions specially allocated to *X*.

made will—to the extent of the allocation—be fully charged back to the partner who benefited from the special allocation. In our example, a gain chargeback provision would allocate the first $80,000 of gain to *X* (of course *X* would have received $40,000 of gain in the absence of the special allocation), with the remaining $20,000 to be allocated between *X* and *Y*. This would increase *X*'s capital account to $100,000 and *Y*'s capital account to $100,000, thus permitting them to share equally the proceeds of dissolution. Note that *X* will not receive in cash $90,000 of the $100,000 gain on the disposition of the thoroughbreds. The gain chargeback, like a special allocation on the front end, operates only to affect the tax consequences of partnership transactions reported by the partners and to affect the capital accounts, which in turn will determine the amount of cash distributed to the partners.[114] Assuming that *X* was able to invest this $20,000 savings at a pre-tax rate of return of sixteen percent, the value of the deferral to him will be $1,600 ($20,000 times sixteen percent return times fifty percent tax due equals $1,600). The value of deferral obviously depends upon the tax bracket of the particular taxpayer and the alternative uses of money, but it is easy to see how a gain chargeback provision coupled with a special allocation, perhaps heightened by the use of leverage, can produce substantial net after-tax savings for horse owners.

V. LIKE-KIND EXCHANGES OF PARTNERSHIP INTERESTS

A fashionable tax planning technique is the like-kind exchange. Because an asset which has appreciated in value can be exchanged for one or more like-kind assets without recognition of gain or loss, the technique offers the owner of the appreciated as-

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[114] The result is that, while *X* and *Y* each get $100,000 cash, *X* reports a $90,000 gain and *Y* reports only a $10,000 gain. Still, this is not unfair to *X*. *X*'s reported gain is only $40,000 in excess of what it would have been absent the special allocation. Assuming a 50% tax rate, *X* will pay an additional $20,000 in taxes (the entire amount of the gain would be treated as ordinary income because of depreciation recapture); but in the preceding tax year, *X* was allowed the special depreciation deduction of $40,000 which saved him $20,000 in taxes, so that the net tax effect of the special allocation and the gain chargeback is zero. Actually, *X* has obtained an economic benefit, because he will have the use of the $20,000 in tax savings for one year before he has to pay it back.

set a way to diversify and cash in on an investment without incurring tax liability.[115] Horses are eligible for like-kind exchanges, although the statute does require that a horse be traded for other horses of the same sex in order to be considered a like-kind exchange.[116]

The analytical difficulties of structuring like-kind exchanges of thoroughbreds between partnerships are no different than structuring similar exchanges between individuals. But suppose that, for reasons unrelated to the exchange of the thoroughbreds, the partners in both partnerships want to restructure their ownership interests so that the partners will not only end up owning different horses in their partnerships, but some partners will end up owning interests in different partnerships. Can an exchange of partnership interests qualify as a like-kind exchange, and thus not be considered a taxable transaction?

A. *Section 1031 Reprise*

The exchange of a partnership interest for property, just like the sale of a partnership interest for cash, is obviously not a like-kind exchange. Thus, gain or loss will be recognized to the extent that the amount of cash and/or fair market value of the property received exceeds or is less than the partner's adjusted basis for the partnership interest transferred.[117] Thus, for example, if a partner exchanges his or her partnership interest for an interest as a co-owner in a horse of racing age, the transaction will be a taxable one. Where a dissolution of the partnership followed by co-ownership of the partnership's assets is not feasible,[118] section 1031 of the Code, where applicable, may offer an alternative. Section 1031(a) provides:

> No gain or loss shall be recognized if properly held for productive use in trade or business or for investment (not including

[115] I.R.C. § 1031 (1976).

[116] I.R.C. § 1031(e) (West Supp. 1982).

[117] I.R.C. § 741 (1976).

[118] A frequently encountered problem occurs with a partnership which has such a large number of partners that the co-ownership is simply too unwieldy a form of business entity. Also, as noted above, a co-ownership may be treated as a partnership for federal income tax purposes. *See* note 52 *supra*.

> stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interests) is exchanged solely for property of a like-kind to be held either for productive use in trade or business or for investment.[119]

Thus, to qualify under section 1031, the properties exchanged must: 1) be of a like-kind; 2) not be of the type expressly excluded by the parenthetical clause in section 1031(a), and 3) both before and after the exchange, be held "for productive use in trade or business or for investment."[120]

In planning a section 1031 exchange involving partnership interests, two courses of action are possible. The partnerships can first be dissolved, with the partners taking title to the horses in their individual names, normally a non-taxable event. After the transaction is allowed to cool, the former partners exchange horses, and then contribute the received horses to new separate partnerships in which the former partners' interests are different. A second technique is simply to exchange the partnership interests directly between the partners.

The first technique—dissolution, swap and recontribution—would satisfy the like-kind requirement and would not directly fall within the parenthetical exclusionary clause of section 1031. However, two obstacles to section 1031 treatment would be unavoidable. First, the Service could contend (since any cooling off period would be rather short as a matter of business necessity) that the transaction was in substance nothing more than a swap of partnership interests regardless of its form, with the result that the unsettled question as to whether an exchange of partnership interests qualifies as a "like-kind" exchange will have to be faced. Because the business realities of the transaction may well require that the recontribution plan be set forth from the beginning, the Service's chances of successfully invoking the form-over-substance doctrine would be good. Second, even if the transaction is not treated by the Service as a swap of partnership interests, the Service could contend that the thoroughbreds received upon dis-

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[119] I.R.C. § 1031(a) (1976).

[120] *Id.*

solution of the respective partnerships were not "held for productive use in trade or business or for investment," but were in reality held for the purpose of being traded and recontributed to new partnerships. This second danger is illustrated by Revenue Ruling 77-337.[121] There, the taxpayer, following a pre-arranged plan, liquidated his corporation and immediately attempted to exchange the real property which would otherwise qualify as like-kind property under section 1031. The Service, ruling that the taxpayer had never held the shopping center for productive use or for investment, concluded that section 1031 treatment was not available.[122]

Analysis of whether a direct swap of partnership interests can qualify under section 1031 must begin with the first case to consider this question, *Meyer v. Commissioner.*[123] In *Meyer*, the Tax Court held that general partnership interests could be exchanged tax-free under section 1031 as long as the underlying assets were themselves eligible for like-kind treatment.[124] The Service announced its nonacquiescence to the *Meyer* case in Revenue Ruling 78-135,[125] taking the position that partnership interests are "securities" within the parenthetical exclusionary clause of section 1031(a) and thus are *never* eligible for section 1031 treatment.

In the second Tax Court case to consider the question, *Gulfstream Land & Development Corp. v. Commissioner*,[126] the Tax Court reaffirmed its *Meyer* holding that a like-kind exchange of general partnership interests is permissible under section 1031.[127] However, the Court denied summary judgment to the taxpayer because the underlying property might have been inventory property (and hence ineligible under the parenthetical exclusionary clause) rather than property used in the trade or business or held for investment.[128]

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[121] 1977-2 C.B. 305.

[122] *Id.* at 306.

[123] 58 T.C. 311 (1972), *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974), *nonacq.*, 1975-1 C.B. 3.

[124] 58 T.C. at 314.

[125] 1978-1 C.B. 256.

[126] 71 T.C. 587 (1979).

[127] *Id.* at 593-94.

[128] *Id.* at 596-97.

Revenue Ruling 77-321,[129] although issued prior to *Gulfstream* and Revenue Ruling 78-135, might support the argument that partnership interests are not embraced by the parenthetical exclusionary clause of section 1031. The ruling dealt with a taxpayer who had caused his corporation to transfer all its assets—which included money and securities—to a partnership in exchange for a partnership interest. The partnership interest was then transferred to the shareholder in a section 333 liquidation of the corporation, with the hope that since the corporation distributed no money or securities, gain could be avoided (the corporation had no current or accumulated earnings and profits). The Service, relying on the step-transaction doctrine, restructured the transaction as a distribution of assets by the corporation in a section 333 liquidation *followed* by a contribution of assets to the partnership by the distributive shareholders in exchange for the partnership interest.[130] By implication, the partnership interest received in the transaction as structured by the taxpayer was not a "security" within the meaning of section 333(e)(2)—and by analogy, not within the meaning of section 1031(a)'s exclusionary clause—or otherwise the Service would not have had to restructure the transaction.

In *Long v. Commissioner*,[131] another recent case to consider the qualification of partnership interests under section 1031, the Tax Court firmly resisted the Service's contention that partnership interests are either "choses in action" or "evidences of . . . interest" within the parenthetical exclusionary clause. The court permitted an exchange of general partnership interests to qualify under section 1031 after finding that the underlying assets were of the same type and the partnerships were engaged in the same principal activity.[132] The case does not, however, make it clear whether the look-through approach requires that *all* the assets of the two partnerships qualify for like-kind exchange treatment. Rather, the Tax Court seemed more concerned with making sure "that the exchange of partnership interests does not

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[129] 1977-2 C.B. 99.

[130] *Id.*

[131] 77 T.C. 1045 (1981).

[132] *Id.* at 1068.

shield a transaction which could not have otherwise qualified under section 1031(a)."[133] But the court said that "[i]n making this analysis, it should be emphasized that the determination of whether the exchange initially qualifies as a like-kind under section 1031(a) will be applied to the partnership interests and not on a partnership-asset-by-partnership-asset approach."[134] In *Pappas v. Commissioner*,[135] the Tax Court reaffirmed its position that partnership interests are not "choses in action" or evidences of interest within the parenthetical exclusionary clause and permitted a tax-free exchange of general partnership interests in hotel partnerships.

B. *Planning the Exchange*

Like-kind exchanges of partnership interests might be used where two partnerships both own horses of different sexes (although this result is not perfectly clear). Because the statute itself prevents an exchange of horses of different sexes from qualifying as like-kind property,[136] it may, as a practical matter, be difficult to structure a non-taxable deal directly between individual co-owners. The relative values of the horses of the same sex to be traded, the liabilities encumbering those horses, and the desired after-exchange ownership percentages inhibit the deal. A like-kind exchange of partnership interests, on the other hand, permits adjustments to be made from an aggregate standpoint, i.e., by taking into account all the horses of both sexes, all the liabilities and the percentage ownership interests in all the horses desired to be retained following the transaction. Assuming that *Long* and its predecessors do not require an asset-by-asset, look-through qualification, a like-kind exchange of partnership interests in partnerships owning horses of both sexes may be a way to accomplish a tax-free exchange which cannot, as a practical matter, be accomplished by a direct exchange. *Long's* admonition that a partnership interest exchange not be used to "shield a

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[133] *Id.* at 1069.
[134] *Id.* at 1068.
[135] 78 T.C. 77 (1982).
[136] I.R.C. § 1031(e) (West Supp. 1982).

transaction which could not have otherwise qualified under section 1031(a)"[137] should be read to refer to an exchange of assets otherwise denied section 1031 treatment, such as those embraced by the parenthetical exclusionary clause. *Long* does not prohibit the use of a partnership exchange in which the parties involved adjust, in a fashion satisfactory to all concerned, their ownership interests in assets which themselves clearly qualify for section 1031 treatment.[138]

CONCLUSION

Thoroughbred racing's epithet as the sport of kings is well deserved these days, if only by virtue of the royal prices paid for thoroughbred yearlings and bloodstock. As the cost of top quality thoroughbreds increases, the way the industry attracts capital also is changing. Within the past three years alone, at least five publicly registered offerings of interest in thoroughbred operations have been marketed, and the number of private placements of multi-investor deals of substantial stature must be well into the hundreds. The natural structure for increased public investment in the industry is the partnership, and more specifically, the limited partnership. The limited partnership combines the tax advantages of individual ownership of property with the statutory assurance of limited liability that an investor generally demands when most operational decisions are reserved for a managing agent/general partner.

These developments will continue and the use of partnerships in the equine industry will expand further. We hope that the techniques outlined in this Article may help bring new investors some of the excitement and pleasure which go with the ownership of thoroughbreds and will help ease some of the frustrations

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[137] 77 T.C. at 1069.

[138] Taxpayers contemplating an exchange of syndicate shares in different stallions may also wish to rely on the analysis which prevailed in *Long* and *Meyer* if the Service argues that syndicate shares are "choses in action" or "evidences of . . . interest" within the parenthetical exclusionary clause of § 1031(a). However, the *Guggenheim* case, which holds that an individual who sells stallion shares pursuant to a syndication of a stallion he or she owned had sold undivided fractional interests in the stallion, is authority for the proposition that the stallion shares are not "choses in action" or "evidences of interest" under § 1031(a). 46 T.C. at 559.

with the Service experienced by those already involved in thoroughbred partnerships.