Take a close look at that gift horse

Giving a racehorse or broodmare to children has some advantages—and some pitfalls

by Neal Hayias

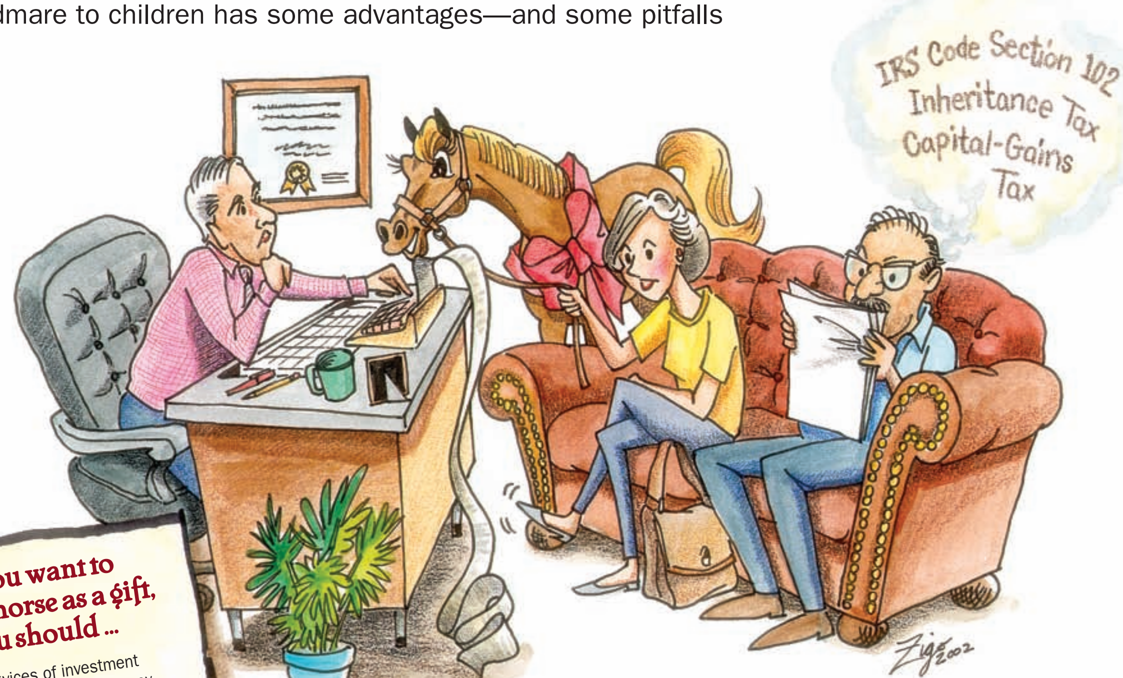
TOM AND BARBARA have been successful in their horse-owning and horse-breeding activities, and their children have shared their interest in Thoroughbred racing.

Now well advanced into that period of life euphemistically known as late middle age, they want to reward their children for their support of the horse-owning venture. They want to give their children a piece of the stable, specifically one or more horses that would be provided to the three children as gifts.

The children are agreeable to this arrangement and are not inclined to look a gift horse in the mouth. They all know the stable members and their value, and they also are aware that they will be paying training or boarding fees.

The trick, however, will be to transfer ownership of the gift horses without triggering unpleasant and costly tax consequences for Tom, Barbara, and their children, all of whom are fictional.

Here, in a case where a misstep can result in a big expense rather than a gift, horse owners need the services of investment professionals, including an attorney, accountant, and investment adviser. With their help, a gift can be a rewarding event rather than a costly hassle for both the giver and the recipient. Or, they may find that a gift is an unsatisfactory idea and that ownership should pass through Tom and Barbara's estate.



Tami K. Zigo illustration

If you want to give a horse as a gift, you should ...

- ❑ Acquire services of investment professionals, including attorney, accountant, and investment adviser.
- ❑ Consider potential costly tax consequences for you and recipient.
- ❑ Consider transferring ownership of horse over a number of years.
- ❑ Consider passing ownership of horse through your estate instead.
- ❑ Consider possibility of disputes among multiple recipients over horse.

About gifts

The principal reason for Tom and Barbara wanting to pass along a horse or horses to their children is to provide a gift that will appreciate outside of the parents' estate. Horses may or may not appreciate, however, so it is important to look at the gift dispassionately.

Internal Revenue Code Section 102 specifically excludes from gross income the value of property received as a gift or inheritance. This exclusion is based on the premise that such transfers are merely a redistribution of a donor's or decedent's after-tax income. This exclusion does not extend to the income earned on the transferred property, which will be taxed to the recipient.

But limits are set upon how much of a gift is free of taxation, for the simple reason that, without some ceilings, a person could transfer an entire estate, farm, or business before death to his or her heirs without paying the inheritance taxes currently on the books. (Many would ask why those inheritance taxes are on the books at all, but death taxes exist for now and must be dealt with.)

For 2002, the annual gift-tax exclusion is $11,000, which means that anything above that amount to any one individual is taxable. The question then becomes whether the tax can be limited, deferred, or eliminated altogether.

For the purposes of this example, let us assume that Tom and Barbara are giving a three-year-old, stakes-placed filly to their three children. The filly, still in training, has a current appraised value of $450,000.

First, Tom and Barbara can double the amount that is excluded from taxation if they want to make the entire gift in 2002. Tom owns half of the filly, at an equity value of $225,000, and Barbara owns the same equity interest.

So, Tom can make a gift of his half to the three children, and Barbara can make a separate gift of her half-interest to the children. At $11,000 multiplied by three for each of the children, the exclusion for Tom's half of the filly is $33,000, and Barbara's gift has the same $33,000 exclusion, for a total of $66,000.

Thus, the taxable gift has been reduced to $384,000 from $450,000 if they wanted to transfer full ownership of the horse this year. The filly would no longer be a part of their estate, and the children would be entitled to any gains or would sustain any losses.

An alternative would be to transfer ownership of the filly over a number of years. Initially, the children would obtain a 14.7% interest ($66,000 divided by $450,000) in the filly for 2002, and their stake would increase each year according to the gift-tax exclusion. After four years, the children would own a majority interest in the filly, which by then probably would be a broodmare.

Tom and Barbara also are realistic parents. They know that their three children have all enjoyed the Thoroughbred business, but each of their grown children has a life and a family. And, they know that their children do not agree on everything.

Recipe for discord

Moreover, with one-third ownership of the filly, one child could not make a decision without the consent of another. The parents also know that two children lining up against the third is a recipe for discord around the extended family's dinner table.

The parents cannot rule out disputes and, interestingly, the federal tax code recognizes that partial ownership means partial rights. Thus, it allows for discounts on the valuation of the asset. The discount also reflects, in part, the fact that one-third of a family-owned filly is difficult to sell on the open market.

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Discounts can run as high as 50%, and financial and legal advisers should be consulted in determining any discount against the full, appraised value. For purposes of illustration, let us assume that the family-owned filly is eligible for the full one-half discount. Thus, it is possible for Tom and Barbara to transfer up to $132,000 of value in the filly each year without incurring a gift tax if that gift is structured in the right way with the help of professional advisers.

This strategy is desirable for a number of reasons. First, the income from the filly might be taxed at smaller percentages if the children are in lower brackets than Tom and Barbara. Second, the value of the horse might be removed from Tom and Barbara's estate for federal estate tax purposes. Whether this is a good idea depends on the value of their combined estate. Removing the filly from the estate might be a desirable strategy in some circumstances.

As breeders, Tom and Barbara also have the opportunity to provide their children with a gift of relatively low cost and an opportunity for significant appreciation. In this scenario, Tom and Barbara would give their children a yearling that has shown some promise of being very good.

An independent valuation would be required to satisfy the IRS, but the appraisal would be based on stud fee and what older siblings have earned or sold for at public auction. Because private breeders like Tom and Barbara commonly do not go to the most expensive stallions, the total might fall within the limit of tax-free gifts that were considered when giving the three-year-old filly.

An alternative for Tom and Barbara, of course, is to give the children and grandchildren nice, big gift checks at Christmas and keep the filly or yearling in their estate. Tom and Barbara would be assured that their children would not be fighting over the filly and that the filly or her offspring either would be sold at the time of their deaths or passed on to the children through their estates.

Inherited property normally receives a step-up in basis to the property's fair market value at the date of the decedent's death. This means that the donor of property with a low cost basis will never have to pay capital gains taxes at death on the gain over cost if the horse is immediately sold.

Also, there would be no income tax due on any depreciation recapture. The difference between the property's fair market value and its adjusted basis completely escapes income taxation. Unfortunately, the recipient of a gift does not obtain this advantage if the donor makes the gift during his or her during life.

With financial and legal advisers, Tom and Barbara should consider all the scenarios and their financial ramifications when deciding whether to transfer the gift horse to their children or simply to keep the horse in their estates. Whether they decide to make a gift or not, they will have explored the consequences of their gift horse.

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