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STATE OF CALIFORNIA

BOARD OF EQUALIZATION

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law [redacted] Petitioner	)	DECISION AND RECOMMENDATION No. [redacted]

The above entitled matter came on regularly for hearing on February 10, 1987, in Oakland, California, before Stephen A. Ryan, Hearing Officer.

Appearing for Petitioner: [redacted]

Appearing for the Board: Mr. Bob Alexander
Tax Auditor

Mr. Vern Ferreira
Supervising Tax Auditor

Protested Item

On July 29, 1985, petitioner filed a petition for redetermination of a Notice of Determination issued by the Board on July 5, 1985, for the period October 1, 1980 through September 30, 1983. Petitioner [redacted] submitted a letter dated April 8, 1987 containing points and authorities in support of his position as well as numerous documents. The protest involves tax deficiencies determined on the following audit item:

	Tax Measure
Use tax on purchases and California use of horses	$793,182

Petitioner's Contentions

Oral Contentions of Petitioner According to Auditor Robert Alexander:

1. These horses were purchased for resale.

2. The decision in McConville v. State Board of Equalization is incorrect.

As Stated in Petition for Redetermination Filed by [redacted]

3. No tax is due because petitioner purchased and held these horses primarily for resale in the regular course of business and also for the "generation of income". The interim breeding was incidental to petitioner's resale activity.

As Stated in Letter of [redacted] Dated April 8, 1987:

4. Petitioner purchased these horses for breeding rather than for resale.

5. Petitioner does not owe California use tax because the horses were first functionally used (bred) outside California for more than 90 days before entering this State.

Summary

Petitioner apparently was a purchaser, owner, seller, breeder, boarder, and showman of Arabian horses during the period in question. He purchased horses in Russia and Europe and then brought them to California. He did not self-report or pay use tax to the Board on his California use of these horses.

The auditor conducted an audit of petitioner but said that petitioner would not then supply many facts regarding his operations. The auditor obtained as much information from petitioner as possible plus from other sources before completing his audit. His conclusion of taxability was based upon petitioner's use of these 14 horses for purposes other than retention, demonstration or display for resale, which included his treatment of the horses as capital assets with depreciation deductions taken for state and federal income tax purposes and capital gains treatment upon sale.

The auditor also denied petitioner's request for an exemption pursuant to the 90-day test for functional use outside California due to discrepancies in dates. The discrepancies still exist. The name, date of out-of-state purchase and date of first entry into California of each of these 14 horses are represented to be as follows by [redacted].

[redacted]	June 1980	December 1980
	June 1980	December 1980
	June 1980	December 1980
	June 1980	December 1980
	December 1980	March 1981
	June 1981	September 1981
	April 1981	November 1981
	April 1981	November 1981
	April 1981	December 1981
	June 1981	January 1982
	June 1981	January 1982
	December 1980	June 1982
	May 1981	June 1982
	May 1981	June 1982

The petition for redetermination filed by [redacted] reads that the auditor used incorrect dates of purchase and entry into California on seven horses. The date of purchase for five horses is different than the date set forth by [redacted] for each such horse. The differences are as follows:

Horse	Date of Purchase Set Forth In Petition for Redetermination
[redacted]	June 1981
	June 1981
	June 1981
	October 1981
	October 1981

Petitioner sent a letter dated July 30, 1984 to the auditor wherein he set forth purchase dates for these five horses which are the same as set forth by [redacted] That letter, however, identified a July 1981 date of purchase for [redacted] and a January 1981 date of purchase for [redacted] which differ from the June 1981 and December 1980 dates of purchase, respectively, represented by [redacted]

According to the auditor, petitioner's amended income tax returns listed the dates of purchase for the former five horses as set forth in the petition for redetermination. The

auditor's workpapers indicate that petitioner declared an August 1981 purchase of [redacted] and January 1981 purchase of [redacted] for income tax depreciation purposes which differs from the dates represented by both CPA firms.

[redacted] explained that she has a background in the horse industry and was brought into this case by her employer due to her specialized knowledge in the field. She explained that she personally had become aware of petitioner and his activities previously when his horses performed at shows which she attended. She said that he extensively showed his horses, primarily three other well-known stallions. She did not recall any mares being shown. She did not think that he then raced any horses primarily because Arabians were not raced at that time according to her.

She said that petitioner owned a large ranch where he kept and boarded horses. She thought that he had potential buyers come to his ranch during this time. She did not think that he conducted any auctions or sold any horses in that manner. She said that he employed a stud manager to handle the other stallions who were rented out for their stud services. She said that all his horses were of excellent pedigree having been reproduced from famous ancestry outside the United States.

The auditor said and wrote that petitioner advised him that the horses were purchased for resale by petitioner in the regular course of his business. He added that in-depth discussions were conducted regarding the extent and legal result of the breeding of these horses by petitioner, including the meaning of the decision in McConville v. State Board of Equalization on this subject.

The petition for redetermination filed by petitioner's CPA representatives, [redacted] provides that petitioner's purchase and use of these horses should be exempt because "they are held for sale in the ordinary course of business." These horses, which were therein labeled as "breeding stock", were contended to have been continuously held for the purpose of sale and generation of income. The subsequent breeding of the horses was written to have been directly related to the sale by evidencing good health and thus value. The income tax depreciation deductions taken on this "inventory" was argued not to be a controlling factor.

[redacted] said at the preliminary hearing twice that [redacted] said he bought them for resale." She said that each of his horses was for sale for the right price.

[redacted] said that in her opinion based upon the facts in this case, these 12 mares (excluding filly [redacted] were probably "broodmares". She defined a "broodmare" as one purchased "to have babies". The offspring, also being of fine pedigree, would then be sold. She then informed the hearing officer that petitioner probably purchased the older broodmares for immediate resale (after recuperation from the travel) because of their age. She explained that mares typically begin having reproduction problems in the fourteenth year and petitioner probably would have sold these older brood mares of fine pedigree for a substantial profit rather than attempting to breed them. These older mares included [redacted] (16 years old, $31,300 purchase price), [redacted] (19 years old, $40,000), [redacted] (21 years old, $9,000), [redacted] (23 years old, $9,328), [redacted] (19 years old, $19,100), [redacted] (15 years old, $10,000), and [redacted] (16 years old, $65,000).

The other 5 broodmares included [redacted] (4 years old, $14,354), [redacted] (10 years old, $190,000), [redacted] (7 years old, $280,000), [redacted] (3 years old, $56,100), and [redacted] (3 years old, $55,000).

[redacted] said that she found evidence that 11 of the 14 horses had been bred previously. The young filly [redacted] and colt [redacted] had not. She said she found no evidence that four-year-old [redacted] had ever been bred.

She explained that twelve of these mares were in foal (pregnant) at the time of the sale or petitioner paid stud fees to get them pregnant prior to bringing them to California. She said that two horses remained in Europe to give birth until being moved to California [redacted]. A reaudit by the auditor resulted in adjustments to the dates of entry into California of these horses as set forth by petitioner's first CPA firm which resulted in a later date to incur the tax liability and to begin interest charges than had been set by the auditor based upon the sale dates originally told to him.

[redacted] explained that mares and colts are usually initially bred in their third year. The breeding period of a mare is 11 months and 10 days. Mares live approximately 20 years and breed most of that time.

She said that Arabian horses were used for pleasure, show, or breeding purposes with very little racing during this time in question. Apparently, racing has become more extensive since then. She said that the shows were basically for advertising for breeding or sale purposes rather than prize money since the prizes were typically $100 plus a ribbon. She advised the hearing officer that a pleasure Arabian (owned

merely for personal pleasure) typically sold during this period for about $800.

She explained that petitioner generally advertised his stallions in horse publications. She was not sure whether they were advertised for sale or for breeding but figures the latter was more likely. The auditor agreed based upon his prior examination of the publications and his finding that petitioner earned a substantial income from breeding services. He said that he requested proof from petitioner that these horses were advertised for sale but no specific evidence of sale advertising was submitted.

[redacted] informed the hearing officer that petitioner took depreciation deductions for state and federal income tax purposes on the purchase prices of these 14 horses. She said that two were taken in error because they were too young to breed or race (the colt [redacted] and filly [redacted] both then less than seven months old). She advised that no investment tax credits were taken. She said that petitioner treated these horses as capital assets with capital gains treatment for income tax purposes when they were all sold in 1983.

Petitioner's 1981 federal income tax return 1040, Schedule F, which was attached to his 1981 California income tax return, identifies sales of four horses for a total of $800,000 generating a $695,458 profit. He also attached six separate form 6252's indicating 1980 and 1981 sales of six other horses on an installment basis. Five were listed each as an "ordinary asset". One horse, [redacted] (not involved in this deficiency), was listed as a capital asset. His 1982 return indicates the sale of four other horses for $200,500 generating a profit of $125,213.

The auditor had originally included use tax on petitioner's California use of other horses purchased by him but deleted those purchase prices from the proposed deficiency when petitioner filed amended income tax returns removing his depreciation deductions. No amended returns were filed regarding the depreciation of these 14 horses.

According to the auditor and [redacted] petitioner sold these horses in the latter part of 1983 wnen he ceased business as part of the settlement of a lawsuit.

The auditor said that petitioner is an attorney who previously practiced law but quit due to his generation of substantial profits from his Arabian horse business.

The recent letter of April 8, 1987 from [redacted] was sent by [redacted] He initially described petitioner's [redacted] as a "horse breeding farm". He described broodmares as being "the life blood of any breeding farm." He wrote that petitioner purchased these "broodmares" for breeding purposes rather than for resale. He explained that these Russian-bred Arabians made petitioner's farm and breeding program world famous. He wrote that "[n]one of the horses purchased overseas had any use other than as breeding stock."

He further wrote that the mares were purchased pregnant, with an agreement that they soon become pregnant, or that they be transferred to another location to be bred so as to be pregnant before shipment to California. He described that the stallions to whom these mares were bred were handpicked from famous pedigree.

[redacted] submitted copies of an article in Arabian Horse World (January 1983) on the subject of petitioner and his farm. According to the unidentified author, petitioner's primary purpose was to breed Arabian horses. The author wrote therein that petitioner said all sales by the Soviet government were F.O.B. at its border. He also submitted copies of portions of numerous other monthly publications of Arabian Horse World under his heading of "advertising". An examination of the pictures and writings do not indicate whether petitioner's horses were shown and identified therein to solicit breeding or sale. One of the authors labeled petitioner as a "breeder". That author described his purchases and intended breedings.

Both [redacted] and [redacted] submitted copies of numerous documents regarding these 14 horses. The evidence included copies of some registration documents, pedigree certificates, lineage charts, several contracts most of which are incomplete, a statement from The Veterinary Officer of the Netherland Government, "covering" certificates, unidentified test results, several letters, many telex messages, a U.S. Department of Agriculture importation report, and some charts from petitioner's farm. Some of the documents were in Russian or Dutch and have not been translated. The telex message copies are of poor quality and are not totally readable.

The portions of offer and contract copies submitted contained various conditions required before a horse was actually sold. The primary condition identified was that the particular horse to be sold be "in foal". Apparently, some mares were not pregnant when the auction was conducted or agreement of sale was made requiring an attempt of the expected seller to breed the mare before petitioner would agree to

purchase it. The documents further indicate some problems of the proposed sellers in getting several mares pregnant. In the interim, petitioner did not pay the purchase price to the proposed seller. It also appears that petitioner acquired a new young foal each with and

The copy of a Report of Importation from the U.S. Department of Agriculture dated December 14, 1981 identifies the importation of five horses at Los Angeles by , from Holland for petitioner. The stated purpose of importation was "SHOW". The document contains primarily typed characters. The names of , and three other horses were handwritten on the document. This is the only document verifying actual shipment of any of these horses.

A summary document recently submitted by expressly represents that the "use outside California" of and was "none".

Analysis and Conclusions

The main issue is whether petitioner incurred use tax liability on each purchase and California use of these 14 horses.

Use tax is imposed upon a purchaser who purchases tangible personal property from a retailer for use, storage, or other consumption in this State (see Revenue and Taxation Code sections 6201 and 6202). No use tax is incurred, however, if the property is purchased by a retailer for resale in the regular course of his business and the only use of the property is retention, demonstration, display, and such sale (see Revenue and Taxation Code sections 6009, 6007, 6244(a), and Regulation 1620(b)(1) and (2)(A)).

However, Revenue and Taxation Code section 6244(a) further provides that when a person who purchased tangible personal property for resale in the regular course of business but later used it for purposes other than mere retention, demonstration or display, that other use renders him liable for use tax at the time of that other use.

It appears petitioner had conducted several activities in the equestrian industry at his ranch. Apparently, his main activity involved breeding--the stud service fees for his famous stallions, and the income for the pregnancy of and foals born to his broodmares. He apparently also sold other horses in the regular course of his business.

This results in an apparent dual purpose of petitioner in purchasing and owning these horses. The question is whether petitioner purchased these 14 horses now in question primarily for resale in the regular course of his business or primarily to generate income from the breeding which included sales of the young foals produced from the broodmares.

The court in McConville v. State Board of Equalization (1978) 85 Cal.App.3d 156, 149 Cal.Rptr. 194, found that the acts of breeding a mare and selling the foal can be consistent with holding that mare for resale because it proves to potential buyers of the mare that it is healthy and capable of reproduction. The real distinction involved the intent of the owner--was the mare held for resale or for breeding purposes. When a mare has been held but with no buyer making a purchase, this distinction is not apparent from the objective circumstances.

Petitioner did not appear at either scheduled preliminary hearing so the hearing officer has not been able to question him regarding his activities, intent, purchase, use, and sales of these horses. His true intent for use of these horses at the time of each purchase is not clear.

Petitioner apparently told the auditor he purchased these horses for resale. This probably is the best evidence in this proceeding of his position regarding his intent. The totally opposite contentions from petitioner's two CPA representatives about his alleged intent appear to be legal conclusions made for purposes of this administrative proceeding rather than on the actual facts.

The filly [redacted] and colt [redacted] were only several months old and could not physically have been purchased for immediate breeding because they were too young. He could have purchased them for resale or to retain them for approximately three years before breeding could occur to generate breeding benefits. The same would be true for the two other young foals purchased by petitioner along with [redacted] and [redacted]

Revenue and Taxation Code section 18182 provides that the term "property used in the trade or business" includes . . . horses held by a taxpayer for "draft, breeding . . . or sporting purposes" for 24 months or more from the date of acquisition. The two results of this definition are that horses held for such purposes can be deemed to be "capital assets" rather than inventory to become (1) the subject of the beneficial capital gains treatment rather than ordinary income upon sale by the owner, and (2) the subject of income tax depreciation deductions (see Revenue and Taxation Code sections 18181, 17072, and 17208,

respectively). There are similar provisions in the Internal Revenue Code for federal income tax purposes.

Petitioner took advantage of these provisions for income tax purposes. The treatment by petitioner of these horses as capital assets with depreciation deductions and capital gains treatment for income tax purposes is additional evidence that he intended to hold them as capital assets for breeding purposes rather than as inventory for resale in the regular course of business. However, this is only one factor to consider in deciding this issue.

From the evidence available to the hearing officer, it is our finding that his primary activity was breeding horses rather than selling horses. The descriptions by petitioner's various representatives of the 12 eldest mares as "broodmares" and of all 14 horses as "breeding stock" are consistent with the facts. It is our conclusion that he intended to and actually purchased the horses primarily for breeding purposes. If he had been offered the right price for one of these horses during the breeding activity, he may have sold. However, this did not constitute a holding for resale in the regular course of business. His primary goal with these broodmares was to breed with sales or eventual breeding of foals producing profits together with the beneficial income tax benefits derived from treating them as capital assets. The eventual resale of the horses after breeding at the liquidation of that business does not change our conclusion (see Kirk v. Johnson (1940) 37 Cal.App.2d 224). Consequently, absent an exemption, he is liable for use tax since he purchased the horses for storage, use, or other consumption in California.

It is further our conclusion that petitioner is responsible for California use tax even if he originally intended to purchase one or more of these horses for resale in the regular course of business because he later used each horse in California for purposes other than retention, demonstration, and display (Rev. & Tax. Code § 6244(a)).

It is possible, however, that petitioner is exempt from use tax on the California use of any horse which had been previously functionally used outside California by petitioner for more than 90 days (see Regulation 1620(b)(3)). We lack critical evidence in each transaction which will be required before any such exemption can be proved.

There are three horses for which evidence indicates a possible location outside California for significantly more than 90 days between petitioner's purchase date and delivery into

California. These horses are [redacted] and [redacted] (identified in the documents as [redacted]

The registration of [redacted] was transferred to petitioner on April 1, 1981. This followed the apparent contract of sale dated December 13, 1980 (the contract is in German). It appears from another document in German that [redacted] gave birth to a foal in Germany on March 25, 1981. She had previously been bred with the famous stallion [redacted] Petitioner represented that she first entered California in June of 1982. His representatives have stated that she was also rebred in Europe after April 1981 before being imported to the U.S. No importation or shipment documents were submitted.

Petitioner's representatives contend that [redacted] was purchased by petitioner in England in May 1981 and transferred to Holland where she was bred before arrival in California in June 1982. The registration certificate copy submitted does not appear to identify the date registration was transferred to petitioner. No contract of sale was submitted. The Holland government document identifies a May 25, 1982 inspection of [redacted] and an intended May 26, 1982 shipment commencement from Amsterdam to California.

A horse identified as [redacted] was also listed on that Holland government document for inspection and intended shipment on the same dates. The registration certificate copy submitted for that horse is indecipherable. Petitioner's representatives contend similar facts and dates for this horse (as [redacted] as for [redacted]

Although [redacted] contends that the 90-day test has been met, the available evidence indicates that the remaining 11 horses may have been functionally used outside California (excluding the time of shipment and storage for shipment) for less than 90 days. Functional use does not include mere physical location of a horse while owned by petitioner awaiting shipment to California. It requires an actual use such as breeding or giving birth to a foal while owned by petitioner after his purchase with such an act not being a condition of the sale.

The dates represented now by [redacted] are not specific as to days but only months. The differences in represented dates of purchase and entry into California range from 3 to 8 months. The four horses for which a 7-month difference is represented [redacted] are all indicated on documentation as possibly not being sold until several months after represented by petitioner's representative. Petitioner's prior CPA representative declared in

the petition for redetermination that these four were sold at later dates. There is evidence indicating that the two horses in the three-month category ( ) may not have been sold until later than represented. The horse in the eight-month range (as the subject of a contract of sale one month after the represented sale month. Petitioner's prior CPA representative also declared that this horse was sold later. Three mares in the six-month category (and (were not verified as pregnant by the potential seller while still in the seller's possession until much later dates and petitioner did not pay the purchase prices until after such verification. A telex also indicates a possible sale of the colt (later than represented.

Without receipt of the missing evidence, we cannot verify the actual date of purchase or date of first entry of each horse into California. Petitioner should be allowed 30 days to submit proof of sale and importation, including contracts of sale, contract terms, auction terms, dates of payment of purchase price, dates of delivery to petitioner (or his agent), date of verification of pregnancy, date(s) of occurrences of other contract conditions, dates of storage for shipment, dates of shipment, and dates of entry into California. It should also submit proof of the breeding of any horse in a location other than that of the seller after delivery to petitioner but prior to entry into California.

Without satisfactory proof of these facts, we are unable to verify that any horse was first functionally used outside California for more than 90 days from the date of purchase under Regulation 1620(b)(3).

Recommendation

Allow petitioner 30 days to submit additional evidence to the hearing officer for further examination. If no evidence is timely received, redetermine without adjustment.

Stephen A. Ryan

Stephen A. Ryan, Hearing Officer

5-11-87

Date

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