

Equine Business Year in Review – 2001 is published by Dean, Dorton & Ford's Equine Industry Group. We hope you find the information we present to be interesting and helpful. We welcome your feedback.

Located in the heart of central Kentucky, known for its world-class horse farms, racing, and sales, Dean, Dorton & Ford has provided accounting, tax, and business consulting services to the horse industry since our inception in 1979. Our clients cover a broad spectrum of organizations involved in the horse industry, from small boarding farms to large multi-departmental farms involved in boarding, breeding, selling, stallion management, and crop production; from racing stables to a racetrack; from bloodstock agents to equine veterinary firms to equine insurance agencies; and from industry associations to industry publications. Not all of our clients are based in central Kentucky; horse industry clients from other parts of the country and from outside the United States also gain comfort by having our industry specialists work with them.

As a firm, we endeavor to know the business of horses, not just accounting and tax rules relating to the industry. We accomplish this in a number of ways, including meeting periodically, often with outside experts, to discuss business topics of interest in the industry; by reading industry periodicals; by studying the abundance of statistical data available regarding different measures of industry performance; and most usefully, by working with our clients in the industry on their business matters.

We perform a variety of services for our clients involved in the equine industry and welcome inquiries, whether from new participants in the industry who want assistance in properly structuring and administering their stables or farms, or from long-time industry participants seeking to improve the performance and administration of their equine operations. Members of our Equine Industry Group will be pleased to answer any questions you may have. Please call any of the following: Doug Dean, Richard Dorton, Joe Ford, Martha Jones, Leigh McKee, or Steve Schnettler.

ADDRESS: 106 West Vine Street, Suite 600

Lexington, Kentucky 40507

TELEPHONE: (859) 255-2341

FAX: (859) 255-0125

WEB SITE: www.deandortonford.com

E-MAIL: ddean@deandortonford.com

Dean, Dorton & Ford, P.S.C. - Equine Industry Group

Accounting

- For smaller enterprises, directly performing many accounting, payroll, and clerical functions.
- Designing and implementing farm accounting and management information systems.

Business Consulting

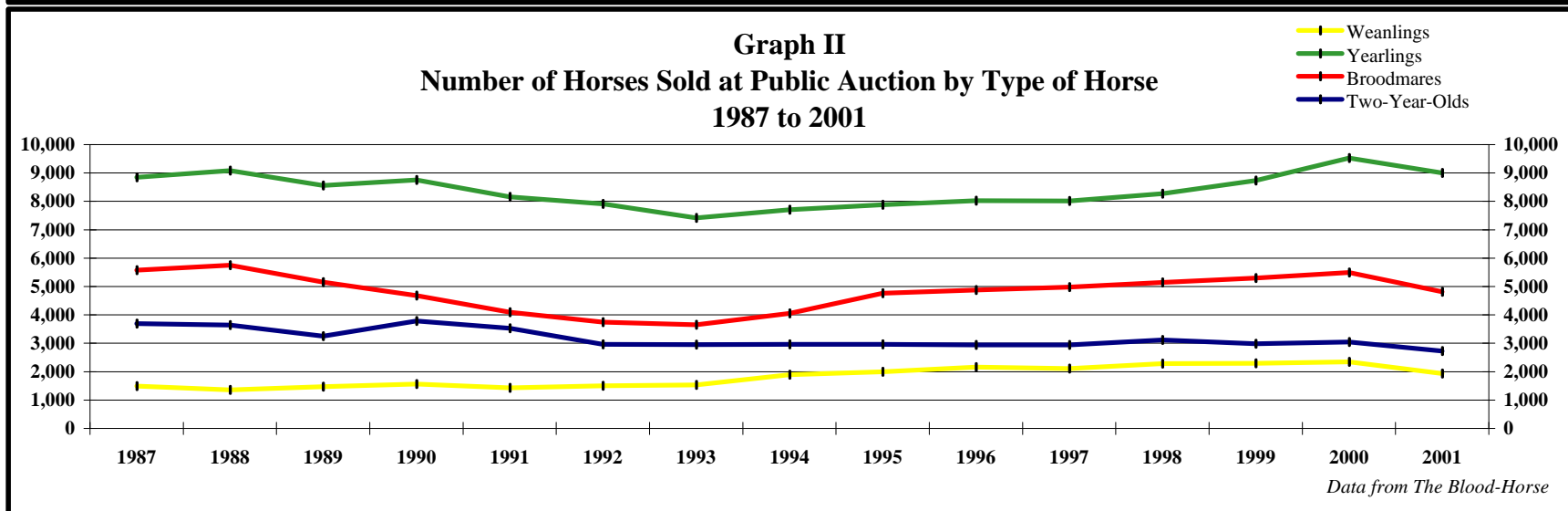
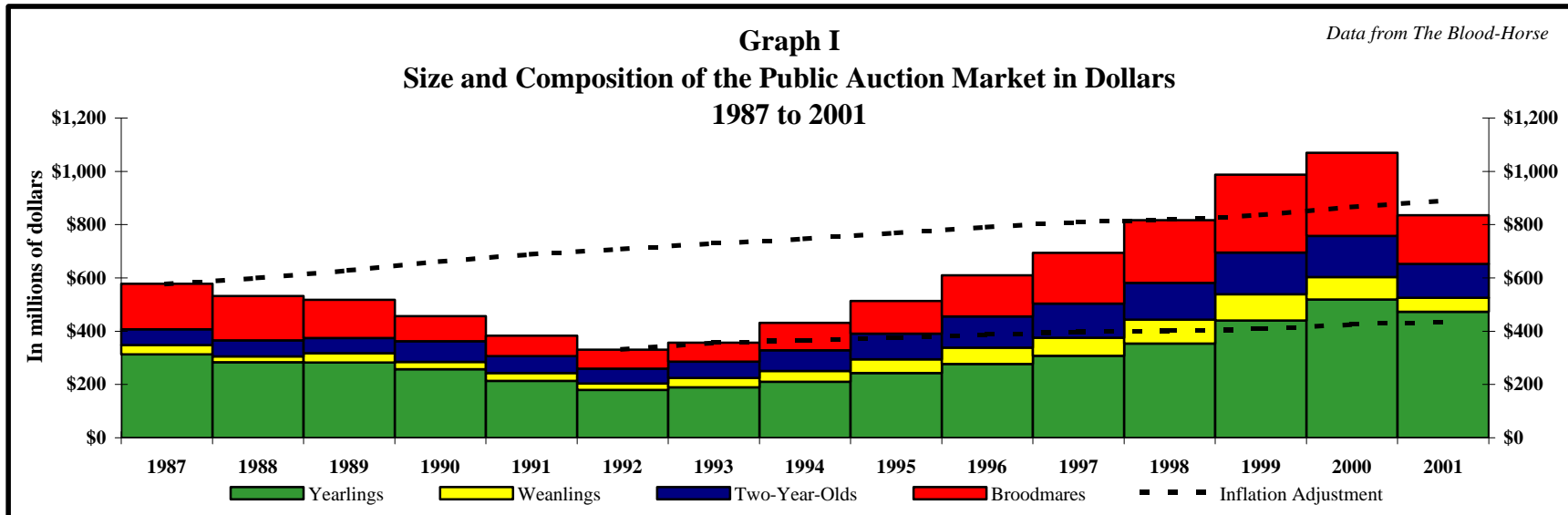
- Developing strategies to use the optimum forms of organization in which to conduct horse and farm businesses.
- Developing financial and business plans for farms, breeding operations, and racing stables.
- Financial analysis of stallion prospects.
- Designing and implementing retirement plan and other employee benefit programs.

Tax

- Developing strategies to make maximum use of potential tax losses.
- Avoiding exposure to the hobby loss rules.
- Structuring transactions to avoid or minimize sales and use taxes.
- Avoiding or managing the potential impact of the passive activity loss rules.
- Using current and deferred trades of horses and farms to avoid or postpone income taxes.
- Using the involuntary conversion tax rules to defer income taxes on insurance recoveries related to horse and farm casualties.
- Estate planning designed to use special use valuation and family farm conservation incentives, family limited partnership strategies, and deferred tax payments.
- Handling multi-state tax allocations.
- Helping foreign owners and breeders to minimize exposure to U.S. taxes and comply with filing requirements.
- Developing tax accounting systems to comply, where required, with rules requiring capitalization of preproductive period costs.
- Representing clients with federal and state tax audits.
- Taking advantage of unique tax depreciation rules.

Table of Contents

- Information and Commentary on Thoroughbred Public Auction Markets 4-8
- Information and Commentary on Thoroughbred Breeders' Costs and Profits 9-11
- Information and Commentary on Stud Fee Multiples 12-14
- Information and Commentary on Changes in Production Costs and Yearling Selling Prices for Thoroughbred Breeders 15-17
- Information and Commentary on Racing Purses 18-19
- Potential Tax Planning Opportunity for Horse Owners 20-22
- Tax Implications of MRLS Losses 23-26



Commentary on Graphs I and II

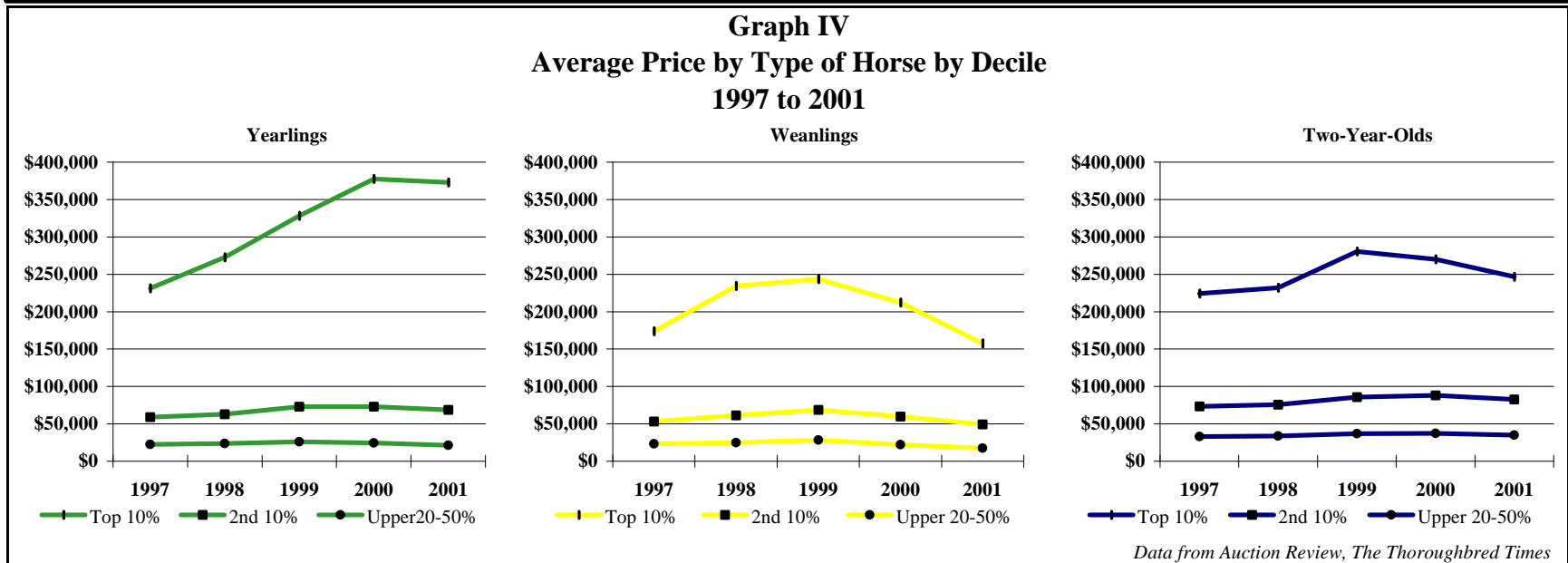
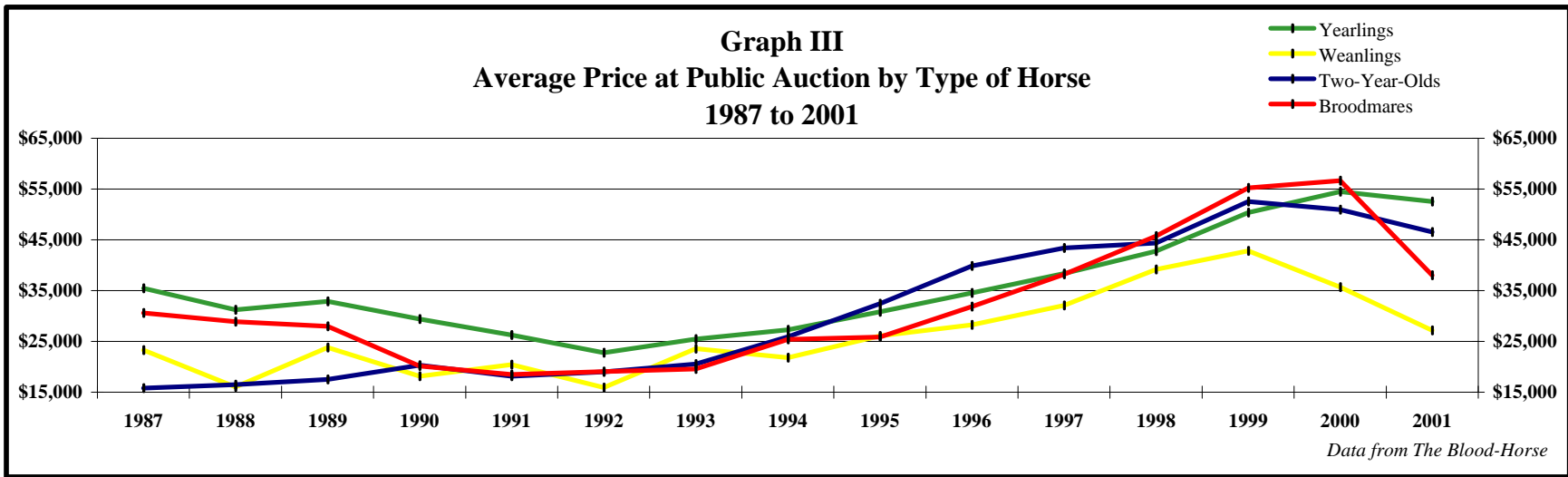
- A significant decline in the aggregate amount of dollars involved in thoroughbred public auction sales occurred during 2001 after 8 consecutive years of increases. On an inflation-adjusted basis, 2001's dollars dipped below 1987's, but remain well above the 1992 level (nominally and inflation-adjusted), the lowest of the previous downturn. The obvious suspects for 2001's decline include mare reproductive loss syndrome (MRLS), the downturn in the U.S. economy, the disruption of September 11, and the continuing drop in the U.S. stock market.
- Sales by category (in dollars) as a percentage of the total auction market have trended as follows in recent years:

	1998	1999	2000	2001
Weanlings	10.9%	9.9%	7.8%	6.3%
Yearlings	43.3	44.6	48.6	56.6
Two-Year Olds	16.9	15.9	14.5	15.2
Broodmares	28.9	29.6	29.1	21.9

Note the steady decline in the portion of the public auction market represented by weanlings and the substantial decline in 2001 for broodmares.

- The total number of horses sold at auction reached its highest level in 2000 (after 7 consecutive years of increases), but decreased 9% in 2001. There were decreases in every category, with weanlings (18%) and broodmares (12%) taking the largest plunges. Yearlings and two-year-olds sold at auction decreased 6% and 10%, respectively.
- 5% of the 2001 foal crop sold at public auction as weanlings, and 25% of the 2000 foal crop sold at public auction as yearlings. The following shows the relationship of these numbers to the two previous years:

	1999	2000	2001
Weanlings	7%	7%	5%
Yearlings	27%	29%	25%



Commentary on Graphs III and IV

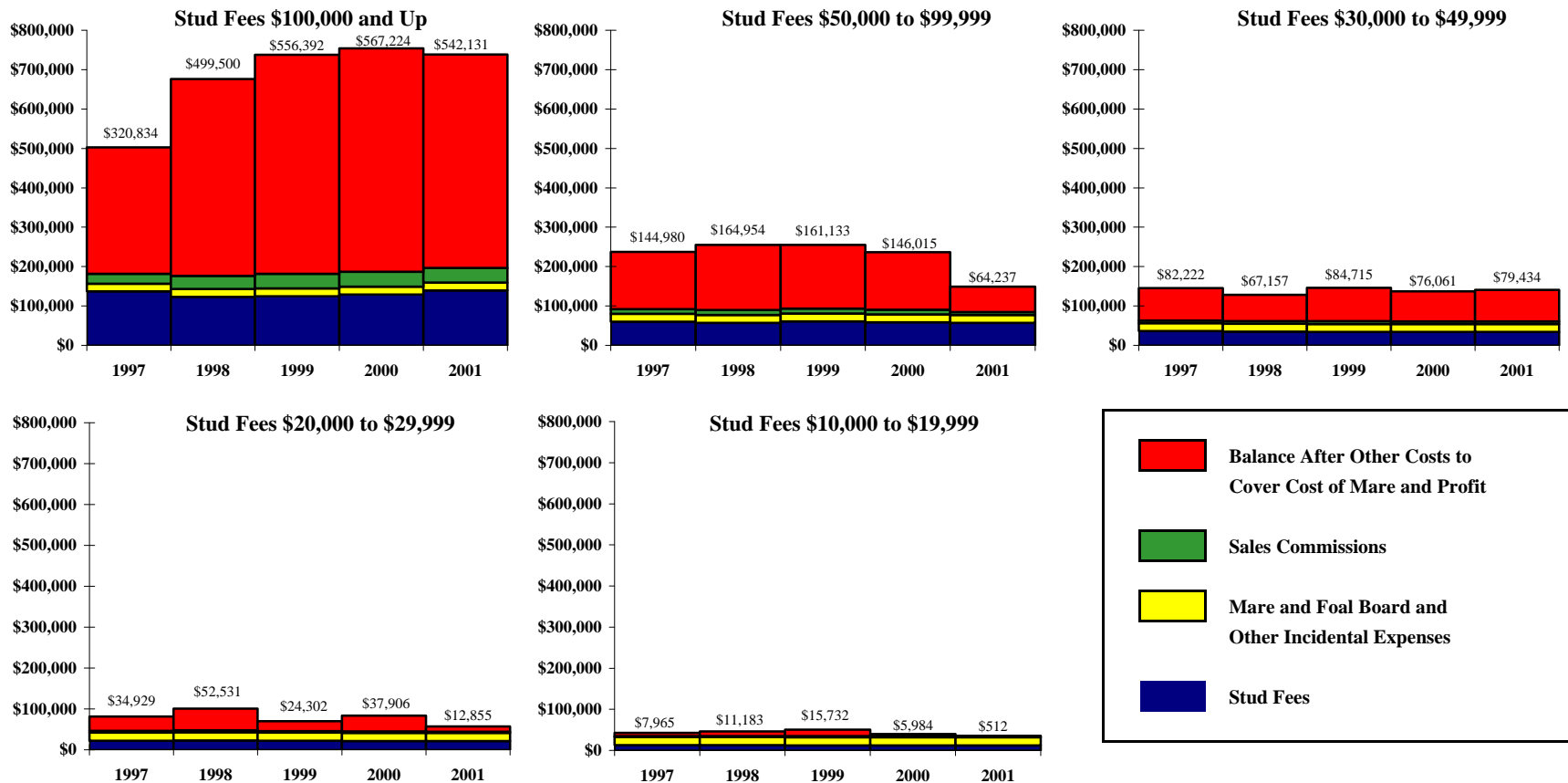
- From 1998-2000, broodmares had the highest average price of all categories. In 2001, broodmare average prices dropped below average prices of yearlings and two-year-olds and even dropped back to the 1997 average broodmare price. The decrease in average broodmare price from 2000 to 2001 was 33%.
- The average weanling price was quite volatile from 1987 through 1994, then steadily increased through 1999, but decreased 17% in 2000 and another 24% in 2001.
- Two-year-old average prices, which had increased every year from 1991 through 1999, including an 18% increase from 1998 to 1999, decreased by 3% in 2000 and by 9% in 2001.
- Average yearling prices experienced steady growth from 1995 to 1998 of approximately 11-12% each year. In 1999, average yearling prices jumped 18%, in 2000 they increased 8%, and then they dropped by 4% in 2001.
- Graph IV examines the top 50% (by price) of each market segment – yearlings, weanlings, and two-year olds - over the last five years. The following table shows the ratio by category of the top decile to the second decile in terms of average prices. Note how much more the top decile of yearling prices is than the second decile – over 5 times, a substantially greater multiple than in relation to weanlings and two-year-olds – each about 3 times:

	1999	2000	2001
Yearlings	4.5	5.2	5.4
Weanlings	3.5	3.5	3.2
Two-Year Olds	3.3	3.1	3.0

- Note that even the top decile average yearling price leveled off in 2001 (a 1% decrease, following a 15% increase in 2000). The second decile (6%) and combined third through fifth deciles (14%) also declined. Although not shown, each of the sixth through tenth deciles of yearling prices also dropped from 2000 to 2001.
- For two-year-olds, the average price in the top decile again dropped (9% in 2001; 4% in 2000).
- Note that for weanlings and two-year-olds, average prices for the second and third through fifth deciles held up better in 2001 than for the top decile.
- The average price in the top decile for weanlings declined again in 2001 (26%; 13% in 2000). For weanlings, the overall 24% decline in average prices was represented by declines in each decile.

Note: Dollar figures above bars on bar graph represent amounts remaining after other costs to cover mare and profit.

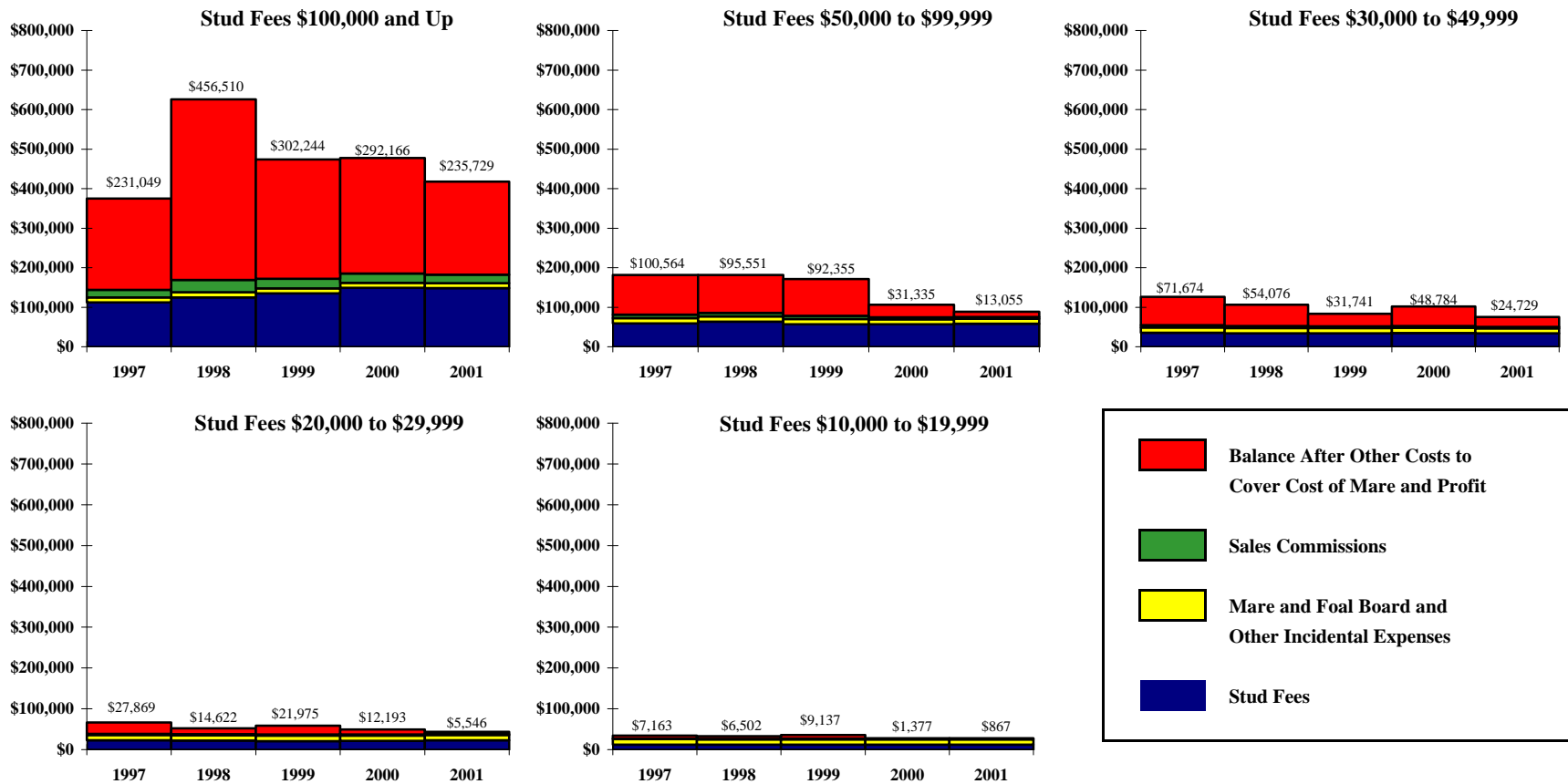
Graph V
Breakdown of Price of Yearling Sales into Cost Components - Stud Fees, Sales Commissions, and Mare and Foal Board and Incidental Expenses -- Balance Available to Cover Cost of Mare and Profit
YEARLINGS -- By Stud Fee Range
1997 to 2001



Underlying Data from Auction Review, The Thoroughbred Times

Note: Dollar figures above bars on bar graph represent amounts remaining after other costs to cover mare and profit.

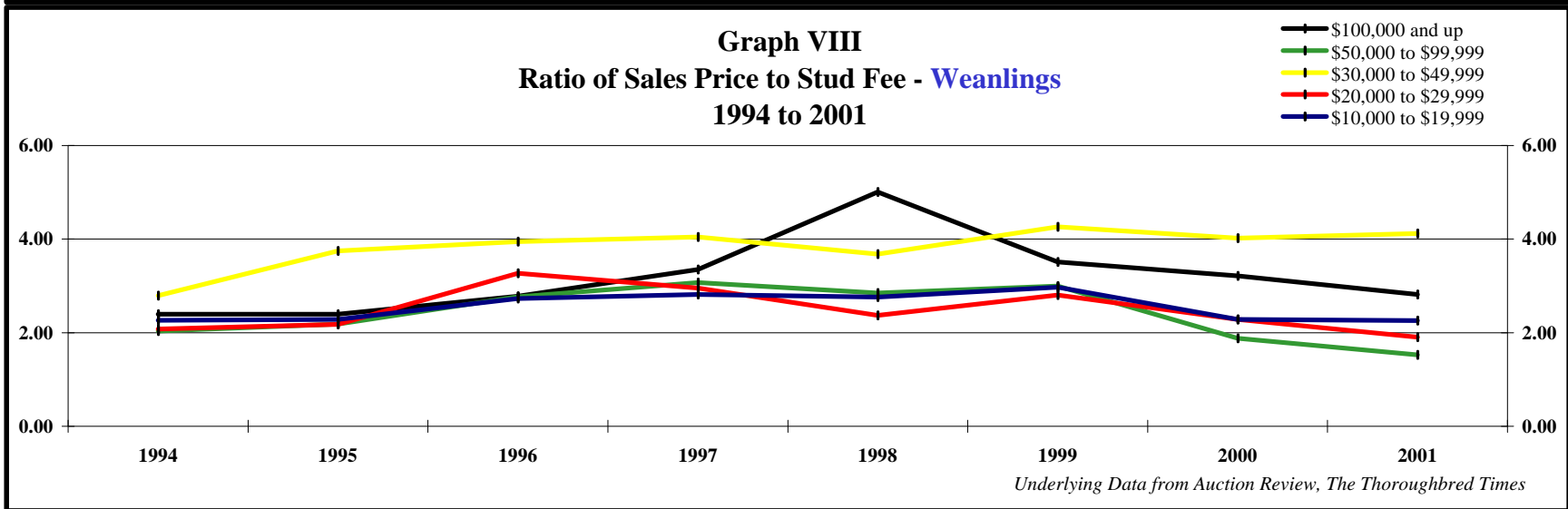
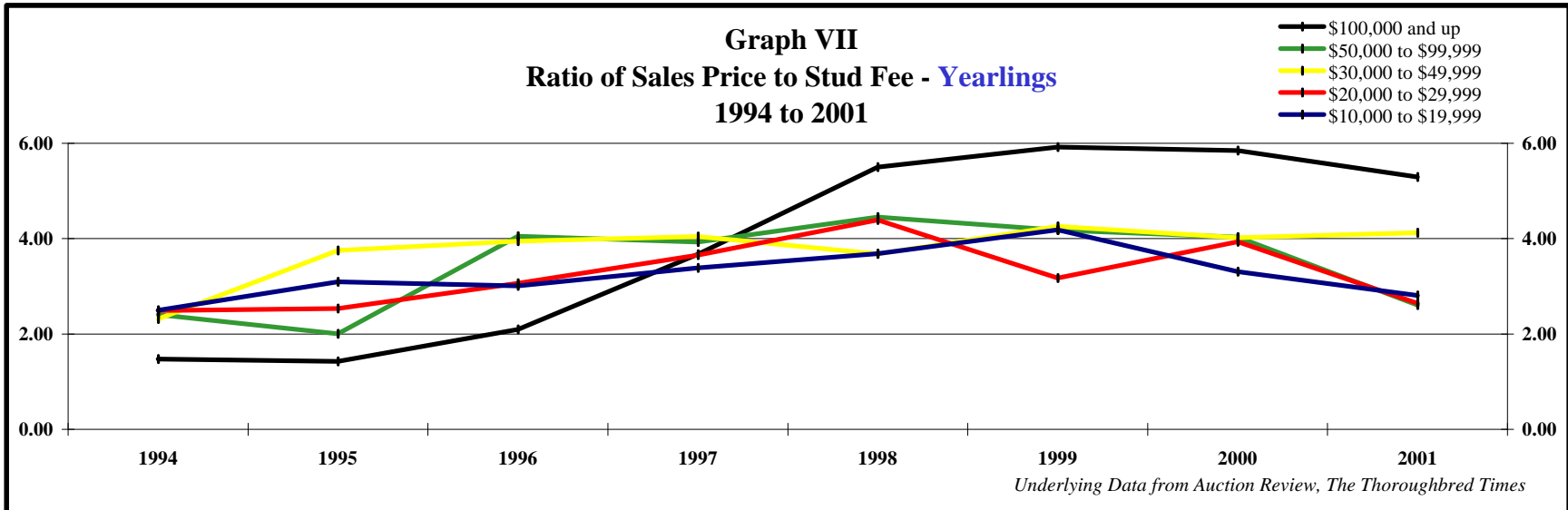
Graph VI
Breakdown of Price of Weanling Sales into Cost Components -- Stud Fees, Sales Commissions, and Mare and Foal Board and Incidental Expenses -- Balance Available to Cover Cost of Mare and Profit
WEANLINGS -- By Stud Fee Range
1997 to 2001



Underlying Data from Auction Review, The Thoroughbred Times

Commentary on Graphs V and VI

- We have analyzed data which shows the relationship of yearling (Graph V) and weanling (Graph VI) sales results to stud fee costs over 1997-2001, segmented by stud fee ranges (for the breeding year). These graphs show the portion of average sales price consumed by related stud fees, and add two other significant components of cost, a 5% sales commission and the cost of boarding and otherwise caring for the foal from an approximate weaning date until sold and the dam for a year. For this latter cost, primarily board and veterinary, we used \$20,000 and \$13,000 for yearlings and weanlings, respectively. We have not included sales tax on stud fees, because not all states tax stud fees and because stallion owners who use their seasons are not subject. The balance of average sales prices not consumed by the specific costs outlined above is available principally to cover the cost of using the mare for a year to produce the foal and, hopefully, to provide a profit to the breeder.
- We note in Graph V that for 2001 yearling sales where the dams were bred to stallions with fees of \$100,000 or more, there was a relatively small decline (4%) in the amount available to cover the cost of the mare and provide the breeder with a profit. The decline was quite substantial for breeders to \$50,000 to \$99,999 stallions, the third consecutive and most precipitous decline. Breeders to stallions whose fees were in the \$30,000 to \$49,999 range did all right, but in the \$20,000 to \$29,999 and \$10,000 to \$19,999 stud fee ranges, the coverage of costs dropped greatly, with almost no coverage in the latter category.
- In Graph VI, we note that the coverage for weanling sellers dropped in each stud fee range we present. Those who bred to the highest-priced stallions did somewhat better, in relative terms, than the others shown.



Commentary on Graphs VII and VIII

- Considerable published data is available to breeders on stud fee multiples (sales price of yearling or weanling as a ratio of related stud fees) on a stallion-by-stallion basis. We have taken the data that groups stallions by stud fee ranges – see Graphs V and VI – and looked in Graphs VII and VIII at trends over time and relationships among different stud fee ranges. In doing this analysis, the stud fees are from the breeding year, not the sales year.
- The following table shows stud fee multiples for yearlings sold in 1994 through 2001, by stud fee range:

Stud Fee	1994	1995	1996	1997	1998	1999	2000	2001
\$100,000 and up	1.5	1.4	2.1	3.7	5.5	5.9	5.9	5.3
\$50,000 to \$99,999	2.4	2.0	4.1	3.9	4.5	4.2	4.0	2.6
\$30,000 to \$49,999	2.3	3.8	4.0	4.0	3.7	4.3	4.0	4.1
\$20,000 to \$29,9999	2.5	2.5	3.1	3.7	4.4	3.2	3.9	2.6
\$10,000 to \$19,999	2.5	3.1	3.0	3.4	3.7	4.2	3.3	2.8

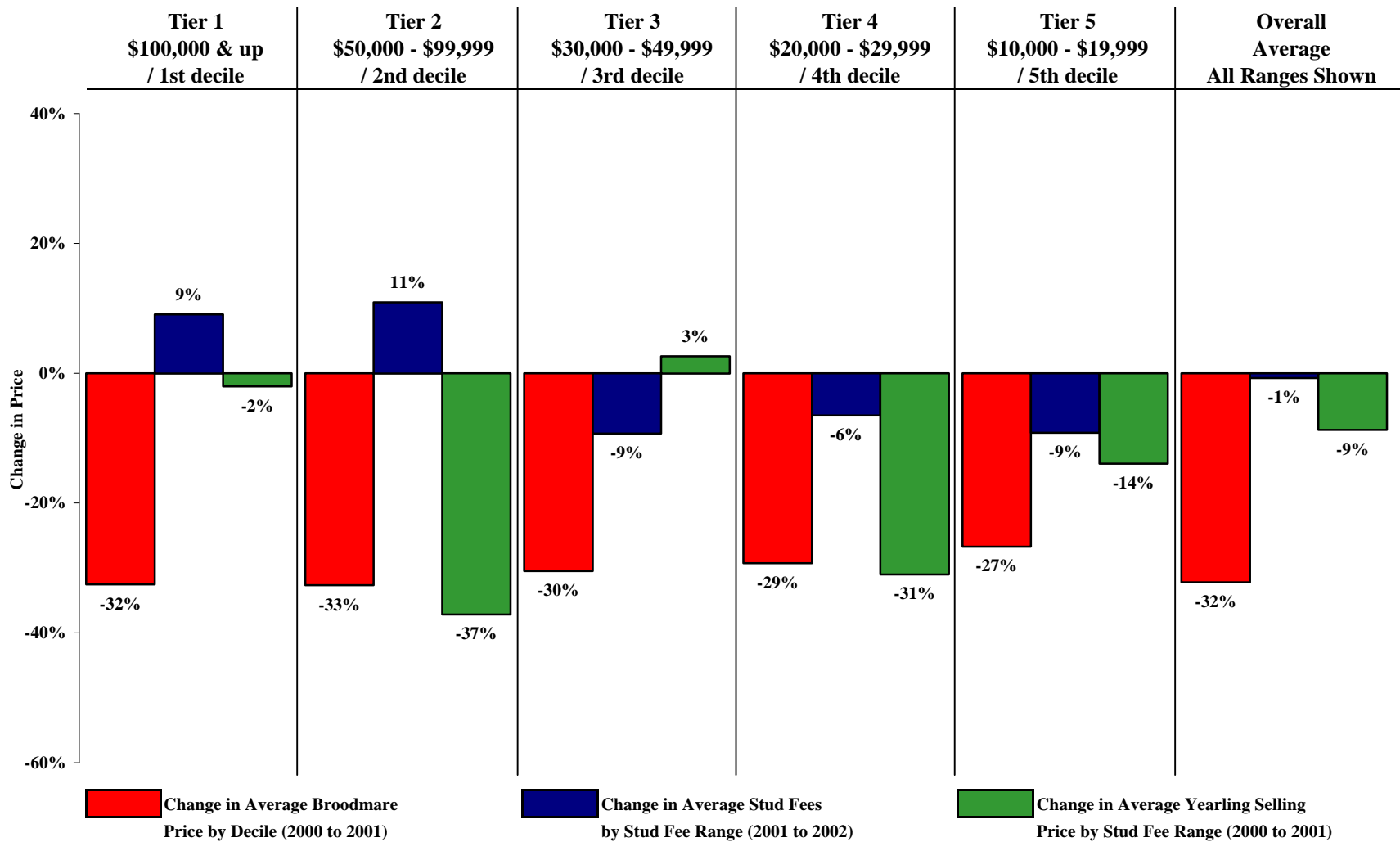
- We note that yearlings sired by the higher-priced stallions had multiples below the other stud fee categories in the mid-1990s, but have had substantially greater multiples in recent years. We also note the stability of stud fee multiples for yearlings sired by stallions with fees in the \$30,000 to \$49,999 range (between 3.7 and 4.3 for 1995-2001).

- This table shows stud fee multiples for weanlings sold in 1994 through 2001, by stud fee range:

Stud Fee	1994	1995	1996	1997	1998	1999	2000	2001
\$100,000 and up	2.4	2.4	2.9	3.4	5.0	3.5	3.2	2.8
\$50,000 to \$99,999	2.0	2.2	2.8	3.1	2.9	3.0	1.9	1.5
\$30,000 to \$49,999	2.8	3.7	4.0	4.0	3.7	4.3	4.0	4.1
\$20,000 to \$29,9999	2.1	2.2	3.3	3.0	2.4	2.8	2.3	1.9
\$10,000 to \$19,999	2.3	2.3	2.7	2.8	2.8	3.0	2.3	2.3

Note the difference between yearling and weanling multiples for breeders to the highest-priced stallions (in 2001, 5.3 for yearlings and 2.8 for weanlings). Also, note that weanling sellers who bred to the highest-priced stallions have not on average achieved the highest multiples, except in 1998. Again, we note the stability of multiples for stallions with fees in the \$30,000 to \$49,999 range (from 3.7 to 4.3 for 1995 through 2001, the same range as for yearlings).

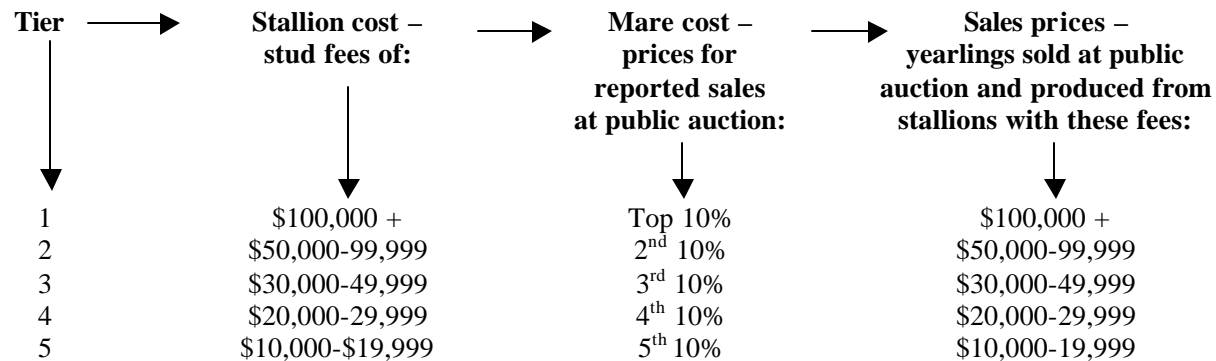
Graph IX
Changes in Production Costs and Yearling Selling Prices for Breeders by Stud Fee Range and Decile



Data from The Blood-Horse and Thoroughbred Times

Commentary on Graph IX

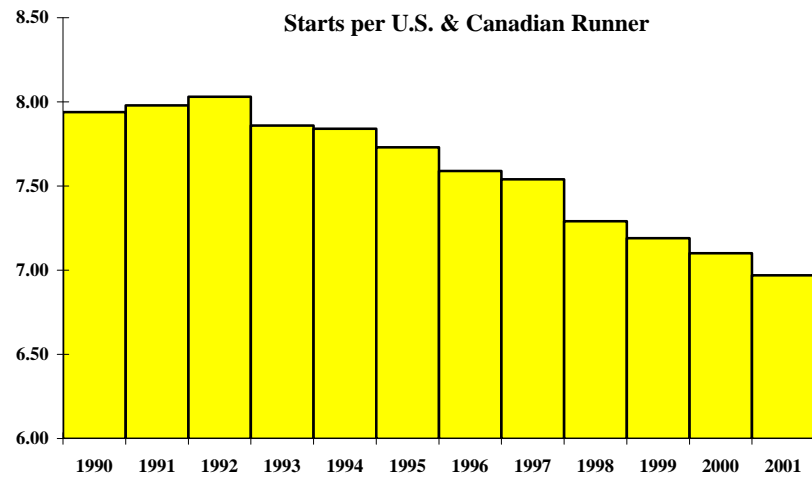
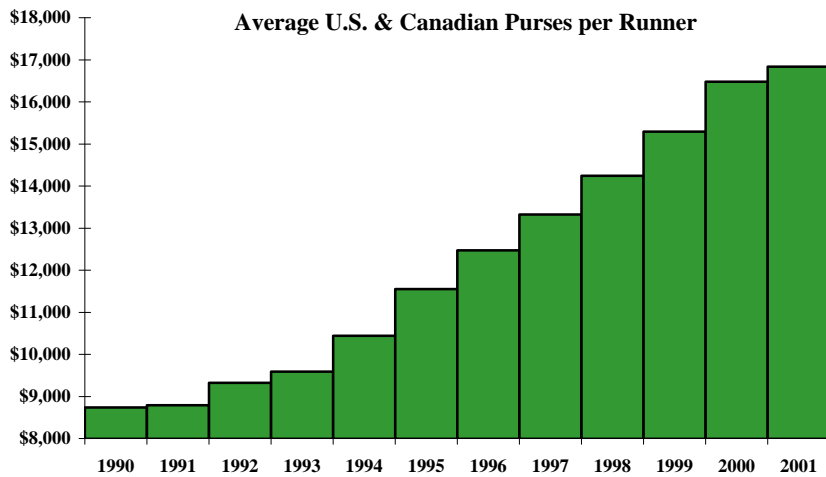
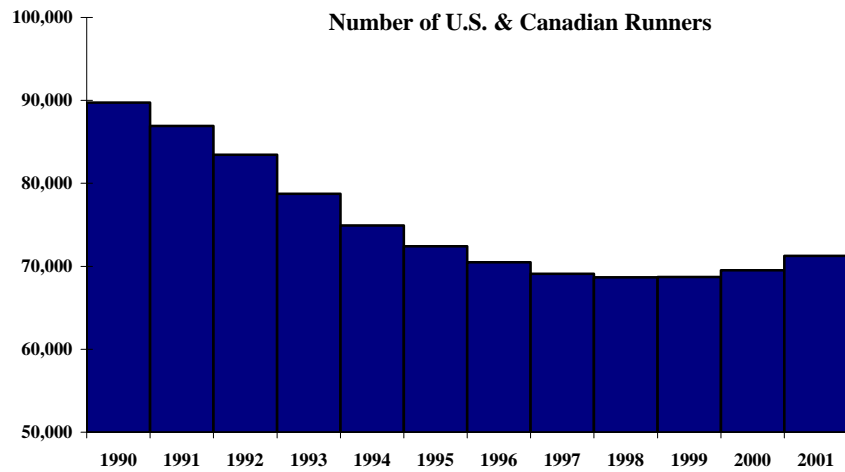
- In Graph IX, we try to provide insight into a critical question for breeders: Are your production costs increasing at a higher or lower rate than the prices you're receiving for your products? For costs of production, we focus on the two major elements: (1) broodmare costs – based on public auction prices – and (2) stud fees. For sales prices of breeders' products, we examine auction prices of yearlings.
- The analysis is based on current production costs and current sales prices and does not attempt to correlate sales prices with the costs of producing these foal crops. In other words, we are focusing on current costs – replacement costs – and current sales prices.
- Specifically, we are measuring changes in stud fees by the change in published stud fees by stallion from 2001 to 2002. For broodmares, we are measuring the change in this cost by reference to changes in average auction prices from 2000 to 2001. Similarly, the change in sales price of yearlings is measured by reference to average auction prices from 2000 to 2001.
- We segment our analysis into five tiers:



These tiers can be considered to represent approximately the top one-half of the thoroughbred breeders' market. We also show the overall changing cost and price levels for all the tiers we analyzed.

- The data shows that broodmare costs are declining substantially (no doubt impacted by MRLS) and, except for \$50,000 and higher, stud fees also are declining, giving breeders some relief from generally declining sales prices of their yearlings.

Graph X
Racing Purses and Numbers of Horses Racing
1990 to 2001



Data from The Jockey Club Fact Book

Commentary on Graph X

- From 1990 to 2001, average purses per runner have increased from \$8,700 to \$16,800 – 93%.
- From 1990 to 1994, the increase in purses per runner was due primarily to a decrease in the number of runners (by 17%) – gross purses changed only negligibly from 1990 to 1994 and were slightly lower in 1994 than in 1990.
- From 1994 to 2001, on the other hand, the increase in purses per runner was due primarily to an increase in gross purses available to owners (by 53%). The number of runners continued to decline during that period (by 5%).
- While average purses per runner increased an impressive 93% between 1990 and 2001, the costs of maintaining a horse in training still substantially exceed average winnings per runner.
- We also note that the increase in average purses per runner from 1990 to 2001- 93% - has more than kept pace with the increase in the average cost of purchasing yearlings and weanlings over the same period – 79% and 50%, respectively, but is below increases in the cost of purchasing two-year-olds – 129%.
- After consistent decreases in the number of runners from 1990 through 1998, the number leveled out in 1999 and increased somewhat in 2000 and 2001.
- Starts per runner continued to decline in 2001, the ninth consecutive year.

Potential Tax Planning Opportunity for Horse Owners

1997 tax legislation created new maximum capital gain rates for qualifying assets acquired after 2000 and held for more than five years. The lower rate - for taxpayers who would otherwise be taxed at 20% - is 18%. On the surface this change would not seem to be beneficial until 2006, at the earliest.

However, this legislation permits taxpayers to elect to treat individual assets as being sold on January 1, 2001 for fair market value and reacquired on the same day for the same amount. As a result of making this election, the property becomes eligible for the lower capital gain rate, if held more than 5 years after January 1, 2001. The cost of making the election is current tax on the recognition of gain from the deemed sale. Losses are not allowable.

Why, you might ask, would you pay tax now to save 2% tax in 2006 or later? Well, if you can pay tax now at the current capital gain rate – 20%, and generate future depreciation deductions to offset ordinary income, you might be interested. Consider the following example:

T, who is in the business of breeding horses, has a homebred mare (no initial cost basis for tax purposes) who was age 14 in 2001. On January 1, 2001, the mare had a fair market value of \$100,000. T makes the deemed-sale election with respect to this mare. T recognizes gain of \$100,000 and pays tax on the gain at the capital gain rate. T begins depreciating the mare on the 3-year schedule (over a 4-year period) in 2001, reducing ordinary income.

T's net cash flows from the election are as follows (assuming T is in the top tax bracket and considering only federal taxes):

	2001	2002	2003	2004
<i>Annual</i>	(10,225)	14,475	9,650	4,700
<i>Cumulative</i>	(10,225)	4,250	13,900	18,600

Assuming a 4% after tax discount rate, the net present value to T is \$16,000. While T is out-of-pocket \$10,225 in the first year, this is more than fully recovered in the second year.

The result demonstrated in the above example probably represents an unintended loophole in the statute. We say this because when one sells depreciable property to a related person, the seller ordinarily must report ordinary income, rather than capital gain. This related-party provision is designed to prevent related taxpayers from selling property that would result in capital gain to the seller and creating a new basis which can be depreciated and produce ordinary deductions for the buyer. However, these related-party rules do not cover a sale to oneself, and there is nothing in the statute which deals with the election which covers this.

The election can be made by individuals, pass-through entities such as partnerships and S corporations, and by estates and trusts. It cannot be made by C corporations.

Generally, for there to be a benefit from making the election, a horse under consideration should have these characteristics:

- On the deemed sale of the horse, a relatively high amount of the gain should qualify for capital gain under Section 1231 of the Code and not be depreciation recapture, reportable as ordinary income.
- The horse should qualify as 3-year recovery property, meaning that it generally would be a racehorse over 2-years old or a breeding horse over 12-years old on January 1, 2001. In the case of a racehorse, those considering the election must also consider how long the racehorse will continue to race, as it will move to a longer recovery period if its use changes to breeding.
- The owner considering making the election should not have significant current year Section 1231 losses or unrecaptured Section 1231 losses from the previous five years, as these losses cause gains otherwise treated as capital to be treated as ordinary income instead.
- The horse must not have been sold in 2001 and is not likely to be sold in 2002.

The advisability of making this election is a complex matter that needs to be carefully considered case-by-case with tax advisors. The election can only be made on 2001 tax returns. The election can be made on a horse-by-horse basis; a blanket election for all assets owned is not required.

Please contact us if you are interested in exploring this possibility further. Note that there is no published guidance from IRS confirming the tax treatment we've described, but from informal discussions we've had with IRS National Office personnel, we believe the treatment we've described is correct as the law is written currently.

Tax Implications of MRLS Losses

The economic impact of last year's mare reproductive loss syndrome (MRLS) will be felt throughout the Thoroughbred industry for years. Losses suffered by Thoroughbred breeders due to MRLS will also impact their tax liabilities and tax planning opportunities. Some of the expected tax impacts and opportunities presented by this situation are discussed in this article.

A Review of the Basics: Economic Loss Does Not Necessarily Equal Tax Loss

Breeders who lost foals in 2001 may have lost future expected profits, but it is their actual investments in the foals that will determine the timing and amount of their tax losses. An expected (or hoped for) profit is not deductible for tax purposes. For example, if a breeder who for tax purposes uses the cash-method of accounting - as most do - lost a foal to MRLS in 2001 and had paid the stud fee in 2000, that fee normally would have been deducted in 2000. If the fee is recovered in 2001 as a result of a live-foal guarantee, the recovery will increase 2001 taxable income.

If our hypothetical breeder instead uses the accrual-method of accounting for tax purposes and capitalizes the costs of producing foals, the capitalized costs - not the foal's market value - would be the tax loss if the foal is lost due to MRLS or another cause.

In another example, if the breeder purchased a mare in foal and the mare subsequently lost the foal to MRLS, the breeder would have a loss equal to the portion of the mare's cost that was allocated to the unborn foal. What if it was the breeder's practice for tax purposes to not allocate any portion of the in-foal mare's cost to the foal? Could there be a retroactive allocation to the foal? Or, to the same effect, could a portion of the mare's cost be claimed as a loss for tax purposes? Or less favorably, would the full cost of the in-foal mare remain on the books, only to be recovered through depreciation? The answers to these questions are not clear, but a current loss deduction is hardly certain. The best practice, we believe, for breeders who purchase mares in-foal is to be *consistent* in how they account for these situations. In many cases, allocating a reasonable amount to the unborn foals is preferable.

Cash-method owners of stallions, stallion shares, and breeding rights who provide stud services with a live-foal guarantee may find themselves with similar timing considerations. For example, if fees were received in 2000 subject to a live-foal guarantee, those fees normally would be included in the owner's taxable income in 2000, even if they may have to be returned in 2001. If the foal was lost in 2001 due to MRLS (or any other cause), the fees returned in 2001 will reduce 2001 taxable income.

Net Operating Loss Provisions

MRLS may cause Thoroughbred breeders and others in the industry who are less directly impacted to have tax losses. Fortunately, federal and most state tax laws provide for the carryback and carryover of net operating losses, allowing the potential refund of tax already paid or reducing tax to be paid. Federal law allows a net operating loss to be carried back 2 years and carried forward up to 20 years, until consumed.

In Kentucky, where the incidence of MRLS was hardest felt, most localities (counties and cities) impose a net profits tax on businesses, including Thoroughbred businesses. These localities typically do not permit businesses to carry losses back or forward, resulting in no tax benefit from the net loss.

Farm Income-Averaging Provisions

Breeders and others whose incomes decline as a result of MRLS may benefit from farm income-averaging provisions. Starting in 1998, Congress provided relief to farmers, including persons raising animals, who experience fluctuations in their incomes and move from lower to higher marginal tax brackets.

Farmers are allowed to designate all or a portion of their current year farming income, allocate one-third of the elected amount to each of the prior 3 years, and determine the current year tax liability by adding the tax on the current year's income without the elected income to the increase in tax for each of the 3 prior years resulting from the addition of the elected income.

This may seem (at least) a bit complex, but the rules can reduce a farmer's tax liability in higher income years by smoothing out the differences in the tax brackets over a 4-year period. Thoroughbred owners who have relatively low income years resulting from MRLS may benefit from these rules when their incomes recover in later years.

Involuntary Conversion Provisions

Breeders who lost foals in 2001 and who received insurance proceeds as a result ordinarily would include the proceeds (or their gain, if they have a tax basis in the foals) in their taxable income in the year received. The involuntary conversion rules permit owners to defer recognition of the gain resulting from receipt of insurance proceeds to the extent that the proceeds are reinvested in an animal that is “similar or related in service or use” to the animal that was lost.

The reinvestment must occur within 2 years of the close of the tax year in which insurance proceeds are received. For example, a breeder who lost a foal to MRLS and received insurance proceeds in 2001 would have to reinvest the proceeds by December 31, 2003, to defer gain recognition.

What kind of reinvestment will satisfy the requirement that the reinvestment be in an animal that is “similar or related in service or use” to an unborn foal? While there is no direct authority on this point, reinvestment in one or more mares in foal, at least to the extent the cost of the mare or mares reasonably can be allocated to the unborn foals, is consistent with involuntary conversion principles.

Less clear is the question of whether the breeder can buy an unweaned foal, a weanling, or a yearling and satisfy the reinvestment requirement. It appears to be unnecessary that the gender of the lost unborn foal be the same as that of the replacement horse. Regardless of gender, the replacement will be held to raise and later sell or race. We do not believe that reinvestment in a breeding horse will qualify as being “similar or related in service or use” to a foal.

Sales Tax Provisions

Some states, including Kentucky, impose sales tax on stud fees. When a breeder pays a stud fee subject to a live-foal guarantee on a Kentucky-based stallion and the fee later is returned, sales tax paid also is refundable (from the seller of the season, who in turn would obtain a refund from the state).

However, if the sales tax paid was on a stallion in Kentucky and the season was sold on a no-guarantee basis, no refund of the sales tax is available. Sales tax laws vary from state to state, however, so the results may be different in other states.

The year 2001 will be remembered by Thoroughbred owners as the year that MRLS, the disruption in the September sales resulting from the terrorist attacks, and the stumbling stock market combined to deliver quite a blow to the industry. The economic impacts of these events will be felt for years. Thoroughbred owners who take advantage of some favorable tax provisions can help mitigate their losses to some extent.

Leigh McKee and Doug Dean