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Thoroughbred Business
Year in Review
2010

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Thoroughbred Business Year in Review 2010 is published by Dean Dorton Allen Ford's Equine Industry Group. We hope you find the information we present regarding the thoroughbred business to be interesting and helpful.

Located in Kentucky, known for its world-class horse farms, racing, and sales, our firm has provided accounting, tax, and business consulting services to the horse industry for over 30 years. Our clients cover a broad spectrum of organizations involved in the horse industry, from small boarding farms to large multidepartmental 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 Kentucky; horse industry clients from other parts of the country and from outside the United States also gain comfort from 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, most usefully, by working with our many clients in the industry on their business matters.

We perform a variety of services, many of which are listed on the next page, for our clients involved in the equine industry. And, we welcome inquiries, whether from new participants in the industry who want assistance in properly structuring and administering their stables or farms or from longtime industry participants seeking to improve the performance and administration of their thoroughbred operations.

Members of our Equine Industry Group will be pleased to answer any questions you may have. See the following page for contact information.

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Equine Industry Group Services

Accounting

- Directly performing many accounting, payroll, and clerical functions for smaller enterprises.
- Designing and implementing farm accounting and management information systems.
- Performing audit, review, and compilation services on client financial statements.

Business Consulting

- Developing financial and business plans for farms, breeding operations, and racing stables.
- Financial analysis of stallion prospects.
- Designing, implementing, and administering retirement plan and other employee benefit programs.
- Providing litigation support and forensic accounting services.
- Providing a wide range of technology solutions, e.g. complete managed services, network design and support, technology assessments, software consulting, accounting software solutions, and business application training.

Tax

- Developing strategies to use the optimum forms of organization in which to conduct horse and farm businesses.

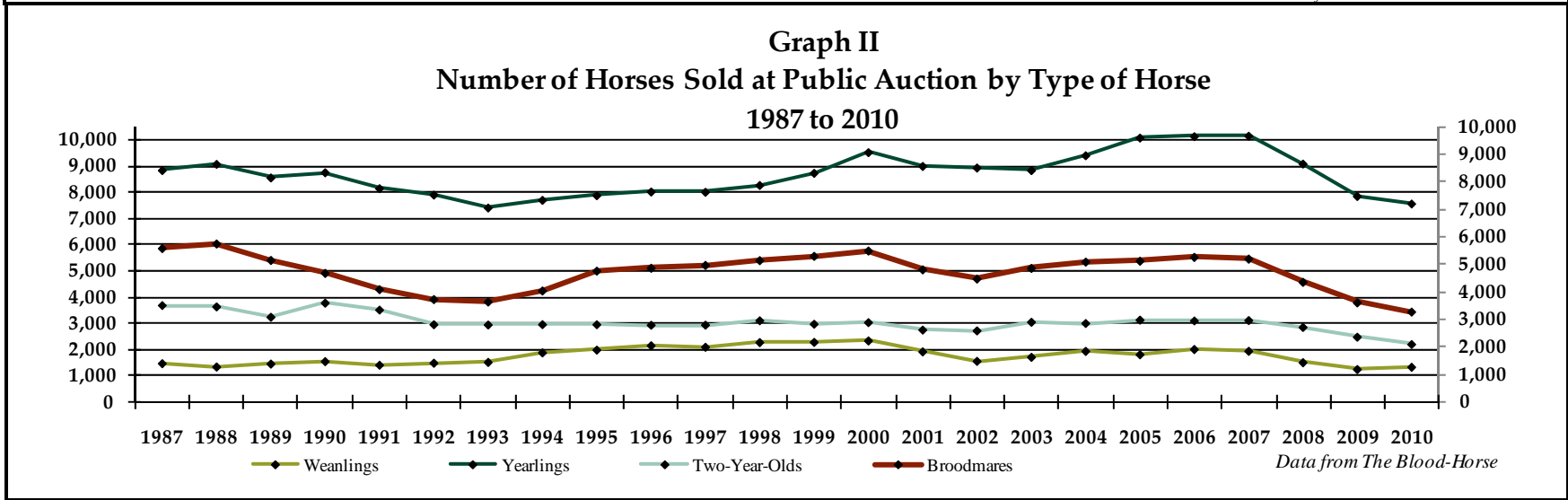
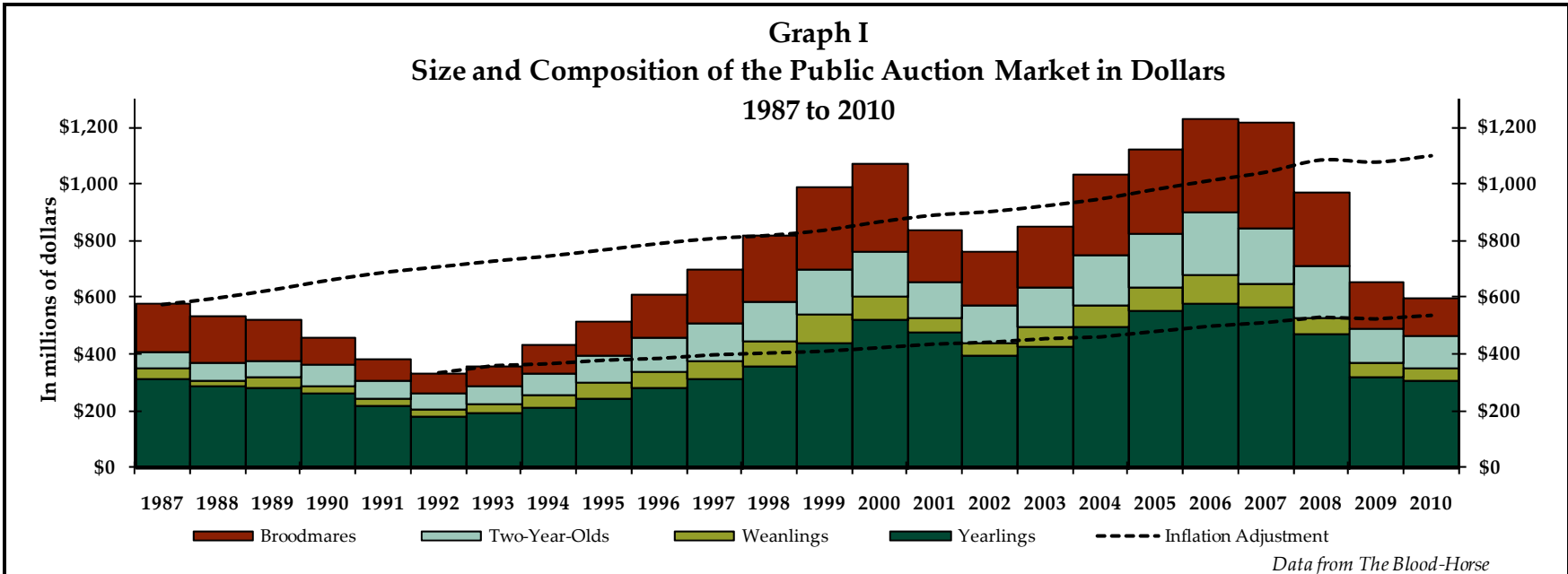
Tax, continued

- Reducing 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 multistate tax issues.
- 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.
- Maximizing the tax benefit of the qualified production activities

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Commentary on Graphs I and II

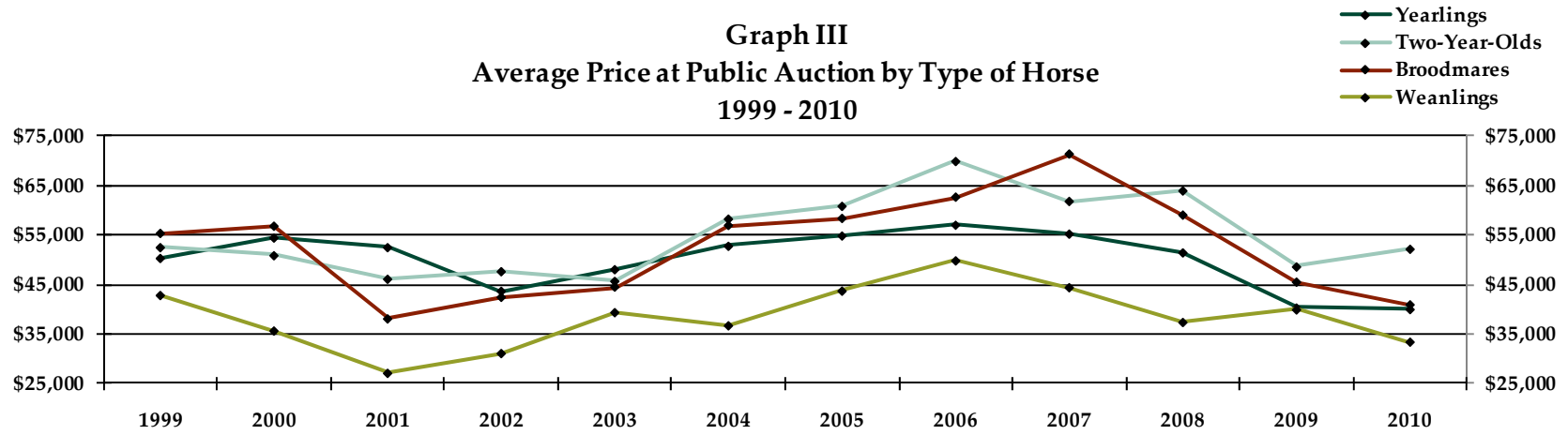
- The market for thoroughbred horses continued its decline in 2010, but the smaller degree of decline suggests some general stabilization of thoroughbred markets. This can readily be seen on Graph I, which shows a smaller decline from 2009 to 2010, following large declines from 2007 to 2008 and from 2008 to 2009 in dollars expended at North American thoroughbred auctions. From the peak in 2006 to 2010, dollars expended at public auctions dropped by 51%, or \$628 million.
- If we observe trends shown in Graph I over the full 24-year period shown, we see that dollars invested in thoroughbreds at North American public auctions decreased steadily from 1987 to 1992 (post 1986 federal tax law imposing passive activity rules), then increased steadily and impressively from 1993 to 2000. The sharp drops in 2001 and 2002 (post “dot.com bust” and September 11, 2001 terrorist attacks in the U.S.) then were followed by steady increases from 2003 through 2006. This growth leveled-off in 2007 (down 1.2%), though dollars invested continued to surpass the \$1.2 billion level reached in 2006. The declines in 2008 (20.4%) and 2009 (32.3%) were dramatic; 2010’s decline was 8.6%. As tough as the last three years have been, and even after considering inflation, 2010’s level of investment exceeded the low year of 1992.
- For 2010, the auction volume in dollars decreased for yearlings (4%), weanlings (12%), two-year-olds (5%), and broodmares (18%).
- Sales by category (in dollars) as a percentage of the total auction market are as follows in recent years:

	2003	2004	2005	2006	2007	2008	2009	2010
Weanlings	8.0%	7.0%	7.1%	8.2%	7.2%	5.9%	7.8%	7.5%
Yearlings	50.1%	48.1%	49.3%	47.2%	46.4%	48.5%	48.5%	50.7%
Two-Year-Olds	16.5%	16.9%	17.0%	17.7%	15.9%	18.9%	18.5%	19.2%
Broodmares	25.4%	28.0%	26.6%	26.8%	30.5%	26.7%	25.1%	22.6%

- The total number of horses sold at auction reached its highest level in 2006, the fourth consecutive year of increases, but leveled-off in 2007, then decreased by 12.7% in 2008, 14.7% in 2009, and 5.3% in 2010. From the 2006 peak, the number sold in 2010 dropped by 30%, or over 6,000 thoroughbreds, sold at public auctions. The number sold in each of the four categories decreased in 2008, 2009, and 2010, except more (85) weanlings sold in 2010 than in 2009. In the 24 years of data shown, fewer broodmares and two-year-olds sold at public auctions in 2010 than in any other year, and the numbers of public auction sales of yearlings and weanlings were the second lowest in the 24-year period.
- Five percent of the 2010 North American foal crop sold at public auctions as weanlings, and 24% of the 2009 North American foal crop sold at public auctions in 2010 as yearlings. The following shows the relationship of these numbers to the four previous years.

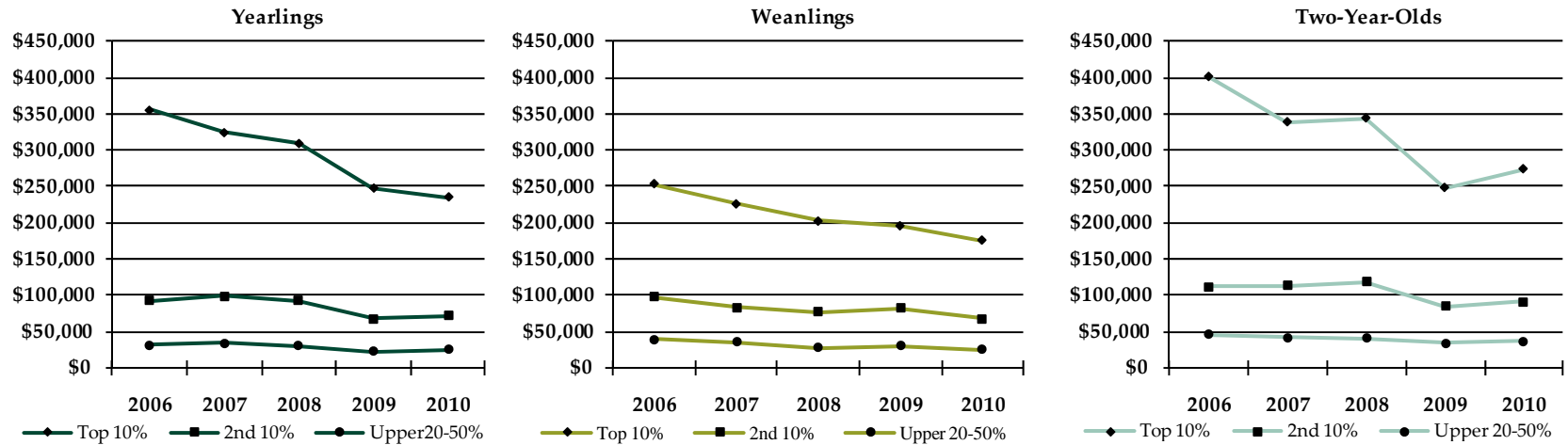
	2006	2007	2008	2009	2010
Weanlings	5%	5%	4%	4%	5%
Yearlings	27%	27%	24%	23%	24%

Graph III
Average Price at Public Auction by Type of Horse
1999 - 2010



Data from The Blood-Horse

Graph IV
Average Price by Type of Horse by Decile
2006 to 2010



Data From Auction Review, The Thoroughbred Times

Commentary on Graphs III and IV

- The average price for yearlings (down 1%) stabilized in 2010, following a 22% decline in 2009. However, the average weanling price, which had increased 7% in 2009, declined by 16% in 2010. The two-year old average price increased 7% in 2010, after declining 24% in 2009. The average broodmare price declined 10% in 2010, after a 23% decline in 2009. For racing prospects, the data suggest that buyers were willing to invest relatively more in 2010 in relation to 2009 prices the closer the prospects were to racing (two-year old prices were up, yearling prices were stable, and weanling prices were down materially).
- Graph IV examines the top 50% by price of these market segments – 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 higher the top decile of prices has been than the second decile – from about two and one-half to four times.

	2006	2007	2008	2009	2010
Yearlings	3.9	3.3	3.4	3.6	3.3
Weanlings	2.6	2.7	2.6	2.3	2.6
Two-Year-Olds	3.6	3.0	2.9	2.9	3.0

- For yearlings, the following table shows annual changes in average prices in 2010 and 2009, and from 2006 to 2010:

Decile	2009 to 2010	2008 to 2009	2006 to 2010
1 st	-5%	-20%	-34%
2 nd	4%	-26%	-23%
3 rd – 5 th	9%	-26%	-23%

- For weanlings, the following table shows similar data:

Decile	2009 to 2010	2008 to 2009	2006 to 2010
1 st	-10%	-3%	-31%
2 nd	-17%	7%	-31%
3 rd – 5 th	-19%	8%	-37%

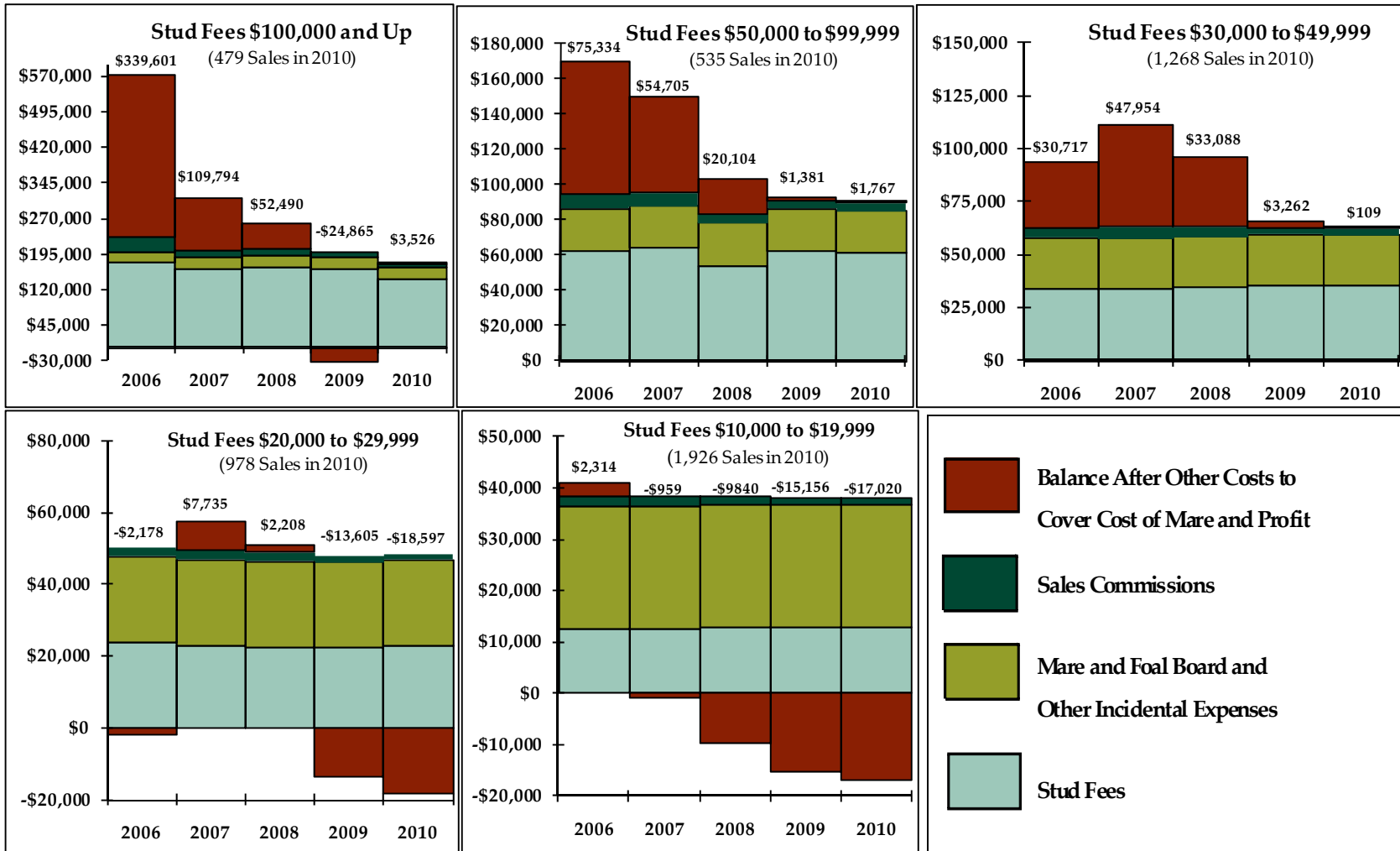
As breeders tried to avoid carrying costs, accelerate cash flow, and pass-along risk sooner by offering their produce sooner (as weanlings rather than as yearlings), the demand for weanlings was not sufficient to avoid significant price decreases in 2010.

- For two-year olds, the following table shows similar data:

Decile	2009 to 2010	2008 to 2009	2006 to 2010
1 st	10%	-28%	-32%
2 nd	7%	-28%	-18%
3 rd – 5 th	8%	-17%	-19%

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

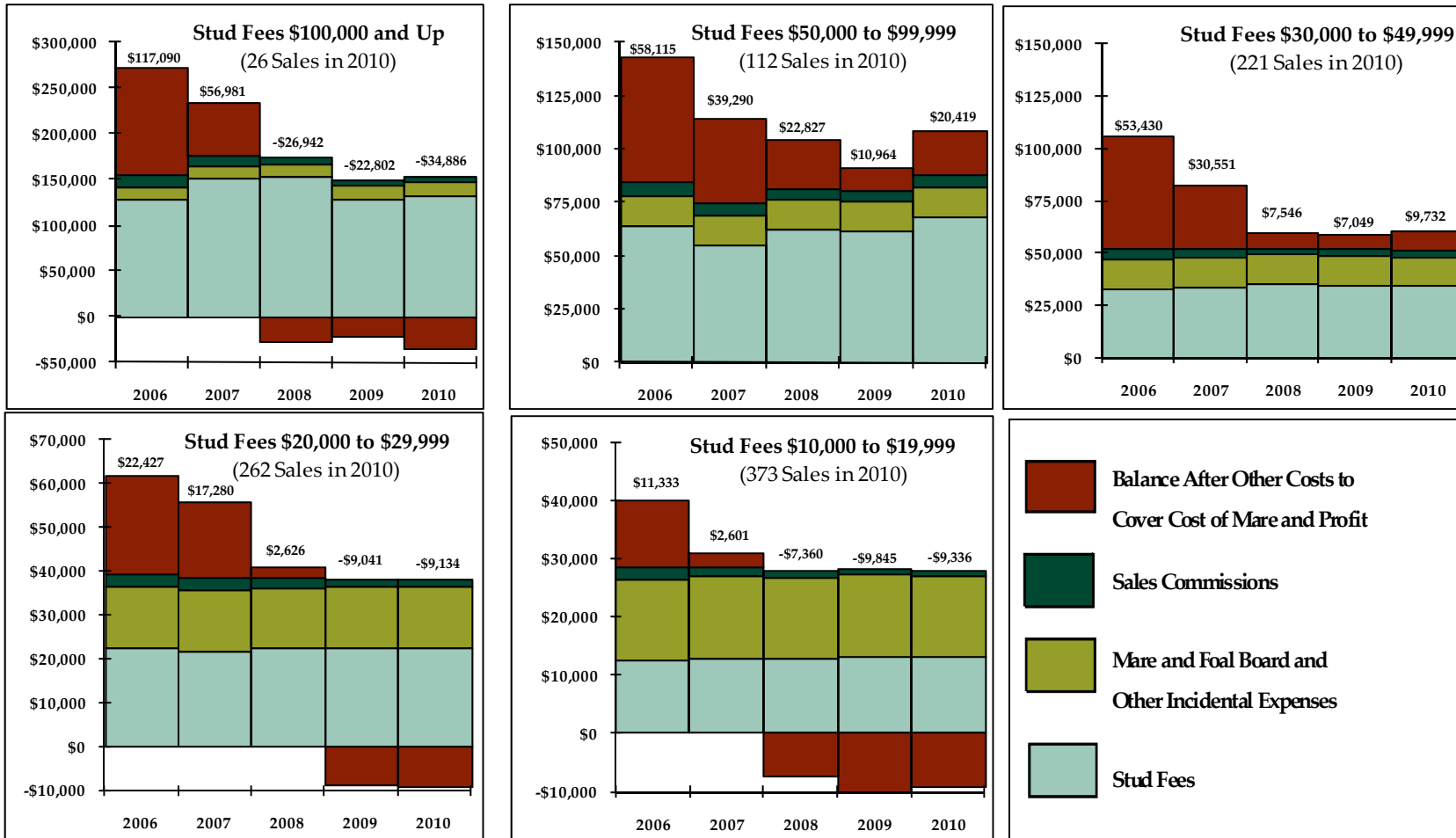
Graph V
Breakdown of Price of Yearling Sales into Cost Components -- Stud Fees, Sales Commissions, and Mare and Foal Board and Incidental Expenses -- Balance Available to Cover Cost of Mare and Profit
YEARLINGS -- By Stud Fee Range
2006 to 2010



Underlying Data from Auction Review, The Thoroughbred Times

Note: Dollar figures above bars on bar graphs 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
2006 to 2010



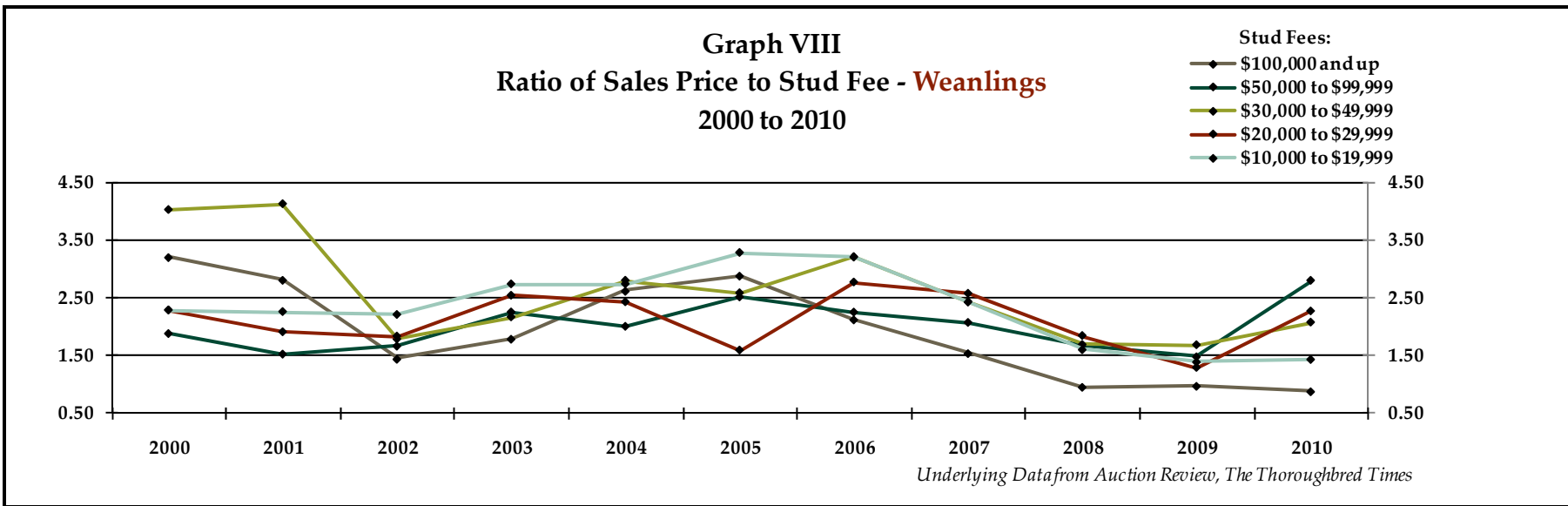
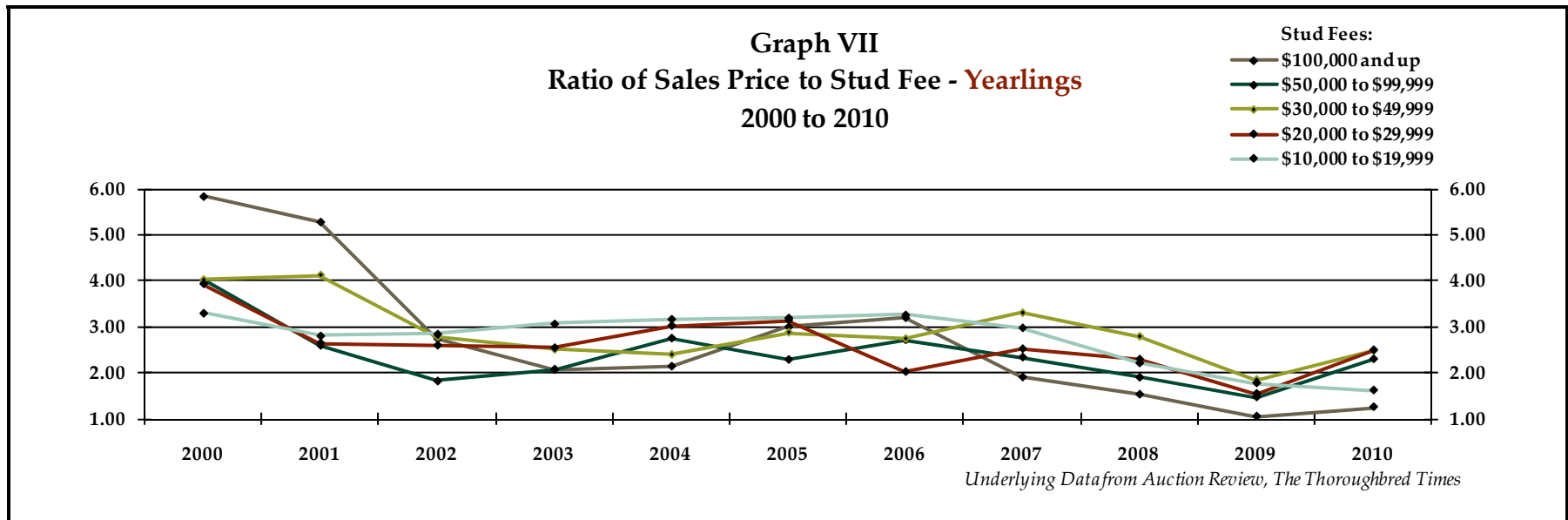
Underlying Data from Auction Review, The Thoroughbred Times

Commentary on Graphs V and VI

- We have analyzed data which show the relationship of yearling (Graph V) and weanling (Graph VI) sales results to stud fee costs over 2006 to 2010, 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 caring for the mare and the foal for one year and from an approximate weaning date until sold, respectively. For this latter cost, primarily board and veterinary, we used \$24,000 and \$14,000 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. Note that this analysis does not take into account costs associated with barren mares and lost foals. Further note that, by using a cutoff of \$10,000 stud fees for this analysis, we are including 70% of yearlings and 75% of weanlings sold publicly in 2010.
- The table below shows the percentage change from the prior year in the amount of selling price available to cover the cost of using the mare and to produce a profit, broken down by the stud fee ranges shown in the graphs.

Dollar Change from Prior Year in Selling Price Available for Mare and Profit				
Stud Fee Range	Yearlings		Weanlings	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
\$100,000 and up	\$ 28,391	\$ (77,355)	\$ (12,084)	\$ 4,140
\$50,000 to \$99,999	\$ 386	\$ (18,723)	\$ 9,455	\$ (11,863)
\$30,000 to \$49,999	\$ (3,153)	\$ (29,826)	\$ 2,683	\$ (497)
\$20,000 to \$29,999	\$ (4,992)	\$ (15,813)	\$ (93)	\$ (11,667)
\$10,000 to \$19,999	\$ (1,864)	\$ (5,316)	\$ 509	\$ (2,485)

- In Graph V (re: yearlings), every stud fee category shown experienced significant declines in 2008 and again in 2009. The graph shows striking declines in margins from 2006 to 2010 in each category. But, the 2010 margin showed some improvement in the highest stud fee category, and the next two highest stud fee categories showed some stabilization. The lowest two stud fee categories continued their declines in 2010. This analysis, in general, showed that on average breeders on stud fees of about \$30,000 and above recovered their stud fees, selling expenses, and other out-of-pocket costs, but got virtually no return on their investments in their mares and realized no profits. For those breeding to lower value stallions, the averages show less than full recovery of “out-of-pocket” expenses.
- In Graph VI (re: weanlings), the “profit” picture is not much, if any, better than it is for yearlings. In general, the analysis shows a third consecutive year of negative returns at the highest stud fee level; somewhat better 2010 returns from fees in the \$30,000 to \$99,999 ranges; and continuing, but stabilized, negative returns in the two lowest stud fees ranges examined.



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 2001 through 2010, by stud fee range:

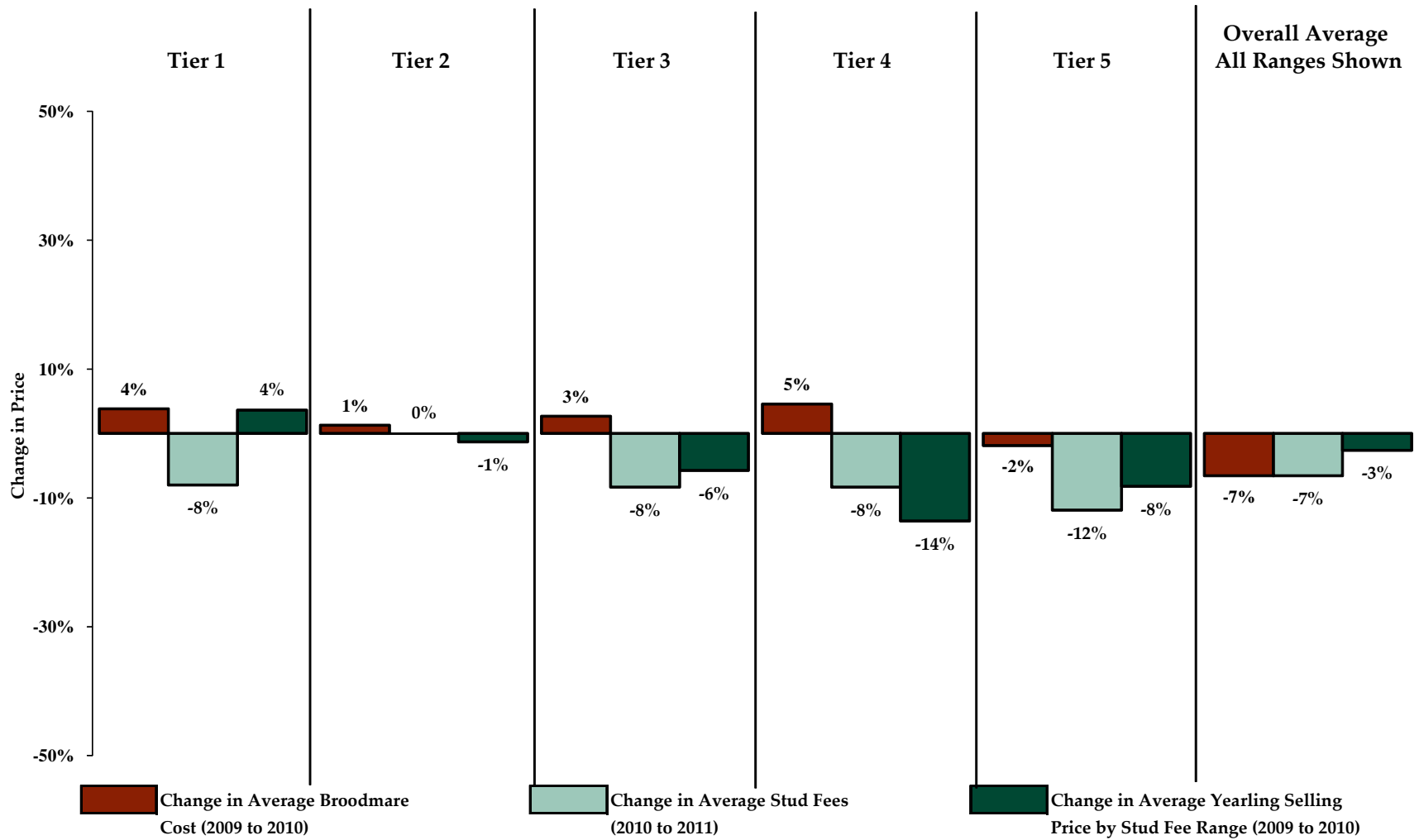
Stud Fee	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	10-year avg
\$100,000 and up	5.3	2.7	2.1	2.1	3.0	3.2	1.9	1.5	1.0	1.3	2.4
\$50,000 to \$99,999	2.6	1.8	2.1	2.8	2.3	2.7	2.4	1.9	1.5	2.3	2.2
\$30,000 to \$49,999	4.1	2.8	2.5	2.4	2.9	2.7	3.3	2.8	1.9	2.5	2.8
\$20,000 to \$29,999	2.6	2.6	2.5	3.0	3.1	2.0	2.5	2.3	1.5	2.5	2.5
\$10,000 to \$19,999	2.8	2.8	3.1	3.2	3.2	3.3	3.0	2.2	1.8	1.6	2.7

- Note that yearlings sired by the highest-priced stallions had a substantially greater multiple (5.3) in 2001. The multiples in 2005 and 2006 in this category increased compared to 2002-2004, but then declined substantially in 2007, 2008, and again in 2009. The 2010 multiple improved (to 1.3), but still lagged substantially below the 10-year average (2.4). In each of the last four years, the multiple for this category has been the lowest of the categories analyzed. For each stud fee range shown, except the lowest, the 2010 multiple was more than the prior year, due to stud fee declines. In each of the middle three categories, the 2010 stud fee multiple is close to the 10-year average.
- In each of 2007, 2008, and 2009, the highest multiple was achieved by stallions with stud fees in the \$30,000 to \$49,999 range.
- This table shows stud fee multiples for **weanlings** sold in 2001 through 2010, by stud fee range:

Stud Fee	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	10-year avg
\$100,000 and up	2.8	1.4	1.8	2.6	2.9	2.1	1.5	1.0	1.0	0.9	1.8
\$50,000 to \$99,999	1.5	1.7	2.2	2.0	2.5	2.2	2.1	1.7	1.5	2.8	2.0
\$30,000 to \$49,999	4.1	1.8	2.2	2.8	2.6	3.2	2.4	1.7	1.7	2.1	2.5
\$20,000 to \$29,999	1.9	1.8	2.5	2.4	1.6	2.8	2.6	1.8	1.3	2.3	2.1
\$10,000 to \$19,999	2.3	2.2	2.7	2.7	3.3	3.2	2.4	1.6	1.4	1.4	2.3

- Weanling sale multiples declined in 2007 and again in 2008, were relatively stable from 2008 to 2009, and generally, were stable or increased in 2010. Stud fee multiples for the highest and lowest stud fee costs shown here were significantly below their 10-year averages.

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



Data from The Blood-Horse, Thoroughbred Times, and Keeneland

Commentary on Graph IX

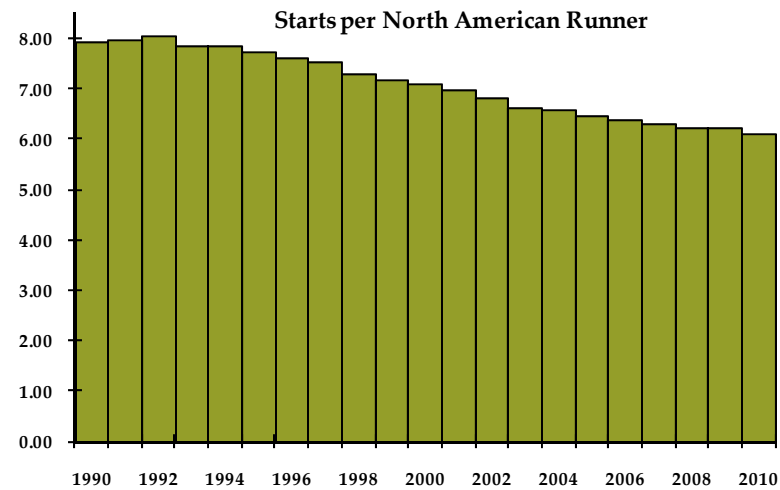
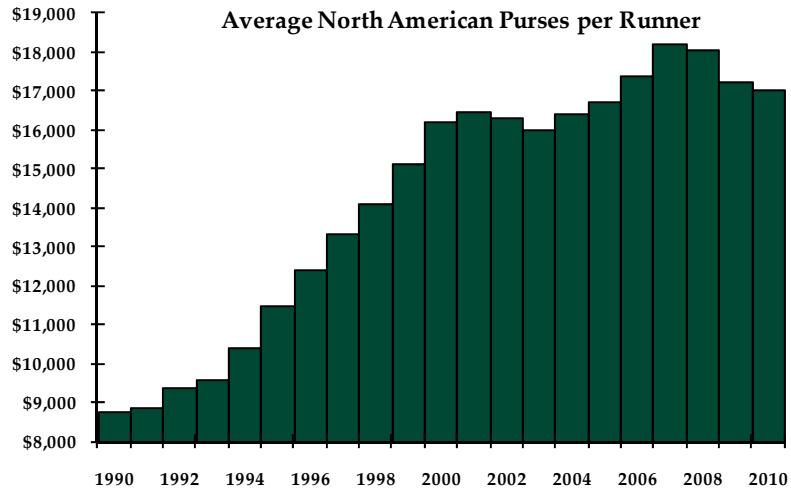
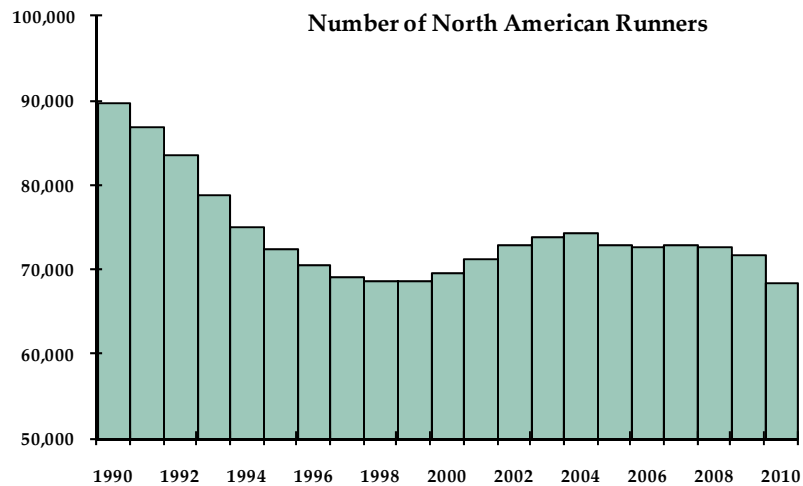
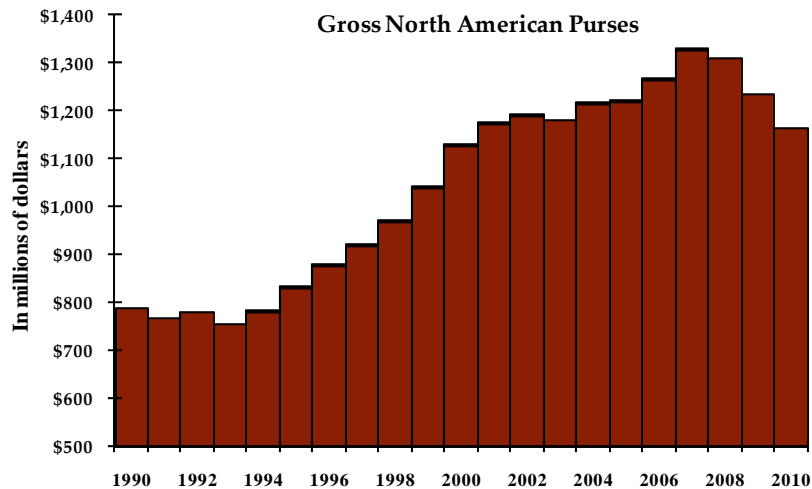
- In Graph IX, we try to provide insight into a critical question for breeders: are your production costs increasing at a higher or lower rate than the prices you're receiving for your products? For costs of production, we focus on the two major elements: broodmare costs – based on public auction prices – and 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 2010 to 2011. For broodmares, we are measuring the change in this cost by reference to changes in average auction prices from 2009 to 2010. Similarly, the change in sales price of yearlings is measured by reference to average auction prices from 2009 to 2010.
- We recognize that by using published stud fees, we may not be capturing actual fee data as accurately as we would prefer, but we believe that our use of published fees year-to-year should reasonably capture annual price-level changes.
- We segment our analysis into five tiers:

Tier	Stallion cost – stud fees of:	Mare cost – prices for reported sales at public auction:	Sales prices – yearlings sold at public auction and produced from stallions with these fees:
	↙ ↘	↙ ↘	↓
1	\$100,000 +	\$250,000 +	\$100,000 +
2	\$50,000-99,999	\$150,000-249,999	\$50,000-99,999
3	\$30,000-49,999	\$100,000-149,999	\$30,000-49,999
4	\$20,000-29,999	\$50,000-99,999	\$20,000-29,999
5	\$10,000-19,999	\$25,000-49,999	\$10,000-19,999

We also show the combined changing cost and price levels for all five tiers we analyzed.

- In general, the data show the expected result. Overall, the cost of broodmares decreased 7% and stud fees are decreasing 7%. Selling prices of offspring as yearlings in 2010 were down 3% overall (see last column). The smaller percentage decline in yearling prices than in broodmare and stud fee costs is favorable for a breeder desiring to make investments in breeding stock.
- Overall, stud fees declined to a greater degree than mare costs, and only in Tier 4 (\$20,000-29,999 stud fees and \$50,000-99,999 mare costs) did yearling prices decline at a higher rate (down 14%) than stud fees (down 8%) and mare costs (up 5%).

Graph X Racing Purses and Numbers of Horses Racing 1990 - 2010



Data from The Jockey Club Fact Book

Commentary on Graph X

- Gross purses declined again in 2010 (5.6%), the third consecutive year of declines after a generally favorable upward trend from the early 1990s. The 2010 amount was the lowest since 1999 (unadjusted for inflation).
- The number of runners (number which started in at least one race in the year) was relatively stable from 2005 through 2009, but the 2010 number declined 4.7% from 2009.
- From 1990 to 2007, average purses per runner increased 107%, from \$8,800 to \$18,200. But, in 2008 the decline in gross purses and the smaller relative decline in number of runners resulted in a decline in average purses per runner (0.8%). The average purses per runner declined again in 2009 (4.7%), mainly due to the decline in gross purses, and again declined, though slightly, by 0.1% in 2010 (to about \$17,000).
- Average purses per runner from 1990 to 2010 have increased 94%, which has exceeded the 36% increase in the average cost of purchasing yearlings and the 84% increase in the average cost of purchasing weanlings over the same period. The increase in average purses per runner from 1990 to 2010 trails the average purchase price of two-year olds, which increased 157% over the same period.
- Starts per runner decreased slightly in 2010. In 1992, the highest of the 21 years considered, average starts per runner were just over eight; by 2010, the average had declined to just over 6.1.

A Brief Summary of Where Congress Has Landed on Taxes (for Now)

Congress and President Obama acted in December 2010 to change the near-term tax landscape in very significant ways from what had been scheduled to apply beginning in 2011. Many farm and horse owners stand to benefit, often substantially, from the changes. But, most of these changes, unless renewed by future legislation, will be effective only temporarily.

This article provides a brief overview of some of the law's more noteworthy features:

Income Tax

In broad terms, the new law's income tax provisions retain 2010 income tax rates on ordinary income (top rate of 35%), capital gains (15%), and dividends (15%) through 2012. A noteworthy income tax benefit, designed to spur capital spending by businesses, expands the 50% bonus depreciation on qualifying new property additions to 100% (full expensing) for such property acquired and placed in service after September 8, 2010 (note retroactivity) and by December 31, 2011.

This latter provision would enable buyers of certain racehorse prospects (those considered not to have been "used" by any prior owner) to write-off the full cost of the prospect (provided no other tax limitation applies).

Payroll Tax

In the payroll tax area, the big change is a 2% point reduction (from 6.2% to 4.2%) in the Social Security tax rate for the *employee's portion only* of wages and salaries. For self-employed individuals, the rate changes from 12.4% to 10.4%. These changes are effective for 2011 only.

Estate, Gift, and Generation-Skipping Taxes

The most dramatic changes relate to transfer taxes, and in this area vast planning opportunities are presented for many families. The now current status of the law perhaps can best be summarized by segregating into time segments: 2011 and 2012; 2010; and post-2012. We'll mention the last first:

Post 2012:

Absent intervening Congressional action, we will approach 2013 with the same concerns about the much lower exemptions (\$1 million each) and much higher rates (up to 55%) that we had as we approached 2011. In other words, the 2011 and 2012 expanded exemptions and reduced rates (described next) are temporary.

2011 and 2012:

- The exemption goes to \$5 million per person for estate, gift, and generation-skipping taxes. This compares very favorably with previous highest exemptions of \$3.5 million for estate and generation-skipping taxes and \$1 million for gift taxes.

Observation – A tremendous incentive will exist for wealthy families to make large gifts over the next two years.

- The top transfer tax rate goes to 35%.
- The concept of “portability” of a deceased spouse’s unused exemption is adopted. In short, this provision allows a surviving spouse to use both his or her exemption, plus any unused exemption of the “last deceased spouse.”

Observation – Conventional planning has involved trying to make sure each spouse had sufficient assets to fully utilize each exemption. Under the new provision, this generally won’t be necessary.

Portability applies to estate and gift taxes, but not to generation-skipping taxes.

2010:

- The most complex provisions involve individuals dying in 2010. Recall that there was no 2010 estate tax. Now, under the new law, there is, but an estate’s executor can elect out of the estate tax and into the carryover basis regime that had been in place for individuals dying in 2010.

Observation – Executors and their advisors, in the case of 2010 deaths, will need to carefully assess which approach – estate tax with full “stepped-up basis,” or no estate tax with limited stepped-up basis – is better. For those estates below the estate tax exemption (set by the new law at \$5 million for 2010), the former choice, in most if not all cases, will be advisable.

Conservation Easements

Of special interest to many farm owners, enhanced tax incentives for conservation easement donations which had expired after 2009 were reinstated through 2011. These enhanced incentives include:

- An increase in the annual limit on the charitable contribution deduction for conservation easements from 30% of adjusted gross income (AGI) to 50%, generally, and to 100% of AGI if more than 50% of the donor’s gross income is from farming; and
- An extension of the available period for using the available charitable contribution deduction from six to sixteen years (the year of the donation and fifteen carryover years).

In general, these changes create an opportunity in 2011 and 2012 to save, through careful planning, large sums of income and transfer taxes. Failure to take advantage of these opportunities may prove to be costly.

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