

Equine Business Year in Review – 2005 is published by Dean, Dorton & Ford's Equine Industry Group. We hope you find the information we present regarding Thoroughbreds 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, Emily Carpenter, or Jen Shah.

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Dean, Dorton & Ford, P.S.C. - 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.

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.
- 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 multi-state 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 benefit of the new qualified production activities deduction.

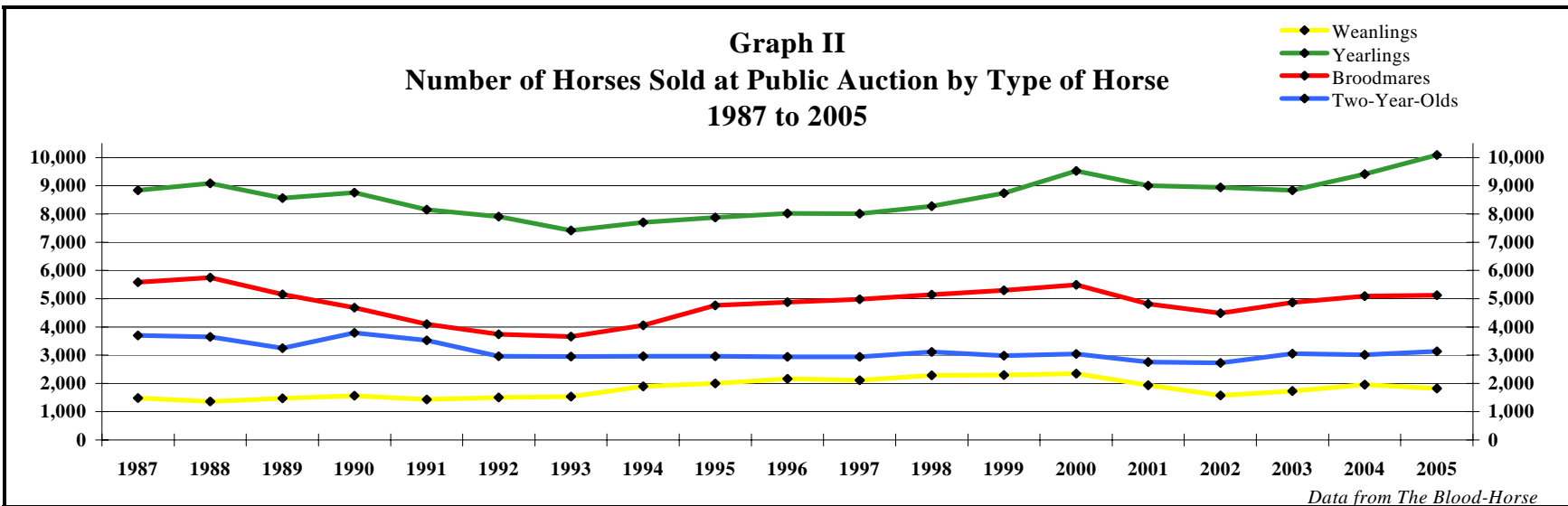
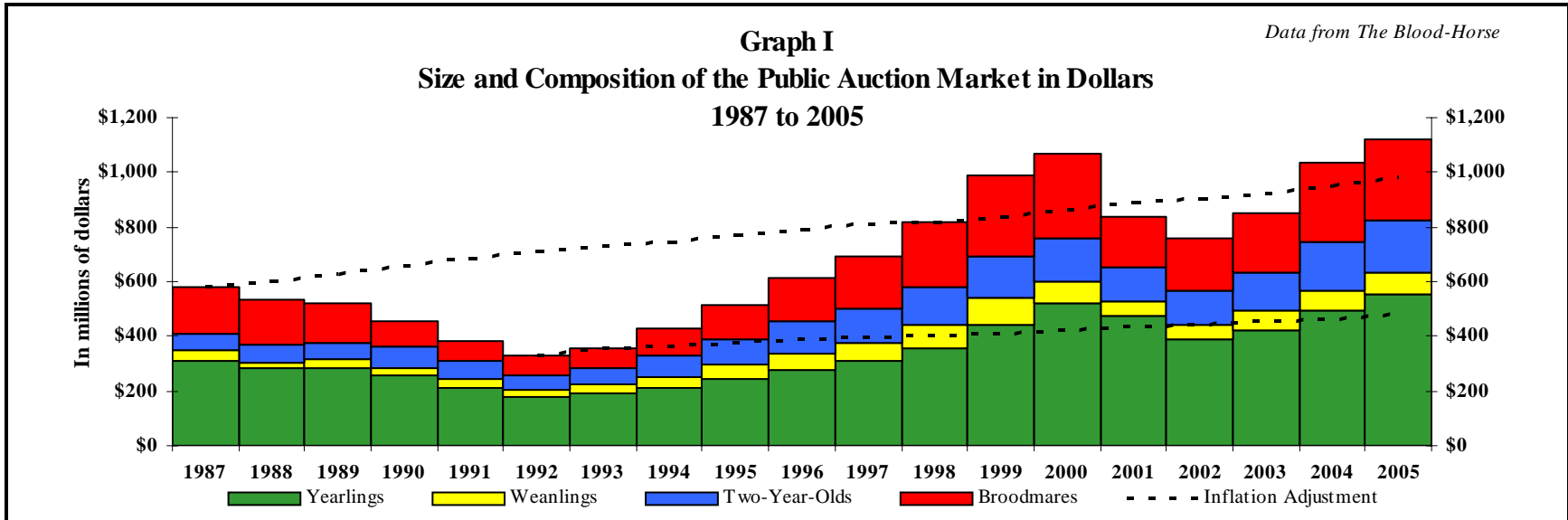
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Commentary on Graphs I and II

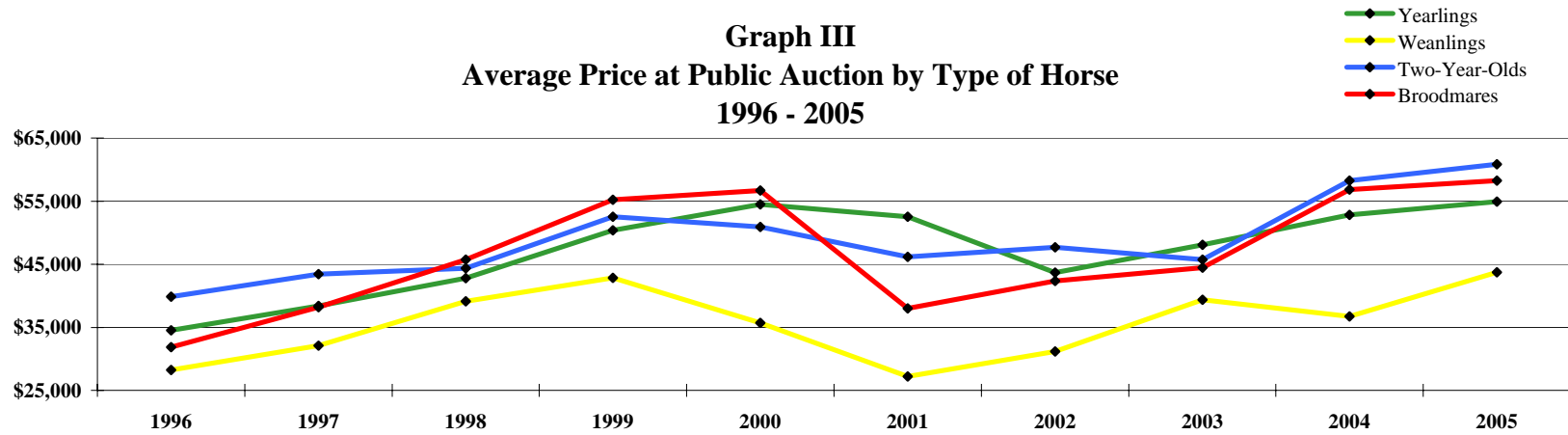
- Our 19-year view of the aggregate amount of dollars involved in North American Thoroughbred public auction sales readily shows the steady decline from 1987 to 1992, followed by an even longer and more pronounced increase from 1992 to 2000. The downward trend experienced in 2001 and 2002 has been followed by a steady recovery in 2003-2005. 2004 was the first time since 2000 that sales dollars have exceeded the inflation-adjusted dollar value from 1987. 2005 sales increased 9% over 2004, well above inflation of about 3.5%.
- Sales by category (in dollars) as a percentage of the total auction market are as follows in recent years:

	2000	2001	2002	2003	2004	2005
Weanlings	7.8%	6.3%	6.5%	8.0%	7.0%	7.1%
Yearlings	48.6%	56.6%	51.4%	50.1%	48.1%	49.3%
Two-Year-Olds	14.5%	15.2%	17.1%	16.5%	16.9%	17.0%
Broodmares	29.1%	21.9%	25.0%	25.4%	28.0%	26.6%

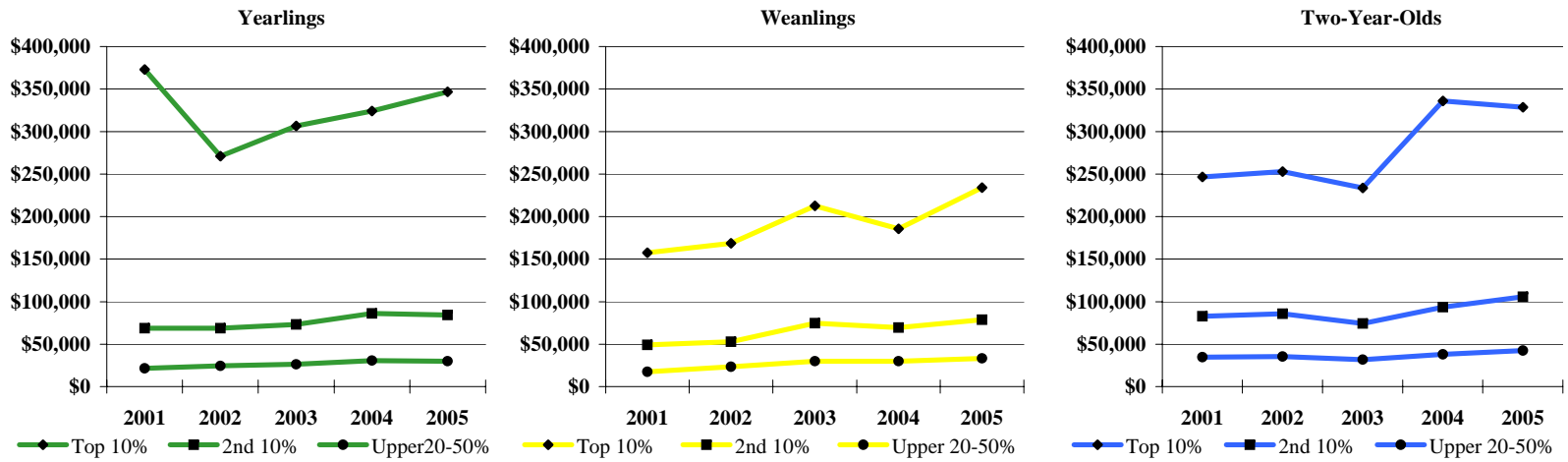
- The total number of horses sold at auction reached its highest level in 2000 (after seven consecutive years of increases), decreased 9% in 2001 and 4% in 2002, then increased 4% in 2003, 5% in 2004, and 4% in 2005. For 2005, there were increases in the number of yearlings (7%), two-year-olds (4%), and broodmares (1%) sold, while weanling numbers decreased 7%.
- 5% of the 2005 North American foal crop sold at public auction as weanlings, and 27% of the 2004 North American foal crop sold at public auction in 2005 as yearlings. The following shows the relationship of these numbers to the four previous years. Note the consistency from year-to-year of the size of the foal crops selling at public auction.

	2001	2002	2003	2004	2005
Weanlings	5%	5%	5%	5%	5%
Yearlings	25%	25%	24%	25%	27%

Graph III
Average Price at Public Auction by Type of Horse
1996 - 2005



Graph IV
Average Price by Type of Horse by Decile
2001 to 2005



Data From Auction Review, The Thoroughbred Times

Commentary on Graphs III and IV

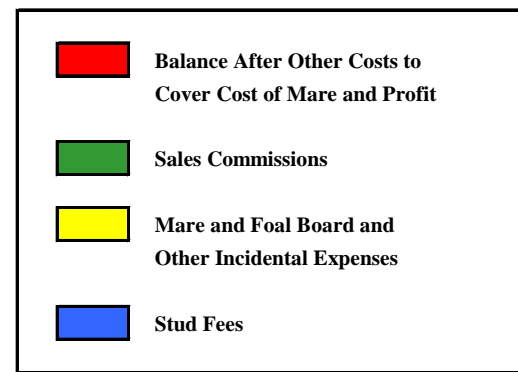
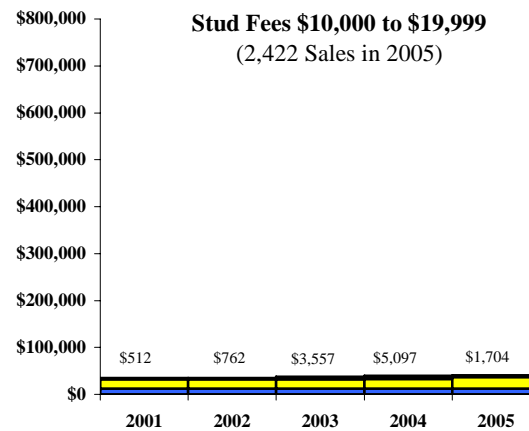
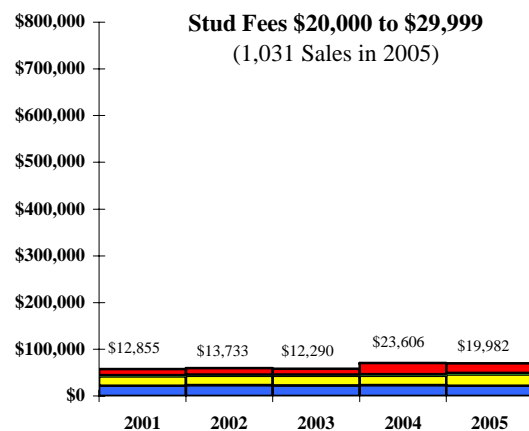
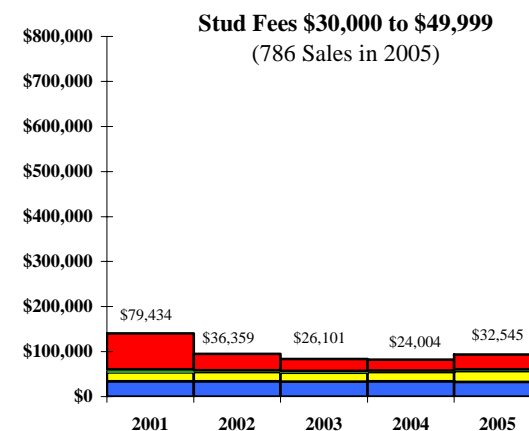
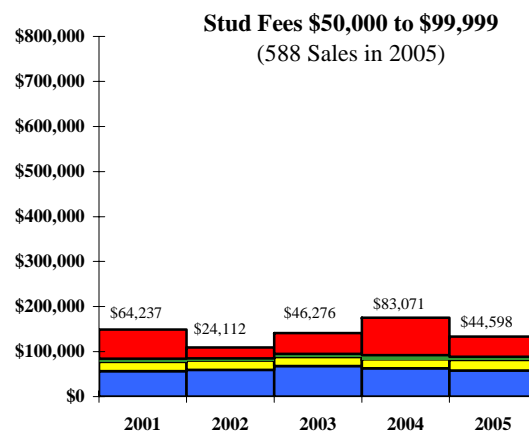
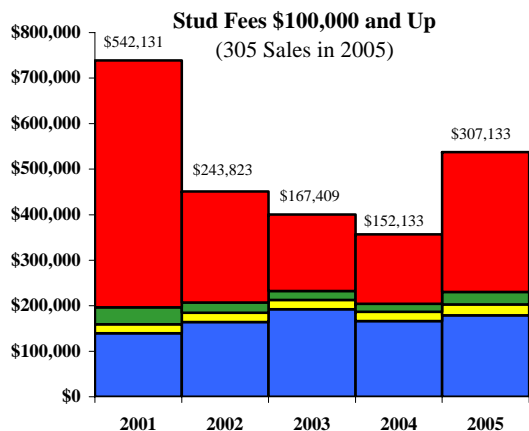
- Average prices for weanlings, yearlings, two-year-olds, and broodmares increased in 2005. Weanlings, after decreasing by 7% in 2004, showed the most pronounced increase from 2004 to 2005 with a growth in average price of 19%.
- After dropping 17% in 2002, average prices of yearlings sold at public auction increased by 10% in 2003 and again in 2004 and by 4% in 2005. Note the increase in yearling prices even with the increase in supply in the aftermath of reduced numbers available for sale in 2002 and 2003 as a result of MRLS.
- Average prices of weanlings, yearlings, two-year-olds and broodmares each reached its highest level of the years shown in 2005. The prior peak years for average prices were in 1999 for weanlings, 2000 for yearlings, and 2004 for both two-year-olds and broodmares.
- 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 – generally from at least three to more than five times.

	2001	2002	2003	2004	2005
Yearlings	5.4	4.0	4.2	3.8	4.1
Weanlings	3.2	3.2	2.8	2.7	3.0
Two-Year-Olds	3.0	3.0	3.1	3.6	3.1

- Note that the top decile average yearling price, which experienced a 6% increase in 2004, showed a 7% increase in 2005, continuing a rebound from 2002. The second decile decreased 2%, and the combined third through fifth deciles decreased 1% in 2005.
- The average price in the top decile for weanlings increased in 2005 by 26%. The 18% overall average price increase for weanlings for 2005 was comprised of increases in deciles 1 through 5, net of decreases in deciles 6 through 10.
- Average two-year-old prices in the top decile decreased 2% in 2005. Deciles 2 through 4 each increased about 12-13%. Deciles 6 through 10 each also increased, but with single digit growth. This resulted in a 3.4% increase across the board for two-year-old average sale prices. Average two-year-old prices increased at a much slower rate in 2005 (3.4%) than in 2004 (27.7%).

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

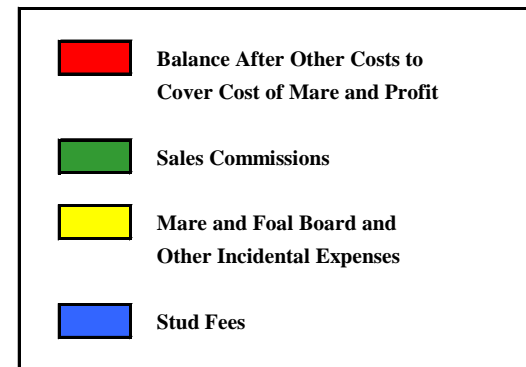
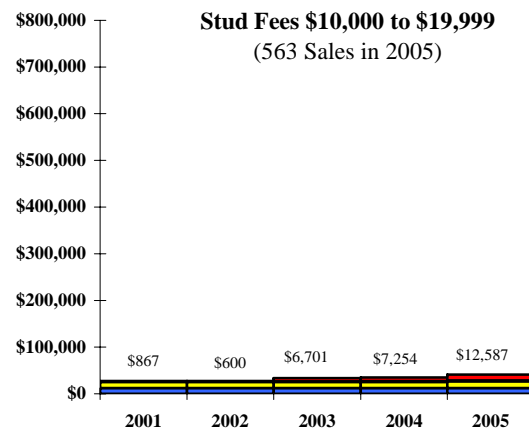
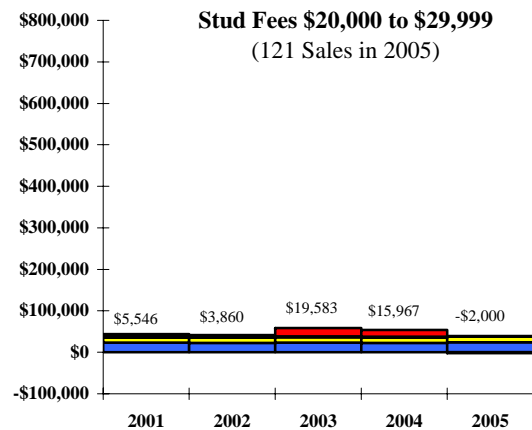
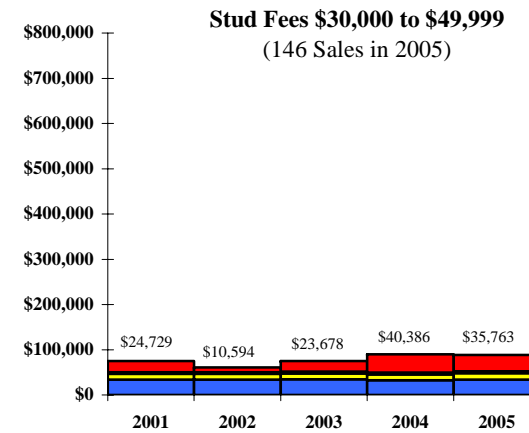
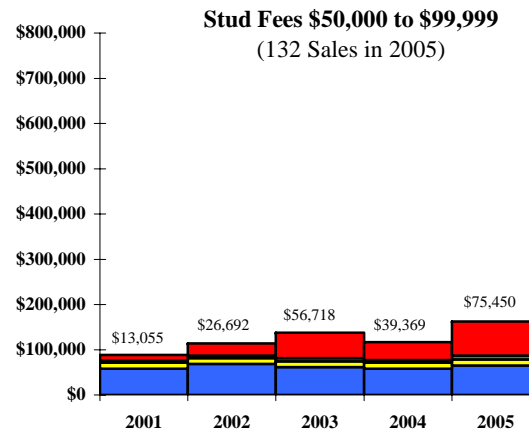
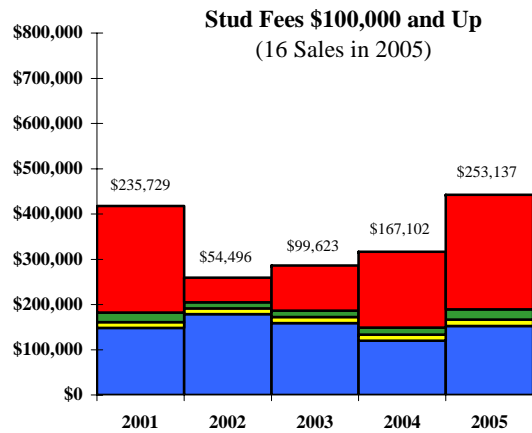
Graph V
Breakdown of Price of Yearling Sales into Cost Components -- Stud Fees, Sales Commissions, and Mare and Foal Board and Incidental Expenses -- Balance Available to Cover Cost of Mare and Profit
YEARLINGS -- By Stud Fee Range
2001 to 2005



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
2001 to 2005



Underlying Data from Auction Review, The Thoroughbred Times

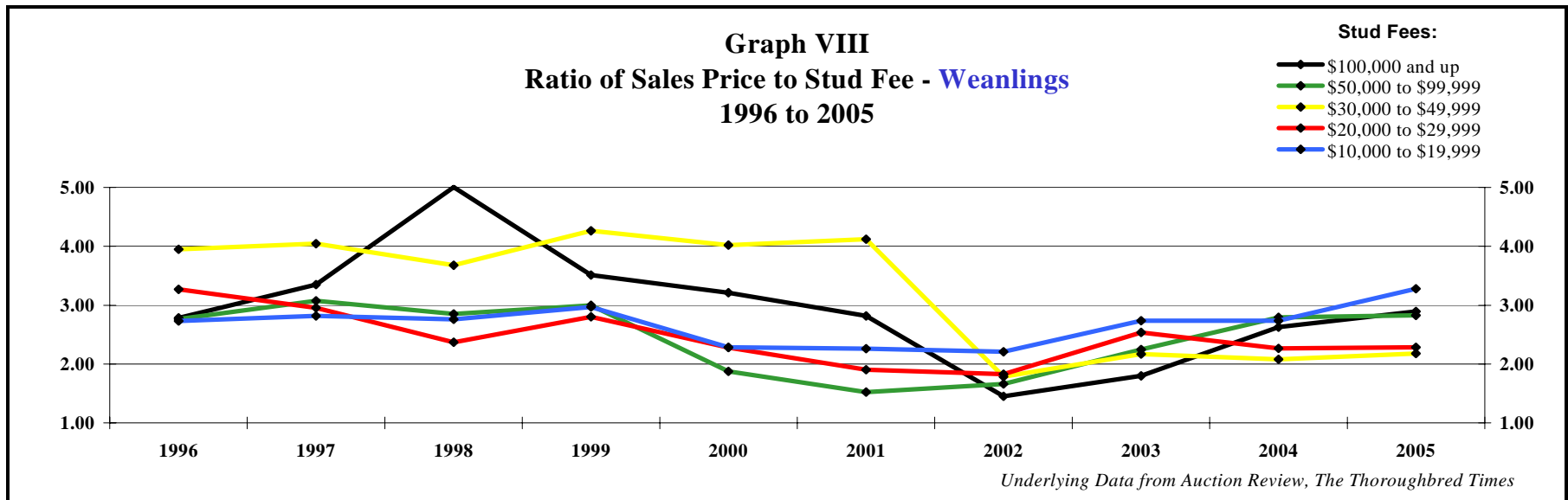
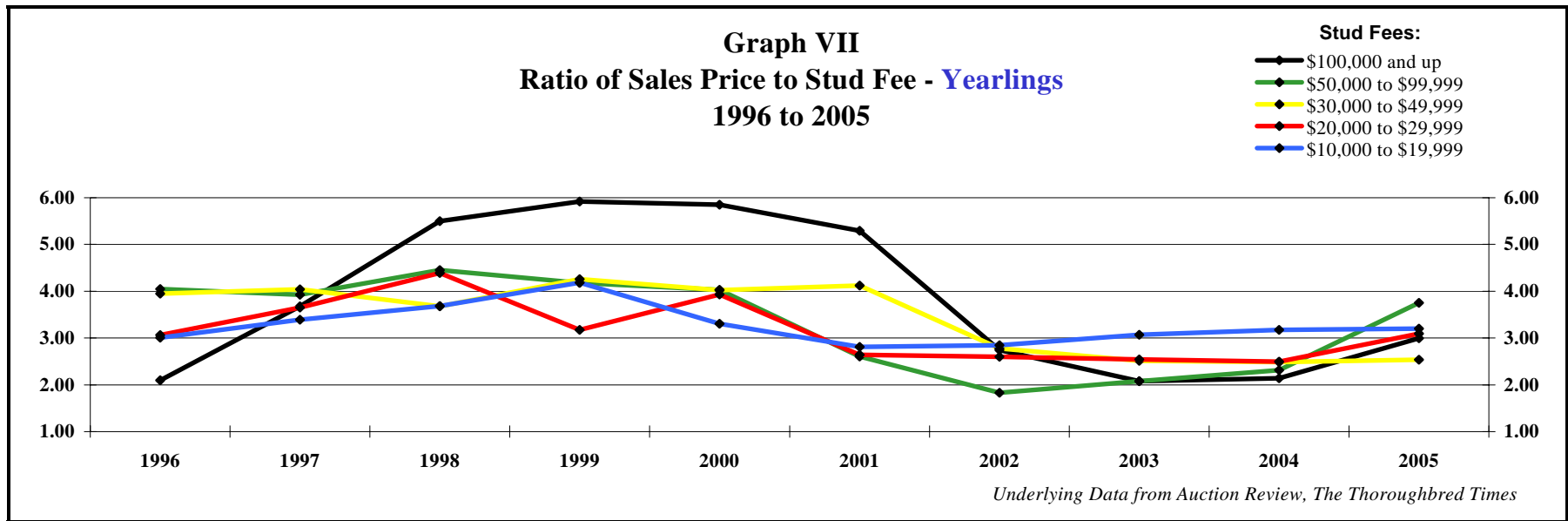
Commentary on Graphs V and VI

- We have analyzed data which shows the relationship of yearling (Graph V) and weanling (Graph VI) sales results to stud fee costs over 2001-2005, 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 \$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.
- 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.

Percentage Change from Prior Year in Selling Price Available for Mare and Profit

Stud Fee Range	Yearlings		Weanlings	
	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2005</u>
\$100,000 and up	-9%	102%	68%	51%
\$50,000 to \$99,999	80%	-46%	-31%	92%
\$30,000 to \$49,999	-8%	36%	71%	-11%
\$20,000 to \$29,999	92%	-15%	-18%	-113%
\$10,000 to \$19,999	43%	-67%	8%	74%

- In Graph V and the above table, note the rebound in “profitability” in the case of yearlings resulting from breedings to the highest-priced stallions.
- In Graph VI and the above table, note the continued increase in “profitability” for 2005 weanling sellers resulting from breedings to the highest-priced stallions, with mixed results in the other stud fee ranges.
- Note that this analysis does not take into account costs associated with barren mares and lost foals. Further note that by using a cut-off of \$10,000 stud fee for this analysis, we are including 53% of yearlings sold publicly and 54% of weanlings sold publicly in 2005.



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 1996 through 2005, by stud fee range:

Stud Fee	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
\$100,000 and up	2.1	3.7	5.5	5.9	5.9	5.3	2.7	2.1	2.1	3.0
\$50,000 to \$99,999	4.1	3.9	4.5	4.2	4.0	2.6	1.8	2.1	2.3	3.7
\$30,000 to \$49,999	4.0	4.0	3.7	4.3	4.0	4.1	2.7	2.5	2.5	2.5
\$20,000 to \$29,9999	3.1	3.7	4.4	3.2	3.9	2.6	2.5	2.5	2.5	3.0
\$10,000 to \$19,999	3.0	3.4	3.7	4.2	3.3	2.8	2.8	3.1	3.2	3.2

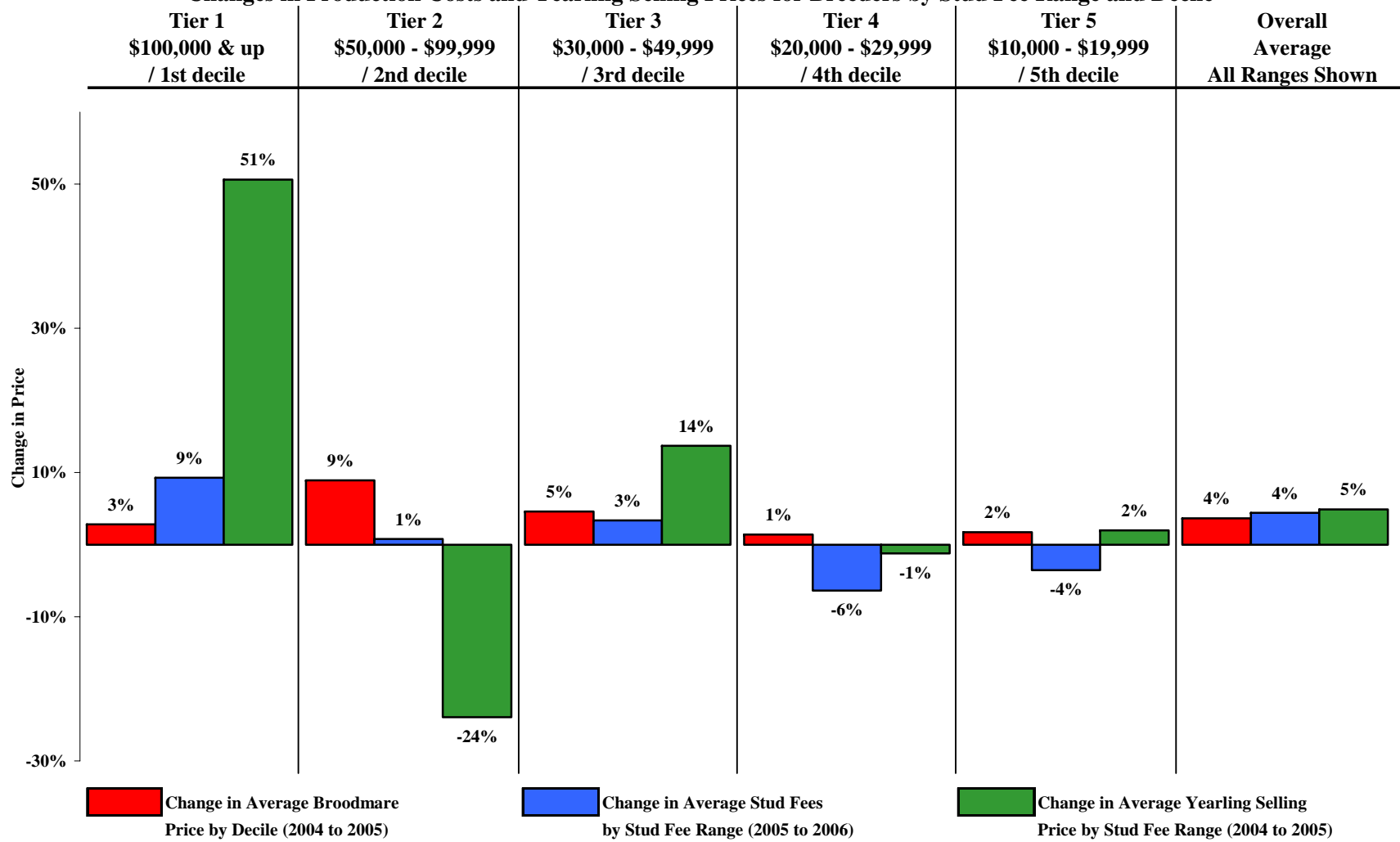
- Note that yearlings sired by the higher-priced stallions had substantially greater multiples in 1998-2001, but generally similar multiples in 2002-2005. Note that 2005 multiples were stable or increased in relation to 2004.
- This table shows stud fee multiples for **weanlings** sold in 1996 through 2005, by stud fee range:

Stud Fee	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
\$100,000 and up	2.9	3.4	5.0	3.5	3.2	2.8	1.5	1.8	2.6	2.9
\$50,000 to \$99,999	2.8	3.1	2.9	3.0	1.9	1.5	1.6	2.2	2.8	2.8
\$30,000 to \$49,999	4.0	4.0	3.7	4.3	4.0	4.1	1.8	2.2	2.1	2.2
\$20,000 to \$29,9999	3.3	3.0	2.4	2.8	2.3	1.9	1.8	2.5	2.3	2.3
\$10,000 to \$19,999	2.7	2.8	2.8	3.0	2.3	2.3	2.2	2.7	2.7	3.3

- Note the improved and highest multiple in the lowest stud-fee category considered for 2005.

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

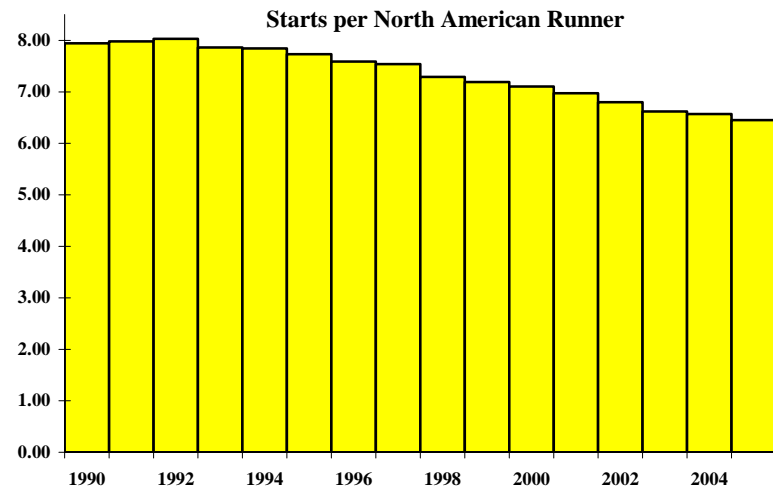
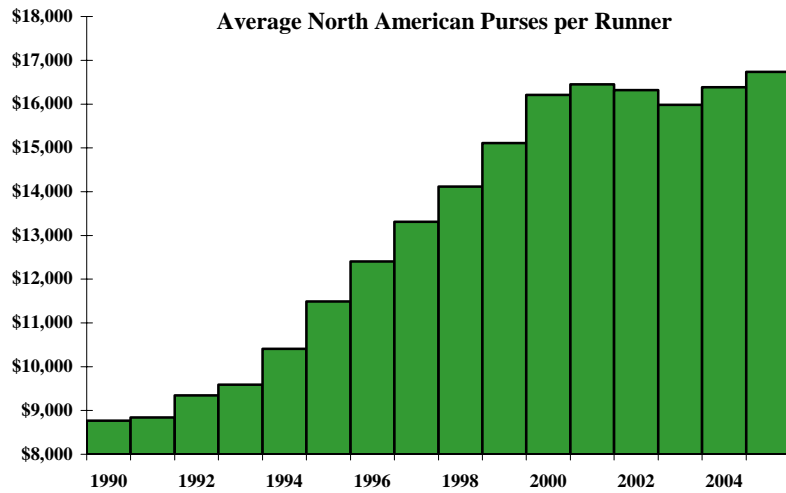
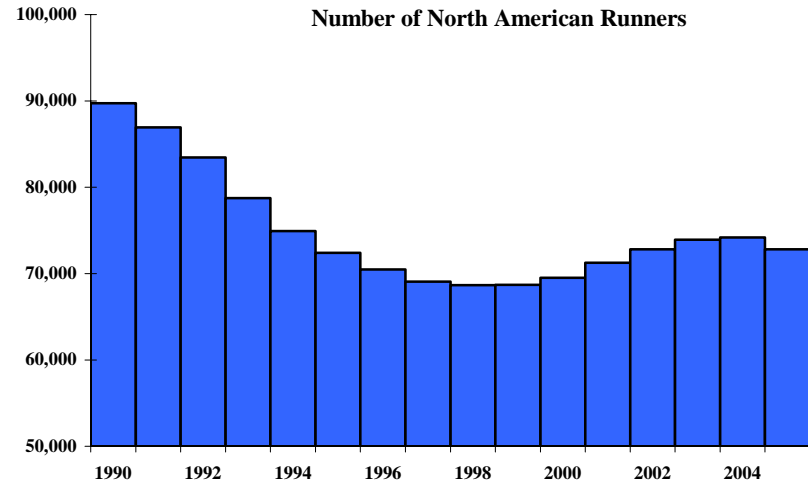
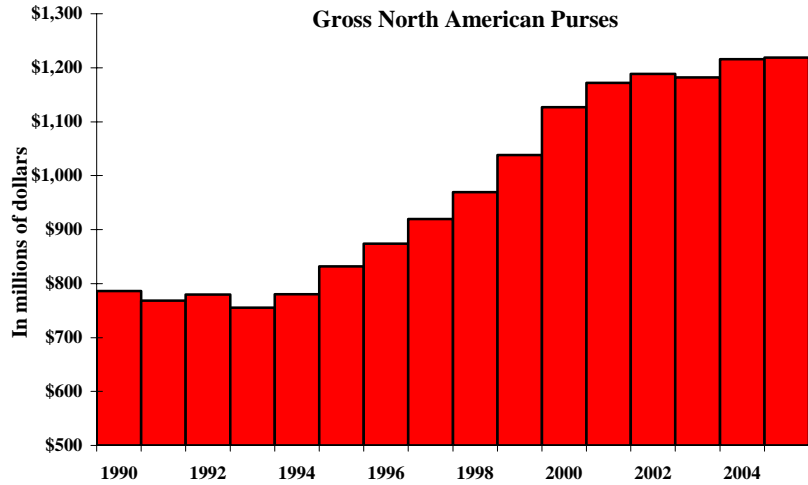
- In Graph IX, we try to provide insight into a critical question for breeders: Are your production costs increasing at a higher or lower rate than the prices you're receiving for your products? For costs of production, we focus on the two major elements: (1) broodmare costs – based on public auction 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 2005 to 2006. For broodmares, we are measuring the change in this cost by reference to changes in average auction prices from 2004 to 2005. Similarly, the change in sales price of yearlings is measured by reference to average auction prices from 2004 to 2005.
- 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 +	Top 10%	\$100,000 +
2	\$50,000-99,999	2 nd 10%	\$50,000-99,999
3	\$30,000-49,999	3 rd 10%	\$30,000-49,999
4	\$20,000-29,999	4 th 10%	\$20,000-29,999
5	\$10,000-19,999	5 th 10%	\$10,000-19,999

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 mixed results. In the highest end of the market, yearling prices significantly outpaced corresponding increases in broodmare prices and stud fees. In general for 2005, the cost of broodmares increased 4% (significantly down from 27% last year), and stud fees also increased 4%, the same as in 2004. Selling prices of offspring as yearlings are mixed, way up for yearlings bred to the highest priced stallions and up 5% overall – see last column.

Graph X
Racing Purses and Numbers of Horses Racing
1990 - 2005



Data from The Jockey Club

Commentary on Graph X

- 2005 gross purses remained steady with 2004's amount.
- After 6 consecutive years of increasing numbers of runners, the number decreased in 2005.
- From 1990 to 2005, average purses per runner have increased from \$8,800 to \$16,700 – 90%. 2005 average purses per runner increased, due to a decrease in the number of runners. Note that average purses per runner have remained relatively stable over 2000-2005; substantially all the 90% growth from 1990 occurred by 2000.
- 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 50%).
- Also note that the increase in average purses per runner from 1990 to 2005 - 90% - has just kept pace with the increase in the average cost of purchasing yearlings over the same period – 87%, but is below increases in the cost of purchasing weanlings and two-year-olds – 141% and 200%, respectively.
- Starts per runner continued to decline in 2005, the thirteenth consecutive year. In 1992, the highest of the 16 years considered, average starts per runner was just over 8; by 2005, the average had declined to 6.5.

What Equine Businesses Need to Know About Payments to Non-U.S. Residents

Payments of U.S. source income to non-U.S. persons generally are subject to U.S. withholding and reporting requirements, regardless of whether or not the payor is a U.S. person and regardless of where the payment is made.

Employees – New Rules

U.S. and foreign businesses are generally required to withhold income tax on all employees performing services in the U.S. For wages paid after 2005, there is a new procedure for calculating the amount of federal income tax withholding on wages of nonresident alien (NRA) employees. Under this procedure, employers add a “phantom” amount set forth in the chart below to the nonresident alien’s wages for purposes of calculating the income tax withholding for each payroll period and determine the amount to be withheld by applying the income tax withholding tables to that total amount. The addition is not reported on the nonresident’s W-2 and has no impact on the employee’s FICA tax. The new rules eliminate the previous requirement that a specified additional amount be withheld from each nonresident alien’s paycheck.

Employers should ask all of their nonresident alien employees to complete a new Form W-4 if they have not done so already to comply with these new rules.

When completing Form W-4 for wages to be paid after 2005, nonresident alien employees are required to:

- Not claim exemption from withholding.
- Request withholding as if they are single, regardless of their actual marital status.
- Claim only one allowance (except residents of Canada, Mexico, or South Korea may claim more than one allowance).
- Write “Nonresident Alien” above the dotted line on line 6 of Form W-4.

Amount to Add to Nonresident Alien Employee’s Wages for Calculating Income Tax Withholding

<u>Payroll Period</u>	<u>Add Additional</u>
Weekly	\$ 51.00
Biweekly	102.00
Semimonthly	110.00
Monthly	221.00

Quarterly	663.00
Semiannually	1,325.00
Annually	2,650.00
Daily (or miscellaneous)	10.20

These amounts will be updated at least annually.

Reminder to Withhold on Other Payments to Nonresidents – Individuals and Businesses

The equine business is a very international one. Periodically we like to remind our clients and friends in the business of the withholding requirements relating to payments to nonresidents.

This is even more important now as IRS has recently indicated that it will begin auditing accounts payable, looking for payments to foreign businesses and individuals. IRS has audited banks, brokers, and universities on this issue in the past, but is now focusing on other U.S. businesses.

Generally, businesses operating in the U.S. are required to withhold at 30% on payments to nonresident aliens of the following U.S.-source income:

- interest
- dividends
- rents
- royalties
- nonemployee services performed in the U.S.

Payors generally are not required to withhold on payments to nonresident aliens for purchases of property other than direct or indirect U.S. real estate holdings.

Additionally, partnerships are required to report and deposit withholding payments quarterly on foreign partners' share of the partnership's U.S. income – whether or not the income is actually distributed.

Penalties for failure to comply with these rules can be steep, but there are some exceptions to the rules.

To identify nonresident payees, look for:

- A foreign address or payments made to foreign locations.
- An EIN beginning with “98.”
- Something other than Inc., LLC, LP, or other U.S. business entity designations at the end of a business name – e.g., PLC, Ag, or SA.

If you find any of these indicators, you must withhold on all payments of the above types at 30% unless you have additional documentation on a W-8 series form.

The withholding tax is required to be deposited in a manner similar to payroll tax deposits, and the penalties for late deposit are similar – and potentially very high.

Please let us know if we can help you with any of these matters.

- Leigh McKee and Flora Djojo

New Tax Benefit for Horse Breeders and Owners – the Qualified Production Activities Deduction

Horse breeders and owners may be entitled to a new tax deduction beginning with their 2005 tax years. This deduction, called the qualified production activities (QPA) deduction, potentially applies when a business derives revenue from leasing, renting, licensing, selling, or otherwise disposing of tangible personal property (e.g., bloodstock) which was produced or grown within the U.S. (referred to below as “qualifying revenue”).

The deduction eventually is scheduled to be 9% (in 2010) of the lesser of: (1) net income attributable to qualifying revenue, or (2) overall taxable income, each determined before the QPA deduction. The 9% is phased-in, beginning at 3% for 2005-2006, then increasing to 6% for 2007-2009.

Some other limitations may apply to reduce or eliminate the deduction; principal among them are: (1) revenue from leasing, licensing, or renting property to a related party for its use doesn’t qualify; and (2) the deduction can’t exceed 50% of the business’s W-2 wages paid.

Although the IRS has issued no guidance on the subject, we’ve given consideration to what types of equine business revenue we believe may or may not be treated as qualifying for the QPA deduction:

<i>Type of Income</i>	<i>DDF Initial View</i>
Sale of homebred (regardless of age)	YES: If horse bred and raised to a significant extent in the U.S.
Resale of purchased weanling as a yearling	MAYBE: Producing a racehorse, if in the U.S.
Resale of purchased yearling as a 2-year-old	MAYBE: Producing a racehorse, if in the U.S.
Resale of purchased yearling or weanling while still racing	MAYBE: Producing a racehorse, if in the U.S.
Resale of purchased horse upon retirement from racing or after having been bred	NO: Probably not deemed to be producing a breeding horse
Stud fees	YES: If stallion was a homebred as to seller
Race winnings	NO: Not related to the sale, lease, license, rental, or other disposition of the horse
Commissions income	NO: Services; not production
Boarding income	NO: Services; not production
Training income	NO: Services; not production

Please contact us if you would like to explore whether you might benefit from this deduction.

- Jen Shah and Doug Dean