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DEAN DORTON ALLEN FORD, PLLC

Thoroughbred Business Year in Review 2015

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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 35 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, and stallion management; from racing stables to a racetrack; from bloodstock agents to equine veterinary firms; and from industry associations to equine insurance agencies.

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.

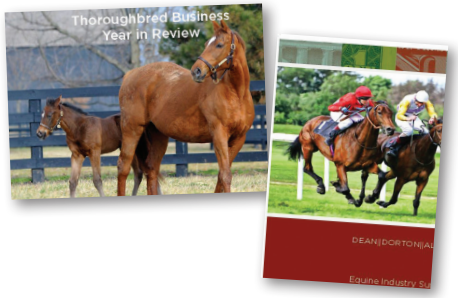
As a firm, we endeavor to know the business of horses, not just accounting and tax rules relating to the industry. We accomplish this in a number of ways, including, most usefully, by working with our many clients in the industry on their business matters.

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 operations.

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

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

Our firm also periodically conducts and reports results of surveys of horse farm metrics and practices, mainly centered on pay rates, employee benefits practices, and client billing rates and practices. Our team also co-authors the Equine Sales & Use Tax Review.



Please visit our website to view recent survey results or contact Shannon Abbott at 859-255-2341 or sabbott@deandorton.com if you would like to be placed on our list to receive these publications in the future.

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Equine Industry Group Services

The unique attributes of the equine industry demand accounting services with the particular depth of experience and expertise that Dean Dorton delivers. When equine industry participants enlist Dean Dorton to provide tax services, they can be confident they are engaging a firm with in-depth industry experience and know-how. We are interested in our clients' business, know the industry, and can provide a wide range of valuable services designed to both optimize savings opportunities and avoid unanticipated problems. Among our team's services are:

Tax

- Developing strategies to use the optimum forms of organization.
- 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.
- Developing policies to expense or capitalize costs relating to depreciable assets which are in compliance with new tax regulations.
- 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 deduction.

Accounting and Assurance

- 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.
- Performing risk assessments and tailored internal audit functions.

Business Consulting

- Developing financial and business plans for farms, breeding operations, and racing stables.
- Assessing farm accounting and financial management procedures and practices.
- 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.

Table of Contents

Cover Photo by Anne M. Eberhardt/Blood-Horse

Executive Summary

- Dollars spent at North American public auctions of thoroughbreds have been very stable during 2013 through 2015. The recovery from the big declines experienced in 2008 through 2010 seem to have stalled for now, well below the levels reached during the mid-2000s. Average prices paid for racing prospects – yearlings, weanlings, and two-year-olds – have been increasing nicely for breeders during at least the last three years. But, broodmare prices have declined over the last two years. See pages 2-5.

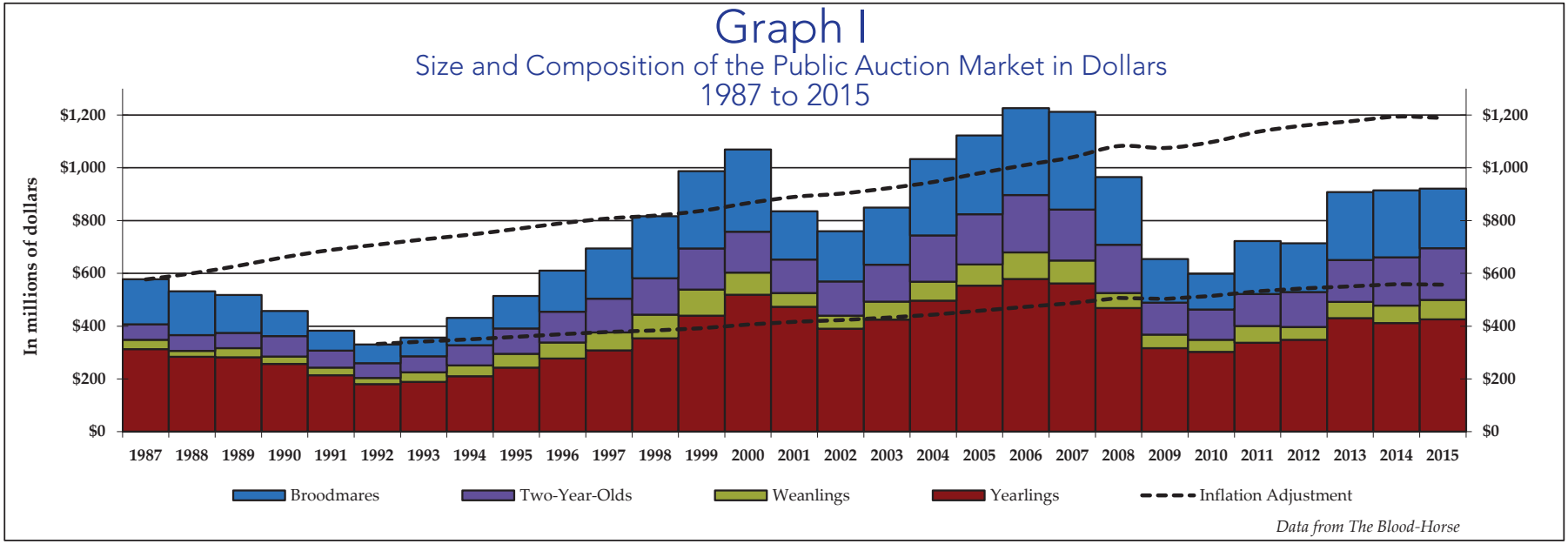
- Amounts available to thoroughbred breeders from yearling sales proceeds, after recovering stud fees, sales commissions, and mare and foal board costs, generally declined in 2015. But, on average, 2015 weanling sellers generally had improved results from 2014. See pages 6-8.

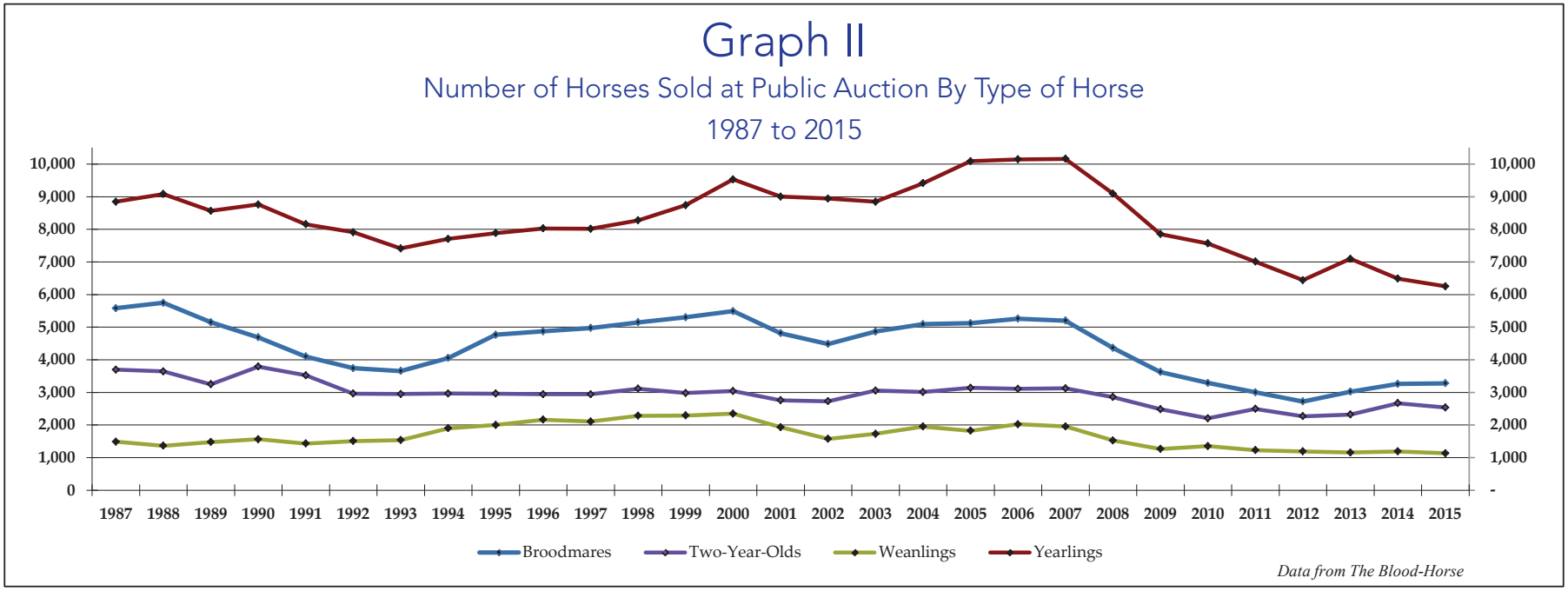
- The 2015 ratios of yearling sales prices to stud fees in relation to the 3-year averages and to 2014 varied by stud fee range. These ratios for 2015 weanling sales in most stud fee ranges were notably stronger. See pages 9-10.

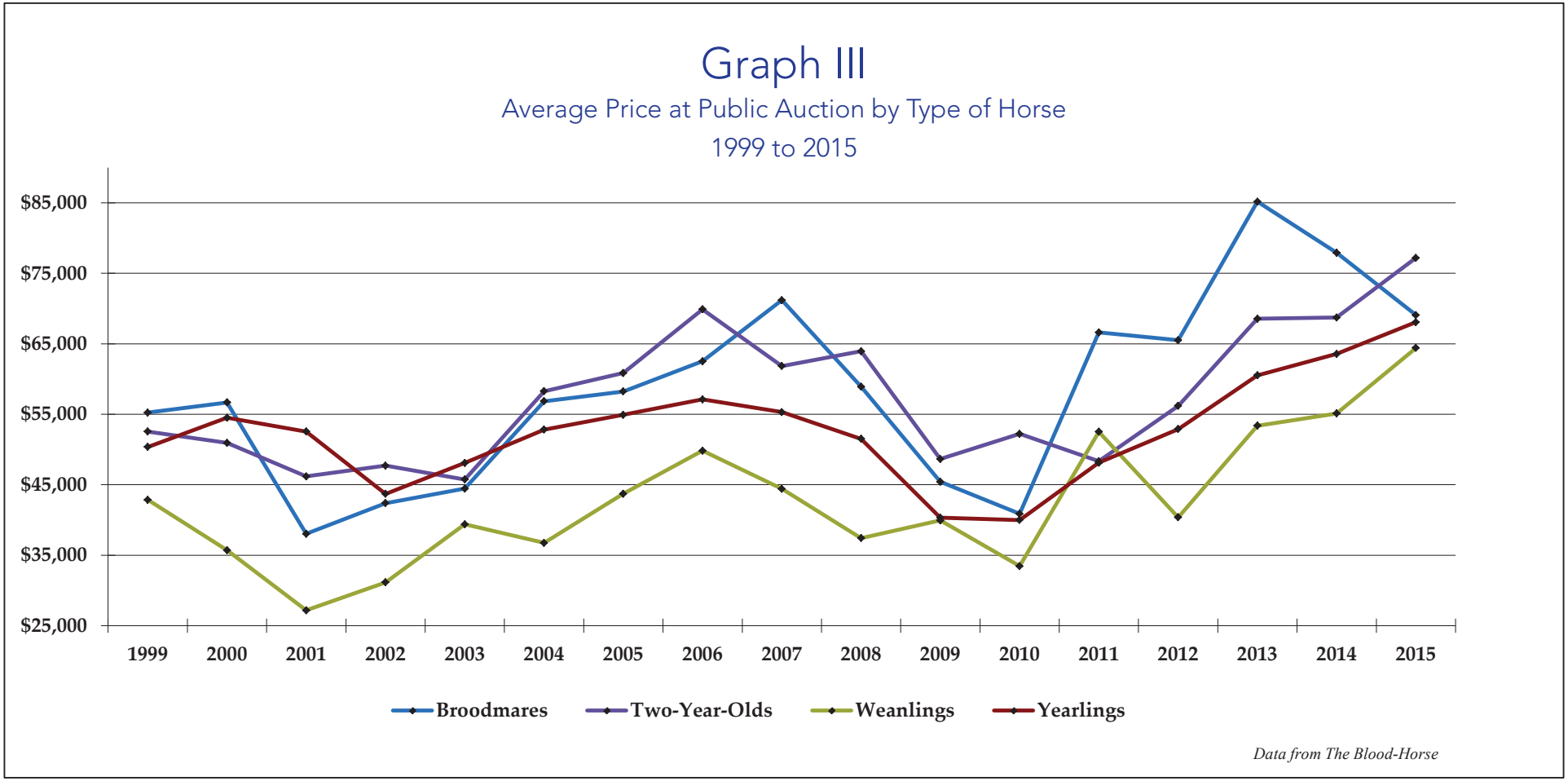
- Costs of owning broodmares are declining, but stud fees are increasing significantly. Moderate yearling price increases are unlikely to enable breeders to maintain their margins. See pages 11-12.

- Average race purses per runner increased again in 2015, and average starts per runner have stabilized over the last several years after a long period of declines. See pages 13-14.

- Although the economics of breeding and racing thoroughbreds are not where industry participants want them to be, our analysis shows generally stable financial conditions for breeders and somewhat improving financial prospects for racehorse owners.


Graph I
Size and Composition of the Public Auction Market in Dollars
1987 to 2015
In millions of dollars
$1,200
$1,000
$800
$600
$400
$200
$0
1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015
Broodmares
Two-Year-Olds
Weanlings
Yearlings
Inflation Adjustment
Data from The Blood-Horse


Graph II
Number of Horses Sold at Public Auction By Type of Horse
1987 to 2015
10,000
9,000
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
-
1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015
Broodmares
Two-Year-Olds
Weanlings
Yearlings
Data from The Blood-Horse


Graph III
Average Price at Public Auction by Type of Horse
1999 to 2015
$85,000
$75,000
$65,000
$55,000
$45,000
$35,000
$25,000
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
Broodmares
Two-Year-Olds
Weanlings
Yearlings
Data from The Blood-Horse

Commentary on Graphs I,II, and III

- After the precipitous declines in the amounts spent at North American horse sales in 2008 and 2009 and a less severe decline in 2010, the thoroughbred horse market recovered some ground in 2011 and 2012, followed by a significant increase in 2013 (27%). The market has remained at about the same level in 2013-2015, as shown on Graph I.

  For 2015, Graph I shows very stable total dollars invested (up 0.7% from 2014), with mixed results in the different categories:

Broodmares	-11%
Two-year-olds	+7%
Yearlings	+3%
Weanlings	+11%

  From the peak of $1.226 billion in 2006, to 2015, dollars expended at public auctions dropped by 25%, to $921 million.

- If we observe trends shown in Graph I over the full 29-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 impacts), 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. The declines of 20% in 2008 and 32% in 2009 (housing bubble burst and ensuing recession) were dramatic; 2010's decline was 9%. The 2011 increase (21%) was the first increase since 2006. Dollars invested declined by 1.5% in 2012, increased by 27% in 2013, and were stable for 2014 and 2015 (up less than 1% in each year).

- On an inflation-adjusted basis, to be on par with the approximate $600 million level of public auction dollars in 1987, the first year of our analysis, auction sales in 2015 would have to have been almost $1.2 billion, but at $921 million, sales lagged well below. However, 2015's auction sales, after adjusting for inflation, substantially exceeded the low point (1992) of this 29 year period.

- Sales by category (in dollars) as a percentage of the total auction market are as follows in the last several years:

	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Weanlings	5.9%	7.8%	7.5%	8.9%	6.9%	6.8%	7.2%	7.9%
Yearlings	48.5%	48.5%	50.7%	46.7%	48.7%	47.4%	45.0%	46.3%
Two-Year-Olds	18.9%	18.9%	19.2%	16.8%	18.4%	17.5%	20.0%	21.3%
Broodmares	26.7%	25.1%	22.6%	27.6%	26.0%	28.3%	27.8%	24.5%

Commentary on Graphs I,II, and III
(continued)

- From its peak in 2006, the number of each type of thoroughbred sold at public auction has dropped significantly through 2015:

Broodmares	-38%
Two-year-olds	-18%
Yearlings	-38%
Weanlings	-44%

- For each category, the change in number sold remained relatively stable from 2014 to 2015.

- Five percent of the 2015 North American foal crop sold at 2015 public auctions as weanlings, and 28% of the 2014 North American foal crop sold at public auctions in 2015 as yearlings. The following shows the consistency of these numbers over the last seven years.

	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Weanlings	4%	5%	5%	5%	5%	5%	5%
Yearlings	23%	24%	26%	25%	32%	28%	28%

- From Graph III, we can see substantial increases in average prices for each category in 2013 and mixed results in 2014 and 2015:

	2013	**2014**	**2015**
Broodmares	+30%	-9%	-11%
Two-year-olds	+22%	0%	+12%
Yearlings	+14%	+5%	+7%
Weanlings	+32%	+3%	+17%

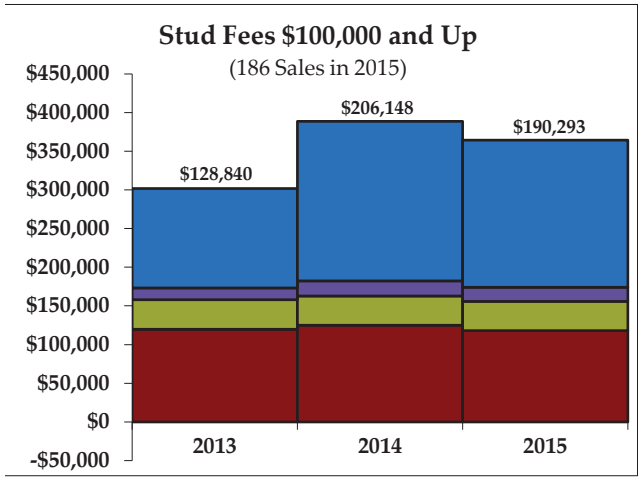
Graph IV

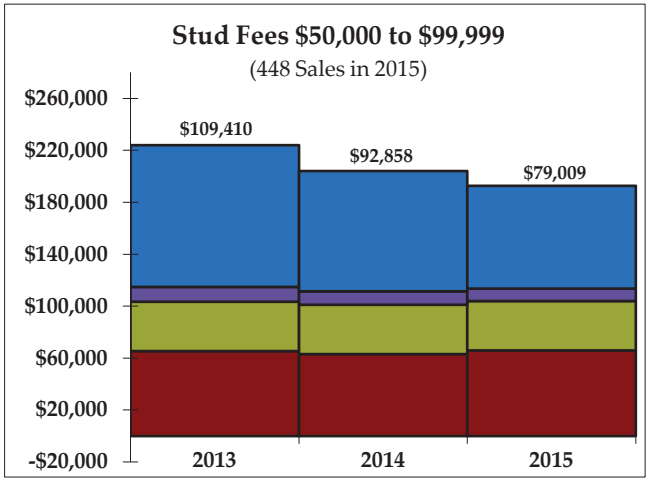
Breakdown of Price of Yearling Sales into Cost Components — Stud Fees, Sales Commissions, and Mare and Foal Board and Incidental Expenses — Balance Available to Cover Cost of Mare and Profit

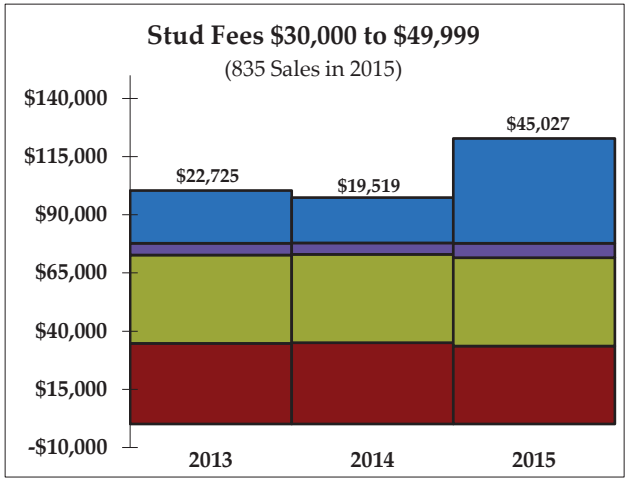
YEARLINGS — By Stud Fee Range

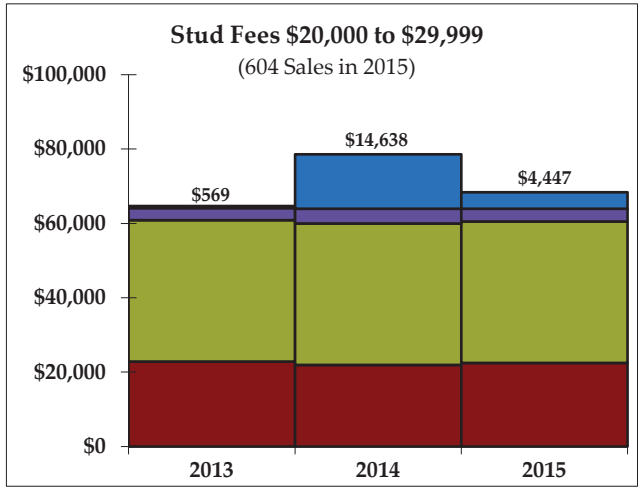
2013 to 2015

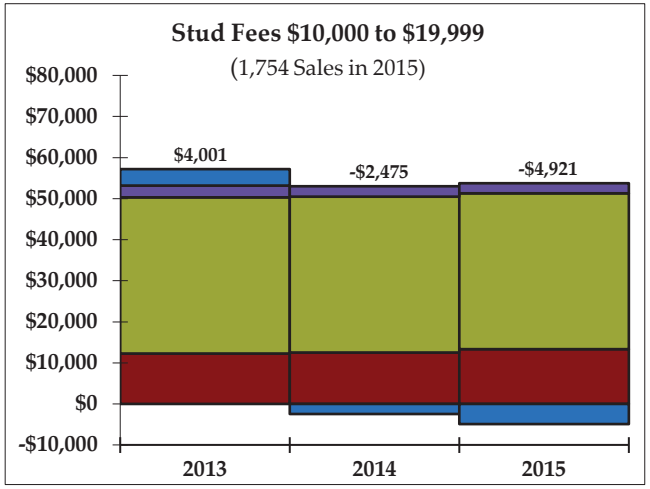
Note: Dollar figures above bars on bar graphs represent amounts remaining after other costs to cover capital costs associated with mare and profit.

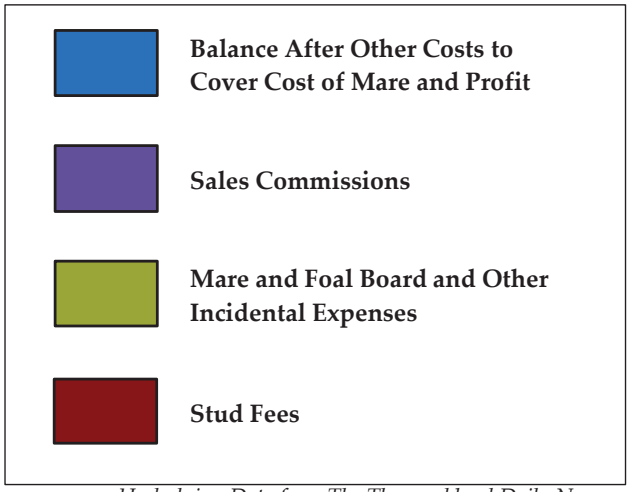












Underlying Data from The Thoroughbred Daily News

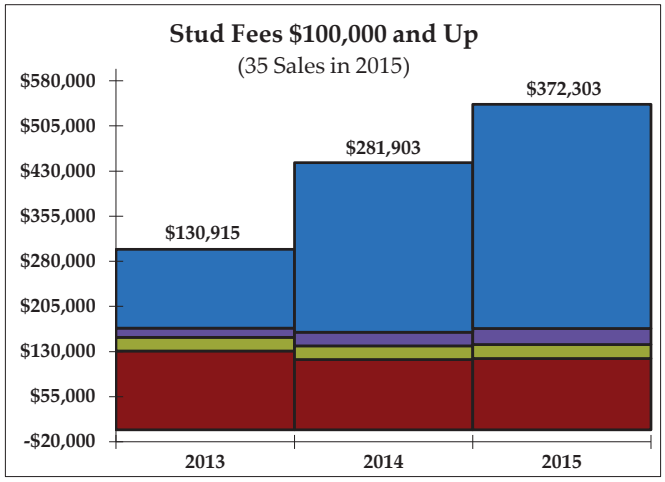
Graph V

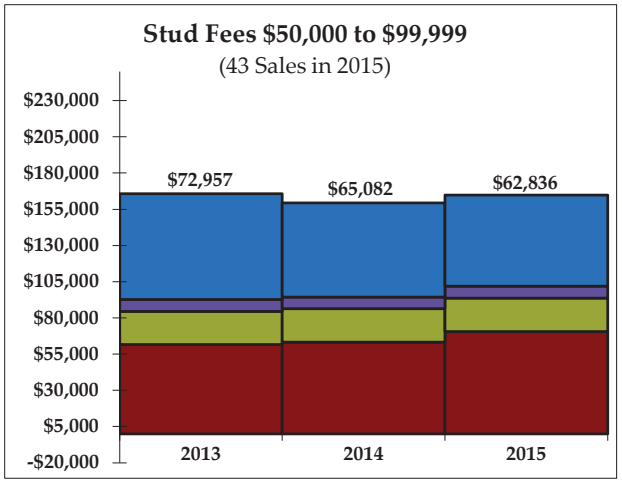
Breakdown of Price of Weanling Sales into Cost Components — Stud Fees, Sales Commissions, and Mare and Foal Board and Incidental Expenses — Balance Available to Cover Cost of Mare and Profit

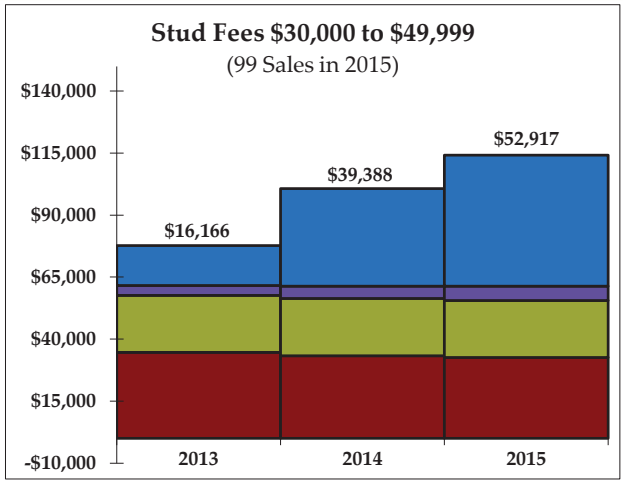
WEANLINGS — By Stud Fee Range

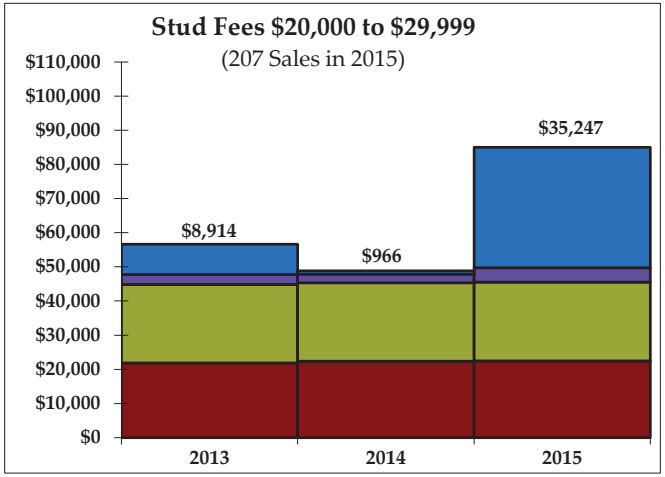
2013 to 2015

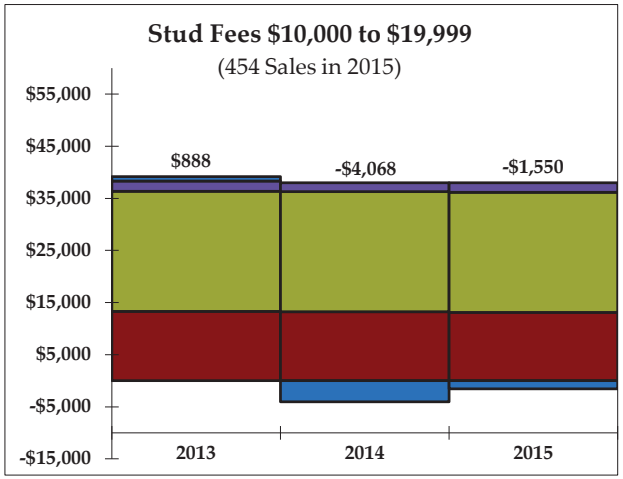
Note: Dollar figures above bars on bar graphs represent amounts remaining after other costs to cover capital costs associated with mare and profit.

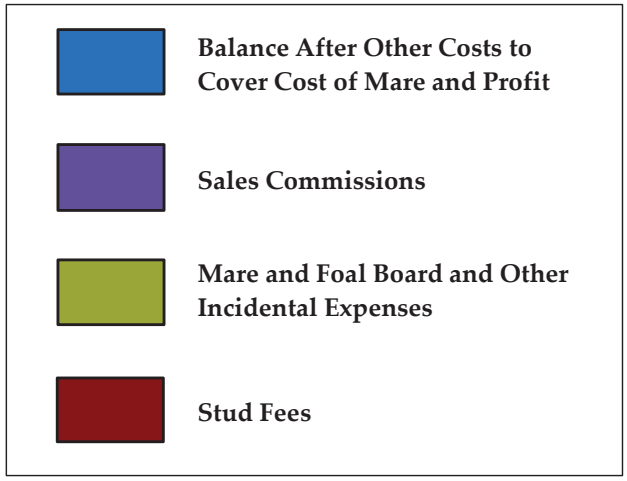












Underlying Data from The Thoroughbred Daily News

Commentary on Graphs IV and V

- We have analyzed data which show the relationship of North American yearling (Graph IV) and weanling (Graph V) sales results to stud fee costs over 2013 to 2015, 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 estimated cost of boarding and caring for the mare for one year and her foal until assumed sale dates (November for weanlings and September for yearlings). For this latter cost, primarily board and veterinary, we used $38,000 and $23,000 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 own 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, our analysis does not cover the entire yearling and weanling markets.

- For purposes of this analysis, we are treating as weanlings those yearlings that are sold in January following their foaling year.

- The table below shows the dollar and percentage changes from 2014 to 2015 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.

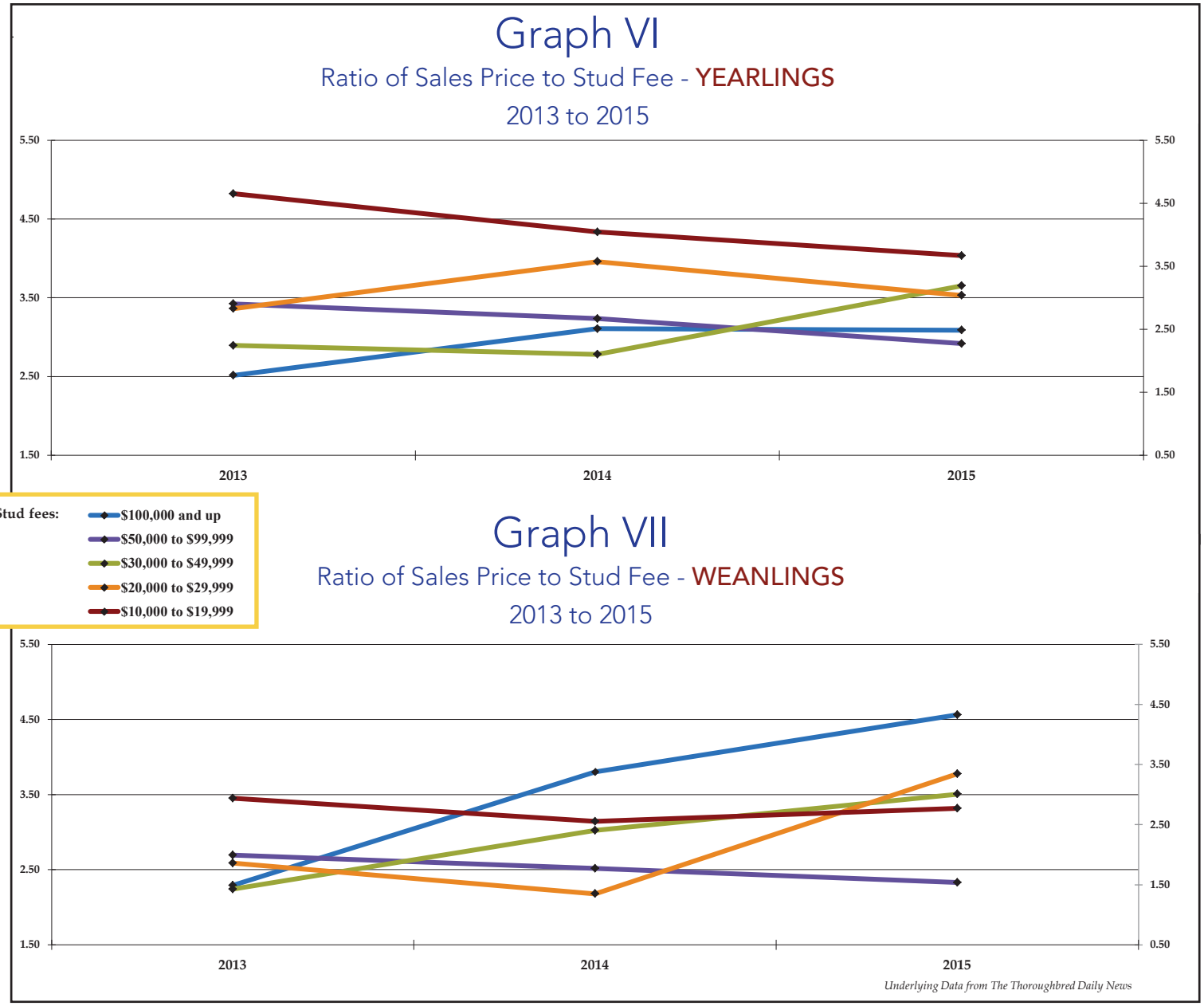
Changes from 2014 to 2015 in Selling Price Available for Mare Cost and Profit

	Yearlings				Weanlings			
Stud Fee Range	**Increase <Decrease>**	**% Change**	**2015**	**2014**	**Increase <Decrease>**	**% Change**	**2015**	**2014**
$100,000 and up	<$15,855>	-8%	$190,293	$206,148	$90,400	+32%	$372,303	$281,903
$50,000 to $99,999	<$13,849>	-15%	$79,009	$92,858	<$2,246>	-3%	$62,836	$65,082
$30,000 to $49,999	$25,508	+131%	$45,027	$19,519	$13,529	+34%	$52,917	$39,388
$20,000 to $29,999	<$10,191>	-70%	$4,447	$14,638	$34,281	NM	$35,247	$966
$10,000 to $19,999	<$2,446>	NM	-$4,921	-$2,475	$2,518	NM	$-1,550	$-4,068

- In Graph IV (re: yearlings), in what we loosely call "profitability," a large increase in 2014 was followed by declines in 2015 in all the stud fee categories, except in the $30,000 to $49,999 stud fee range.

- In Graph V (re: weanlings), positive-to-stable contributions to mare cost recovery and profit margin occurred on average in 2015 in relation to 2014 in each stud-fee range shown. But, for weanlings out of mares bred to stallions in the $10,000 to $19,999 range, the results remained negative.

- Note that we used sales data for 2013-2015 to include only North American sales results. This resulted in restatements of 2013 and 2014 sales amounts, which used international sales data in our prior reports.


Graph VI
Ratio of Sales Price to Stud Fee - YEARLINGS
2013 to 2015
5.50
4.50
3.50
2.50
1.50
0.50
2013
2014
2015
Stud fees:
$100,000 and up
$50,000 to $99,999
$30,000 to $49,999
$20,000 to $29,999
$10,000 to $19,999
Graph VII
Ratio of Sales Price to Stud Fee - WEANLINGS
2013 to 2015
Underlying Data from The Thoroughbred Daily News

Commentary on Graphs VI and VII

- 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 IV and V) and looked in Graphs VI and VII 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 sales data again include January yearling sales as if these young yearlings were weanlings.

- The following table shows stud fee multiples for **yearlings** sold in 2013 through 2015, by stud fee range:

Stud Fee	2013	2014	2015	3-year avg
$100,000 and up	2.5	3.1	3.1	2.9
$50,000 to $99,999	3.4	3.2	2.9	3.2
$30,000 to $49,999	2.9	2.8	3.7	3.1
$20,000 to $29,999	2.8	3.6	3.0	3.1
$10,000 to $19,999	4.7	4.0	3.7	4.1

Note that 2015 multiples generally aligned with the 3-year averages for each stud fee range, with the $30,000-$49,999 range materially exceeding the average. The highest 3-year average multiple was in the lowest stud fee range in the analysis.

- The table below shows stud fee multiples for **weanlings** sold in 2013 through 2015, by stud fee range:

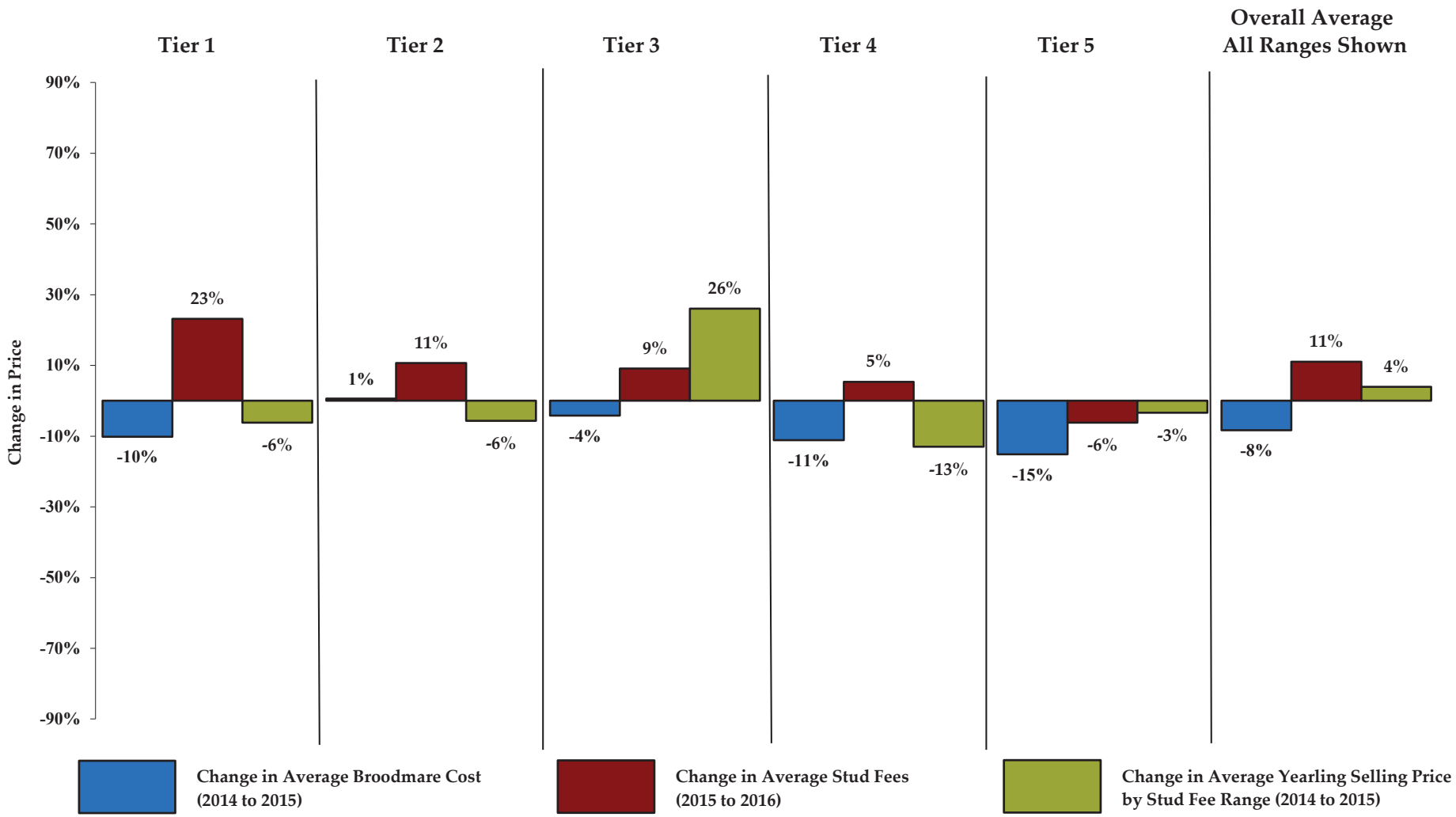
Stud Fee	2013	2014	2015	3-year avg
$100,000 and up	2.3	3.8	4.6	3.6
$50,000 to $99,999	2.7	2.5	2.3	2.5
$30,000 to $49,999	2.2	3.0	3.5	2.9
$20,000 to $29,999	2.6	2.2	3.8	2.8
$10,000 to $19,999	2.9	2.6	2.8	2.8

The 2015 averages generally were higher than or stable with the 3-year averages.

- Note that we used sales data for 2013-2015 to include only North American sales results. This resulted in restatements of 2013 and 2014 sales amounts, which used international sales data in our prior reports.

Graph VIII

Changes in Production Costs and Yearling Selling Prices for Breeders by Stud Fee and Mare Cost Ranges



Data from The Blood-Horse, Keeneland, Fasig-Tipton, and The Thoroughbred Daily News

Commentary on Graph VIII

- In Graph VIII, we 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 (excluding January sale yearlings, which are more like the prior year November weanling sales than the September yearling sales).

- 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 2015 to 2016. For broodmares, we are measuring the change in this cost by reference to changes in average auction prices from 2014 to 2015. Similarly, the change in sales price of yearlings is measured by reference to average auction prices from 2014 to 2015.

- 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 2015 sales at public auction:	Sales prices — yearlings sold at public auction and produced from stallions with these fees (in the breeding year):
1	$100,000 +	Top decile	$100,000 +
2	$50,000-99,999	2nd decile	$50,000-99,999
3	$30,000-49,999	3rd decile	$30,000-49,999
4	$20,000-29,999	4th decile	$20,000-29,999
5	$10,000-19,999	5th decile	$10,000-19,999

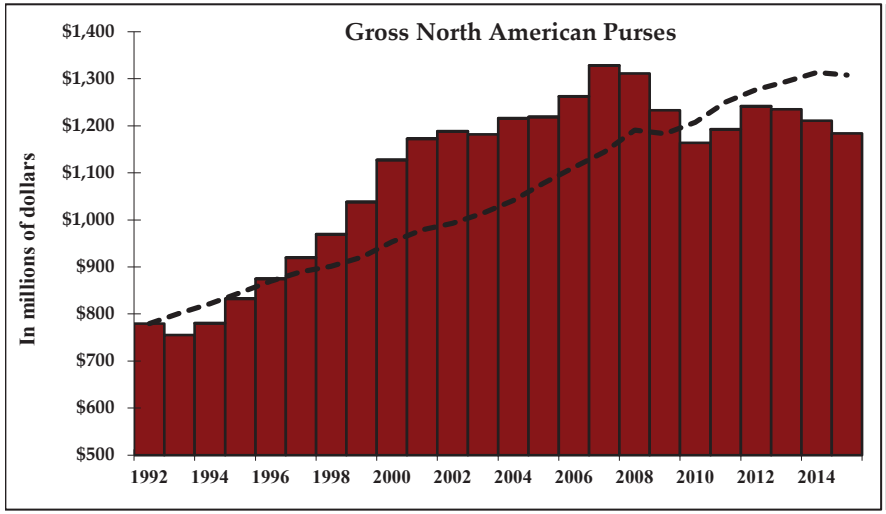
We also show the combined changing cost and price levels for all five tiers we analyzed.

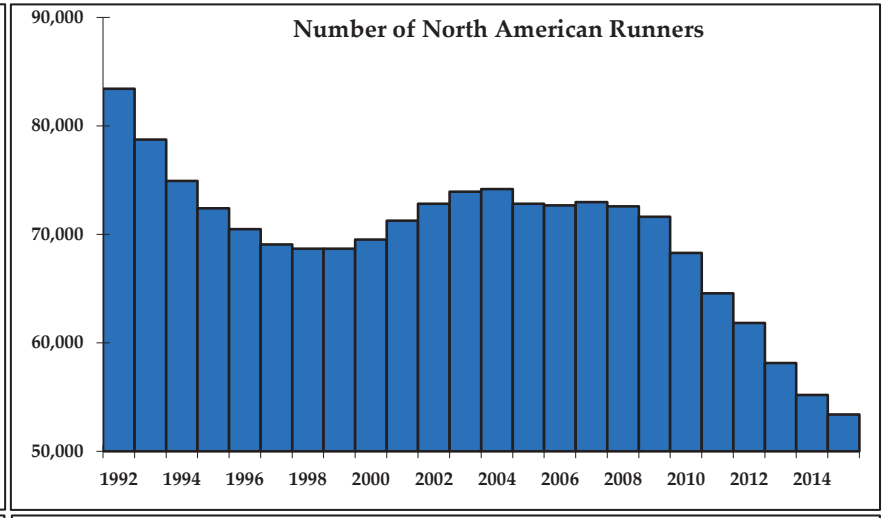
- Our analysis shows that capital costs associated with buying or retaining broodmares generally are declining (8% overall for the market segments we analyzed), but stud fee costs are on-the-rise (11% overall for fees of $10,000 or more). Yearling prices increased moderately (4%).

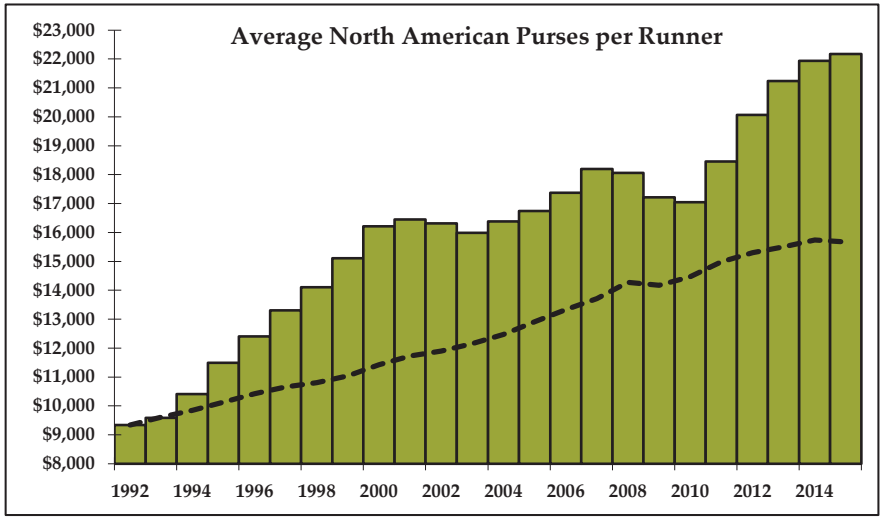
Graph IX

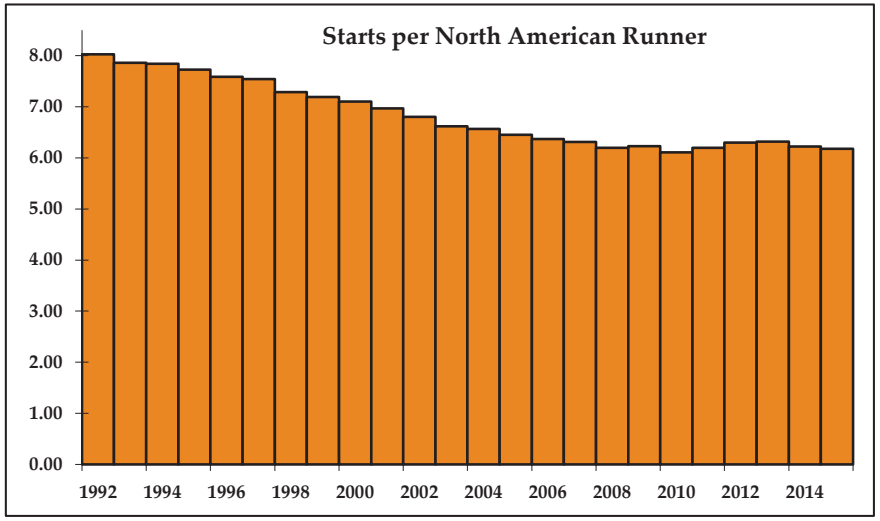
Racing Purses and Numbers of Horses Racing

1992 to 2015









------Inflation Adjustment

Data from The Jockey Club Fact Book

Commentary on Graph IX

- Gross purses decreased again in 2015 (2.3%), following modest decreases in 2014 (2.0%) and 2013 (0.5%). These decreases followed two consecutive years of increases. Note the generally favorable upward trend from the early 1990s through 2007. None of the post-2007 amounts have reached the 2007 level.

- The number of runners (number which started in at least one race in the year) was relatively stable from 2005 through 2009, but a 3% decline in 2015 follows 4-6% declines in 2010 through 2014. From 1992 to 2015 the number of runners declined 36% (from 83,433 to 53,394).

- From 1992 to 2007, average purses per runner increased 95%, from $9,300 to $18,200. But, in 2008 through 2010 the declines in gross purses and the smaller relative declines in number of runners resulted in a decline in average purses per runner of 6% from 2007 to 2010. However, with still fewer runners competing in 2011 and 2012 for more purse money, the 2011 average purse per runner increased to $18,500, followed by a 2012 increase to $20,100. Then, although gross purses decreased in 2013 through 2015, the relatively greater decreases in number of runners pushed the 2013 through 2015 average purses per runner to $21,200, $21,900, and $22,200, respectively.

- Average purses per runner from 1992 to 2015 have increased 139%, much less than the 199% increase in the average cost of purchasing yearlings, the 304% increase in the average cost of purchasing weanlings, and the 306% increase in the cost of purchasing two-year-olds over the same period.

- Starts per runner decreased slightly in 2015 (0.6%) following a 1.6% decrease in 2014. Note the clear decreasing trend from the early 1990s. In 1992, the highest of the 23 years considered, average starts per runner were just over eight; in 2015, the average was 6.2. The number of starts per runner has stabilized over the last eight years, staying within a range of 6.1 (2010) to 6.3 (2013).

- For gross and average purses we show inflation lines starting with 1992, the earliest year we show. Gross purses for 2015 continue below the inflation-adjusted amount. Average purses exceeded the inflation-adjusted base throughout the period we show.

Income Tax Considerations in Buying and Selling Farms

Purchases and sales of horse farms may seem to be somewhat straightforward transactions from an income tax perspective, but this article is intended to describe some of the more significant income tax aspects and planning opportunities associated with these transactions. We first will look at the purchaser's side of the transaction, then turn to the seller's side. In this discussion we assume that the parties to the transaction are not related parties under applicable tax rules and are not engaged in a like-kind exchange under Internal Revenue Code (IRC) § 1031 and that the seller is not a C-Corporation.

Purchaser - Determination of the Purchase Price Required to be Capitalized

The buyer is required to capitalize the amount paid to the seller plus other costs associated with the purchase ("transaction costs"). If the buyer is assuming any liabilities of the seller, the amount of such liabilities is considered to be part of the amount paid by the buyer.

IRC § 263(a) and related regulations govern transaction costs required to be capitalized by buyers. These costs include:

- securing an appraisal or otherwise determining the value or price of property
- structuring and negotiating the transaction and obtaining related tax advice
- preparing purchase agreements
- conveying property from buyer to seller
- finder's fees or buyer commissions
- architectural, geological, survey, engineering, environmental, or inspection fees pertaining to properties being acquired.

Note that if the farm purchase is being debt-financed, some costs are likely to be associated more closely with obtaining the debt-financing than obtaining the property. Such costs would be capitalized as loan costs, not into the property's cost, and these costs should be amortized over the life of the loan for income tax purposes.

Purchaser - Purchase Price Allocation

Normally, a number of different assets are acquired in a farm purchase. In addition to the land itself, the purchase of a farm may involve the following assets:

- Tangible personal property, such as farm equipment, office equipment, farm vehicles, and horses or other animals
- Farm supplies, such as tack, fuel, straw and hay, small tools, and other farm and office supplies
- Furniture and fixtures, such as appliances, carpets, drapes, and furniture in farm offices and residences
- Growing crops
- Trees and other landscaping
- Farm buildings, such as barns, run-in-sheds, farm office buildings, and equipment maintenance buildings
- Farm residences, including the owner's home, other residences used to house farm employees, and still other residences that may be rented

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- Land improvements, such as fences, roads, water systems, and training tracks
- Intangible assets, such as the farm's name, an assembled work force, and relationships with vendors and customers

Note that some of these items represent tangible and intangible personal property which would not be part of the real estate transaction, while others would be real property under local law.

The following table is intended to provide some guidance as to the tax treatment of these different assets, to the extent they are among the assets being purchased:

Depreciation/Recovery Periods	
Type of Horse Farm Property	**Recovery Period**
Automobiles and general-purpose light-duty trucks (actual unloaded weight of less than 13,000 pounds)	5
Tractors and other farm machinery and equipment	7
Horse trailers and vans	5
Heavy trucks	5
Fences	7
Feed and grain bins	7
Single-purpose agricultural structures	10
Office furniture and equipment	7
Land improvements, such as walkways, roads, waterways, drainage facilities, sewers, and landscaping shrubbery	15
Barns, stables, and other nonresidential farm buildings	20
Residential housing	27.5
Broodmares, stallions (or stallion shares), or other horses if the animal is more than 12 years old	3
Broodmares or stallions (or stallion shares) if the animal is 12 years old or younger	7
Race horses	3
Show horses, hunters, jumpers, equestrian horses and any other depreciable horses if 12 years old or younger	7
Goodwill and other IRC § 197 intangibles	15

How does the buyer determine the allocation of the total price to these assets? In general, the sum of the amount paid to the seller and capitalized transaction costs is allocated based on the fair market values of the separate assets being acquired. An appraisal of the value contributed to the deal by each component is the preferable way to allocate. If the buyer chooses not to incur the expense of an appraisal, it may be possible to obtain from the seller a copy of an appraisal the seller may have gotten to determine a selling price for the property. In the absence of an appraisal, some of the purchase price, such as the price allocated

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to farm buildings, may be estimated by reference to the values at which these structures are insured. However, insured values will not facilitate separately valuing such items as roads, fences, and water systems and often represent replacement cost, not fair market value.

Purchaser and Seller - Application of IRC § 1060, Special Allocation Rules for Certain Asset Acquisitions

If the purchase is an "applicable asset acquisition" under IRC § 1060 and the related regulations, the buyer's basis in the acquired assets (and the seller's amount realized) are allocated among such assets in accordance with the "residual method" described below.

An "applicable asset acquisition" means any transfer (1) of a group of assets which constitutes a trade or business (in the hands of either the buyer or seller), and (2) with respect to which the buyer's basis in such assets is determined wholly by reference to the consideration paid for such assets. This definition presents a question in the context of a purchase of a horse farm. If the farm purchase does not include any horses, does the farm property itself constitute a business? Further provisions in the regulations help answer this question: A group of assets constitutes a business if goodwill or going concern value could under any circumstances attach to such group. See Treasury Regulation § 1.1060-1(b). Unless the farm will be re-named and retain no employees, customers, or other ongoing business relationships, it may be difficult to conclude that the farm is not a business within the meaning of these rules.

Under the residual method for allocating cost among different assets, different types of assets are assigned to classes. Classes I, II, and III, which are unlikely to be involved in farm purchases, include cash (Class I); other highly liquid assets, such as certificates of deposit, U.S. government securities, and publicly-traded stock (Class II); and amounts owed to the business, such as accounts receivable (Class III). If these types of assets are included in an "applicable asset acquisition," fair market values are assigned to them in order: Class I followed by Class II, etc. Class IV, next in line, includes inventory-type assets, which may be present in some farm sales. Skipping Class V for now, Class VI includes intangible assets other than goodwill and going concern value. Examples of Class VI assets that could be included in a farm transaction are trade names, trademarks, workforce in place, books and records, operating systems, customer lists, and contracts with customers or suppliers. Class VII assets are goodwill and going concern value. Class V, which includes all other assets, encompasses most, if not all, assets included in a farm purchase: land and depreciable real and tangible personal property. Class V assets are assigned fair market values after Class IV and before Class VI, followed by Class VII. The result is that goodwill and going concern are assigned the residual value, if any, after allocations to assets in all the other classes.

IRC § 1060(a) further provides that if the buyer and seller agree in writing as to the allocation of any consideration involved in the transaction or as to the fair market value of any of the assets being transferred, such agreement is binding on both parties unless the Treasury determines that such allocation (or fair market value) is not appropriate.

If the farm transaction is an "applicable asset acquisition," both buyer and seller must attach a completed Form 8594 - Asset Acquisition Statement Under Section 1060 to their tax returns. Because Form 8594 just shows allocations by totals per Class (I-VII), rather than asset-by-asset, farm buyers and sellers may allocate most or all the consideration to Class V assets even as they allocate different amounts to individual assets within the class. In the author's experience, disparities in buyer's and seller's Form 8594 allocations by class do not necessarily lead to an IRS audit; however, it is logical to believe that material differences could lead to a greater chance of one or both parties having their tax returns for the year of sale being audited.

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Seller's Tax Considerations

Overall, the seller will have gain or loss measured by the gross sales price reduced by selling expenses and the aggregate of each transferred property's adjusted tax basis. Just as the farm buyer should consider the allocation of the cost associated with acquiring the farm, the seller's allocation of the sales price to each identifiable asset sold is likely to have tax impacts. The seller generally will have transferred one or more of these categories of assets:

- tangible personal property which is depreciable, such as vehicles, farm and office equipment, and horses and other animals
- nondepreciable tangible property, such as consumable supplies
- depreciable real property, such as farm buildings, residences (other than the owner's residence), and other land improvements
- owner's residence
- goodwill and most other intangible assets (§ 197 intangibles)

The character of gains or losses and the top tax rates applicable to gains depend on the category of the asset sold.

For depreciable tangible personal property, which is "Section 1245 property," gains are treated as ordinary income to the extent of depreciation allowable, a result sellers generally want to minimize. Note that farm fences, even though they constitute real estate improvements, generally are treated as Section 1245 property (under IRC § 1245(a)(3)(B)(i)). Intangible property also is treated as § 1245 property, so a seller who has amortized the cost of purchased intangibles will recognize ordinary income to the extent of the lesser of (1) the seller's accumulated amortization, or (2) the gain on selling the intangible personal property.

Values allocated to nondepreciable tangible personal property, which may be referred to as "materials and supplies," are ordinary income to the extent of gains on them. If these items have been expensed as incurred, thus having no tax basis, as may often be the case, the values assigned to them will be ordinary income in full. Similarly, if the seller maintains an inventory of property held for sale, gains or losses on inventory will be ordinary income or loss.

For buildings and other real estate improvements (exclusive of Section 1245 property – fences), IRC § 1250 may cause some ordinary income recapture. Except in the case of residences, IRC § 1250 provides that the excess of (1) accumulated depreciation adjustments over (2) the amount that depreciation adjustments would have been had the straight-line depreciation method been used is treated as ordinary income (but limited to the amount of gain). The depreciation method for residences is straight-line, so no § 1250 recapture occurs on residences.

Most farm property is Section 1231 property. Such property includes depreciable property and land, in each case held, in general, for more than one year. An exception requires a 24-month holding period for horses held for draft, breeding, or sporting purposes.

When farm property is sold, one of the first steps in analyzing the types of gain or loss to be recognized is to determine the gains and losses on Section 1231 property. [Gains and losses on non-Section 1231 property will be ordinary gains and losses, unless the property involved is a capital asset.] Then, gains are analyzed to determine the amounts that are treated as ordinary income under § 1245 and § 1250. The balance of the gains and losses would be net § 1231 gain or loss.

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The next step is to combine all of the taxpayer's § 1231 gains and losses to determine if the net is a gain or loss. If the net is a loss, it gets favorable treatment as an ordinary loss. If the net is a gain, it generally gets favorable treatment as long-term capital gain. However, net § 1231 losses in a year are tracked forward, and if the taxpayers have net § 1231 gains within the five following years, they are treated as ordinary income to the extent of the amount tracked forward.

If, after the analysis just described, the seller recognizes capital gain from the farm sale, the seller's capital gain must be further analyzed to determine the applicable capital gain tax rates. Capital gains, in general, are taxed at federal rates of 15% or 20%, depending on the taxpayer's overall level of income. [The 3.8% supplemental tax on investment income may or may not apply to the gain, depending on a number of factors which are beyond the scope of this article.] However, a special rule for depreciable real estate raises the general 15%/20% rate to 25% on the gain on buildings and other depreciable land improvements to the extent of related accumulated depreciation not recaptured as ordinary income under § 1250.

Finally, if the property being sold is owned by an individual (or the individual is treated as the owner under single member LLC or grantor trust rules) and includes the owner's principal residence, the seller may qualify for the $250,000 single / $500,000 joint gain exclusion provided for in IRC § 121.

So, what can the seller do to reduce income taxes if a gain is to be recognized from selling the farm? Here are a few basic ideas:

- Take advantage, if possible, of the principal residence gain exclusion rules.
- Maximize the allocation of the sales price to land, avoiding § 1245 and § 1250 ordinary income and the 25% capital gain rate on this part of the allocation. [Note: The buyer likely will not find this approach to be attractive, since his land cost is nondepreciable.]
- To the extent reasonable, and if the seller has no purchased intangibles associated with the farm, allocate sales price to intangible assets, again avoiding ordinary income and the 25% capital gain rate. [Note: The buyer ordinarily would be able to amortize the cost applicable to intangibles over 15 years, which is more favorable than allocations to land or buildings.]
- Allocate to buildings and land improvements (other than fences) instead of to tangible personal property and fences to take advantage of the 25% capital gain rate instead of ordinary income rates. [Note: The buyer may push-back, due to the shorter cost recovery periods for tangible personal property and fences.] Consider, however, the potential large impact of Section 1250 ordinary income recapture when farm buildings and other depreciable land improvements were placed in service by the seller in years when bonus depreciation was available and was claimed by the seller.

Closing Comments

As can be seen, what on the surface may appear to be a fairly straightforward real estate transaction can be a complex transaction involving several material tax considerations and tax planning opportunities for farm buyers and sellers. Much of the tax impact relates to purchase price allocations. Although not required, buyers and sellers may be able to reduce their exposure to IRS audit adjustments relating to allocations by contractually agreeing to asset-by-asset allocations. Absent contractual agreements, a sound appraisal of the values of the different assets included in the sale may be advisable.

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This article is based on one originally published in the American Horse Council's August 2015 Tax Bulletin.

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