DEANDORTON

DEAN DORTON ALLEN FORD, PLLC

Thoroughbred Business Year in Review 2018

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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.

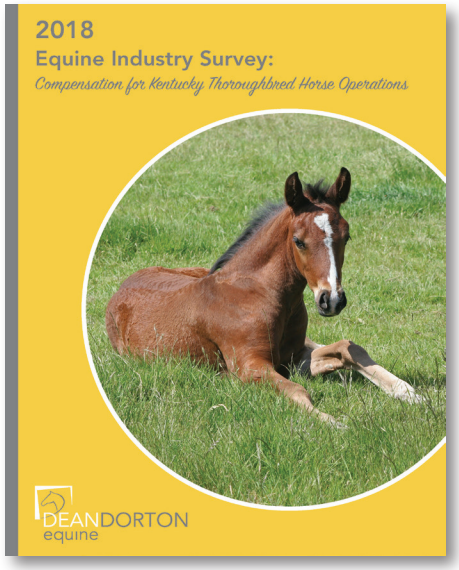
As a firm, we endeavor to know the business of horses, not just accounting and tax rules relating to the industry. We accomplish this in a number of ways, including, most usefully, by working with our many clients in the industry on their business matters.

We perform a variety of services, many of which are listed on the next page, for our equine industry clients. 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 questions you may have regarding this publication. See the Equine Industry Group Leaders 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.

Dean Dorton 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 deandorton.com/publications to view recent publications, 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.



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 services, they can be confident they are engaging a firm with in-depth industry experience and know-how. We are interested in our clients' businesses, 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 farms to avoid or postpone income taxes
- Developing policies to expense or capitalize costs which are in compliance with current 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. income and estate 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

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
- Providing outsourced basic transaction processing, mid-level controller, and CFO services

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.

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Executive Summary

Dollars spent at North American Thoroughbred public auctions increased again in 2018 (up 7%), surpassing the $1.0 billion mark for the first time since 2007. The increase was driven by a 17% increase in total yearling sale dollars and a 12% increase in average yearling prices at public auctions. *See pages 2-5.*

Despite the increase in average yearling sales prices, amounts available to Thoroughbred breeders from yearling sales proceeds—after recovering stud fees, sales commissions, and mare and foal board expenses—decreased in 2018 when broken down into stud fee ranges, except for fees in the $50,000 to $99,999 range. *See pages 6-8.*

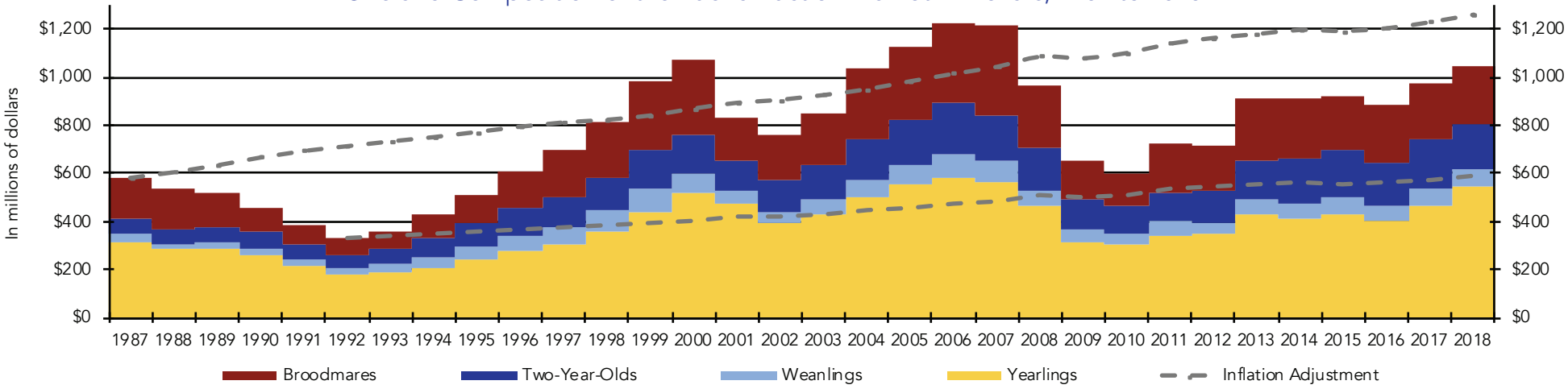
The amounts available from 2018 weanling sales proceeds declined in each stud fee range we analyzed. On average, owners breeding to stallions with fees under $20,000 did not cover their expenses whether they sold yearlings or weanlings. *See pages 6-8.*

Depending on the stud fee range, we see a wide variation in the multiple of yearling sales price averages to stud fee averages, from 2.5 to 4.1 in 2018. For 2017 and 2018, the highest multiple for yearlings has been in the $30,000 to $49,999 range. For weanlings, the range for 2018 sales is narrower, 1.7 to 2.7. *See pages 9-10.*

The declining trend of gross racing purses reversed itself in 2018, with almost a 4% increase, the first increase since 2012. With still fewer runners in 2018 (a 2.5% drop), average purses per runner increased from $23,000 to $24,500. The long decline in starts per runner through the 1990s and first half of the 2000s definitely has stabilized, staying within a 6.1 to 6.3 range over the last 11 years. *See pages 13-14.*

Graph I

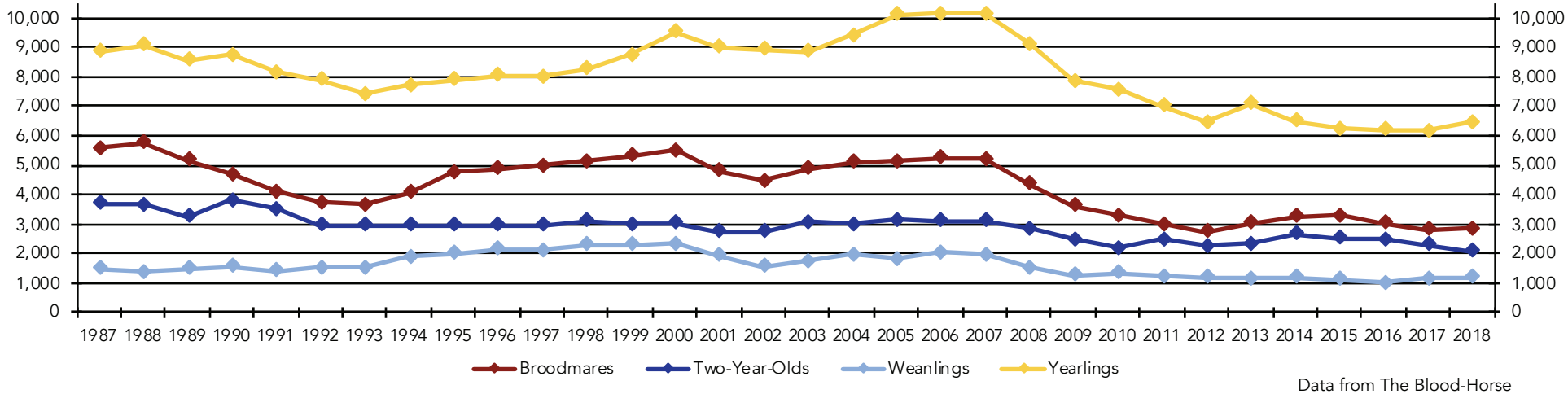
Size and Composition of the Public Auction Market in Dollars, 1987 to 2018



Data from The Blood-Horse

Graph II

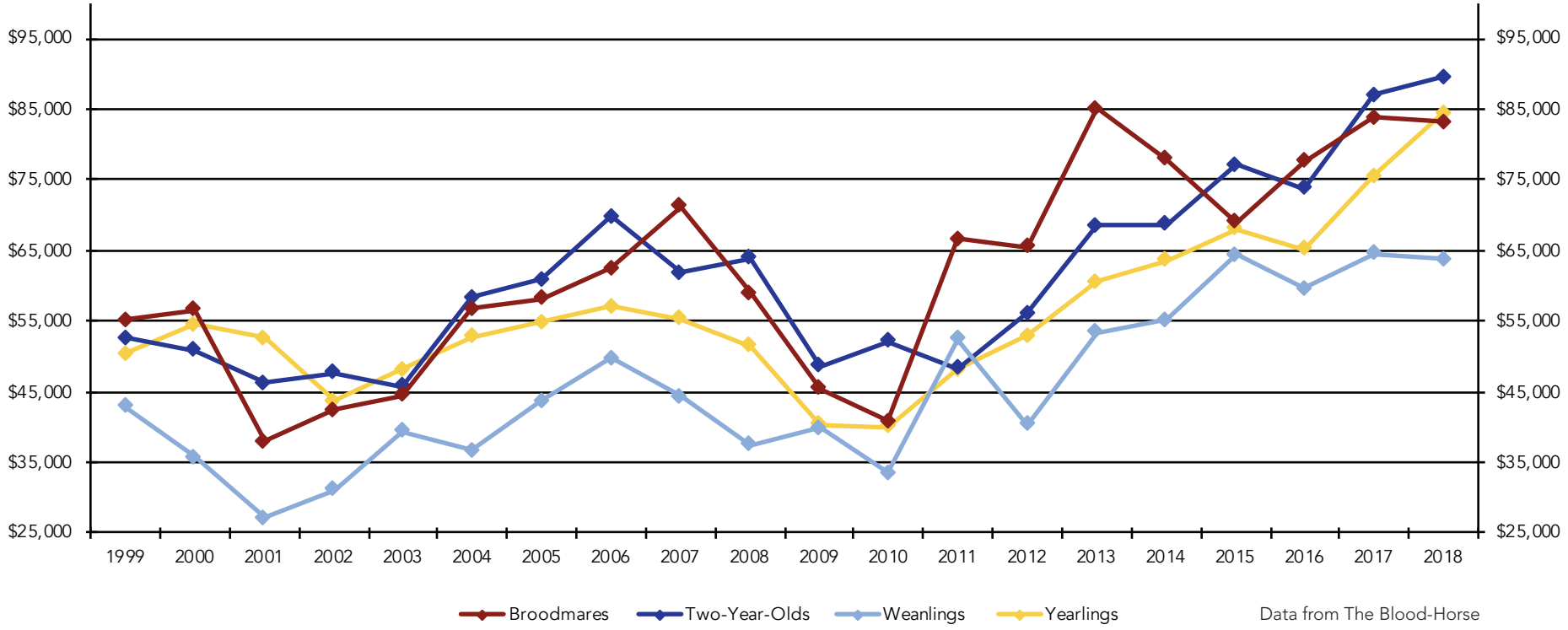
Number of Horses Sold at Public Auction by Type of Horse, 1987 to 2018



Data from The Blood-Horse

Graph III

Average Price at Public Auction by Type of Horse, 1999 to 2018



Commentary on Graphs I, II, and III

After the precipitous declines in the amounts spent at North American 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 remained at about the same level in 2013-2016, then increased 10% in 2017, the largest increase since 2013, followed by a 7% increase in 2018, as shown on Graph I.

For 2018, Graph I shows that while total dollars invested at public auctions increased 7%, the results in the different categories varied as follows:

Broodmares	+1%
Two-year-olds	-6%
Yearlings	+17%
Weanlings	+4%

From the peak of $1.226 billion in 2006, to 2018, dollars expended at public auctions dropped by 15%, to $1.046 billion.

If we observe trends shown in Graph I over the full 32-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.) were then 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.
- After pausing at about the same level in 2012, 2013 results were up 27%.
- Public auction dollars then remained steady through 2016, before increasing 10% in 2017 and 7% in 2018.

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 2018 would have to have been $1.257 billion. But, at $1.046 billion, sales lagged 17% below. After adjusting for inflation, 2018's auction sales substantially exceeded the low point (1992) of this 32-year period.

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

	2011	2012	2013	2014	2015	2016	2017	2018
Broodmares	27.6%	26.0%	28.3%	27.8%	24.5%	26.6%	24.1%	22.6%
Two-Year-Olds	16.8%	18.4%	17.5%	20.0%	21.3%	20.8%	20.4%	18.0%
Yearlings	46.7%	48.7%	47.4%	45.0%	46.3%	45.7%	47.8%	52.0%
Weanlings	8.9%	6.9%	6.8%	7.2%	7.9%	6.9%	7.7%	7.4%

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 2018 (Graph II):

Broodmares	-46%
Two-year-olds	-33%
Yearlings	-36%
Weanlings	-41%

For each category, except two-year-olds, the change in number sold increased from 2017 to 2018. Overall, the number sold increased 1.5% from 2017 to 2018.

Six percent of the 2018 North American foal crop sold at 2018 public auctions as weanlings, and 27% of the 2017 North American foal crop sold at public auctions in 2018 as yearlings. The following shows the consistency of these numbers over the last eight years:

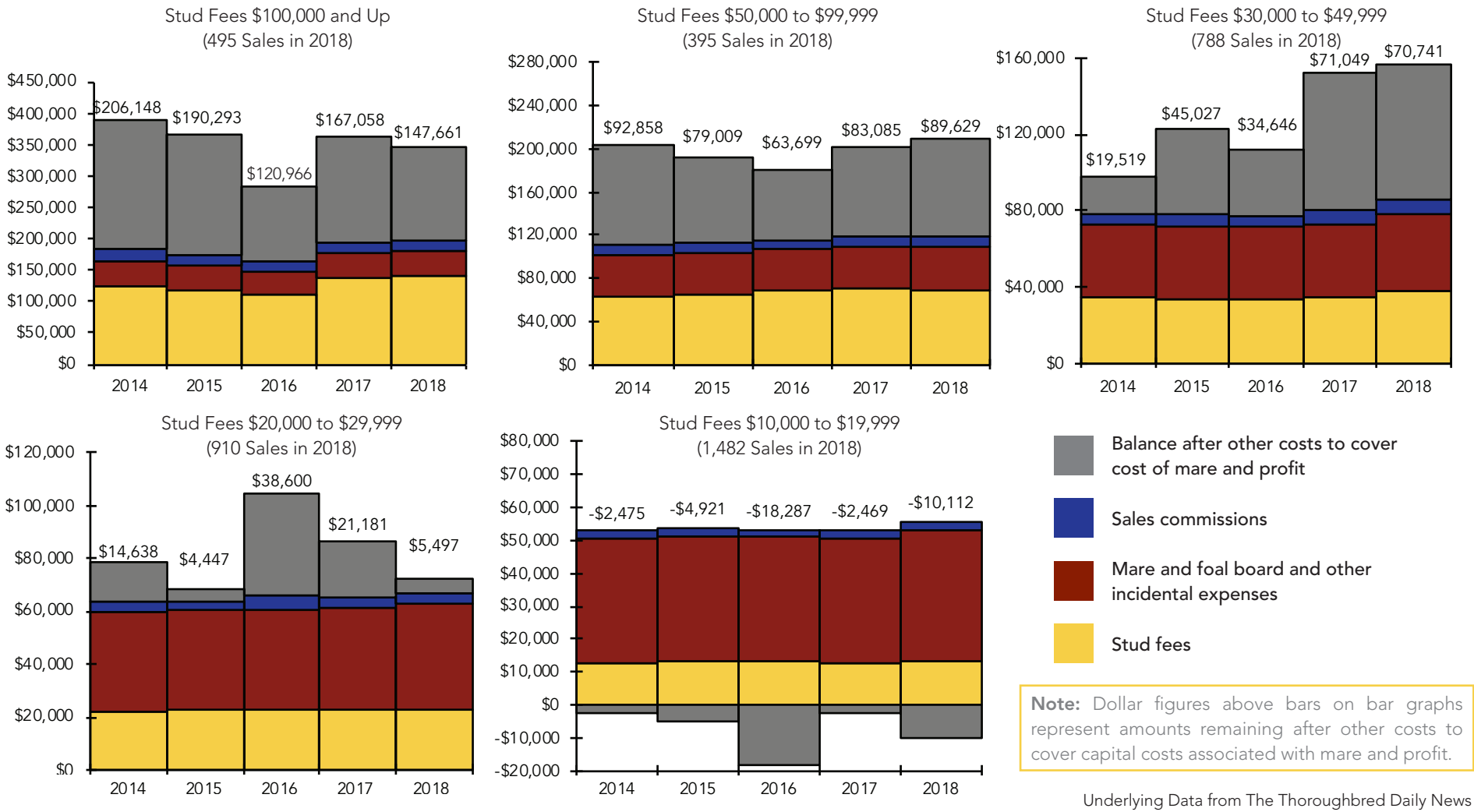
	2011	2012	2013	2014	2015	2016	2017	2018
Weanlings	5%	5%	5%	5%	5%	5%	5%	6%
Yearlings	26%	25%	32%	28%	28%	28%	27%	29%

From Graph III, we can see substantial increases in average prices for each category in 2013, mixed results in 2014 through 2016, increases in each category in 2017, and mixed results in 2018:

	2013	2014	2015	2016	2017	2018
Broodmares	+30%	-9%	-11%	+12%	+8%	-1%
Two-year-olds	+22%	0%	+12%	-4%	+18%	+3%
Yearlings	+14%	+5%	+7%	-4%	+16%	+12%
Weanlings	+32%	+3%	+17%	-7%	+8%	-1%

Graph IV

Breakdown of Sale Price of Yearlings 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, 2014 to 2018

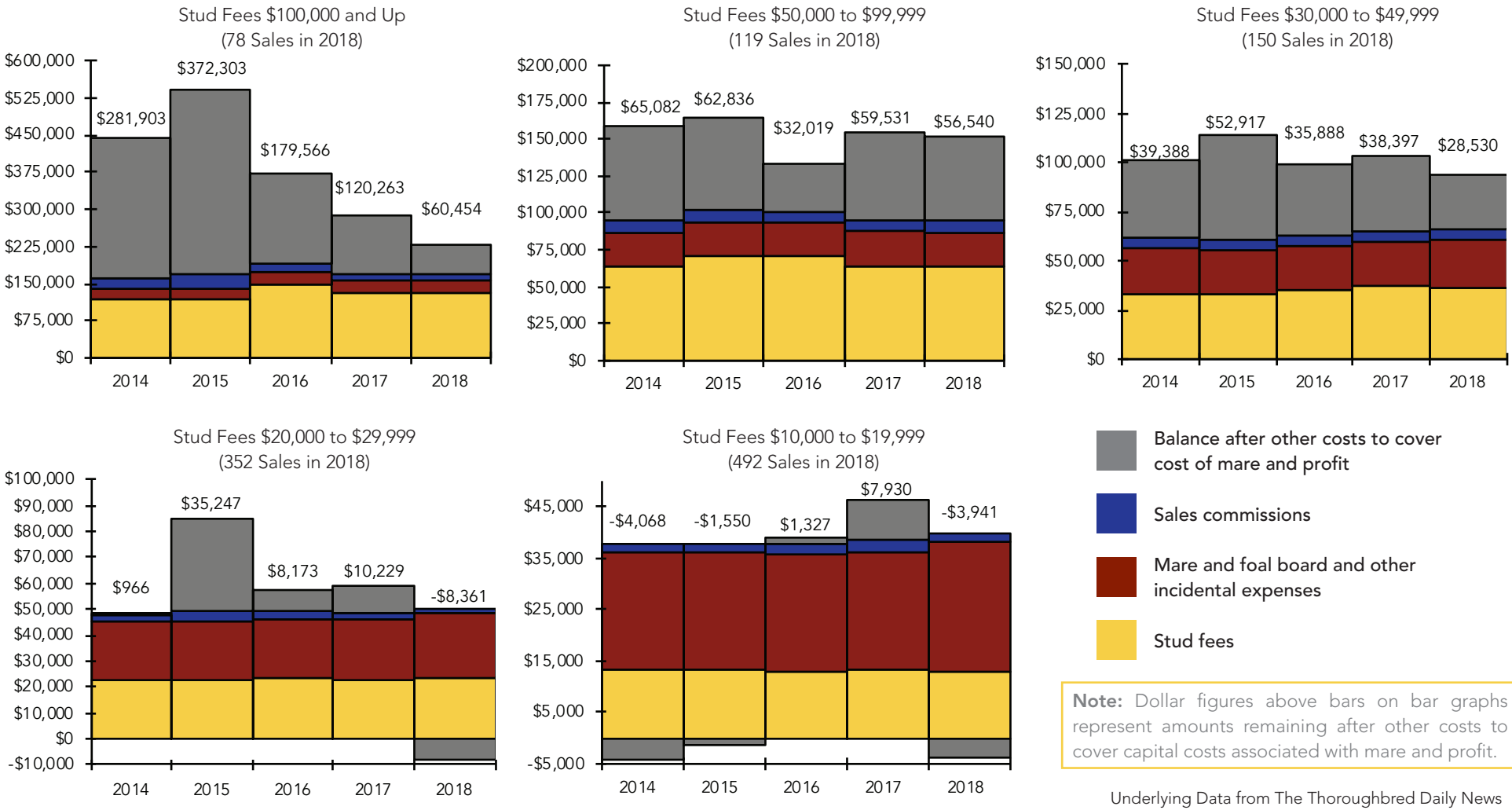


Note: Dollar figures above bars on bar graphs represent amounts remaining after other costs to cover capital costs associated with mare and profit.

Underlying Data from The Thoroughbred Daily News

Graph V

Breakdown of Sale Price of Weanlings 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, 2014 to 2018



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 shows the relationship of North American yearling (Graph IV) and weanling (Graph V) sales results to stud fee costs over 2014 to 2018, 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 care, we used $40,000 and $25,000 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 to this tax. 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, by using a cutoff of $10,000 stud fee 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 "short yearlings" that are sold in January and February following their foaling year.

The table below shows the dollar and percentage changes from 2017 to 2018 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.

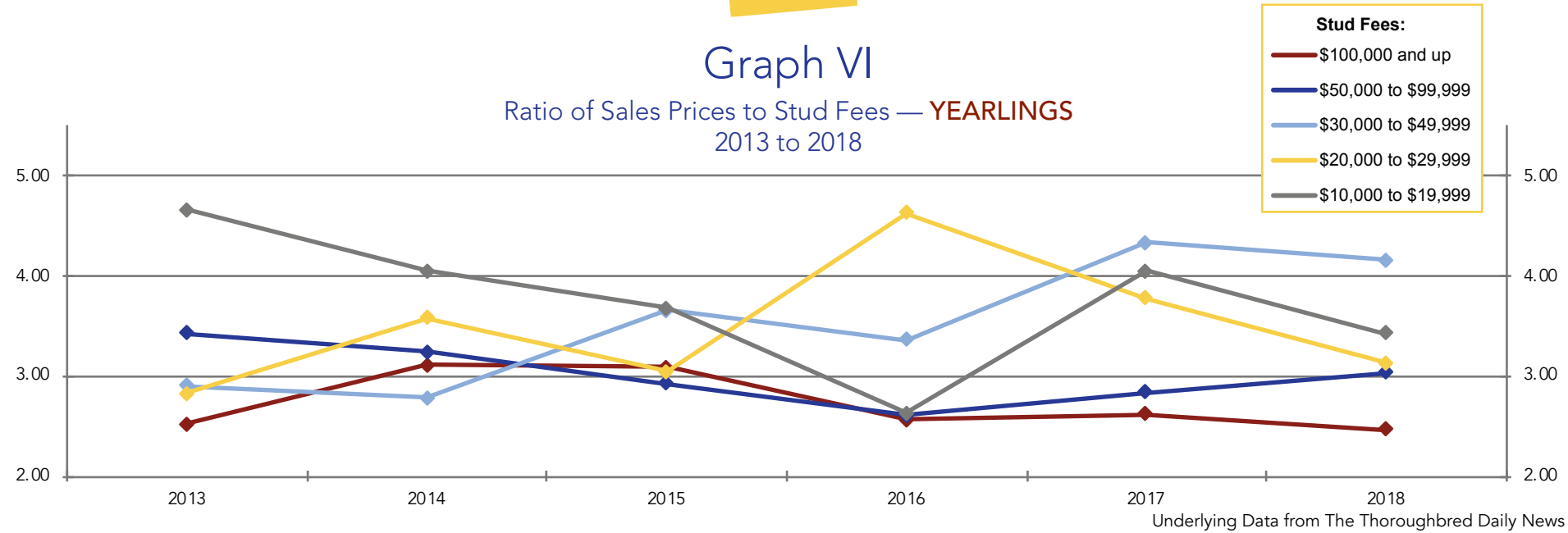
Changes from 2017 to 2018 in Selling Price Available for Mare Cost and Profit

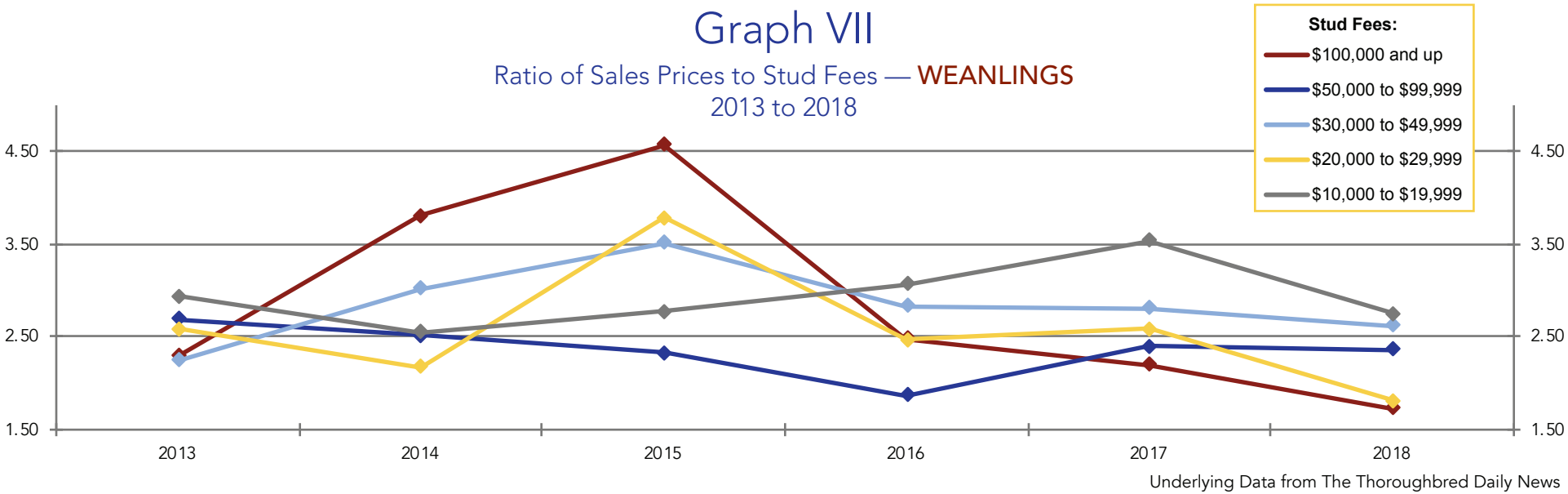
	Yearlings				Weanlings			
Stud Fee Range	**Increase <Decrease>**	**% Change**	**2018**	**2017**	**Increase <Decrease>**	**% Change**	**2018**	**2017**
$100,000 and up	<$19,397>	-12%	$147,667	$167,058	<$59,809>	-50%	$60,454	$120,263
$50,000 to $99,999	$6,544	+8%	$89,629	$83,085	<$2,991>	-5%	$56,540	$59,531
$30,000 to $49,999	<$308>	NM	$70,741	$71,049	<$9,867>	-26%	$28,530	$38,397
$20,000 to $29,999	<$15,684>	-74%	$5,497	$21,181	<$18,590>	NM	<$8,361>	$10,229
$10,000 to $19,999	<$7,643>	NM	<$10,112>	<$2,469>	<$11,871>	NM	<$3,941>	$7,930

NM = not meaningful

In Graph IV (regarding yearlings), in what we loosely call "profitability," decreases occurred, except in the $50,000 to $99,999 stud fee range.

In Graph V (regarding weanlings), contributions to mare cost recovery and profit margin decreased in 2018 in relation to 2017 in each stud fee range shown and dropped from positive to negative amounts for the two lowest stud fee ranges.


Graph VI
Ratio of Sales Prices to Stud Fees — YEARLINGS
2013 to 2018
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
5.00
4.00
3.00
2.00
2013
2014
2015
2016
2017
2018
Underlying Data from The Thoroughbred Daily News


Graph VII
Ratio of Sales Prices to Stud Fees — WEANLINGS
2013 to 2018
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
4.50
3.50
2.50
1.50
2013
2014
2015
2016
2017
2018
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 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 includes January and February yearling sales as if these "short yearlings" were weanlings.

The following table shows stud fee multiples for **yearlings** sold in 2014 through 2018, by stud fee range:

Stud Fee	2014	2015	2016	2017	2018	5-year average
$100,000 and up	3.1	3.1	2.6	2.6	2.5	2.8
$50,000 to $99,999	3.2	2.9	2.6	2.8	3.0	2.9
$30,000 to $49,999	2.8	3.7	3.4	4.3	4.1	3.7
$20,000 to $29,999	3.6	3.0	4.6	3.8	3.1	3.6
$10,000 to $19,999	4.0	3.7	2.6	4.0	3.4	3.5

2018 multiples exceeded the five-year averages only for stud fees in the $50,000 to $99,999 and $30,000 to $49,999 ranges.

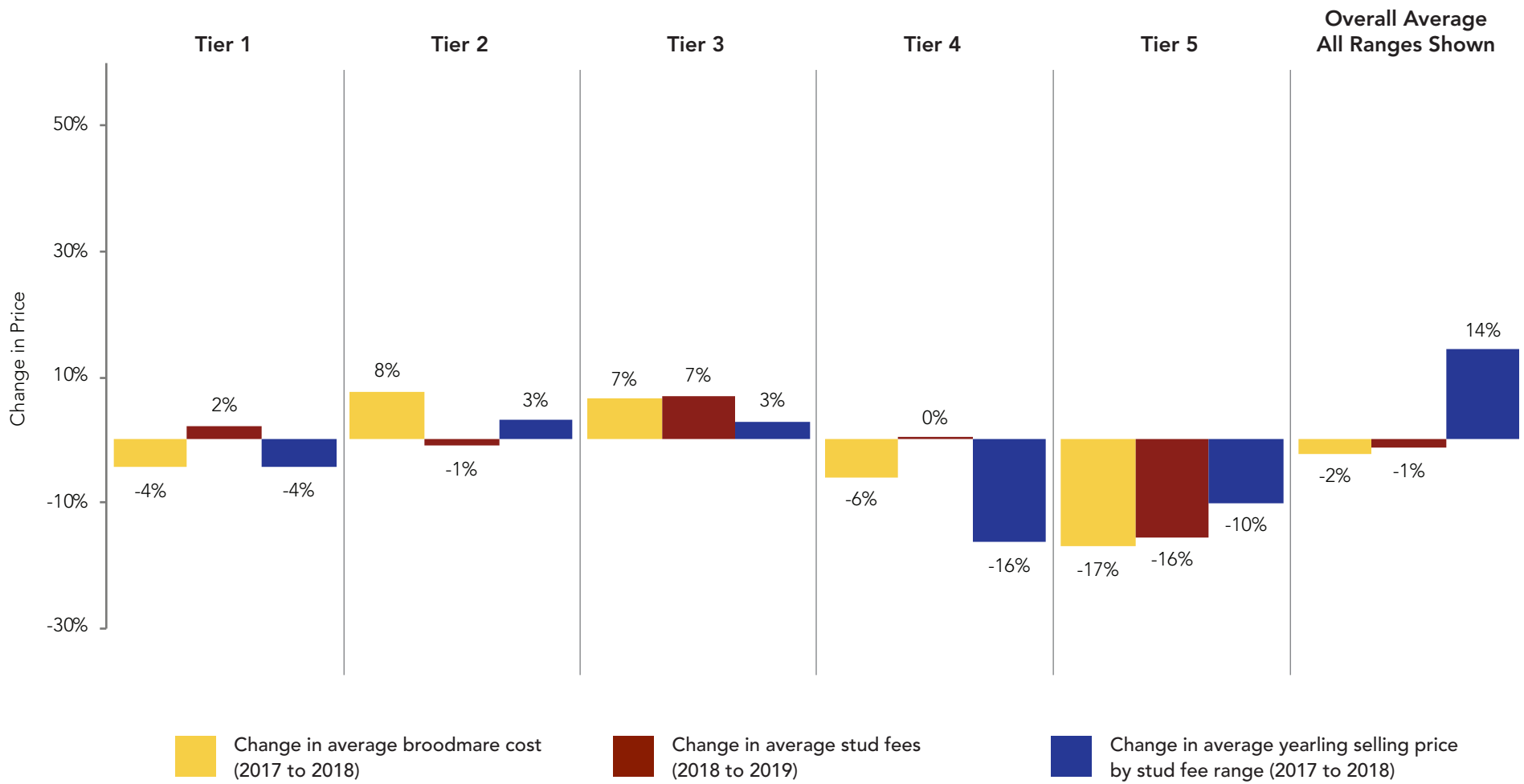
The table below shows stud fee multiples for **weanlings** sold in 2014 through 2018, by stud fee range:

Stud Fee	2014	2015	2016	2017	2018	5-year average
$100,000 and up	3.8	4.6	2.5	2.2	1.7	3.0
$50,000 to $99,999	2.5	2.3	1.9	2.4	2.4	2.3
$30,000 to $49,999	3.0	3.5	2.8	2.8	2.6	2.9
$20,000 to $29,999	2.2	3.8	2.5	2.6	1.8	2.6
$10,000 to $19,999	2.6	2.8	3.1	3.5	2.7	2.9

The 2018 multiple was materially below the five-year average multiple for the highest stud fee range and for the $20,000 to $29,999 range. The 2018 multiple for the $50,000 to $99,999 stud fee range slightly exceeded the five-year average.

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 and February 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 2018 to 2019. For broodmares, we are measuring the change in this cost by reference to changes in average auction prices from 2017 to 2018. Similarly, the change in sales price of yearlings is measured by reference to average auction prices from 2017 to 2018.

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 2018 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

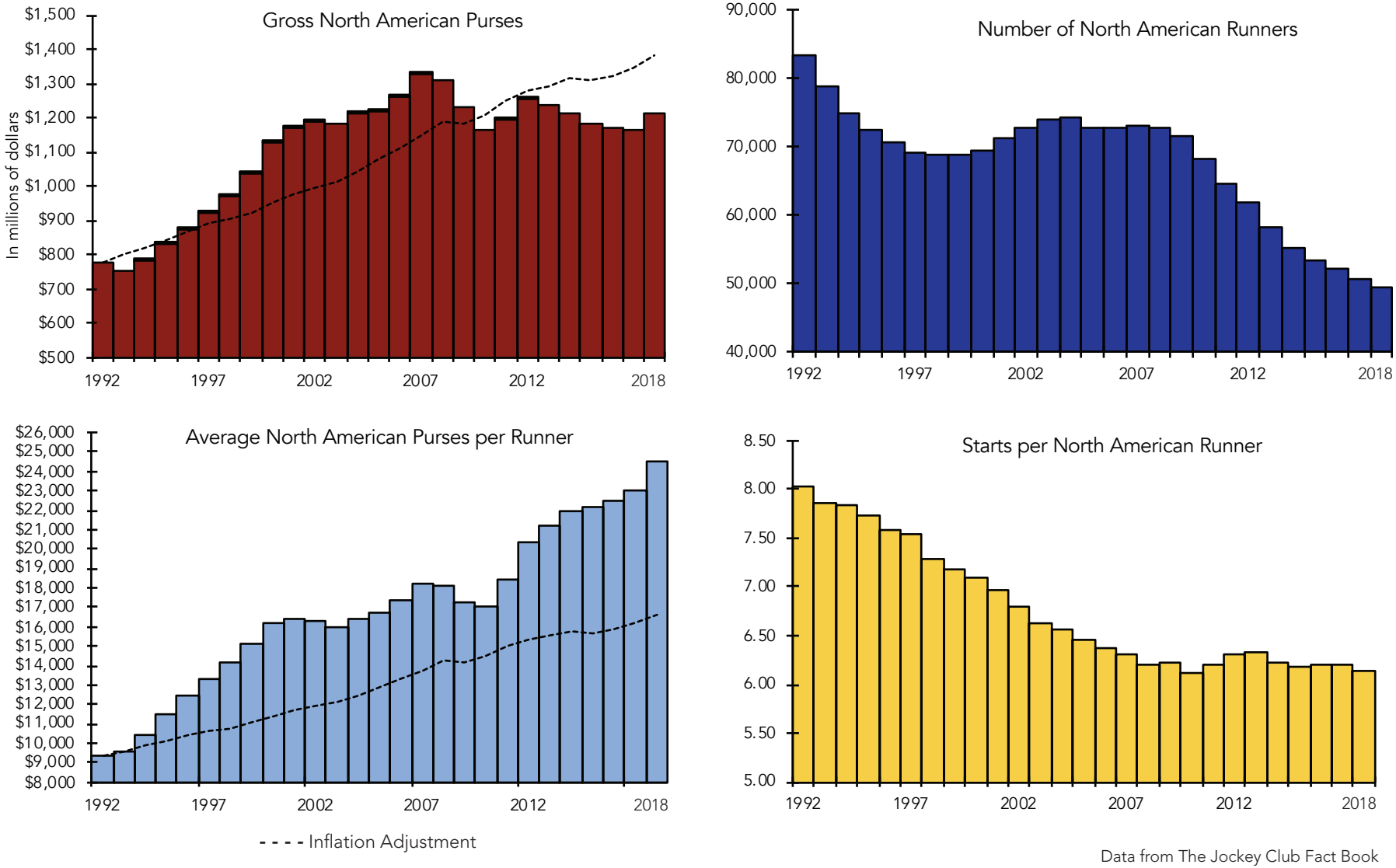
We also show the aggregate changing cost and price levels for all five tiers we analyzed.

Our analysis shows that capital costs associated with buying or retaining broodmares generally are stable (down 2% overall for the market segments we analyzed), and stud fee costs also are stable (down overall by 1%). Yearling prices, though, increased 14%. This overall trend is generally positive for breeders. The reduced average yearling sales prices for our Tiers 4 and 5 are financially unhealthy for breeders; their major production costs show some declines.

Graph IX

Racing Purses and Number of Horses Racing

1992 to 2018



Data from The Jockey Club Fact Book

Commentary on Graph IX

After five consecutive years of declines in gross purses, 2018 showed an increase of 3.8%. 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 2001 through 2008, but has declined steadily from 2009 through 2018, including a 2.5% decline from 2017 to 2018. From 1992 to 2018, the number of runners declined 41% (from 83,433 to 49,351).

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 $20,300. Then, although gross purses decreased in 2013 through 2017, the relatively greater decreases in number of runners pushed the 2013 through 2017 average purses per runner to $21,200, $21,900, $22,200, $22,500, and $23,000, respectively. In 2018, this trend continued, as average purses per runner increased to $24,500.

Average purses per runner from 1992 to 2018 have increased 162%, much less than the 271% increase in the average cost of purchasing yearlings, the 300% increase in the average cost of purchasing weanlings, and the 371% increase in the cost of purchasing two-year-olds over the same period.

Starts per runner remained stable in 2018. Note the clear decreasing trend from the early 1990s. In 1992, the highest of the 27 years considered, average starts per runner were just over eight; in 2018, the average was 6.1. The number of starts per runner has stabilized over the last 11 years, staying within a range of 6.1 to 6.3.

For gross purses and average purses per runner, we show inflation lines starting with 1992, the earliest year we show. Gross purses for 2018 continue below the inflation-adjusted amount. Average purses per runner have exceeded the inflation-adjusted base throughout the period we show.

Selected Impacts of Tax Law Changes on Thoroughbred Horse and Farm Owners

The Tax Cuts and Jobs Act (TCJA) which became law in December 2017 is considered by many to be the most comprehensive set of federal tax changes since 1986. This article focuses on a few of the changes that may be of particular interest to Thoroughbred horse and farm owners.

DEPRECIATION

Bonus Depreciation

Already attractive, bonus depreciation became even better. The bonus write-off available in the year placed-in-service for qualifying assets increased from 50% to 100% of cost, and qualifying property now generally includes used property. This latter change means most horse purchases which were not qualified previously now qualify for bonus depreciation.

The change from a 50% first year write-off to 100% applies to property purchased and placed-in-service in the United States before 2023, when the 100% begins to phase-down. The qualification of used property applies unless the purchaser previously owned the property.

For the purchase of a farm, the cost allocable to such assets being acquired as barns, fences, roads, and equipment, because their cost recovery periods do not exceed 20 years, qualifies for 100% bonus depreciation. Land, of course, remains nondepreciable.

Bonus depreciation applies only to assets acquired by "purchase." This excludes acquisitions from certain related parties, gifts, and inheritances.

Note that bonus depreciation, unlike Section 179 depreciation which is briefly discussed next, is available without regard to whether the owner has positive business taxable income.

Section 179 Expensing

TCJA included a number of provisions expanding the benefit of Section 179. However, with 100% bonus depreciation now available and Section 179 being limited to positive business taxable income, the usefulness of Section 179 expensing is not of much value to horse and farm owners, at least until bonus depreciation begins to phase-down in 2023.

General Depreciation Matters

Prior to TCJA, horse and farm owners were required to use a 150% declining balance method for computing depreciation of such assets as horses and equipment. This contrasts with 200% declining balance, a more accelerated method, for tangible personal property used by other industries. Under TCJA, the 200% declining balance method now is available for newly placed-in-service assets that before were required to be depreciated using the 150% declining balance method.

Also, previously unused farm equipment acquisitions now can be depreciated over five rather than seven years.

continued on the following page

EXCESS BUSINESS LOSSES

Effective for 2018 through 2025, TCJA adds a limit on the deductibility of annual net business losses of noncorporate taxpayers. They now can deduct such losses up to only $250,000 (single) and $500,000 (married and filing jointly). These limits are adjusted for inflation after 2018.

This new law applies to all pass-through business losses, not just to farming or horse activities. The limit is calculated after applying the "passive activity loss" rules of existing Section 469. The new rule will adversely affect those owners who presently are able to use large losses (for a horse business or any other business) to offset investment income, such as interest, dividends, and capital gains. The new law's more favorable depreciation rules may lose some of their short-term benefit if they create or increase large tax losses.

While business losses greater than the limits are currently disallowed, the good news is the unused losses are converted into a net operating loss (NOL) that rolls forward into the following tax year(s). NOLs generated in 2018 through 2025, including those attributable to excess business losses, can be used to offset up to 80% of overall taxable income, including investment income, in subsequent tax years, and the remaining NOL, if any, continues to roll forward indefinitely as an NOL carryover available for future years.

Consider the following examples:

- **Example 1** – A single taxpayer is actively involved in a horse racing operation which generates a $500,000 loss in 2018. He also operates another business venture in which he actively participates and generates 2018 income of $300,000. His net business loss in 2018 is $200,000, which is less than the $250,000 limit, so he has no excess business loss.
- **Example 2** – A married horse owner filing jointly who is a sufficiently active participant in her horse business in 2018 generates a $2,000,000 loss from that business. In 2018 she also has $3,000,000 of investment income. When this income and the horse business loss are netted, the preliminary result is taxable income of $1,000,000; however, she is limited to using only $500,000 of the net business loss. Thus, her 2018 taxable income will be $2,500,000, and she will have an NOL carryover to 2019 of $1,500,000 (the deferred portion of the 2018 horse business loss).

HOBBY LOSSES

The TCJA contains no direct changes to the hobby loss rules, but an indirect impact may make the cost of having revenue from an activity determined to be a hobby more expensive. Pre-TCJA, expenses associated with a hobby activity were treated as a miscellaneous itemized deduction. As a result, they were combined with other expenses categorized as miscellaneous itemized deductions, and such combined expenses were deductible to the extent they exceeded 2% of adjusted gross income. However, they were nondeductible in computing alternative minimum tax. Under TCJA, they no longer are deductible, period.

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THE NEW 20% "QUALIFIED BUSINESS INCOME" DEDUCTION

Effective for 2018 through 2025, a new deduction may be available for business owners, but not for "C" corporations or their shareholders. This deduction is intended to reduce tax on most business income to align more closely with the new 21% rate on businesses conducted in "C" corporations. The deduction is 20% of "qualified business income" (QBI), subject to a number of limitations. The deduction also applies to dividends received from real estate investment trusts (REITs) and income passed-through from publicly traded partnerships, neither of which benefits from the reduced "C" corporation tax rate.

QBI is the net income, if any, after calculating all income, gains, deductions, and losses for each of a person's U.S. businesses. Business income does not include investment income, such as interest, dividends (other than from REITs), and capital gains, nor does it include wages earned by an employee or guaranteed payments by a partnership to a partner. A business owner may be active or passive under the passive activity loss rules and still qualify.

The QBI deduction is calculated at the owner, partner, or shareholder level and is available to individuals, trusts, and estates. Generally, the taxpayer must have net positive taxable income from qualifying businesses to have a QBI deduction. Thoroughbred owners who conduct operations as sole proprietorships or via flow-through entities may benefit from the QBI deduction if they have positive taxable income from those operations. On the other hand, tax losses from these businesses may reduce the QBI deduction that otherwise would be available from other businesses conducted by the taxpayer which are generating positive taxable income.

The QBI deduction is one of the most complex provisions of TCJA, in part due to multiple limitations applicable when certain income levels are exceeded. This article summarizes the general mechanics of the deduction and the limitations without providing an in-depth analysis of the computations.

The QBI deduction cannot exceed 20% of overall taxable income in excess of net capital gains and qualified dividends (calculated prior to the QBI deduction). If 2018 taxable income exceeds $157,500, or $315,000 if married filing jointly (fully phased in at $207,500 or $415,000, if married filing jointly, and indexed for inflation after 2018), then two additional limitations may apply. The first deals with wages paid by the business and the original cost of qualifying depreciable assets. The second involves whether or not a particular business provides "specified services," defined as a business that (a) includes services in these specified fields: law, health, accounting, actuarial science, performing arts, consulting, athletics, and financial and brokerage services. Many Thoroughbred operations, including breeding and sales, would fall outside the definition of "special services" and potentially qualify for the QBI deduction. However, under definitions of "athletics" and "consulting" contained within Treasury Regulations issued in January 2019, Thoroughbred racehorse owners, bloodstock agents, and jockeys may fall under the "special services" restriction and be ineligible for the 20% QBI deduction, ***but only if taxable income for the year exceeds $157,500 (or $315,000, if married and filing jointly)***. A noncorporate business owner with taxable income less than these amounts who has positive business taxable income (horse business or otherwise) will be entitled to a QBI deduction, unless the owner has an overall tax loss.

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