AMERICAN HORSE COUNCIL'S
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Presidential Candidates Latest Tax Proposals

The brief summary below outlines the basic plan of each candidate, at least for the moment. They will no doubt continue to make changes as the campaign goes on.

TRUMP

- Reduce top individual marginal income tax rate to 33%, down from 39.6%, with two other tax brackets of 12% and 25%.
- Limit top tax rate on all business income to 15%, including partnerships and sole proprietorships. (There is concern by the campaign that this proposal may need to be revised because most of the pass-through income goes to the top 1% of the taxpayers. Clinton calls this proposal the Trump loophole.)
- Lower the tax rate on corporations to 15% and apply this rate to partnerships and other types of businesses that pass their profits on to individuals who are taxed at the applicable ordinary income rate. Also allows immediate expensing.
- Lower taxes across the board on middle and lower income families, including a rate reduction on those in the 15% income tax bracket (currently $18,551 to $75,300 for a joint tax return) from 15% to 12%.
- Tax capital gains and dividends at a maximum rate of 20%.
- Make child care tax- deductible.
- Eliminate the estate tax.
- Eliminate the AMT tax.

CLINTON

- Existing corporate tax rates would not change, but would allow tax credits for businesses investing in community development, infrastructure, and those which have employee profit sharing. Clinton would also like to make changes to the corporate tax code to dissuade companies from moving their operations abroad to reduce taxes.
- The existing tax treatment of partnerships and other pass-through entities would not change.
- A 4% tax surcharge would be imposed on income over $5 million, raising the top marginal rate on these taxpayers to about 44%. A minimum tax of at least 30% on individuals with over $1 million in income would also be imposed. The value of tax deductions would be limited and other measures included which would make the tax code less favorable to the affluent.
- There would be little change to those in the bottom 95% of earned income. Clinton does want a

broader effort to make child care more affordable.

- The current estate tax exemption for an individual would be reduced from $5.45 million to $3.5 million and for a couple from $10.9 million to $7 million.
- Assets would be required to be held for at least two years to qualify for capital gains treatment, after which the tax rate goes down four percentage points in the third year and thereafter one additional percentage point for each year the asset is held until reaching a tax rate of 23.8% on assets held more than six years.

Tax Bulletin No. 381

Favorable Tax Depreciation Rules For Race Horse Owners Remain in Place for 2016

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On December 18, 2015, Congress enacted the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"), which extended various expiring tax depreciation rules that are applicable to the horse racing industry.[1] Importantly, the PATH Act extended two important depreciation provisions that allow taxpayers who place a race horses into service during 2016 to recover their costs for such race horses in a more expedient timeframe. First, the PATH Act maintained the rule allowing taxpayers to depreciate the costs of a racehorse over a three-year recovery period. Second, the PATH Act retroactively extended the 50% bonus depreciation available for taxpayers that place race horses into service through December 31, 2019.

To help illustrate the potential benefits that the PATH Act provides for taxpayers involved in the horse racing industry, this article will provide a general overview of the depreciation rules currently in effect under the Internal Revenue Code (the "Code"). Additionally, this article will briefly describe tax rules that could act to limit the availability of depreciation deductions. Lastly, this article will provide examples to show how the depreciation rules apply to a taxpayer engaged in a horse racing activity.

I. Overview of Depreciation Rules

Under the Code, taxpayers are generally allowed to take an annual depreciation deduction for the wear, tear, and deterioration to their tangible property used in an income-producing activity.[2] Taxpayers are first eligible for this annual deduction in the year in which they place the applicable tangible property in service for the production of income and the deduction ends once the taxpayer has fully recovered the cost or other basis for the applicable tangible property or takes such property out of service. For most taxpayers, the proper depreciation method to be used is the Modified Accelerated Cost Recovery System ("MACRS"). Under MACRS, taxpayers can recover their costs for applicable tangible property under two methods: (1) the general depreciation system; and (2) the alternative depreciation system. For purposes of this article, the focus will be on the general depreciation system because it provides the most beneficial tax benefits for taxpayers engaged in a horse racing activity.[3]

1 PL 114-113.
2 I.R.C. § 168.
3 See I.R.C. § 168 (G), which requires that a horse race be deducted over a 12-year period under the alternative depreciation system

A. Summary of General Depreciation System

Under the general depreciation system, taxpayers are allowed to deduct their costs for tangible property used in an income-producing activity over the applicable recovery period at certain defined percentages beginning in the year in which such property is placed into service.[1] For race horses, the current applicable recovery period is 3-years. Therefore, you will generally be entitled to deduct the costs of your race horse over a 3-year period.[2]

To determine the amount of your depreciation deduction, the Code provides special rules setting forth the applicable percentage and timing of your depreciation deductions. To provide a simple reference point, the IRS has published charts to assist the taxpayer with calculating applicable depreciation deductions. For tangible property with a 3-year recovery period that was placed into service during 2015, IRS Publication 946 (2015) sets forth the following percentages to assist you with calculating your depreciation deduction for your race horse:[3]

- In the year the race horse is placed into service, the taxpayer will be entitled to deduct 33.33% of the original adjusted basis (less any bonus depreciation discussed below) in the race horse;
- In the following year, the taxpayer will be entitled to deduct 44.45% of the original adjusted basis (less any bonus depreciation discussed below) in the race horse;
- In the third year, the taxpayer will be entitled to deduct 14.81% of the original adjusted basis (less any bonus depreciation discussed below) in the race horse; and
- In the final year, the taxpayer will be entitled to deduct the remaining 7.41% of the original adjusted basis (less any bonus depreciation discussed below) in the race horse.

However, if the taxpayer decides to no longer race the horse prior to deducting its full costs, the taxpayer will no longer be entitled to take a depreciation deduction because the horse will no longer be considered tangible property used in an income producing activity.[4]

B. Special 50% Bonus Depreciation

To help spur economic growth following the September 11th attacks, Congress enacted a special temporary bonus depreciation provision that allowed taxpayers to deduct 50% of their acquisition costs for certain types of tangible property that was placed into service by taxpayers.[5] Since its initial enactment, Congress has continued to renew this bonus depreciation provision, sometimes on a retroactive basis. Under the PATH Act, the special bonus depreciation provision was extended retroactively to allow taxpayers who purchased certain types of qualified property to deduct 50% of their acquisition costs where such property was placed into service during the 2015, 2016 and 2017 taxable years. However, the PATH Act reduced this bonus depreciation amount to 40% for qualified property placed into service during the 2018 taxable year and further reduced the amount to 30% for qualified property placed into service during the 2019 taxable year.

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1 I.R.C. § 168 (a)
2 I.R.C. § 168 (E)(3)(a)(i)
3 Note: Publication 946 will be updated with new percentages for 2016.
4 See IRS Publication 946 (2015)
5 See I.R.C. § 168(K)

To qualify for the special 50% bonus depreciation deduction in 2016, the taxpayer must have acquired qualified property under the Code.[1] Since race horses have a recovery period of 20 years or less under the general depreciation system, race horses qualify as qualified property that are eligible for the 50% bonus depreciation deduction.[2] Importantly, the 50% bonus depreciation deduction only applies for the year in which a taxpayer places the race horse into service in an income producing activity. Additionally, the 50% bonus depreciation deduction will reduce the taxpayer's adjusted basis in the race horse, which will limit the amount deductible under the general depreciation system.[3] Therefore, the taxpayer will only be able to take the 50% bonus depreciation deduction once for race horses placed into service during 2016 and the total cost under the general depreciation method will be reduced by the amount of the deduction.

II. Limitations on Depreciation Deduction

The Code has numerous statutory provisions that can limit the availability of the depreciation deduction otherwise available to taxpayers engaged in a horse racing business. While these statutory limitations are beyond the scope of this article, each of these provisions are worth briefly mentioning.

A. Hobby Loss Rules

If the depreciation deductions would cause your Thoroughbred racing activity to incur a loss for the taxable year, your depreciation deductions could potentially be limited under the "Hobby Loss" rules. Under the "Hobby Loss" rules, a taxpayer will not be able to take a loss deduction for any activity where it is determined that the taxpayer did not engage in the activity for profit. Therefore, if your depreciation deductions would cause your Thoroughbred racing activity to incur a loss for the taxable year, it is important that you be able to demonstrate that you engage in your Thoroughbred racing activity with an actual and honest profit objective. Otherwise, the IRS could disallow your depreciation deductions unless you have sufficient gross income from your horse racing activity to offset the entire deduction.

B. Passive Activity Loss Limitation

If the taxpayer fails to materially participate in the horse racing activity, the depreciation deduction will be limited under the passive activity loss rules.[4] To show that the taxpayer materially participated in a race horse activity, there are numerous tests that the taxpayer can satisfy. The most common test utilized by taxpayers in the horse racing industry is the test showing that the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year (at least 100 hours).[5] However, activities undertaken solely as an investor (i.e. review financial statements, preparing analysis, and monitoring general business activities) will not be considered when determining whether the taxpayer has satisfied the 100-hour threshold.[6] Therefore, it is important that the taxpayer actually engage in some form of actual participation for at least 100 hours in each year in order to be eligible to take depreciation deductions for its race horses.

1 I.R.C. § 168(k)(1)
2 I.R.C. § 168(k)(1)(A)
3 I.R.C. § 168(k)(1)(B)
4 See I.R.C. § 469
5 Treas, Reg. § 1.469-5T(a)(7)
6 Treas. Reg. § 1.469-5T(f)(2)(ii)

C. At-Risk Limitation

If the taxpayer finances any portion of the purchase of its horse racing business, the taxpayer needs to be sure that it is considered at-risk for the entire portion of the loan.[1] Amounts are considered at risk under the Code to the extent that the taxpayer contributed money and property into the activity and to the extent that the taxpayer borrowed money for the activity provided that either the taxpayer is personally liable to repay the borrowed funds, or the taxpayer has pledged assets as security for the borrowed funds.[2] Therefore, if the taxpayer borrows money to fund its horse racing activity, the taxpayer needs to ensure that it is either personally liable on such loans, or that the taxpayer provides property security as collateral for such loans. Otherwise, the depreciation deductions otherwise available for the taxpayer's race horse may be limited.

III. Example

Assume for this example that the Taxpayer has formed a limited liability company on July 1 of the current tax year (2016) to conduct a Thoroughbred racing and breeding business. The Taxpayer is a calendar year Taxpayer and has very detailed business plan to generate significant revenues in the first year full year of operation and sufficient revenues to generate profits thereafter. Assume also that the taxpayer materially participates in the business, has sufficient profit motive and is "at risk" for the entire investment necessary to implement the business plan. Finally, assume that the Taxpayer generates approximately $2,000,000 from other sources of earned income and investments.

The Taxpayer's business plan calls for the investment of 2.5 million dollars for the purchase of: a) yearlings in July and September of year one; b) in foal mares in November and January of year one; and c) two-year-old racing prospects in the winter and spring of year one. Revenues in year one will be generated by: a) the sale of yearlings to two-year-old pinhooks in the winter and spring of year one (but in tax year two) of the business and thereafter; 2) the racing in year one of two-year-old prospects purchased in the winter/spring of year one and the yearlings purchased in July and September of year one; and 3) the sale of weanlings and in foal mares in November and January of year two of the business and thereafter.

To implement the business plan, the Taxpayer purchases four yearlings (two colts and two fillies) in July and September of year one (checking the box on the acknowledgement of purchase indicating that the yearlings were bought for resale or were being shipped out of state, thus exempting them from sales tax) for a total of $400,000, immediately places them "in service" and has them "broken" to the saddle and placed in training in preparation for sale in the following winter/spring two-year-old in training sale or for racing. It is the Taxpayer's intent to sell the colts and race the fillies.

In November of year one the Taxpayer purchases four in foal mares and two maiden mares for a total of $600,000. In the January the Taxpayer purchases two more maiden mares for a total of $200,000. Finally, in the winter/spring two-year old in training sales the Taxpayer purchases four colts as racing prospects for a total of $800,000. The remaining $500,000 is set aside for the payment of expenses associated with the care and training of the purchased horses, for stud fees and for insurance.

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1 I.R.C. § 465(a)

2 I.R.C. § 465(b)

In January of the first year of the Thoroughbred business operation, the Taxpayer visits a tax attorney/accountant and wants to know to what expensing or depreciation deductions he may be entitled to. Since he purchased four yearlings (assume for this example that each yearling was purchased for a price of $100,000,) two of which would be raced and two of which would be held for resale as two-year-olds, the Taxpayer was told that an election was available to expense the entire purchase price of the two yearlings purchased for racing, or the Taxpayer could take the bonus depreciation of 50% of the purchase price, plus the normal depreciation allocation of the remaining basis ($50,000 for each horse) subject to the mid-year convention and the balance of the depreciation over the next two tax years. The two yearlings purchased for resale would not afford the Taxpayer any expensing or depreciation deductions because they were being held in inventory for resale. The expenses of caring for and training these two yearlings would be deductible to the extent they were reasonable and necessary to prepare them for re-sale.

For the maiden broodmares purchased (again assume that each was purchased for $100,000), the Taxpayer was told that, since they had raced, they would be considered "used" by the IRS and therefore not eligible for expensing. These mares, however, would still be eligible for the 50% bonus depreciation, plus the normal depreciation on the remaining basis ($50,000) after the bonus depreciation deduction reduction of basis by $50,000. For the in foal broodmares, the Taxpayer was told that a reasonable allocation for the value of the foals would be $25,000 per mare (25% of the purchase price of each mare) and that the remaining purchase price ($75,000 for each mare) would be the adjusted basis for the mares. All of the mares had raced so were not eligible or the expensing deduction, but like the maiden mares, were eligible for bonus and normal depreciation.

Finally, the Taxpayer asked for what deductions would the two-year-olds purchased to race be eligible in the second tax year of the business, operation. The attorney/accountant would need to know additional facts to answer the question. If the two-year-olds were purchased as weanlings or yearlings for resale, (prior to being purchased by the Taxpayer) they would not be eligible for the expensing deduction, but would still be eligible for bonus depreciation (reduced to 40% in 2017) and regular depreciation of the remaining basis after adjustment for the bonus depreciation taken. If, on the other hand, the two-year-olds were sold by their respective breeders (i.e. they were not considered "used" property by the IRS by virtue of having been bought and sold by pinhookers) the Taxpayer would be eligible to elect to expense the full purchase price of the two-year-olds purchased for racing, subject to the overall $500,000 cap on expensing deductions.

Tax Year	Depreciation Deduction %
Year 1	33.33%
Year 2	44.45%
Year 3	14.81%
Year 4	7.41%

If the Taxpayer in tax year one elected to expense the horses eligible for expensing, (the two yearlings purchased for racing, assuming they were sold by their breeders) the expensing deduction would be $200,000 (2 x $100,000 purchase price of each yearling.) In addition, the Taxpayer would be eligible for a deduction $50,000 for each maiden mare in bonus depreciation and of $37,500 for each in foal mare ($37,500 x 4 =$150,000), plus regular depreciation, depending upon their respective ages and the corresponding recovery period (i.e. 3 or 7 years.)

In tax year two, the Taxpayer would have to determine if the two-year-olds purchased were eligible for expensing by determining if they had been "used" before their purchase (by being pinhooked. It is unlikely the IRS would take the position that the selling of the foal or yearling by the breeder constitutes prior use. Accordingly, if it could be determined that the breeder sold the two-year-olds then they likely would be eligible for expensing and their entire purchase price could be expensed, so long as the total amount of the allowed cap for expensing was not exceeded. If the expensing some or all of the two-year-olds would cause the Taxpayer to exceed the overall $500,000 expensing limit, it would be necessary to elect to maximize the expensing deduction by approaching but not exceeding the cap, then treat the remaining horses (and their remaining basis) under the bonus and regular depreciation rules. If, on the other hand, it was determined that the two-year-olds had been "used" prior to the Taxpayer's purchase and were therefore ineligible for the expensing deduction, then the bonus depreciation (reduced to 40% in 2017) and regular depreciation rules would still be available and the deductions would be calculated according to the applicable tables provided by the depreciation rules.

As each taxpayer's circumstances will vary significantly based upon all the facts and circumstances, readers should consult with an attorney or an accountant before taking action based upon any information provided in this article.

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For more information, or for a response to any questions you may have, please call Joel B. Turner at (502) 568-0392 or email him at jturner@fbtlaw.com. For additional information about the full range of services offered by the Frost Brown Todd LLC Equine and Tax Section attorneys, and links to other articles of interest, you should visit www.frostbrowntodd.com and follow the link to the Equine or Tax Group under Practice Areas. Thanks to Austin Byars abyars@fbtlaw.com (also of Frost Brown Todd LLC) for his contributions to this article.

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