

NEW BLOODSTOCK LEGISLATION - WHAT IS THE BEST COURSE OF ACTION FOR NEW BREEDERS?

The Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Act 2019 passed its third reading on 12 March 2019 and received Royal Assent on 18 March 2019, and the detailed impact has been covered in earlier *Circulars*.

Now that we have this legislation, what is the practical advice to new breeders?

THE STICKING POINTS.

The November 2018 *Tax Circular* set out a detailed summary of the proposed new legislation. Now that the final changes have been incorporated the purpose of this paper is to point out the undesirable features and suggest a course of action for new investors into the breeding industry. This paper should be read in conjunction with the earlier comments on the technical aspects of the legislation.

INFORMATION REQUIREMENTS.

The devil is in the detail, as the saying goes. The new section EC 39B (1) (b) (ii) states rather innocuously “information as the Commissioner requires....”. Page 3 of the Revenue’s April 2019 special Policy and Strategy Report on the new legislation lists nine detailed items of information that must be sent to the Revenue within four months of acquiring the high-priced bloodstock by a prospective breeder. Whilst some items would normally be prepared where there is a syndicate formed under the NZ Rules of Racing there is a large volume of extra work for the small private syndicate, partnership or sole trader. It is moot point as to whether the private syndicates – not formed under the syndication rules – or sole traders will be bothered with business plans, pedigree and breeding research, racing programmes, start and management of the future breeding programme and financial forecasts. And these are only part of the list.

It is interesting to note that the list in the April Policy and Strategy Report is far more detailed than the “Standout Yearling Information Requirements” Schedule prepared for industry use and dated February 2019.

By way of clarification, the new proposals apply to all prospective new breeders

who wish to purchase yearlings under the new legislation. A good part of the supporting documents refer to “syndicates” but the act itself defines a prospective breeder as simply “a person”.

Existing breeders in business are not faced with any of these time-consuming information requirements.

THE APPROVED PRICE THRESHOLDS.

For the 2019 thoroughbred sales, the Revenue laid down the approved minimum prices for thoroughbreds:

Fillies, \$467,000

Colts, \$402,000

It has been well recorded that apart from New Zealand’s leading bloodstock syndicator, Te Akau Stud, there have been no new investors prepared to spend anything near these amounts. For example, from the 2019 Karaka Book 1 Sale, only 15 yearlings reached these price levels. Of these 6 were purchased for New Zealand – 4 by Te Akau for a new 2019 “business” syndicate and 2 by existing breeders or for racing. It is this author’s opinion that Te Akau is in reality “repeat business” and is clearly not a new investor attracted to the industry by the new legislation. Further, only a proportion of the 2019 investors in the syndicate would be new, the others being existing Te Akau investors re-investing. One earlier very unofficial estimate had new investors being “about half”. This information is not publicly available.

The top 10% of yearlings sold in 2019 have been analysed in depth. This analysis produced 21 fillies and 27 colts but sale price thresholds dropped to \$290,000 for fillies and \$270,000 for colts. Although a total of 23 yearlings were purchased by New Zealand interests none were for “new investors”, apart from the Te Akau purchases.

Similar results came out of the 2018 Karaka Book 1 Sale. The only “new investors” above the 2018 threshold were Te AKau Stud.

For the 2017 Karaka Premier Sale (as it was then known) the analysis went much further. The total New Zealand filly purchases were established – 56 fillies at an average of \$140,178. Sale prices ranged from \$35,000 to \$375,000. The only fillies that may have been purchased by new breeders came to 3 in number and all were at the lower levels.

The last example is for the 2016 Karaka Premier Sale. The notional colt threshold was \$460,000. Only 10 colts exceeded this figure and only 4 were for New Zealand – all for Te Akau. In respect of fillies, the notional threshold was \$450,000 and applied to only 6 fillies, of these two were for New Zealand buyers – one each for Te Akau and an existing breeder.

Expert advice from well-regarded bloodstock agents has it that new investors into the thoroughbred breeding industry would be best advised to purchase a well-bred broodmare, and not a yearling at the necessary cost level, as the start of the breeding business. Buying and racing a yearling filly, say, prior to breeding, is just too risky when compared with a well-bred commercial quality broodmare.

GEOGRAPHICAL RESTRICTION ON YEARLING PURCHASES.

Although the Minister's budget announcement did not restrict the source of well-bred yearlings it appears that the Revenue have taken it upon themselves to interpret the announcement as restricting the new "incentive scheme" to only yearlings offered at one thoroughbred sale in New Zealand (Karaka) and three Standard bred sales split between Auckland and Christchurch. The theory behind this being that purchases under the new scheme would benefit only existing New Zealand breeders. Unfortunately, the internationalism of the breeding industry has been ignored and there is a complete lack of awareness that artificial stimulus or restrictions no longer have any place in the modern-day breeding industry.

It is quite incongruous to note that of the top 5% of the yearlings sold at the 2019 Karaka sale, four were actually bred in Australia. In addition, of the top 23 yearlings, colts and fillies, purchased by New Zealand buyers, four were also bred in Australia.

If a new breeder was to purchase a broodmare of, say, similar quality and pedigree to a "superior" yearling, there is absolutely no geographical restriction.

It is noted that the restriction on Australian purchases will be reviewed sometime in 2020. From a practical viewpoint the review is unlikely to be before the 2020 New Zealand sale series are completed. The Karaka Book 1 thoroughbred sale, for example, commences on 26 January 2020.

There is no provision to include yearlings purchased from private sources. This was described at a meeting with Revenue officials as, surprisingly, an “integrity measure”.

The following summary was printed in the November 2018 *Tax Circular*, but is worth repeating:

- **Existing breeders may purchase yearlings from worldwide sources;**
- **Existing breeders may purchase mature breeding stock worldwide;**
- **New investors may purchase mature breeding stock worldwide;**
- **New investors are restricted to purchasing yearlings only in New Zealand.**

RECOVERY RULES.

The new legislation contains an unusual requirement for prospective new breeders. The idea is that the stand-out yearling – now known as stud-founding bloodstock – must be raced or bred in New Zealand. If there is change in intention or the bloodstock are shipped out of New Zealand or sold the recovery rules apply in respect of that bloodstock. If the bloodstock are simply shipped, say, to Australia before racing or breeding in New Zealand there is a deemed disposal of that bloodstock. The value used for the deemed disposal is the market value of the high-priced bloodstock on the day the bloodstock leaves New Zealand.

The recovery is described in the Special Report as: “the greater of the amount of the consideration received for the sale of the high-priced bloodstock or the total deductions that have been allowed in relation to that bloodstock.”

The report of Parliament’s Finance and Expenditure Committee clarified the position of bloodstock that had been genuinely purchased for breeding but unexpectedly could not be used for breeding. Reasons would include gelding on account of temperament issues, injury or infertility. The new sections in the act, sub-clauses (c) to both CG 8B and CG 8C provide that at the time of the disposal the bloodstock were able to be used for future breeding. This a rather back to front way of saying that if the bloodstock cannot be used for future breeding at time of shipment offshore there is no deemed disposal. A small win for the industry.

Note that if an injury, say, prevents the bloodstock from racing but it may still be used for breeding it is still part of the stud-founding bloodstock under the new legislation.

The catch is - under the Recovery Rules - if the stud-founding bloodstock have little or no value the deductions previously allowed for that bloodstock are effectively reversed. Although this may have been a legitimate business venture, unlike any other business venture known to this author, the taxpayer loses the earlier deductions. This is unnecessarily onerous. In the explanatory notes to the original SOP 135 this was also described as an “integrity measure”.

GENERAL.

Another win for the industry was the new section EC 47C noting that the prospective bloodstock breeder is treated as commencing the bloodstock breeding business as from when the “stud-founding bloodstock” are purchased.

It is indeed a great pity that this simple phrase could not be included in the main bloodstock sections of the act and all the industry’s problems following Drummond would be over.

The officials’ response to the industry’s submissions to the Parliament Finance and Expenditure Committee, dated November 2018, contain numerous concerns re potential fiscal risk and the budget funding allocations. Readers will recall that the 2018 Budget allowed for a revenue cost over four years of \$4.8 million.

Taking the Te Akau purchases out of the “new investor” category it appears that there have been no yearling 2019 purchases over the threshold – and it is suspected never will be – thus giving a zero revenue cost.

The industry’s submissions have always made it clear that a stand-out yearling is based on type and pedigree and not the selling price.

The threshold proposals have not been a success and with the lack of new investment there is really a negligible fiscal risk. The thresholds should be abandoned and a simple amendment made to the existing bloodstock sections of the act to make it quite clear that new investors are subject to the same rules as existing breeders and that their new breeding business commences at the time of purchase of their potential breeding bloodstock.

RECOMMENDATION.

What should happen when a new prospective breeder arrives on the scene? Will accountants recommend the new client enter the breeding business under the new proposals or find alternative means of structuring the client's business entity for tax purposes?

This author recommends reverting to the suggestions first made some 4 or 5 years ago. Very briefly, first purchase one or two commercial broodmares; put in place a plan to commence the breeding business before the first balance date and, if desired, purchase suitable yearlings only after the breeding business has been established.

Warning: no two breeding ventures are the same and all potential new investors in the breeding industry must take their own independent advice. The notes above are of a general nature only and should not be relied upon as formal tax or accounting advice.