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BLOODSTOCK TAX CASE –
DECISION IN FAVOUR OF THE COMMISSIONER

HIGH COURT FINDS THAT THERE WAS NO BREEDING BUSINESS

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The decision delivered on 15 July could well prove to be a major blow to the bloodstock industry coming as it does at a time of diminishing returns and a grave loss of confidence in the future.

In addition, there will inevitably be a substantial expansion in the Revenue's investigation of bloodstock syndicates.

The case, *DRUMMOND & ORS v THE COMMISSIONER OF INLAND REVENUE [2013] NZHC 1768* (collectively known as the Te Akau Stallion Syndicate No. 1) has been with us since for about 4½ years since the first Revenue enquiry in early 2009. The cost of legal and tax advice has been enormous but such were the ramifications if the case was lost the Syndicate and its manager were determined to have their day in Court.

By way of background the case goes back to January 2008 when David Ellis purchased Lot 80 at the Karaka Premier Sale, a colt by Zabeel out of Desert Lily, for $550,000. The colt was subsequently syndicated and the Te Akau Stallion Syndicate No 1 formally established in March 2008. The colt was later named Roman Gladiator.

The syndicate contended that the colt was purchased for development and future use as a stallion. In addition to the customary expenses the syndicate claimed write-downs of 75% of the cost price and reducing value. An essential feature of the planned business activity was to race the colt because if it was successful on the race track its value as stallion would be greatly enhanced. Considerable evidence was centred on the success of Darci Brahma and the desirability of following this model.

The Revenue disagreed and the matter moved through the various stages of the disputes process.

ADJUDICATION UNIT

The first step in the judicial process was to seek a successful result from the Inland Revenue's Adjudication Unit. This is part of the Office of the Chief Tax Counsel which in turn is part of the Revenue's National Office.

In respect of GST the unit found that the taxpayer had carried on a taxable activity which involved the care, training and racing the colt. This involved the supply of race participation services. The consideration for the supply of the colt's participation in a race was the right to receive stake money from

the race organiser if the colt won or was placed. Until the colt was gelded the taxable activity also included the intention to supply breeding services when the colt was eventually retired to stud.

For Income Tax, the Adjudication Unit found that the syndicate had conducted a business operation of purchasing and preparing a colt for the provision of stud services. But, there was not a breeding business. This meant that the customary write-downs could not be taken as these only applied when there was a breeding business.

The syndicate chose to appeal to the High Court on the issue of whether or not there was a breeding business.

HIGH COURT HEARING

Brewer J. described the issue before the Court as follows:

(a) Is an existing breeding business a prerequisite for section EC39(1)(c) to apply?
(b) If not, did the plaintiffs [the Syndicate] carry on a breeding business?

The colt, after purchase, was duly prepared for racing, on the basis that if it was successful it would earn [stake] money for the syndicate and its worth as a stallion would be greatly increased. The colt turned out to have temperament problems and after severely injuring a stable staff member it was gelded. No income was received in the 2008 year as a 2YO and in 2009 it had three trials, took part in no official races, and received no stake earnings. In 2010, before gelding, it had one race. It goes without saying that it never went to stud.

Section EC 39 Income Tax Acts 2004 & 2007:

Section EC 39(1)(c) reads as follows:

> "This section applies to bloodstock that is 2 years of age or older at the end of the first income year in which a person –
> ……
> (c) buys the bloodstock, with the intention of using it for breeding in their breeding business."

The syndicate's (plaintiff) position was that its breeding business commenced with the purchase of the colt and it is "the intended use in a future breeding business of the particular taxpayer which is contemplated".

Brewer J. agreed with a submission from the Commissioner (defendant) concerning the legislative changes:

> "Parliament did not intend by these changes to remove the requirement that the person seeking to deduct the change in valuation of the bloodstock from assessable income be carrying on the business of bloodstock breeding. Rather, Parliament extended the circumstances in which a person already carrying on a bloodstock business was entitled to deduct such a change in valuation from assessable income."

Sub-paragraph (c) of the act, he said, "extends the circumstances in which a person already in a breeding business can begin writing down the cost of bloodstock."

The judgement stated that the plaintiff's argument could not prevail and if an existing breeding business is required then an intention to use the bloodstock in a future breeding business was not sufficient.

Was There A Breeding Business?
The leading case on the definition of a business is *Grieve v Commissioner of Inland Revenue [1984] 1 NZLR 101 (CA).* Justice Brewer noted that the parties based their arguments around the customary tests in the *Grieve* decision.

The decision of Richardson J. in *Calkin v Commissioner of Inland Revenue [1984] 1 NZLR 440 (CA*) at page 447 was quoted twice in the judgement –

> " he [the plaintiffs] must first establish a profit making structure and begin ordinary current business operations".

Racing the colt with the intention of copying the Darci Brahma model was still not enough to establish a breeding business. The acquisition of the colt, which was then raced was considered to be preparatory to a breeding business and was not the establishment of such a business. Similarly, racing the colt with a contingent intention of one day standing at stud is not the commencement of a breeding business. The judgement noted that some significant activity undertaken as a regular part of the revenue earning process was a prerequisite.

In the view of Brewer J. a requirement was a decision to stand the colt at stud followed by activities to support that decision. He found that no decision was ever made and no such activities occurred. Evidence was given that the colt would have gone to stud regardless of racing performance. However, there was nothing produced in support and any plan to implement that decision was missing.

Syndicate Agreement:
The Agreement came in for very detailed analysis and, in the end, was a contributing factor in the judgement going against the taxpayers.

Clause 1.1 of the Agreement set out the objects of the syndicate. Included with statements about acquiring, training and racing the colt and carrying on any other business associated with the racing industry there was a limited reference to carrying on business as owners of stallions and increasing the value of colts as stallions. There was no specific reference about retirement to stud, the whereabouts of the stud or any mention of ordinary stud standing issues.

The members of the syndicate had only a limited involvement in the management of the colt whether as a racehorse or as a potential stallion at stud. Only one syndicate member was on the management committee and apparently did not become actively involved. The considerable powers of the manager – even extending to gelding the colt without advising the members - were noted in the judgement.

In the opinion of Brewer J. because there was no formal consultation before the colt was gelded – one or more of the plaintiffs may have been notified – and indeed there was no formal obligation to consult; standing the colt at

stud was never a fixed obligation but was merely an intention contingent upon future events.

Justice Brewer contrasted this with the fixed intention of racing the colt. Syndicate members had an aspiration to stand the colt at stud and from that earn an income but beforehand there were still a number of decisions to make. He said that the decisions made were in the best interests of the colt's racing career but any decisions on any stud career were left to some point in the future.

A Racing Business?
The judgement concluded with a brief comment that there was a racing business.

Justice Brewer commented that he had read the Adjudication Unit Report dated 23 November 2011. He agreed with the conclusion.

With respect, the problem that now arises is that the report referred to is, in fact, related to the GST dispute. The High Court action relates to the Income Tax dispute. The definition of a "taxable activity" for GST purposes is somewhat different from the definition of a "business" for Income Tax.

It is all very well having a racing business for GST purposes but Inland Revenue are firm in their belief that as a general policy racing is a hobby or a private recreational pursuit. In addition the Revenue apparently still regards the GST issue as being "wide open" in spite of a decisive GST decision in favour of the taxpayer from the Adjudication Unit.

The breeding industry could possibly live with the "income tax adjudication" as noted above but a business of racing for non-breeding taxpayers is a completely different proposition. This aspect clearly requires further consideration.

Decision:
The plaintiffs' claim was dismissed.

NOTE: This is an edited version of an article in the July 2013 edition of John Aubrey's *BLOODSTOCK TAX CIRCULAR*. A later edition of the *CIRCULAR* will discuss the ramifications of the judgement.