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QUESTION WE'VE BEEN ASKED QB 16/XX

INCOME TAX AND GOODS AND SERVICES TAX – TREATMENT OF BLOODSTOCK BREEDING PARTNERSHIP

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Question We've Been Asked is about ss CH 1(3), CW 60, DB 49(3), DW 2, EC 39, EC 46 and HG 2 of the Income Tax Act 2007 and ss 6 and 20(3C) of the Goods and Services Tax Act 1985.

Question

1. We have been asked to clarify the Commissioner's view on certain aspects of the income tax and GST treatment for a partnership formed for the purposes of carrying on a bloodstock breeding business. In particular, we have been asked about the situation where a new partnership is purchasing its first horse with a plan to race the horse for several years before using the horse for breeding.

2. The specific income tax issues we have been asked to consider are:
   - whether s EC 39 allows a write-down in the year of purchase; and, specifically
     - whether s EC 39 requires a pre-existing breeding business; and
     - whether the purchase of the first horse will commence a "bloodstock breeding business";
   - whether partners carrying on another bloodstock breeding business may apply the write-down in s EC 39; and
   - how the sale of breeding stock should be treated when the partnership is carrying on a bloodstock breeding business.

3. The specific GST issue we have been asked to consider is whether a partnership in this situation with the following characteristics is carrying on a taxable activity for GST purposes:
   - The horse selected had a top pedigree and cost in excess of $200,000.
   - The partnership engages an experienced manager with the necessary contacts to deliver in accordance with the breeding plan once the partnership reaches the actual breeding phase.
   - The partnership engages an experienced trainer with a history of training successful racehorses.
   - The partnership implements (and follows) a detailed plan covering the purchase of the horse, care, training, racing and breeding, including the estimated timeframes and cost for each stage.

4. While the issues and fact situations dealt with (particularly, in relation to GST) are quite specific, the Commissioner, nevertheless, considered that other taxpayers and advisors in the bloodstock industry might find the answers and reasoning useful. As several relevant aspects depend on specific facts and circumstances, it is not intended to issue a more general statement on this area.

Answer

5. A partnership purchasing its first horse with a view to racing that horse for several years before breeding will not be entitled to a write-down for that horse in the year of purchase. Section EC 39 requires the taxpayer to be carrying on a breeding business at the time of purchase. Further, the purchase of the first horse in these circumstances will not mean a breeding business has commenced.

6. However, partners that are carrying on another bloodstock breeding business (separate from the partnership) will be entitled to a write-down for their share of the horse, if that horse is being used for racing.

7. Where a partnership **is** carrying on a bloodstock breeding business and breeding stock is sold:

   - the sale proceeds will be income; and
   - there will be no year-end add back in the year of sale for any carrying value for the bloodstock sold.

8. Although each situation must be considered on its facts, the partnership described in [3] is likely to be carrying on a taxable activity. If so, it will be entitled to an input tax deduction for costs incurred in that taxable activity (for example, the purchase of the horse and ongoing costs). The partnership must also return GST on any supplies that it makes (including race winnings and any bloodstock sold).

Explanation

9. The first issue is whether s EC 39 applies to allow a write-down in the year the first horse is purchased. This requires consideration of whether:

   - s EC 39 requires a breeding business to be in existence at the time the horse is purchased;
   - the purchase of the first horse will commence a "bloodstock breeding business"; and
   - taxpayers carrying on a bloodstock breeding business outside the partnership may apply the write-down.

Whether s EC 39 requires an existing bloodstock breeding business

10. The rules for valuing bloodstock used in a bloodstock breeding business are set out in ss EC 39 to EC 48. Section EC 39 specifies the closing value for bloodstock at the end of its first year in a breeding business. It applies to bloodstock that is two years of age or older at the end of the first income year in which a person:

    - uses the bloodstock for breeding in their breeding business (s EC 39(1)(a)); or
    - forms the intention of using the bloodstock for breeding in their breeding business (s EC 39(1)(b)); or
    - buys the bloodstock with the intention of using it for breeding in their breeding business (s EC 39(1)(c)).

11. The relevant paragraph in this situation is para (c). In summary, para (c) requires the taxpayer to purchase the bloodstock with the intention of using it for breeding "in their breeding business". This raises the issue of whether the breeding business is required to be in existence at the time the bloodstock is purchased. The words "in their breeding business" can be read as requiring this.

12. This issue was considered by the High Court in *Drummond v CIR* (2013) 26 NZTC 21-023; [2013] NZHC 1,768. *Drummond* involved a syndicate that purchased a colt for $550,000 (plus GST), which it contended was to be used as a stud stallion in the future. The colt was to be trained and raced before breeding with a view to increasing its value as a stud stallion. However, the colt was never put to stud. Its temperament deteriorated to the point where it was decided to geld the horse. It was then shipped to Singapore to be used as a racehorse. The taxpayers had applied s EC 39(1)(c) to reduce the value of the colt by 75% in year one and 75% of the remaining cost in year two. The Commissioner disallowed the deduction, and the taxpayers challenged those assessments.

13. Brewer J described the issue in the case at [8]:

> Issue
>
> [8] The issue is whether the syndicate, and hence the plaintiffs, came within the scope of s EC39(1)(c) for the income years in question. It has the following components:
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> (a) **Is an existing breeding business a prerequisite for s EC39(1)(c) to apply?**
>
> (b) If not, did the plaintiffs carry on a breeding business? [Emphasis added]

14. Brewer J went on to find that s EC 39(1) requires an existing breeding business for the section to apply. At [27] and [28] of the judgment, his Honour stated:

> [27] I conclude that without an existing breeding business, the acquisition of the colt by the plaintiffs could not bring them within the s EC 39(1)(c) regime.
>
> ***The plaintiffs' alternative argument***
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> [28] The plaintiffs' case focuses on whether the syndicate was in the bloodstock breeding business in the 2008 and 2009 income tax years. Its position is that its breeding business commenced with the acquisition of the colt. That does not assist them if, as I find, s EC 39(1)(c) requires an existing breeding business.

15. His Honour expressly refers to para (c) because that was the paragraph of s EC 39(1) that the plaintiff submitted applied. However, his Honour seems to have also concluded that an existing breeding business is required to satisfy the other paragraphs of the section. This is evident from [25] of the judgment, which states:

> [25] Assistance with the interpretation of s EC39(1)(c) can be gained by considering subparagraphs (a) and (b). Each uses the phrase "in their breeding business" also. The context of the use is clearly that of an existing breeding business. There is no indication that the context of its use in subparagraph (c) is different.

16. His Honour concludes that the use of the words "in their breeding business" in each of the paragraphs of s EC 39(1) indicates a requirement that there be an existing breeding business. This was sufficient to find against the taxpayers (at [36]). However, as the parties had indicated that the decision would be appealed regardless of the outcome, Brewer J decided to go on and consider whether the taxpayers were carrying on a breeding business in the relevant years (the second issue his Honour had identified at [8])[1]. This is discussed below from [24].

17. In summary, the Commissioner's view is that the High Court's decision in *Drummond* establishes that a breeding business is required to exist **before** the relevant s EC 39 trigger occurring (use, forming the intention to use, or buying with the intention of using). Therefore, in the absence of an existing breeding business, s EC 39(1) will not apply. It follows from this that s EC 39 will not apply to a partner in a partnership that buys its first horse with the intention of racing it

[1] It is noted that Brewer J's decision was not ultimately appealed.

before any breeding. Such a partnership will not be carrying on a bloodstock breeding business at the time the bloodstock is purchased.

18. However, as discussed below (from [41]), partners that already carry on another bloodstock breeding business may still be able to access the write-down.

Whether a bloodstock breeding business commences with the first horse

19. We were also asked to consider when a bloodstock breeding business would commence, and, in particular, whether a breeding business could commence with the purchase of a single horse that was to be raced before breeding occurred.

20. The test for whether a business exists is set out in *Grieve v CIR* (1984) 6 NZTC 61,682. This test requires consideration of the nature of the taxpayer's activities and whether they have an intention to profit. The factors to be considered in determining whether a business exists include:

- the nature of the activity;
- the period over which the activity is carried on;
- the scale of operations and volume of transactions;
- the commitment of time, money and effort;
- the pattern of activity; and
- the financial results.

21. *Grieve* also notes that, while statements by the taxpayer as to their intentions are relevant, actions will often speak louder than words.

22. The Court of Appeal in *Calkin v CIR* (1984) 6 NZTC 61,781 considered what is necessary for a business to commence. The court found that a business will not commence until a profit-making structure is established and ordinary current business operations have begun (at 61,787):

> **There is too a distinction between transactions which are preparatory to the commencement of business and those which occur once the business has begun** which is well recognised in the authorities, if sometimes difficult of application in particular cases. Thus in the leading case, *Birmingham and District Cattle By-Products Co Ltd v Commrs of IR* (1919) 12 TC 92, Rowlatt J held that a company had not commenced business during the period in which the works were erected, plant assembled and agreements entered into for the purchase of materials preparatory to commencing manufacturing … **Clearly it is not sufficient that the taxpayer has made a commitment to engage in business: he must first establish a profit making structure and begin ordinary current business operations**. [Emphasis added]

23. This does not necessarily mean the business must be deriving income from its operations. In many industries, such as forestry and horticulture, a business can commence even though no income will be earned until the trees, plants or crops have sufficiently matured. However, this area of law is very fact specific, so what will be sufficient for the commencement of business will vary from industry to industry and from case to case. Consequently, while it is possible to draw analogies with case law on other industries, the most relevant authorities will be those that consider horse racing and breeding.

Leading New Zealand authority – Drummond v CIR

24. The leading New Zealand authority in this area is the High Court decision in *Drummond*. In *Drummond*, Brewer J expressly considered whether a bloodstock breeding business had commenced when the syndicate purchased its first horse (albeit this was considered as an alternative argument).

25. Brewer J found (at [13]) as a matter of fact that the plaintiffs joined the syndicate on the basis that the colt would be used as a stud stallion **if that were feasible**:

> [13] Against this background, I make the following findings of fact:
>
> …
>
> (b) The plaintiffs joined the syndicate on the basis that the colt would be used as a stud stallion if that were feasible.

26. And at [49]:

> … I am entitled to infer from the evidence of Mr Ellis and from the evidence of the plaintiffs, corroborated by the syndicate members' use of the s EC39 regime, that it was the intention collectively of the syndicate to stand the colt at stud if that were feasible.

27. However, this was not sufficient to find that a breeding business had commenced. Brewer J found that it was necessary to have **a fixed intention to breed**, whereas the plaintiffs had only **a contingent intention** to use the colt for breeding purposes. Whether the colt would ultimately be used for breeding was contingent on future events such as how it raced (at [76]) and whether it would be gelded (at [77]). The acquisition, training and racing of the colt – while furthering its chances of one day standing at stud – were preparatory to a breeding business, not a part of it.

28. Brewer J pointed to particular aspects of the syndicate agreement that he noted supported this conclusion. This raises the issue of whether his Honour might have reached a different conclusion, if the relevant documentation between the parties suggested a more definitive decision to breed when the horse was purchased. That is, was his Honour intending to set out criteria for an agreement that would be sufficient to evidence the commencement of a racing business when a colt is purchased?

29. In the Commissioner's view, the contingencies that Brewer J was concerned with could not have been overcome by correcting the perceived deficiencies in the syndicate agreement. What Brewer J was looking for was both decisions and actions: "In my view, what was required was a decision to stand the colt at stud and then activities aimed specifically at implementing that decision" (at [80]). His Honour, quoting *Grieve*, noted that "actions speak louder than words" (at 80). The examples he gave of the sort of actions that would suffice were "making a stallion available for stud, or advertising it as available" (at 80). While he stated that these examples were not prescriptive, both examples are close in time to actual breeding activity and are not likely to occur until the contingencies with which Brewer J was concerned are no longer present.

30. In finding that an intention to breed, if that were feasible, was not a sufficient commitment or decision to breed, it seems Brewer J was influenced by his finding that the taxpayers understood the high probability that the colt would never be able to stand at stud (at [74]). The effects of performance at the race track and the likelihood of gelding were at least part of the factual background against which his Honour concluded that the taxpayer had a contingent intention to breed, not a fixed one.

31. In the Commissioner's view, even if the syndicate agreement in *Drummond* had been more definitive, it would not have been possible for the agreement to do more than evidence an intention to breed the bloodstock if it were feasible to do so. Even with a more detailed plan to get from purchase to breeding, the same fundamental contingences that exist in *Drummond* would still exist. At the time the horse is purchased, which is several years before any actual breeding activity is planned to occur, the nature of the activity means the best that can be said is that the partners are committed to breeding if that is feasible. And, in the horse breeding business, at the time of acquiring the horse, that can be only a contingent intention.

Other bloodstock business cases

32. It has also been suggested that *Case K40* (1988) 10 NZTC 343 supports the view that a breeding business can commence on the purchase of the first horse. The Commissioner agrees that, in some circumstances, a breeding business could commence with the purchase of a single breeding horse, for example, where mature bloodstock is purchased with a view to commencing breeding in a short timeframe. However, the decision in *Case K40* is distinguishable from both that situation and the one under consideration in several respects.

33. *Case K40* did not consider when the business in question began. The years under consideration (1981−1983) were several years after the first mare was purchased (1973). By that time, the taxpayers owned several horses and had successfully bred and sold progeny from their horses. *Case K40* was concerned with whether the taxpayers were carrying on a hobby, rather than a business. In finding that there was a business in the relevant years, District Court Judge Keane considered the pattern of activity over the whole period.

34. Even if *Case K40* could be seen as suggesting that the taxpayer's business commenced on acquisition of the first horse, the facts are very different to those being considered here. There was only a brief period of racing before breeding – the mare had successfully produced a foal within two years of purchase and had produced three foals within six years. The taxpayer also appears to have made a decision about which stallion she wanted to service the mare early on. No evidence existed of any contingencies that would prevent the taxpayer from attempting to breed from the mare of the type that the High Court was concerned existed in *Drummond*.

35. *MR & SL Block v FCT* (2007) ATC 2,735 also considered whether a partnership was carrying on a business of breeding thoroughbred horses or whether the activity was a hobby. The Administrative Appeals Tribunal concluded that the taxpayer (a husband and wife partnership) was carrying on a business. The Senior Member of the tribunal (A Sweidan) noted that the husband and wife had purchased their first mare and bred her to produce a foal in 1991. Between 1991 and 1996, they developed and expanded the number of quality brood mares they held. The tribunal found that, when they commenced business in 1996, they had five or six mares. This case is, therefore, also very different to the fact situation being considered.

36. In *Case X28* 90 ATC 276, the Administrative Appeals Tribunal also held that the taxpayers were carrying on a small-scale horse breeding and racing business. In that case, the business commenced with the purchase of two mares, one of which was already in foal. Breeding activities, therefore, commenced immediately. Consequently, this case is again very different to the facts being considered in this item.

Orchard and forestry cases

37. It has been argued that case law on business commencement in the horticulture and forestry industries is analogous to business commencement in the bloodstock breeding industry. In orchard and forestry cases, the courts have found that the taxpayer is carrying on a business once trees have been planted even though the trees will not bear fruit or timber for years. This could be seen as analogous to purchasing a horse to be used for breeding at some time in the future.

38. However, the Commissioner considers the orchard and forestry cases to be different. As noted above, what is required for the commencement of a business varies from industry to industry. With orchards and forests, there will generally be a fixed intention to carry on the relevant business at the time the trees are planted. This is the case even though an unexpected event may occur before the trees mature. The contingencies Brewer J was concerned with in *Drummond* do not exist with orchards and forests; rather these cases are more consistent with Brewer J's finding that there was a **racing** business notwithstanding that the colt had not yet been raced.

Conclusion – business commencement

39. In the Commissioner's view, a bloodstock breeding business will not commence with the purchase of a single horse that is not intended to be used for breeding for several years but will be raced in the interim to try to improve its value. This is not because the bloodstock is intended to be raced for a significant period before breeding. The Commissioner accepts that racing bloodstock can be an integral part of a breeding business. However, for racing to be part of a breeding business, that breeding business must first have commenced. In the Commissioner's view, a partnership purchasing a horse in these circumstances can have only a contingent intention to breed. A contingent intention is insufficient for a breeding business to have commenced. Once a breeding business exists, s EC 46 allows racing activities to be treated as part of a breeding business.

40. This conclusion may mean that, at the time the first horse is purchased, investors will not have absolute certainty as to the ultimate tax treatment of their investment because the treatment will depend on whether the taxpayer later commences a bloodstock breeding business. However, in the Commissioner's view, the tax treatment is clear. For an investment to be taxed as a bloodstock breeding business, a bloodstock breeding business has to have commenced. At the time a single horse is purchased (with no intention to breed from the horse for several years), no deduction will be available because no breeding business is being carried on. If, subsequently, a breeding business commences, the investor will obtain a write-down then. This is no different from the treatment of pre-commencement expenditure in any other type of business. It simply reflects the different nature of the contingencies relevant to the bloodstock industry compared with those in other industries.

Partners carrying on another bloodstock breeding business

41. If the partnership's breeding business has not yet commenced, it is possible that an investor in the partnership who carries on their own bloodstock breeding business may still be able to apply s EC 39 to write down their share of the horse.

Income tax treatment of horse racing

42. Generally, bloodstock racing is outside the income tax net. No deductions are allowed for expenditure or loss incurred on (or in relation to) the racing of bloodstock (s DW 2(1)). Also, subject to specific exceptions, no deduction is allowed for expenditure or loss incurred in preparing bloodstock for racing (s DW 2(2) and (3)). Consistent with this, stake money and prize money for horse races are generally exempt income (s CW 60).

43. However, s EC 46(1)[2] treats the use of the bloodstock for racing as used in the course of the breeding business where a bloodstock owner:

- is in the business of breeding bloodstock for sale; and
- they use bloodstock for racing.

Therefore, once a taxpayer is carrying on a business of breeding bloodstock for sale, bloodstock that is used for racing may qualify for a reduction under s EC 39. In the Commissioner's view, s EC 46 does not require the raced bloodstock to be used as part of the breeding business (as long as it is capable of being used for breeding in the future (see s EC 46(3)).

Look-through nature of partnerships

44. Section HG 2 provides that partnerships are generally look-through entities. More specifically, s HG 2, among other things, treats a partner as holding their proportionate share of the partnership property and as carrying on the partnership's activity. Where a partnership is racing bloodstock, each partner, therefore, will be treated as owning a proportionate share of a horse used for racing.

Conclusion

45. Where a partner in the partnership in question is also carrying on a bloodstock breeding business, s EC 39 can be applied to the partner's proportionate share of the racing bloodstock. This will be the same whether the bloodstock breeding business is being carried on:

- in the partner's own name, or
- through their investment in another partnership that is carrying on a bloodstock breeding business.

46. However, this write-down can be applied only once. If the partnership later uses the bloodstock in a breeding business, the partner cannot obtain a second write-down.

Treatment where bloodstock sold before breeding

47. As set out above, a partnership that purchases a single horse with a view to racing that horse for a few years and then using that horse for breeding in the future will **not** be carrying on a bloodstock breeding business. However, if the partnership was carrying on a bloodstock breeding business, an issue arises as to how to treat bloodstock that is sold (either before or after that horse has been used for breeding).

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[2] This is subject to the exceptions in s EC 46(2) (the voluntary opt-out for bloodstock not used in the course of a business of breeding bloodstock for sale) and EC 46(3) (the exception for non-breeding bloodstock).

48. At the end of the each income year, the closing value of the bloodstock[3] is income under s CH 1(3). A deduction is then allowed for that amount under s DB 49(3) in the following income year.

49. If bloodstock is sold during an income year, the sale proceeds will be income. There will be no year-end add back in the year of sale for any carrying value for the bloodstock sold. This effectively means a deduction is allowed for the remaining value of the bloodstock (that is, the cost price less any previous write-down).

GST: Taxable activity

50. We have also been asked whether the partnership in this situation (set out in [1]) would be carrying on a taxable activity from the time the first horse is purchased. More specifically, we were asked about a partnership that also had the following characteristics:

- The horse selected had a top pedigree and cost in excess of $200,000.
- The partnership engages an experienced manager with the necessary contacts to deliver in accordance with the breeding plan once the partnership reaches the actual breeding phase.
- The partnership engages an experienced trainer with a history of training successful racehorses.
- The partnership implements (and follows) a detailed plan covering the purchase of the horse, care, training, racing and breeding, including the estimated timeframes and cost for each stage.

This scenario is different to that considered in the draft Question We've Been Asked QWB00280, which was released for consultation on 28 September 2016. QWB00280 covers the situation where horse racing is carried on as a stand-alone activity. The specific scenario considered here is a partnership that has purchased a top pedigree horse with an intention of breeding from it − the racing activity is being undertaken solely to improve potential breeding value.

51. To be a "taxable activity" three requirements must be satisfied. These requirements are that:

- there is an activity;
- the activity is carried on continuously or regularly by a person; and
- the activity involves, or is intended to involve, supplies made to any other person for a consideration.

52. Even if no actual supplies have been made, the definition of "taxable activity" may still be satisfied if there is an "intention" that the activity will involve the making of supplies. Any stated intention of making supplies must be tested objectively.

53. Section 6(2) of the Goods and Services Tax Act 1985 treats anything done in connection with the beginning or ending (including a premature ending) of a taxable activity as being carried out in the course or furtherance of the taxable activity. However, s 6(2) cannot create a taxable activity where one would otherwise not exist; rather, s 6(2) adds the commencement activity to the taxable activity.

[3] The closing value is the cost price less the reduction for the year or the opening value less the reduction for the year as appropriate.

54. Section 6(3) excludes from a taxable activity any activity carried on (or that if carried on by a natural person would be carried on) essentially as a private recreational pursuit or hobby.

55. The Goods and Services Tax Act 1985 does not distinguish between racing and breeding activities. Therefore, a taxable activity could involve either or both racing and breeding. Whether a taxpayer is carrying on a taxable activity is a question of fact that must be considered in each case, taking into account the legal arrangements entered into and whether the taxpayer's subsequent actions support the stated intention.

56. However, the Commissioner's view is that a partnership that meets the above criteria will most likely be carrying on a taxable activity from the time of acquisition of the bloodstock. In particular, on the specific facts set out, the partnership is unlikely to be subject to the private recreational pursuit or hobby exclusion (in the absence of any additional facts that demonstrate that).

57. Where the partnership is carrying on a taxable activity, input tax may be deducted for any goods or services used or available for use in making taxable supplies (that satisfy the requirements of s 20(3C) of the Goods and Services Tax Act 1985). Therefore, the partnership would be able to deduct input tax on the cost of the horse and ongoing expenses in relation to the taxable activity as long as the legislative requirements (for example, holding the relevant tax invoice) are met.

58. The partnership must also return GST on any supplies that it makes (including race winnings and any bloodstock sold).

Draft items produced by the Office of the Chief Tax Counsel represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

In draft form these items may not be relied on by taxation officers, taxpayers, and practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

References

Subject references
bloodstock breeding
business
goods and services tax
GST
hobby
horses
income tax
partnership

Legislative references
Goods and Services Tax Act 1985: ss 6 and 20(3C)
Income Tax Act 2007: ss CH 1(3), CW 60, DB 49(3), DW 2, EC 39–EC 48 and HG 2

Case references
Calkin v CIR (1984) 6 NZTC 61,781 (CA)
Case K40 (1988) 10 NZTC 343
Case X28 90 ATC 276
Drummond v CIR (2013) 26 NZTC 21-023; [2013] NZHC 1,768
Grieve v CIR (1984) 6 NZTC 61,682
MR & SL Block v FCT (2007) ATC 2,735