NO HOBBY HORSE

Clients who run thoroughbred stud farms need to follow a complex maze of HMRC guidelines to protect any tax loss claims, says Julie Butler

The thoroughbred breeding industry has had a rough ride through the recession, exacerbated by the commercial problems facing the racing industry in recent years. The result has been, in some cases, large income tax loss claims. HM Revenue & Customs has been closely reviewing all tax loss claims related to thoroughbred horse breeding, especially when there is no history of profit and the tax relief is at 50%. These are difficult times for the trade, and before conditions improve, it is essential that breeders and studs have protection in place to preserve this relief.

Thoroughbred breeding can be an industry with a slow rate of return. You can't hurry the birth of a foal or its training. Accordingly, there are many breeders who think that they just have to make a profit from the trade by the 11th year when starting off in business, and then every sixth year after that. But though allowances are made for the long-term nature of the trade, to achieve the tax relief that is available there has to be proof of commercial motive in the breeding operation, and clear differences to separate a potentially profit-making business from the hallmarks of a hobby undertaking.

It is essential that breeders and studs have protection in place to preserve their tax relief

It is worth returning to the 1982 communication from HMRC to the Thoroughbred Breeders' Association (TBA), which stated: 'We have long accepted that the breeding of thoroughbred horses is such a long-term venture, and provided that a stud farming business is potentially profit-making, we would not normally seek to invoke section 397(1) until after 11 years from the start of the business' (but note that the Income and Corporation Taxes Act, ICTA 1988, s397, is replaced by the Income Tax Act, ITA 2007, s67).

There are a number of clear directions outlined in HMRC's statement. Firstly, the business must be 'potentially profit making'. A recent relevant case, *John Agnew* (TC566), was actually about a beautician's business, but the

key factor here was whether, within the existing structure, the business was capable of making a profit. There are two ways to prove whether potential profit exists: either by achieving an actual profit, or by showing that a profit can and will be made through accurate, well thought out business plans. There has to be a 'financial road map' for the breeding operation showing how the stud farm has learnt from its own specific mistakes, as well as from generic mistakes common in the trade and any problems arising in the bloodstock industry.

FARMING FOR TAX PURPOSES

There have been signs of recovery in the bloodstock breeding industry as a result of an equalisation of supply and demand in recent years. Primarily, this means fewer foals being born. But the onus is still on the breeders to manage their expectations through financial control, and these valid reservations must be reflected in their business plans. The breeders' calculation has to ensure that the full production cost, plus overheads, will be exceeded by the anticipated sales price, after allowing for production problems.

The HMRC statement refers specifically to a 'stud farm'. This involves land ownership and is different from a 'breeding venture', which does not involve land ownership but generally has boarding mares. The key tax point is that stud farming is 'farming' for tax purposes, and therefore can benefit from the various agricultural tax reliefs available to the farming industry.

Caution must be applied to the 'grabbing' of the extended hobby farming rules for a breeding business that is not essentially stud farming. Many small studs send their mares away to the stallion to foal down and they send the foals to be prepared for the sales – the lines can be blurred, but the exact nature of the business should be understood. There must be a stud farming operation to meet what are known as the hobby farming rules. When the hobby

farming rules were introduced in 1960, the (then) new clause was not designed to debar relief for stud farming, in which there is a view to the overall realisation of profit in the long term, or for any operation run as a serious business.

The tax case *Walls v Livesey* ([1995] STC (SCD) 12) looked at two tests that can be used to prove the commerciality of a business. The first test was that the farmer had neither purpose nor interest in following a course other than the realisation of profit, and the second test that he 'had been blown off course.'

In order to satisfy the second test there must be evidence to show that the problems facing the UK bloodstock industry directly impacted on his increased losses (or failure to achieve the anticipated profit).

BADGES OF TRADE

With regard to the first test, there must be evidence to show that there is no motive other than the realisation of profit. There has to be proof of the profit motive as evidence of one of the important 'badges of trade'. With the power of the internet and its potential for revealing contradictory statements through searches of Google or Twitter, it is essential that there are no quotes anywhere which might suggest otherwise. Indeed it is essential that there are quotes with commercial statements that clarify the desire for profitability as the prime motive. It is important to note that the judgment of profit to meet the 'hobby farming' rules is before capital allowances.

There are also provisions to restrict losses where the involvement in breeding is deemed to be non-active. The tax loss claim will be capped at £25,000 unless there is evidence of 10 hours of active involvement per week. Evidence of the work and involvement should be obtained, especially when the taxpayer making the loss claim has other commercial interests that demand time, making the 10 hours hard to prove. It could actually be easier to pass the 'actively engaged' test with a stud farm operation, as opposed to a breeding operation without land.

Following the principle in *Sharkey v Wernher* ([1955] 36 TC215), horseracing, that is to say owning race horses, is outside the scope of tax. In other words, it is not taxable. This is generally because HMRC regards the prospect of profit from racing to be too remote to be a taxable activity. In response to this state of affairs, HMRC may well attempt to combine breeding and racing activities in its classifications. The argument in favour of this would be that the breeding of horses is itself a hobby, and ancillary to the racing activities.

Many breeders who have not been able to sell their stock have been forced to put their horses in training in order to achieve stronger prices and this principle will be tested in the future.

TOP TIPS PROTECTING A TAX LOSS CLAIM

- Ensure there is a loss memorandum of the history of the tax losses, exact start date, amounts claimed and a summary of the reasons, split between stud income and other income
- Produce a business plan, budgets and regular management accounts that show a realistic profit can be achieved and how lessons have been learned from previous problems. Make it clear how anticipated production costs and overheads can be recovered in sales proceeds
- Keep a portfolio of evidence to show commercial intent, active involvement, lack of hobby status and motive, and how the focus is on profitability
- Look at alternative income streams against which overheads can be offset, eg, farming and woodland grants, renewable energy schemes, diversification with alternative land and building use
- Ask advisers such as bloodstock agents to give advice in commercial terms with monetary predictions of choices and alternatives

If the income tax loss claim is made when the first 11-year loss period allowed by HMRC has been exceeded, then the loss relief can be denied by HMRC. Likewise if the next six years' loss period has been reached, or there is little evidence of 'potential profit' being proved to be something that could ever have been achieved, then the loss relief could be removed by HMRC with a reclaim for income tax and penalties.

PENALTY-BASED SYSTEM

There is now a penalty-based income tax system, so if commerciality and potential profit cannot be proven in a farming business, loss relief will be denied with possible penalties. The structure, motive, business plans, stud accounts and computations will be reviewed.

The bloodstock industry underpins the racing industry and provides a great deal of employment. Over the last four years the British and Irish foal crops have showed a reduction of almost 40% from the peak of 2007 until 2011, and there is scope for improved profitability, but this might still take time to achieve and there must be documentary evidence for the reason for the loss. The income tax relief at 50% will be invaluable as part of the recovery process and it is essential that the relief is protected by proof of commerciality.

JULIE BUTLER FCA
Managing partner of accountancy firm Butler & Co and a specialist author on agricultural and equine tax issues. www.butler-co.co.uk