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## A Helping Hoof?

*Sponsoring racehorses can promote your business and qualify for tax relief – Julie Butler explains how*

**S**ponsorship is currently an essential element of the commercial viability of the horse racing industry. In 1994 owner-sponsorship was introduced into the sport of racing. The change allowed owners to be sponsored and the sponsor to advertise on the jockeys' silks and horse rugs, etc. Accordingly, the owner is in a position to benefit from the financial and fiscal rewards of well-structured and compliant sponsorship. All trainers are aware that 'tax breaks' for the owners can provide financial and emotional incentives to increase the number of horses in training. The whole of the racing industry is acutely aware of the need to keep owners happy .....

### Owning racehorses is 'tax free'

The ownership of racehorses is generally 'tax free' – that is to say, outside the scope of tax. This means that whilst winnings and profits on disposal of racehorses are not taxable, there is a balance in that the costs of training are not deductible. In the minds of HM Revenue & Customs (HMRC), racing is deemed to be a recreational activity, or in the case of a company a non-taxable activity.

Guidance is given in paragraph 55715 of HMRC's *Business Income Manual* and in *Sharkey [HMIT] v Wernher* (1955) 36 TC 275.

### Racing and the 'owner breeder' – is the cost tax allowable?

When is racing 'taxable'? For the owner breeder, racing is often an integral part of a stud farm's activities and should be taxed (and in balance achieve tax relief) as part of the breeding activity.

The arguments put forward for allowability are that for the future commerciality of the stud, the horse will need to be tested on the racecourse to determine whether it has the appropriate physical qualities such as speed, stamina and courage to justify the horse's retention for a breeding career. Where this can be demonstrated, a breeder's racing activities can be regarded as an integral part of his or her breeding trade for tax purposes; the expenses of racing become an allowable deduction; and winnings are taxable as trading income. HMRC accept more readily that fillies should be considered as 'tax allowable' as statistically a higher percentage return to their breeders' stud operations. But in all cases, HMRC look very closely at the evidence to support the justification.

The motive behind the training costs has to be considered. One of the key practical tax planning points here is to encourage the stud owner to keep records which differentiate between the activities of racing and stud ownership, to help the correct recording and apportionment of cost information. The question of why the owner-breeder chooses to race the progeny and not sell them could be asked.

As part of establishing the 'test of the racecourse' argument, it is important to ensure that the name of the Stud is also promoted and that the ownership of the horse is in the name of the Stud (as opposed to the individual owner) to give maximum promotion. The publicity angle of stud ownership will apply to the race card, publications, etc.

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### Racing – a high profile sport

Horse racing is currently a high profile sport and one that achieves maximum television coverage. Many companies use the vehicle of the racing industry to promote their services and products through advertising and sponsorship. The expenses incurred in connection with racing by companies which do not operate a racing or breeding trade can achieve tax allowability. Common examples of such expenditure include the company owning and running a racehorse through the medium of sponsorship and advertising. Claims for these types of expenses to be tax allowable are always examined with caution by HMRC.

### The private company

It may be more difficult successfully to claim a tax deduction for racing expenditure when the directors of the company themselves have a known interest or history in racing, particularly where it is in a private company. HMRC may argue that the expenditure has been incurred because of the personal interest of the directors rather than for the benefit of the trade (see below). There is also the risk that there may be a taxable benefit on the directors of the company where HMRC regard the company's racing expenditure as a benefit for the director. Such tax treatment is more likely to be promoted by HMRC where the company is a close company as defined by section 414, *Income and Corporation Taxes Act 1988* – that is to say, where it is more likely that a director-shareholder will be able to influence the authorisation to spend the company's money.

### Incurred for the benefit of the company's trade

The basic statement of the rule for the deductibility of expenses is found in section 74, *Income and Corporation Taxes Act 1988*. Here it is stated that expenditure will be deductible if it is 'wholly and exclusively' incurred for the benefit of the company's trade. In general, a company will be able to obtain tax relief for racing expenses (and conversely will be taxed on any race winnings). Where the detail of the expenditure can satisfy HMRC that this is incurred to promote the company's trade or business activity, for example by increasing awareness of its products, services and brands, then tax relief can be achieved. As already discussed, advertising and sponsorship may help satisfy this criterion.

### Sponsorship driven by the needs of the family

However, not all expenditure that benefits the company's trade will satisfy the 'wholly and exclusively' rule, as is illustrated by the Special Commissioners' decision in *Executive Network (Consultants) Ltd v O'Connor [HMIT]* (1995) SPC 056. The case concerned a recruitment agency which sponsored an equestrian business run by the wife of the majority shareholder. There was considerable evidence that the recruitment agency had been introduced to some of its major clients through a shared interest in equestrian competitions and sponsorship. Nevertheless, the Special Commissioners disallowed the expenditure. The relevant section of the Commissioners' decision is reproduced below:

'Here Mr Toms and his co-director, Mr Kemp, were witnesses of the highest integrity. We are entirely satisfied from their evidence that the sponsorship payments were laid out for the purpose of EN's trade. But, however hard we review the evidence we cannot displace from

our minds the conclusion that "personal benefit" played a part in the decision to make the sponsorship payments. The benefit to Mrs Toms' trade was more than an incidental result of the expenditure. The decision to fund Mrs Toms in year 1 in her stocking-up with competition horses must, we think, have been a joint decision of both Mrs Toms and Mr Toms in which the long-term capital requirements of her personal business were a key ingredient. The decision to provide part of the cost of Mrs Toms' new horse box in year 4 was another decision to lay out funds for the purpose of her business. The annual decision as to the quantum of the sponsorship was, once again, directed as much at the needs of Mrs Toms' business as at the benefits obtained from sponsorship. It seems to us, therefore, that the non-trade purpose (from EN's point of view) of benefiting Mrs Toms' business coupled with the furthering of the children's equestrian careers can properly be described as conscious motives of the decision-makers so far as concerned the decision to make the payments with which this appeal is concerned .....

'Even if we were wrong so far, we would still be against EN. It seems to us that the non-trading result (i.e., funding Mrs Toms' business as distinct from EN's) was a result that was so inevitably and inextricably involved in the sponsorship activity that the result must have been a purpose of the activity .....

Even if the motive to provide funding for Mrs Toms' business and for advancing the equestrian careers of the children had not been a conscious motive (which we think it was), it was we think inescapably one of the objects for incurring the sponsorship expenditure.'

The point of interest is that, although the sponsorship was for the *benefit* of the business of Executive Network, the *motivation* for the expenditure was private.

### Advertising the company's products or services

A company will only be able to claim a deduction for the cost of keeping and training a racehorse (or a number of racehorses) if it can show that the expenditure is for the purpose of promoting or advertising the company's products or services. The ability to claim tax relief will be dependent on the facts. In circumstances where the expenses are deductible, any prize money from the horse will be taxable. In any case, the cost of purchasing a horse is unlikely to be deductible since it represents capital expenditure, but tax relief is achieved should the horse be written down to a much lower value (which is too often the case in racing).

The factors to be considered when trying to determine whether advertising expenditure is incurred 'wholly and exclusively' for the benefit of the trade include:

- Is there evidence that the horse is being used for advertising purposes? (Where the horse is named after the company or its products, then the expenditure is more likely to be accepted as advertising.)
- What is the purpose behind the expense – is it to provide a corporate entertaining package or is it genuine advertising? What do the Board minutes and authorisation documentation set out with regard to the expenditure?

- What is the form of the advertising and is it in keeping with the company's size, structure and image? Is it part of a comprehensive marketing and 'PR' strategy?
- Is the amount spent reasonable in relation to the benefits claimed from the advertising or promotion? What is it as a percentage of the company's total advertising spend?
- Is the advertising likely to generate more business and has the decision to advertise in this way been based on commercial principles? Can such an inflow of new business be demonstrated by the facts?

### Proving business promotion through racing

It will be essential to support the arguments for the promotion of the business through racing with facts – statistics, company Minutes, marketing reports, documentation of authority for expenditure, etc.

However, as the *Executive Network* case shows, it will not of itself be sufficient to show that sponsorship has introduced important customers or significantly increased sales. The company will have to show that the decision to sponsor was taken wholly on commercial grounds.

### Racehorse sponsorship v advertising

As already mentioned, in 1994 owner-sponsorship was introduced into the sport of racing. The change allowed owners to be sponsored and the sponsor to advertise on the jockeys' silks and horse rugs, etc. Before entering into any sponsorship agreement, companies should consider how the agreement can best be structured for tax, so that the maximum relief is obtained for the company. Claiming a deduction for a sponsorship payment should be no different to claiming a deduction for advertising expenditure, if the structure is correct and the documentation is in place.

### Sponsorship criteria

In structuring sponsorship agreements there are a number of basic principles which should be followed, as set out below:

- It is helpful if the horseracing sponsorship is not the only promotional activity and that it forms just one part of the company's programme. It is essential that the reason for the sponsorship is documented beforehand, for example in the minutes of the company's Board meetings.
- The sponsorship expenditure should be revenue in nature in the hands of the payer, since no deduction will be given where the company is incurring expenditure of a capital nature – for example, fixed assets such as the acquisition of a racehorse, or a share in a racehorse. It is for the recipient to decide how the money should be spent and even if the recipient chooses to use it to acquire a racehorse, the expense to the company of keeping the racehorse should still be deductible as a revenue item. This can present quite a nightmare for the company auditor in carrying out the tests between capital and income.
- The main benefit of the sponsorship expenditure must be to the trade or business activity of the company, and the company needs to show that the sponsorship payment falls into the same category as its normal marketing and

promotional activities. A deduction will be available if the company can show that the sole purpose of the payment is to help market the company's products and services and that any benefit to horseracing is incidental. This is not a principle that the horse racing industry might support or enjoy.

- The sponsorship agreement for racehorses and race meetings should be held by the trading company whose trade is to benefit from the sponsorship and not, for example, by a non-trading holding company of the group. Where a horse or race is to be named after the company, it should be named after a trading company rather than a holding company and the sponsorship should have a clear benefit to its trade or business activity.

### The question of corporate entertaining

A benefit to a company of sponsorship is that it may provide a structured corporate entertaining package, for both staff and clients. A company will only achieve a tax allowable deduction for entertaining expenses if it relates to the entertaining of staff (although the staff could then face personal tax liabilities). Sponsorship deals that include an entertaining package should be carefully structured and recorded so that the entertaining element, if any, can be separately identified and the size of any disallowable expenditure identified. It may be preferable to agree an allocation of cost, showing the element which relates to entertaining, with the provider of the package, rather than leave it to HMRC to suggest an apportionment on a basis which would disadvantage the company. It is essential that good, cross-referenced book-keeping clearly identifies the difference between client and staff entertaining.

### Rewarding of staff

The difference between entertaining clients and rewarding staff is significant for tax purposes – that is to say, the size of the company's tax bill! Where an employee is involved in entertaining clients, then this is counted as client entertaining and the company will not achieve tax relief for the expense. There will also be no benefit taxable on the employee where the employee is entertaining clients and is not there purely for his or her own pleasure. Where the company is solely entertaining employees, for example by paying for a day at the races, the company will be able to claim a tax deduction for the expense but the employee will be taxable on the benefit received (unless the 'staff party' exemption provided by section 264, *Income Tax (Earnings and Pensions) Act 2003* applies).

### Summary

There are many ways of achieving tax efficiency through racehorse sponsorship. The key is review, planning, structure and documentation – as with any tax planning there are judgment calls to be made by the tax adviser and the rules have to be explained to the client at an early stage.

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