Over the jumps

JULIE BUTLER and **LUCY KNIGHTON** consider equine stock valuation for tax purposes.

The principal guidance from HMRC for equine stock is in *HS232 Farm Stock Valuation 2017* (tinyurl.com/y95n9yxw) and the *Business Income Manual* at BIM55710 (tinyurl.com/yaraj2vc). For a stud farm to be treated as agriculture it must be carried out in conjunction with the occupation of the land, whether freehold or leasehold. This is not the case if mares are boarded at stud for a keep fee and, as such, the mare owner is not carrying out an agricultural activity.

The valuation of stock is complex and the wrong workings can result in the incorrect calculation of profit or loss. Equine businesses should prepare an annual reconciliation of opening and closing stock and the movements between. First, there are foals, most often born in the spring. Then yearlings, who the next year become two year olds and so on.

When considering each category of potential valuation, remember that the 'deemed cost' will be needed if accurate figures are not available. For example, the cost of keep of each category may need to be included. However, the 'lower of cost and net realisable value (NRV)' rule applies so, if an animal has problems that place the value *below* cost, this must be considered. All stock valuations must be consistent and accurate so that they are not manipulated for the benefit of the taxpayer.

The general rules, under BIM55710, state: 'Except where the herd basis has been adopted, both stallions and mares should be dealt with as stock in trade and valued individually at the beginning and end of each year in accordance with relevant GAAP on the usual basis of (i) cost or net realisable value (see BIM55705), whichever is the lower, or (ii) at fair value less costs to sell where FRS 102 or IAS 41 are applied. Stock valuations should also include any foals and, where appropriate, stud fees paid (see below).

'In the case of stallions (but not mares) a rule-of-thumb method of valuation, whereby the cost of the animal is written off by equal annual instalments until it reaches the age of 10, is acceptable. This method is an attempt to arrive at an acceptable figure for net realisable value where this is less than cost. It is not appropriate in either of the following circumstances:

KEY POINTS

- The importance of annual valuation of animals.
- Stock valuations must be consistent and accurate.
- Foals should normally be included in the valuation at cost.
- Equine stock valuations can produce tax refunds.

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- where a better figure is available because the animal is valued at the balance sheet date,
- where it would give an unreasonable result. For example, in those exceptional cases where the value of an animal increases, or drops at a rate significantly slower than that used in the rule of thumb, because, for example, of very successful progeny, the figure computed using the rule of thumb should be increased to an amount not exceeding cost.'

Importantly, market value cannot be used unless this is to identify the NRV.

Stud fees, foals and yearlings

The *Business Income Manual* at BIM55710 says: 'The stud fee or "nomination" fee paid by the owner of a mare for the services of a particular stallion can be a substantial sum. Unless:

- the mare has already given birth to the foal, or is known not to have conceived, or has aborted, by the accounting date; or
- an "adjusting event" (see BIM33140) occurs – for example, the discovery between the balance sheet date and the date the accounts were finalised of a congenital defect rendering the foal valueless;
- the fee paid should be reflected in the balance sheet by one of the following methods:
  - including the fee in a stock valuation of the embryo or foetus of the foal;
  - increasing the value of the mare while she is carrying the foal by the amount of the fee;
  - carrying forward the fee as a prepayment.'

Foals should normally be in the stock valuation at cost including the stud fee, the depreciation of the mare and the cost of keep to date at the year end. If the foal has any defects, the net realisable value at each year end must be considered.

The value of the foals should be increased each year by the cost of the keep. Industry standards have been agreed, with £75 a week being the guidance from *The Thoroughbred Breeders' Association Bloodstock Taxation Guide* (tinyurl.com/yb3uzfao). However, different methods can be used if the reasoning and basis can be evidenced. Again, it is important that net realisable value is considered so that, if the cost of production is greater than net realisable value, it must be included at the lower figure.

Breeding stock and tax planning

The equine industry is unique with stud stock values more volatile than teenage fashion. Outside factors, such as the racing achievements of animals from associated bloodlines, have a dramatic impact and keeping stock fit, healthy and free from injury is a problem. However, although some may view equine stock valuations as an unimportant paper exercise, they can produce tax refunds resulting from the tax losses that arise.

If, potentially, valuable equine stock is held at cost, the timing of the profit can be planned around the sale. However, if a disaster awaits in the form of a valuation fall, it can be realised as soon as possible by reflecting this appropriately in the stock valuation. This will accelerate the tax loss or reduce the taxable profit.

The stud farmer must therefore take full cognisance of the importance of year-end stock valuation for the bottom line. The timing of the sale of good and bad stock is critical, as is the timing of any transfer to racing. Owners and tax advisers alike need to give apposite weight to this subject because, often, it will determine exactly when a profit is achieved. As with all tax planning issues, however, commercial common sense should take priority such that, when a good sales price can be achieved, it is very likely that the adviser may need to accept that the owner will ignore the tax planning advice given previously.

It is also important that business owners understand the 'lower of cost and net realisable value' rule because many owners will look to increase the value of their horses based on the successful results of the bloodlines. However, if the cost is not there to support these higher values the valuation cannot be increased above this. Stock valuations cannot be used to falsify profits for the purposes of arguing commerciality with HMRC.

Because stock values affect the taxation position considerably, HMRC tends to examine them closely and it may be worth seeking a written independent valuation in some cases.

Racing is 'outside the scope of tax'

In *Sharkey v Wernher* (1955) 36 TC 275 it was agreed that the racing of horses is 'outside the scope of tax'. Each operation must be looked at case by case and BIM55715 says: 'If the occupier of a stud farm races animals bred by him or her:

- The stud farm accounts should be credited when animals are transferred to training with the then market value of the transferred animals, under ITTOIA 2005, s 172D and CTA 2009, s 157. This is the statutory enactment of *Sharkey v Wernher*. When animals return to the stud farm after racing, the stud farm accounts should be debited with their market value, at the time of return, as if they had then been purchased at that value (ITTOIA 2005, s 172E and CTA 2009, s 158).
- If an animal purchased and not bred on the stud farm is brought into the stud after racing by the occupier, the stud farm accounts should similarly be debited with the then market value of the animal as if it had then been purchased at that value.

'The same treatment should be applied to a person who is a dealer in thoroughbred animals bred by him or her but on a stud farm occupied by some other person.

'If a breeder transfers an animal to training and it is then returned to stud at a higher value after a successful racing career then the uplift in the market value whilst it was in training is tax-free. Furthermore, the value at which the animal is returned to stud is relieved over the rest of its life. The valuations of animals at the dates of transfer to or from training are, therefore, significant.'

Sports horses or race horses

Artificial insemination (AI) or embryo transfer are prohibited by the rules of racing, although used routinely in other areas of equine sport. Through AI, stallions can compete at the same time as being used at stud, although even those used for natural covering on mares can be frequent competitors too. Good-performance mares in show-jumping, eventing and polo can also continue to compete while their genetic offspring is developing in another mare by way of in vitro fertilisation.

If the stud has sports horses competing at the same time as their breeding activities, it can be argued that competing expenses should be treated as wholly and exclusively incurred for business purposes. This is on the basis that it is the current performance in competition of a sports horse stallion and the quality of its offspring, rather than its breeding, that determines the number of mares being sent to it. It is very important that the business plans can show the commercial benefit and correlation between competition expenses and improved trading results.

The adviser must understand into which category their equine client falls – bloodstock, sports, competition or stud – and ensure the ground rules for accounting and tax treatment are established. Matching of costs and forensic analysis is essential with all horse trading operations. Consistent treatment of private horses through the examination of expenses and valuation of stock is key.

Open market valuation

Requests for specialist advice on open market valuations of thoroughbred horses can be made to the Bloodstock Section, Shares and Assets Valuation, Ferrers House, Castle Meadow Road, Nottingham NG2 1BD. and should include: the name(s) of the horse(s) to be valued; the valuation dates; and any opinion of open market value together with reasoning.

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