

Tax Attack on Duality

Julie Butler looks at tax planning for the sports horse

The horsey culture is a thriving UK industry. The dream of the equine enthusiast is to extend the passion (and what might have started as a simple hobby) into a commercial activity. Equine business clients (and moreover potential equine business clients) can be found in every UK accountancy practice. Accordingly, practitioners need to be aware of some current tax issues.

The tax planning surrounding the thoroughbred racehorse has a superb history of tax direction. There is a plethora of tax cases defining (or helping to define) the tax position of this valuable creature and the significant businesses which make up the industry, but what about other areas of equine tax? For example, the sports horses – the eventer, the show jumper and the dressage horse.

Wholly and exclusively

One problem that has recently come to the fore is that HMRC has difficulty in accepting that expenses related to horses taking part in competitions (for example, dressage, eventing, show jumping) are incurred wholly and exclusively for the benefit of an associated business which sponsors the activity. In tax law this goes back to the concept called 'duality of purpose', where HMRC effectively try to argue that if someone enjoys what they are doing, any expenses associated with the activity are disallowable. HMRC generally believe that many equine businesses are an attempt to achieve tax relief for the costs of a hobby. HMRC try to deny expenditure on the grounds that the taxpayer obtains private enjoyment from the expenditure.

HMRC have historically been concerned about duality of purpose and personal benefit. However, horses being competed professionally, which are either for sale or being used for breeding purposes, should not pose a significant problem provided income and commerciality can be shown, as they will be able to display the 'badges of trade'.

Duality of purpose

The concept of duality can be explained by *Mallalieu v Drummond [HMTC] [1983] 57 TC 330*, where the black clothing required for a barrister's appearance in Court was held to be needed for the more conventional use of clothing the body as well.

The legislation that defines the allowability of expenses was contained in section 74, *Income and Corporation Taxes Act 1988*, but is now in section 34, *Income Tax (Trading and Other Income) Act 2005*. Under this section, if an expense is incurred for more than one purpose, say for business and for pleasure, then no deduction for the business proportion is allowed. The problems arise where HMRC believe that personal pleasure is being derived from owning and working with horses.

Mr McQueen, the successful rally driver

Good news for competitors with sponsorship arrangements! A recent tax case *McQueen [2007] UKSPC SPC00601* (19 March 2007) has ruled it is all about the winning – winning new clients or customers that is. The decision in this case has

resulted in a helpful and favourable outcome for those involved in commercial sponsoring of competitors in sporting activities. In *McQueen* it was shown that the marketing advantage was not vague and uncertain but was clear and successful. There was evidence to demonstrate a direct correlation between sponsorship and the gaining of new customers.

Mr McQueen was a good rally driver and he chose to publicise his 'bus and coach business by sponsoring a rally car which he drove with success. The rally car was painted in the colours of the coach business and was generally high profile – for example it was parked outside the business premises in Garelochhead and apparently easy to see in that part of Scotland. The question was whether the expenditure on sponsoring the rally car was incurred wholly and exclusively for the purposes of the business or whether there was a duality of purpose. HMRC argued that this was Mr McQueen's way of indulging his interest in rallying and the business purpose was incidental.

Promoting the business

The Special Commissioner decided against HMRC by concluding that the whole of the expenditure was incurred for the purpose of benefiting the coach business by the promotion of its name and the facilities it offered. The fact that it gave Mr McQueen satisfaction was merely a consequential and incidental effect of the expenditure. The Commissioner stated that: 'Mr McQueen was using his skill and enthusiasm for motor rallying as the best means available to him for promoting the Garelochhead Coaches business.' Accordingly the expenditure was laid out wholly and exclusively for the purposes of the coach trade and was fully deductible.

This may seem like a surprising decision because many have tried and failed in this area before. There was evidence demonstrating a direct correlation between the sponsorship and the gaining of new customers. It may be that in another case such a correlation would not be so clearly established but it certainly looks like a very helpful decision for the taxpayer.

Can equine enthusiasts prove such promotion? It would be difficult to paint the horses in the company's colours, but what about pictures of the horses on the sides of the company's vans?

Purpose and effect

In *McQueen*, the Special Commissioner's view was that the expenditure had been incurred for the purpose of promoting the business and getting business names and vehicle liveries into the public awareness. Although the taxpayer gained some personal satisfaction from competing in rallies, his preferred leisure activity was sailing rather than rallying and the private satisfaction of success on the rally circuit was an incidental benefit of the expenditure, rather than its purpose.

It has been argued that it is the purpose that matters, not the effect. In many cases, although there has been a benefit for the business, the taxpayer could not demonstrate that the main purpose was anything other than for private benefit.

A sponsorship type of arrangement has to be able to prove both the purpose (to promote the business) and the effect,

which in Mr McQueen's case was a direct correlation to sales. Can the trader show more sales as an effect of the sponsorship?

A view to a profit?

Moving away from the sponsorship scenario, where the equine activity is subsidised by an associated business, the other area where HMRC are currently taking a very keen interest is that of horse businesses which do not produce a profit. This is especially the case where the proprietor has other income, against which he or she wishes to set the losses incurred on the horses. The relevant legislation is now contained in section 64, *Income Tax Act 2007* onwards. Section 384, *Income and Corporation Taxes Act 1988* has been replaced by section 66, *Income Tax Act 2007*.

There are therefore two tests to be proven. One that the business is being carried on with a view to profit and two, that it is commercial. To quote HMRC in *Business Income Manual* paragraph 75705, itself quoting from a Minister's statement to Parliament: 'We are after the extreme cases in which expenditure very greatly exceeds income or any possible income which can ever be made and in which, however long the period, no degree of profitability can ever be reached.'

Sideways swipe

Revenue & Customs Brief 18/07 (issued 2 March 2007) ushered in a new swipe at sideways loss relief: relief is limited to the first £25,000 of losses each year, unless the claimant works for an average of at least 10 hours a week in the loss-making business. This is likely to be a particular problem for breeders – establishing a stud is a long-term project – though in reality the non-racing studs are likely to have less problems through this latest Brief as the owners tend to invest more blood, sweat and tears than financial contribution. Another point to watch is that the restriction applies only to loss relief claims by partners – sole traders are not affected.

There is still the requirement that the business should be potentially profitable. Can the non-racing studs produce a business plan that shows a profit? Can the potential sales proceeds cover not just the direct costs (nomination fees) but also the overheads? Can the business contribute to the projected profits with other income streams? Sponsorship? Liveries? Would the diversification from the stud core trade of breeding (which qualifies as husbandry for tax purposes) jeopardise the agricultural reliefs?

The competitive sports horse

It must be noted by the practitioner that in the 'sports horse world' (eventing, dressage, show jumping, showing, endurance riding, arab racing, etc, etc) there are different rules of breeding to the Thoroughbred bloodstock industry.

The rules in racing prohibit using artificial insemination (AI) or embryo transfer. In other areas of equine sport, AI is routinely used, meaning that stallions compete at the same time as being used at stud. Even stallions used for natural covering on mares frequently compete in the 'sports horse' world and have a dual purpose, and so potentially conflicting treatment for tax. Do the stallion rules apply or the competition horse rules?

Embryo transfers are used for good performance mares in show jumping, eventing and polo, where the mare continues to compete while her genetic offspring is developing in another mare via *in vitro* fertilisation.

Consistency of treatment

This creates some interesting accounting and tax considerations and it is essential that the practitioner understands how the client operates. One of the biggest challenges is the stock valuation, for example how to treat the stallion and how monies spent and received on AI are treated in the accounts. The Thoroughbred racing industry has more definition through tax cases and Inspectors' Manuals. There is greater flexibility for the sports horse but the treatment must be consistent.

Show jumping and the joys of ownership

The basic principle of *Sharkey v Wernher* (1955) 35 TC 375, that ownership of horses is tax free and any profits and losses are outside the scope of tax, is something that has been enjoyed by the show jumping industry. But the business of show jumping can be run commercially – prize money, sale proceeds from improved horses, basic dealing profits, training for pupils, sponsorship, etc, can all result in a business plan that will show a profit and genuine trading surpluses exist. The underlying overheads of show jumping can be less than eventing – perhaps the cost of just one discipline, not three, helps.

It is perhaps a total mystery to those who live outside (and inside?) the world of eventing as to why that sport cannot achieve commerciality. Most competitors have to pay to compete and it is almost impossible to achieve a financial return from attempting to be a professional eventer! Yet Badminton Horse Trials attract more spectators than almost any other European team event and our British competitors are always successful at winning team and individual medals. Why can that success not be reflected in a commercial return? Are the costs of producing the horses and the events too high in relation to the income streams? Are world TV deals missing? Perhaps the absent ingredient of gambling is a disadvantage to the sport!

Tax free ownership and transfers

Some clever but well-balanced tax planning has been achieved with horses sold outside the business before they reach their full potential for success and profitability. 'Tax free' ownership profits have been made (compared to £ millions of 'tax free losses!'). This system must not be abused. Any transfers or sales must be at a true market value (as set out in *Sharkey v Wernher*) and convenient retrospective transfers are basically tax fraud.

Cynical transfers of prime prospects from the core commercial business to, say, family members, purely to move the animal from the taxable to a non-taxable environment will be subject to severe attack by HMRC. There are genuine examples where racehorses, eventers and show jumpers are transferred to family members from the 'training business' to keep overheads reduced. Full documentation of when, how and why must always be kept, especially the basis of calculation of market value, which should ideally be carried out by an independent valuer.

Julie Butler FCA is Managing Partner of Butler & Co, Bowland House, West Street, Alresford, Hampshire, SO24 9AT (telephone 01962 735544, e-mail j.butler@butler-co.co.uk, website www.butler-co.co.uk). She is the author of 'Tax Planning for Farm and Land Diversification' (2nd Edition) and 'Equine Tax Planning'. To order a copy of either book, call Tottel Publishing on 01444 416119.