

THOROUGHBRED BREEDERS

Australia

2 November 2009

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600
Dear Sir/Madam

Inquiry into: the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009

Thoroughbred Breeders Australia (TBA) welcomes the opportunity to provide comments on the abovementioned legislation designed to amend certain aspects of the existing non-commercial loss (NCL) provisions.

TBA was founded in 1919 and is the peak national body for all thoroughbred breeders in Australia. It is a registered company comprising of two representatives from each state and from Aushorse Ltd.

TBA advocates the interests of breeders with State and Federal Governments, racing, veterinary and associated bodies throughout Australia. It initiates campaigns both within and outside the industry on the economic, social and cultural importance of the Australian Thoroughbred.

TBA represents all breeders regardless of their size on issues of relevance and importance to their commercial businesses.

TBA is recognised as the industry's peak body by the Australian Government, the Australian Racing Board, the Australian Horse Industry Council, the Australian Stud Book, Austrade, State governments and by all State principal clubs.

Naturally, a particular focus for TBA in reviewing legislation is on its implications for horse breeders throughout Australia. For the purposes of this submission, TBA also represents the views of its State organizations.

We include as an appendix to this submission a background as to the nature, size and significance of the Australian thoroughbred industry. The economic contribution by the Thoroughbred industry to regional as well as national economies is significant and immensely important in job creation.

GENERAL COMMENTS

In our view the legislation will have an adverse affect on the Australian Thoroughbred breeding industry as some breeders will reduce their investment in the industry while others will exit the industry altogether. It will also serve to discourage new entrants to the industry.

We believe that the consequence of the legislation, which appears aimed at quarantining losses incurred by high net worth individuals conducting “hobby-type” activities but in reality has cast a much wider net and will impact larger commercial and legitimate businesses. This will occur because regardless of the size and scale of the business; be it cattle farming, horse breeding or share trading, if a tax loss is returned in any year it will be quarantined if the \$250,000 adjusted taxable income threshold is exceeded.

These consequences are further illustrated by providing some indicative real examples, on an anonymous basis, highlighting our concerns.

In each of these examples, the taxpayer has annual adjusted taxable income in excess of \$250,000 on a continuous or frequent basis and has limited restructuring options available to them.

EXAMPLE # 1

Taxpayer is a Partner at a Big 4 accounting firm in Melbourne. He has slowly but surely been increasing his investment in breeding stock by purchasing fillies. Some of these fillies are approaching the end of their racing career and are ready to retire to the breeding barn. He has built up strong networks and industry knowledge over a number of years. His horse activities are currently treated as a hobby for tax purposes.

However the intention has always been to eventually convert to a business armed with a suitable business plan requiring more significant purchasing of bloodstock e.g. quality broodmares, perhaps a property. The business plan forecasts a profit but due to the nature of the industry this may take 5-7 years. During the earlier years after business commencement, it is understood that the availability of tax deductions will assist with working capital requirements. The investments in the Australian breeding industry over a 5 year period are forecast to be between \$1m – \$3m. Uncertainty will exist for this taxpayers’ tax status due to the proposed changes to the NCL provisions. Accordingly, this individual will definitely not proceed with his planned investment in the Thoroughbred breeding industry.

EXAMPLE # 2

Taxpayer’s main source of income is from other business investments. Existing breeder based in Victoria. Commenced breeding business in 2003. Investment in horse industry to date totals \$9m. Horse business is held in his personal name. He has not achieved a tax profit to date mainly due to some unforeseen circumstances. Underlying bloodstock market value is significantly higher than tax value. For that reason alone, would expect profits in the future but not until realisation of breeding stock.

Availability of tax losses in personal name have assisted funding of breeding activities. Breeder is uncertain as to continuing of business in current form due to proposed changes. This would also result in the demise of smaller trainers, farriers and stable hands who are reliant on this enterprise.

EXAMPLE # 3

Taxpayer's main source of income is as an employee of a major sales and marketing company. Also existing breeder based in Victoria. Commenced breeding business in 2002. Investment in horse industry to date would be in excess of \$1 million. Horse activities held in personal name. Extensive knowledge in horse industry especially bloodlines. Relies on tax deduction to partly fund horse operations. I.e.: reinvests tax refunds to upgrade bloodstock e.g. pay service fees. Strong possibility that he will exit the horse industry.

EXAMPLE # 4

Taxpayer's main source of income as an employee at major IT firm. Existing breeder based in Victoria. Commenced breeding business in 2007. Investment in horse industry to date would be circa \$1m. Horse activities held in personal name. Extensive knowledge in horse industry especially bloodlines. Would dedicate 15-20 hours per week to horse breeding business. Relies on tax deduction to partly fund horse operations. He is uncertain as to his future in the industry due to the new tax laws. Is a possibility to leave the industry entirely.

EXAMPLE # 5

Taxpayer is former director of one of the major Australian banks. Although in semi retirement, he continues his role as director of a number of entities. In 2005, he commenced a breeding business. Investment in horse interest to date is in excess of \$3 million. In process of transferring business from a sole trader to a partnership. Devotes a large amount of time and resources to his horse business and is extremely commercial minded, as to purchases and culling. Has a number of promising stallion and broodmare prospects. Is likely to continue in industry but is tired of constant Tax Office attention.

EXAMPLE # 6

Taxpayer is former director of a number of the major Australian mining companies. Although in semi retirement, he continues his role as director of a number of entities. He has been involved in the breeding of horses from a property in the Hunter Valley for a number of decades. He bred the winner of a recent Melbourne Cup. Investment in horse interest to date would be in excess of \$5 million. Devotes a large amount of time and resources to his horse business. May look at exiting horse industry due to the announced legislative changes.

EXAMPLE # 7

Taxpayer runs an extremely successful investment and wealth management company. Commenced breeding business in 2001. Investment in horse industry to date would be in \$2 million range. Operates in a partnership with his wife. It appears that he will exit the industry as a result of the budget announcement.

EXAMPLE # 8

Taxpayer is former owner of a successful manufacturing company that was taken over by a listed company in the late 1990's. Proceeds of this sale were used to develop a state-of-the-art training and breeding centre in Victoria, with the business commencing as a partnership of individuals in the 2000 financial year. Property would be valued in excess of \$10 million and livestock holding is in similar range. Operating costs are in excess of \$200,000 a month and annual wages are in the \$800,000 range. With the large depreciation writedowns available on the property, plant and equipment and livestock (horses), a tax loss often results. The taxpayer has a significant share portfolio and from time to time sells down shares to fund the operation, if required. If a taxable gain in any year exceeded \$250,000, the loss would be quarantined.

We believe that these examples are representative of an industry so diverse in its mix of participants. These people may be viewed as high income individuals, but they should also be viewed as entrepreneurial and contributing significantly to the economy.

SPECIFIC COMMENTS**1. Uncertainty and extra compliance costs**

The main impact of the legislation on Thoroughbred breeders will be increased uncertainty as to their tax position and the burden of extra compliance costs having to justify their tax position.

1A Uncertainty

We believe that the introduction of the income requirement test to the NCL provisions will have far reaching, adverse consequences.

As noted in the examples above, many Thoroughbred breeding businesses rely on tax deductions to partly fund their operations in the "start-up phase". The use of such deductions is often fundamental in providing adequate working capital to trade through the "start up phase" that has a lag period of between 5-10 years. Such businesses are viable but due to the very nature of the horse industry, profitability is often delayed. Furthermore the underlying asset, being the livestock (horses), anytime after commencement may have a market value that exceeds cost. This unrealised profit can be deferred for many years delaying the profitability of the business.

We note that in the legislation, the amendments provide the Commissioner with a new discretion in cases where an individual does not meet the income requirement. Practically, a breeder operating as a sole trader or individual in a partnership with adjusted income greater than \$250,000, may apply to the Commissioner for relief if their business is objectively assessed as being genuinely commercial. This discretion is welcomed however; we believe that breeders will continue to face uncertainty as to their tax status and consequently the availability of their deductions. Many businesses will be active and needing to commit resources long before the outcome of the Commissioner's new discretion is known. For instance, a breeding business commencing in July 2009 will not be able to request the Commissioner's discretion until after the conclusion of the financial year being 12 months later. With this uncertainty, the taxpayer may not be as willing to commence the business, to the detriment of the economy.

It is also not clear in the legislation if the Commissioner's discretion can be relied on for future years. In other words, does the breeder need to request the Commissioner's discretion each and every year that he or she does not pass the new "income requirement test"?

Furthermore, if a taxpayer seeks a private ruling as to the business status of their breeding activities, will this override the need to request the Commissioner's discretion in the NCL provisions or will this provide no further certainty as to where they are placed regarding the new NCL income requirement?

1B Compliance costs

It is stated in the legislation that the compliance cost impact will be "low". We disagree with this assessment and expect the compliance cost impact for relevant taxpayers to be "high".

The new income requirement test means that genuine, commercial horse breeders will need to justify their commerciality. When requesting the discretion of the Commissioner, taxpayers will need to obtain an independent expert report that confirms that their business is genuinely commercial. Such a report or evidence from experts is likely to cost the taxpayer many thousands of dollars together with many hours of personal input and coordination of the process. This process may need to be repeated for a number of years in succession due to the nature of the Thoroughbred industry where a genuine lag period exists.

2. Request on behalf of Thoroughbred breeders in Australia

In light of our concerns expressed above, we request that the Committee consider the following alternatives in order of preference;

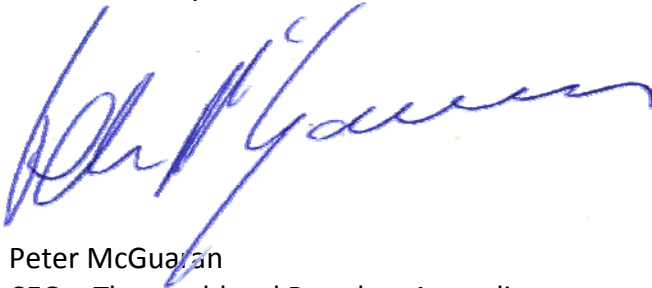
1. Abandon the changes entirely;

2. Remove the real property test (\$500,000) of the original NCL provisions rather than introducing the new income requirement test (\$250,000). Our interpretation of the Federal Government's commentary as to the reason behind these changes is that high net worth taxpayers have been able to satisfy the NCL provisions, in particular the real property test, regardless of the commerciality of their business. With the strength of the property market over the last 10 years, it may be that this provision has become an ineffective measure of a business' commerciality. Therefore, we would recommend the removal of this test, rather than the introduction of an arbitrary income level test; or
3. Provide greater certainty around the Commissioner's Discretion that is outlined at subsection 35-55 (1) (c), by allowing a type of "business passport" for breeders. Taking into consideration the lag period and nature of the horse industry, the Commissioner could provide a breeder a private ruling based on their unique circumstances that they can rely on for a period of say 5 years and produce as evidence that a business exists. This "business passport" could be produced during the relevant period if the "business" status of the breeder is ever questioned by the ATO, whether it is these amended NCL provisions or other areas of tax law eg: GST. The "business passport" would be similar in concept to a motor vehicle log book except that the Commissioner would need to endorse the request for a "business passport". In the year leading up to expiry, the taxpayer would be able to apply for an extension of this passport, if required. This recommendation would remove the uncertainty and reduce the ongoing compliance costs as the two issues raised above highlight.

3. Summary

Under this proposed legislation, genuine Thoroughbred breeding businesses face inherent uncertainty as to their tax status. Together with "high" compliance costs to substantiate their business, many Thoroughbred breeders will be forced to weigh up their involvement in the horse industry. We predict that there will be loss of jobs attributable to the new \$250,000 income requirement test as many legitimate investors in the Thoroughbred industry either exit the industry or reduce their investment. .

Yours sincerely,



Peter McGuigan
CEO – Thoroughbred Breeders Australia

APPENDIX

THE SIGNIFICANCE & CONTRIBUTION OF THE AUSTRALIAN THOROUGHBRED INDUSTRY

A1 Size & Scope of the Australian Thoroughbred Industry

The Australian racing industry is a major economic activity which makes a significant contribution to the national gross domestic product, employment and government revenue. The economic activity generated by thoroughbred racing and breeding alone contributes more than \$5 billion to the national GDP and is the fourth largest industry in Australia ¹.

A2 Globalisation & Exports

Over the last 10 years, the Australian Thoroughbred industry has benefited enormously from the globalisation of the industry and the high regard in which the Australasian racing & breeding industry is held internationally.

Australia exports up to 2,000 breeding and racing stock annually to the value of approximately \$64m.

In recent times, Australasian bred horses have performed magnificently on the world racing stage which has led to increased sale of Australian horses in these markets.. Some of these performances include:

- “Choisir” – winner of a Group One sprint (Golden Jubilee, 1200m) and a Group 2 sprint (King’s Stand Stakes, 1000m) in England during the 2004 racing season;
- “Elvstroem” – winner of the Group One “Dubai Duty Free” at Nad Al Seba in March 2005;
- “Alinghi” – winner of the Group Three “Balston Spa” in New York in August 2005;
- “Takeover Target” – winner of Group Two “King’s Stand Stakes” at Ascot in June 2006;
- “Starcraft” – winner of the Group One “Prix Du Moulin” in France in September 2005;
- “Mummify” – winner of the Group One “Singapore International Gold Cup” in June 2005;
- “Miss Andretti” – winner of Group Two “King’s Stand Stakes” at Ascot in June 2007;

- “Haradasun” – winner of Group One “Queens Anne Stakes” at Royal Ascot in June 2008 and
- “Scenic Blast” – winner of Group One “King’s Stand Stakes” at Ascot in June 2009.

The world class performance of these horses has reinforced the undeniable fact that Australian bred racehorses are amongst the best in the world and this will have a tangible effect on the sales results of our yearlings and older horses. Naturally these results also have a positive impact on exports.

A3 Timing of Profitability – Horse Industry Participants

A3.1 Lag Period

It is generally accepted that most horse industry participants experience a genuine lag period due to the nature of the industry.

Many businesses require some period of establishment and may not be profitable in the initial years of operation. Businesses entering the thoroughbred horse industry commonly experience a lag period, or timing of consistent profitability of between 5-10 years.

The lag period should be obvious if one considers that most thoroughbred businesses purchase bloodstock as yearlings (1 year olds). Although yearlings are untried and unbroken, the marketplace for yearlings allows businesses access to stock that they can control and manage from a young age. It also allows businesses an opportunity to access stock consistent with their business strategy at a competitive price. It follows that bloodstock, either on the racetrack or at stud, may not realise their optimum return to owners until the age of 4-8.

Similarly, breeding stock also experiences a significant lag between the timing of the expenses and sales or prizemoney revenue. A mare is served, in foal for 11 months, foaled down and then the foal is reared to yearling stage and sold or retained to race. This is effectively a three year cycle and a slipped or missed breeding can delay this process by another year.

A3.2 Block’s Case

A relevant horse industry case, Block and Commissioner of Taxation (2007) AATA 1897 (26 October 2007) resulted in the Tribunal overturning an earlier ATO decision regarding income tax and GST concerning whether horse and sheep breeding activities were a business or a hobby or recreational pursuit.

In the decision, the AAT acknowledged that a business can incur significant losses. The income tax losses in Block's case for the years under review were as follows:

- 2001 \$143,955;
- 2002 \$199,750;
- 2003 \$208,401
- 2004 \$169,913

Whilst the taxpayer in Block's case generated significant losses in the years in question, the tribunal held at paragraphs 85-87 that:

"It is clear that the first applicant has incurred significant losses in respect of the business because of the capital costs of setting up the business, the subsequent restructuring of the business and, as a result of a series of unforeseeable setbacks.

The first applicant reasonably in the Tribunal's view anticipates that as all the infrastructure and improvements for the business is now in place, and steps have been taken to upgrade its stock, it will have saleable progeny to secure future income and profit from both the horse and sheep breeding businesses.

The Tribunal finds that the first applicant does not undertake either the horse or sheep breeding as a private recreational pursuit or hobby. The first applicant conducts the businesses in a proper business like and commercial manner with an intention of making profits."

A4 Segmentation of Thoroughbred Horse Industry

The Thoroughbred horse industry is characterised by a vast number of participants from various backgrounds and with differing motivations for being involved in the industry.

Given the size, scope and diversity of the Thoroughbred horse industry, participants operate and compete in a large number of different sectors within the industry. To

illustrate this point, yearling prices can vary between \$1,000 - \$3 million. Prize money on offer varies by a similar range although the richest race in Australia, the Melbourne Cup, is now worth \$6 million.

Costs of maintaining horses naturally differ depending on the age of the horse, the horse's program and the efficiency of the operation. A well structured operation with its own property and staff can reduce ongoing maintenance costs by horse, regardless of the value of such horses. In other words, the cheaper horses can cost more to maintain than more expensive horses.

The proper use of technology and systems can also differ significantly between horse industry participants. Accounting systems, applying statistical information, disease

prevention and advanced training regimes can mitigate risks and optimise the performance of a horse operation. Breeding, racing, trading and training of Thoroughbreds is a very complex, segmented and international market presenting a myriad of possibilities and opportunities. To try to compare horse participants in a general sense would be nonsense.

A5 Unforeseen circumstances affecting the horse industry

Thoroughbred breeders in Australia are a resilient lot and they need to be. They have had to counter the impact of Equine Influenza during 2007/2008. This had a devastating impact on the industry particularly in NSW and QLD.

The Thoroughbred breeding industry as with most other primary industries has been severely affected by the long standing drought in most areas of Australia.

Since 2005, breeders have also been subjected to a targeted audit of the horse industry by the ATO whereby their affairs have been regularly scrutinised. As a result of such audit activity, there has been unprecedented change to the tax landscape including a new tax ruling for the horse industry titled TR 2008/2. There have also been two recent AAT decisions known as Block's case and D'Arcy's case. For many horse breeders, attending to their tax compliance issues is an ongoing challenge.

The very nature of the thoroughbred industry, including its diversity and pleasure aspects, often leads to misunderstanding by the ATO and other regulators. The audits have been a large frustration for genuine breeders having to justify the commerciality of their horse activities. The new income requirement test may just be "the straw that breaks the camel's back" for those trying to establish a viable breeding business.

REFERENCES

¹ Horse Disease Response Levy Bill 2008, Second reading speech Mr. Shorten, Hansard