IN THE HIGH COURT OF NEW ZEALAND
HAMILTON REGISTRY

CIV-2012-419-185
[2013] NZHC 1768

IN THE MATTER OF	the Income Tax Act 2004, the Income Tax Act 2007 and the Tax Administration Act 1994
BETWEEN	PETER SCOTT DRUMMOND First Plaintiff
	PATRICK JOHN DYER Second Plaintiff
	RONALD BOET Third Plaintiff
	KERRY NOTT PHARMACY LTD Fourth Plaintiff
	CHERYL LEANN RENOUF Fifth Plaintiff
AND	THE COMMISSIONER OF INLAND REVENUE Defendant

Hearing:	6, 7 and 8 May 2013
Counsel	JH Coleman for Plaintiffs HL Dempster and SJL Townsend for Defendant
Judgment:	15 July 2013

JUDGMENT OF BREWER J

This judgment was delivered by me on 15 July 2013 at 9:30 am pursuant to Rule 11.5 High Court Rules.

Registrar/Deputy Registrar

SOLICITORS
North End Law (Hamilton) for Plaintiffs
Crown Law (Wellington) for Defendant

Introduction

[1] The plaintiffs challenge income tax assessments by the defendant disallowing their shares of write-downs of the purchase price of a colt in the income years 2008 and 2009.

[2] The plaintiffs are members of an unincorporated syndicate called Te Akau Stallion Syndicate (No 1) ("the syndicate") which was formed in March 2008. The catalyst for its formation was the availability for purchase of a colt named Roman Gladiator ("the colt"). The syndicate, upon its formation, bought the colt for $550,000 plus GST.

[3] The syndicate agreement contains its objects:[1]

> 1.1 The objects of the Syndicate are:
>
> A. To acquire, train and race the Colt, and any other thoroughbred colts acquired by the Syndicate, with a view to increasing their value as thoroughbred Stallions.
>
> B. To carry on business as owners of thoroughbred Stallions.
>
> C. To carry on any other business associated with the racing industry as the Manager, with the approval of the Members, thinks fit.

[4] The plaintiffs contend that pursuant to its objects the syndicate bought the colt for use as a stud stallion. They contend that this was the syndicate's business. It was on this basis that the syndicate members claimed reductions (or write-downs) of the colt's purchase price using the regime established by s EC39 of the Income Tax Acts:[2]

> **EC 39 First income year in breeding business**
>
> *Bloodstock to which this section applies*
>
> (1) This section applies to bloodstock that is 2 years of age or older at the end of the first income year in which a person—

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1 Common bundle, vol 1, tab 10.

2 In the first year of write-down, the Income Tax Act 2004 applied; in the second year, it was the Income Tax Act 2007. Section EC39 of both Acts are identical and so I will refer simply to s EC39.

(a) uses the bloodstock for breeding in their breeding business; or

(b) forms the intention of using the bloodstock for breeding in their breeding business; or

(c) buys the bloodstock, with the intention of using it for breeding in their breeding business.

(2) ...

Closing value

(3) The closing value of the bloodstock at the end of the first income year is its cost price minus the reduction applying in that income year.

Determination of reduction

(4) The reduction that applies is determined under section EC 41, EC 42, EZ 5, or EZ 6 (which relate to bloodstock).

[5] The plaintiffs contend that s EC39(1)(c) applies because the syndicate bought the colt (which, it is common ground, is bloodstock) with the intention of using it for breeding in their breeding business.

[6] The syndicate members opted for the reducing value method permitted by s EC41(3) and reduced the value of the colt by 75% of its cost price in the 2008 income year and 75% of the remaining 25% of the cost in the 2009 year.

[7] The colt was never used as a stud stallion. Its temperament deteriorated to the point where it became too dangerous to keep intact. It was gelded on 5 October 2009. Thereafter, it was shipped to Singapore and used as a racehorse.

Issue

[8] The issue is whether the syndicate, and hence the plaintiffs, came within the scope of s EC39(1)(c) for the income years in question. It has the following components:

(a) Is an existing breeding business a prerequisite for s EC39(1)(c) to apply?

(b) If not, did the plaintiffs carry on a breeding business?

The facts

[9] The plaintiffs called eight witnesses. Each of the plaintiffs gave evidence, as did the syndicate's manager, Mr David Ellis, and two experts, Mr John Aubrey and Mr Royce Walls.[3] None of the witnesses were challenged for credibility. In my view, that was appropriate.

[10] In a notice of objection to the admissibility of evidence filed by the defendant on 16 April 2013, the defendant took exception to large parts of the briefs of evidence of the plaintiffs' witnesses. The evidence of Mr Ellis was challenged almost in its entirety on the ground that he is disqualified as an expert by reason of the closeness of his association with the syndicate and because of the precedent effect a judgment in favour of the defendant would have. Mr Ellis is the promoter of a number of syndicates which have claimed similar tax treatment.

[11] The defendant was content to allow me to receive the evidence on a contingent basis. The witness statements were taken as read and the witnesses for the plaintiffs were cross-examined on them.

[12] I think this issue is a distraction. The factual matters I have to determine are not finely balanced and do not require me to accept evidence which could be challenged for admissibility on any real basis. I have no doubt that Mr Ellis is an expert in his field. I also have no doubt that the weight I should give his evidence should be assessed in the light of his interest in the proceeding as litigation funder and in the light of the potential effect of its resolution on his other business interests.

[13] Against this background, I make the following findings of fact:

(a) The colt has a pedigree which made it a suitable candidate to be a stud stallion. Its price reflected that potential.

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[3] There is an issue between the parties as to whether this case constitutes a test case. Both parties, regardless of the outcome, want the opportunity to make submissions on costs. The defendant called witnesses whose evidence would go primarily to this issue. I do not need to consider their evidence on this issue in this judgment since it was agreed that it would be a matter to be determined after the release of this judgment.

(b) The plaintiffs joined the syndicate on the basis that the colt would be used as a stud stallion if that were feasible.

(c) The plaintiffs understood and intended that the colt would be trained and raced. The purpose of this was twofold:

(i) If the colt were a successful racehorse then it would earn money for the plaintiffs; and

(ii) If it were a successful racehorse then its worth as a stud stallion would be greatly increased.

(d) It is not necessary for a stallion of good pedigree to be a good racehorse before it can stand at stud. Pedigree alone can attract customers and the qualities of the progeny can build up business.

(e) Acquiring a colt for development as a stud stallion is a highly risky venture. I accept the evidence of Mr Walls to the effect that only about 5% of good pedigree colts sold annually at Karaka end up standing at stud. The evidence is that Mr Ellis has greater success than that (perhaps around 30%), but the risk of failure is still high.

(f) The colt was developed for racing. In the 2008 income year that development did not extend to any trialling.

(g) On Christmas Day 2008, the colt attacked and significantly injured one of its jockeys.

(h) In the income year 2009 the colt had three trials.

(i) The colt made no income in the 2008 and 2009 years.

(j) The colt never became a stallion as that term is defined.

(k) The colt was never held out as being available for stud work, and was never used for stud work.

(l) The practical work of caring for and developing the colt was delegated by the syndicate to Mr Ellis as manager. Only one syndicate member, Mr Drummond, was on the syndicate's management committee. Mr Drummond did not take a hands-on approach and the syndicate agreement makes it clear that the powers of the manager to determine the future of the colt (extending to gelding) are extensive.

(m) The syndicate members paid proportionate shares of the ongoing costs of caring for and developing the colt. Since the syndicate is unincorporated, each syndicate member, including the plaintiffs, deducted these costs and claimed their shares of the write-downs individually.

Does s EC39(1)(c) require an existing breeding business?

[14] The meaning of an enactment must be ascertained from its text and in the light of its purpose.[4]

[15] The legislative history of s EC39 is useful. I begin with a predecessor section, s 86H of the Income Tax Act 1976, which dealt specifically with the tax treatment of bloodstock. Subsection (2)(a) addressed the year in which deductions could be made:

> **86H Valuation of bloodstock**
>
> ...
>
> (2) Subject to subsection (4) of this section, the value of any bloodstock of a taxpayer to be taken into account at the end of any income year shall be,–
>
> (a) In relation to the *first income year of ownership by the taxpayer in which the bloodstock is used for breeding in the course of the conduct of any business of the taxpayer*, the amount that remains after deducting from the cost price of

[4] Interpretation Act 1999, s 5.

> the bloodstock, the specified write down in relation to that bloodstock.
>
> ...
>
> (Emphasis added)

[16] As the defendant has submitted, the legislation required bloodstock to be first used by the tax payer for breeding and that use had to be in the conduct of a business. This obviously excludes someone in the business of racing horses with an intention that they be used for breeding in the future in the course of that business or in the course of a future breeding business.

[17] The section was amended by the Income Tax Amendment Act 1990 (No 3), thereafter reading:

> (2) Subject to subsection (4) of this section, the value of any bloodstock of any taxpayer to be taken into account at the end of any income year shall be,—
>
> (a) In relation to the first income year in which the bloodstock (being bloodstock which at the end of that income year is 2 years of age or older) is—
>
> (i) First used by the taxpayer for breeding purposes *in the course of the conduct of the business by that taxpayer of breeding bloodstock*; or
>
> (ii) Purchased with the intention of being used for breeding purposes by the taxpayer in *the course of the conduct of the business by that taxpayer of breeding bloodstock*; or
>
> (iii) *Owned in the course of the conduct of the business of breeding bloodstock* and that taxpayer has the intention of using that bloodstock for breeding purposes,—
>
> the amount that remains after deducting from the cost price the specified write-down in relation to that bloodstock:
>
> (Emphasis added)

[18] I agree with the following submission of the defendant in relation to these changes in legislation:[5]

> Parliament did not intend by these changes to remove the requirement that the person seeking to deduct the change in valuation of the bloodstock from assessable income be carrying on the business of bloodstock breeding. Rather, Parliament extended the circumstances in which a person *already*

[5] Submissions for the Commissioner of Inland Revenue, 8 May 2013, at para 108.

> *carrying on a blood stock breeding business* was entitled to deduct such a change in valuation from assessable income.

[19] As the defendant submits, if the legislation had intended to extend the write-down eligibility beyond established breeding businesses, the words "in the course of the conduct of the business by that taxpayer of breeding bloodstock" would be redundant.

[20] The provision was substantially re-enacted in s EM1 of the Income Tax Act 1994, and took its current form in the Income Tax Act 2004. I quote it again:[6]

> (1) This section applies to bloodstock that is 2 years of age or older at the end of the first income year in which a person—
>
> (a) uses the bloodstock for breeding in their breeding business; or
>
> (b) forms the intention of using the bloodstock for breeding in their breeding business; or
>
> (c) buys the bloodstock, with the intention of using it for breeding in their breeding business.

[21] The words "in their breeding business" replaced "in the course of the conduct of the business by that taxpayer of breeding bloodstock", the word "in" serving to mean "in the course of". There is no apparent change in meaning.

[22] This is confirmed by s YA3 of the Income Tax Act 2004:

> *Intention of new law*
>
> (3) Except when subsection (5) applies, the provisions of this Act are the provisions of the Income Tax Act 1994 in rewritten form, and are intended to have the same effect as the corresponding provisions of the Income Tax Act 1994.

[23] Subsection (5) does not apply here. Accordingly, the change in wording from the 1994 Act to the 2004 Act does not change the effect of the provision.

[24] Section EC39 is carried over in identical terms in the 2007 Act. Further, there is an equivalent to s YA3 of the 2004 Act, being s ZA3 in the 2007 Act.

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6 Income Tax Act 2004, s EC39(1).

[25] Assistance with the interpretation of s EC39(1)(c) can be gained by considering subparagraphs (a) and (b). Each uses the phrase "in their breeding business" also. The context of the use is clearly that of an existing breeding business. There is no indication that the context of its use in subparagraph (c) is different.

[26] Looking at s EC39(1) as a whole, it can be concluded that the purpose of subparagraph (c) is to extend the circumstances in which a person already in a breeding business can begin writing down the cost of bloodstock.

[27] I conclude that without an existing breeding business, the acquisition of the colt by the plaintiffs could not bring them within the s EC39(1)(c) regime.

The plaintiffs' alternative argument

[28] The plaintiffs' case focuses on whether the syndicate was in the bloodstock breeding business in the 2008 and 2009 income tax years. Its position is that its breeding business commenced with the acquisition of the colt. That does not assist them if, as I find, s EC39(1)(c) requires an existing breeding business. However, the plaintiffs make an alternative argument:[7]

> The alternative argument is that as long as the syndicate had the intention of using the bloodstock (ie the colt) in their breeding business, as opposed to another person's breeding business, then the requirements of the section are met. That is, the breeding business does not have to be extant when the relevant intention is formed so long as the use will be in the taxpayer's breeding business, not someone else's business.

[29] The plaintiffs submit that "their" is possessive and is intended to draw a distinction between intended use of the bloodstock for breeding in the taxpayer's business as opposed to someone else's breeding business. This is because it is common for bloodstock to be used in a third party's breeding business.

[30] The plaintiffs submit:

(1) Section EC39(1)(b) and (c) are both concerned with the intention to

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7 Plaintiffs' closing submissions, at para 88.

use bloodstock for breeding in the future.

(2) Section EC40 deals with the computation of the second year's write-down on the assumption that the same taxpayer owns the animal.

(3) Section EC41 provides for various adjustments where someone else used the bloodstock before the taxpayer in question.

[31] The plaintiffs argue that the scheme of the provisions is focused on the identity of the taxpayer who is using the bloodstock. It is the intended use in a future breeding business of the particular taxpayer which is contemplated.

Analysis

[32] This contention is again one of interpretation. It does not turn on factors such as whether a breeding business can operate with one horse, what time a business commences, and whether racing is a legitimate part of the operation of a breeding business. Those issues were all the subject of submissions and I do not need to address them here because they are not relevant to this interpretation issue.

[33] In my view the plaintiffs' argument cannot prevail because of the legislative history of s EC39 which I have set out. If an existing breeding business is required then an intended use in a future breeding business is not sufficient.

[34] From a policy perspective this seems appropriate. If this were not the case, then any bloodstock owner dabbling in racing could use s EC39(1)(c) so long as they have a subjective intention to breed the horse in the future in "their" breeding business.

[35] In any event, although much of the evidence is directed towards whether the colt was going to stand at stud, that does not prove the plaintiffs were committed to using the colt for their own breeding purposes. The colt might have been sold off for a large sum to be used in someone else's breeding business, or leased to someone else's breeding syndicate. Without a commitment to "their breeding business" it is

doubtful whether s EC39(1)(c) would apply. The point is that the future of the colt was unclear.

[36] My findings are fatal to the plaintiffs' case. However, the parties have been explicit that whatever the result of my judgment the unsuccessful party will appeal. It might therefore be of assistance if I go on to examine the issue of whether the syndicate was in the bloodstock breeding business in the 2008 and 2009 income tax years.

Did the plaintiffs carry on a breeding business?

[37] The leading case as to what constitutes a business is *Grieve v Commissioner of Inland Revenue*.[8] It is uncontested that there must be an intention of making a pecuniary profit, but that intention need not come to fruition in order for a business to exist. There need not be any reasonable prospect of profit; an actual intention is sufficient.

[38] Further, an undertaking does not have to be profitable in order for it to be a business:[9]

> It follows from this analysis that the decision whether or not a taxpayer is in business involves a two-fold inquiry – as to the nature of the activities carried on, and as to the intention of the taxpayer in engaging in those activities. Statements by the taxpayer as to his intentions are of course relevant but actions will often speak louder than words. Amongst the matters which may properly be considered in that inquiry are the nature of the activity, the period over which it is engaged in, the scale of operations and the volume of transactions, the commitment of time, money and effort, the pattern of activity, and the financial results. It may be helpful to consider whether the operations involved are of the same kind and are carried on in the same way as those which are characteristic of ordinary trade in the line of business in which the venture was conducted. However, in the end it is the character and circumstances of the particular venture which are crucial. Businesses do not cease to be businesses because they are carried on idiosyncratically or inefficiently or unprofitably, or because the taxpayer derives personal satisfaction from the venture.

[39] The parties marshal their arguments around the above summary of the law.

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8 *Grieve v Commissioner of Inland Revenue* [1984] 1 NZLR 101 (CA).

9 Ibid, at 110, per Richardson J.

The plaintiffs' submissions

[40] Mr Coleman submits that there is no doubt that the plaintiffs' evidence establishes that the syndicate undertook activities which were organised and coherent. The colt was chosen for its pedigree, inspected carefully by Mr Ellis and checked by a veterinary surgeon for "rigging" (a condition of the testicles pointing to infertility). The colt was acquired at a price which reflected its suitability for standing at stud. Mr Ellis, the plaintiffs and the expert witness, Mr Walls, all gave evidence that the purchase price is consistent only with the intention to acquire the colt for breeding.

[41] The syndicate's agreement sets out the objectives and the responsibilities for developing the colt as a business asset. The syndicate's accountant applied for and obtained GST registration for the syndicate. It obtained an IRD number and a non-standard balance date tied into the breeding season for thoroughbreds.

[42] The colt was trained. In one particular, its training was different to that which would apply to horses being developed for racing purposes only. Care was taken to keep it separate from fillies since premature arousal of its libido would render it unfit for a temporary career as a racehorse aimed at establishing it as a premier stud animal.

[43] The plaintiffs' witnesses all referred to the successful breeding syndicate which owns a horse called Darci Brahma. They regarded the training regime for Darci Brahma as being the model which was adopted for the colt, Roman Gladiator.

[44] It is submitted that promotional activities were undertaken by Mr Ellis.[10] These activities were relevant only to the intention to breed the colt.

[45] Development of the colt included placing it in trials. It participated in three trials in the 2009 income year. In the following income year, just before it was gelded, it took part in one race.

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[10] Notes of evidence, p 42, line 14 to p 43, line 11.

[46] Each member of the syndicate paid a proportionate share of the costs of caring for and developing the colt in this way. Proper financial statements were prepared each year.

[47] In short, the submission of the plaintiffs is that everything which was done to acquire the colt and develop it to the point where it had to be gelded was not only consistent with the colt being part of a breeding business but was unexceptional in terms of the business models of other breeding syndicates.

[48] Mr Coleman submits that the evidence establishes that the colt was purchased with the intention to have it stand eventually at stud as a stallion. This is consistent with the objectives of the syndicate as set out in the syndicate agreement quoted above at [3]. Further, cl 19.2 of the syndicate agreement specifically uses the words "while he is a stallion standing at stud", suggesting that is the intended outcome. The evidence of Mr Ellis, and of all of the plaintiffs, supported by the contemporaneous documentary evidence, is that that intention existed. They explicitly repudiate any idea that they were part of a hobby racing syndicate. In particular, Mr Ellis gave evidence when cross-examined that "[t]he horse has been brought (sic) because he's going to stand at stud regardless of his racing ability".[11]

[49] The defendant objects to this evidence. There was never a meeting of the members of the syndicate and the plaintiffs had met none or perhaps one of the other syndicate members prior to its formation. However, while the defendant might be correct strictly, I am entitled to infer from the evidence of Mr Ellis and from the evidence of the plaintiffs, corroborated by the syndicate members' use of the s EC39 regime, that it was the intention collectively of the syndicate to stand the colt at stud if that were feasible. By way of example, in an email from Mr Ellis to a Mr Glen Kierse dated 11 February 2008 he says, "I want to have a colt like this one to train in NZ and Australia and to stand at stud one day..." This evidence supports the position that the ideal outcome was to "one day" have a stallion at stud, and that this colt was, in his view, the best opportunity for that. I find, however, that this was in the nature of an ideal outcome, rather than a fixed intention.

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[11] Notes of evidence, p 29, lines 22-23.

[50] The plaintiffs have contested the defendant's contention that the racing of the colt could only be considered preparatory in relation to any possible future breeding business. Rather, every breeding business repeats the acquisition and mating cycle. There can be no doubt that if the syndicate owned other stallions standing at stud or mares in foal, the activity here would be part of the ordinary operational activity of the breeding business. In principle it cannot be right that the same activity undertaken for the first time does not amount to a business but if it is undertaken for a second or third time it does.

[51] The commencement of a stallion breeding business has affinity with a development undertaking like that in *Whitfords Beach Pty Ltd v Federal Commissioner of Taxation.*[12] In *Whitfords* the Court held that the taxpayer's development business had commenced on the acquisition of land because at that point it was being ventured in the business. Here the colt was ventured in the syndicate's breeding business on the date of acquisition. From the date of acquisition there was a course of continuous conduct directed at the implementation of the syndicate's intention.

[52] It is submitted that the racing of the colt is an inherent part of the conduct of the syndicate's breeding business. The evidence has established that the actions taken by the syndicate here will be taken with respect to every horse owned by a breeding syndicate. A syndicate which owns 1,000 stallions will still race each yearling stallion purchased just as this syndicate has done and for exactly the same reasons.

[53] The plaintiffs rely on the evidence of Mr Aubrey[13] that the thoroughbred industry saw the business of breeding as starting with the acquisition of the filly, brood mare, colt or stallion. The reason for this being that no rational businessperson would pay the sort of money commanded by stud thoroughbreds without the intention of breeding from them.

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12 *Whitfords Beach Pty Ltd v Federal Commissioner of Taxation* (1983) ATC 4277.

13 Witness statement of John Charlton Aubrey, at para 21.

The defendant's submissions

[54] The overarching submission of the defendant is that the activities carried on by the syndicate with respect to the colt do not show an intention to engage in a business, let alone a breeding business. The submission is that the activities are common to the raising and developing of any racehorse, be it for hobby purposes or for the purposes of trying to win stake money. At best, the defendant submits, the plaintiffs showed a conditional intention to stand the colt at stud if it proved itself as a racehorse and thus able to command stud fees.

[55] The defendant relies upon the evidence of Mr Walls who, in cross-examination, said that perhaps 5% of well pedigreed colts sold at Karaka end up standing at stud.[14] The defendant also relies upon the cross-examination of Mr Ellis as to his success with acquiring such colts for breeding purposes. Depending upon how one counts them, between 20% and 33% of his purchases for so-called "breeding syndicates" have ended up standing at stud. A significant number had to be gelded.

[56] The plaintiffs, however, accept that taking a colt from purchase to standing at stud is a risky venture. They submit that the legislation specifically accounts for the fact that it is a high risk industry, pointing to s EC43. That section allows bloodstock to be re-valued following a significant drop in the market value of the bloodstock due to accident, birth deformity, or infertility. The nub of their submission is that simply being a speculative venture should not frustrate the intention of the taxpayers.

[57] As to the income years in question, the defendant points to the fact that in the 2008 income year the colt did not participate in trials or races. In the 2009 income year it participated in three barrier trials. These trials did not carry stake money but were for the purposes of continuing the colt's racing education, getting it fit for racing, exposing its ability with a view to selling it and assessing whether it is worth persevering with as a racehorse.

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[14] Notes of evidence, p 113, lines 20-26.

[58] During the 2008 income year, and before it ever trialled as a racehorse, the colt began to exhibit problems with its temperament. A stallion with a dangerous temperament cannot be used as a stud stallion. On Christmas Day 2008, it broke the leg of a jockey by kicking the jockey. It was a serious injury. The colt's behaviour deteriorated further during 2009 to the point that it could only participate in one race. At some point before 5 October 2009 the decision was taken by Mr Ellis and by the trainer, Mr Walker, that the colt should be castrated.

[59] In the income years in question, the colt was not offered for breeding services.

[60] All of the above, the defendant submits, shows that there was never a real intention to breed the colt. It was acquired as a potential stud stallion, but whether that potential would ever be realised would, in a high risk industry, be dependent upon events. In the meantime, the members of the syndicate would have the excitement of developing a well-pedigreed colt as a racing animal and perhaps, if it proved to be one of the rare horses able to attract attention for its qualities, might come to be worth many millions of dollars as a stud animal. That, submits the defendant, was a hope and not an intention.

[61] The defendant points to the syndicate agreement and notes that it contains no commitment to stand the colt at stud once it becomes a stallion.[15]

[62] The defendant contends that whether a taxpayer is in business involves two considerations:

(1) The nature of the activities (which must amount to a profession, trade, manufacture, or undertaking); and

(2) The intention of the taxpayer (for pecuniary profit).

[63] It is implicit from the reading of the statute that there must be a nexus between the two considerations.

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[15] Submissions for the Commissioner of Inland Revenue, 8 May 2013, at para 62.

[64] While the defendant accepts that the taxpayer's intention will be assessed subjectively, it needs to be more than a vague hope, and must have some basis in reality.[16]

[65] The defendant contests that the plaintiffs intended to carry on a breeding business by "copying or following the Darci Brahma business model". However, if it is assumed, for the sake of argument, that the plaintiffs raced the colt with that intention, it is still insufficient to establish a bloodstock breeding business.

[66] The plaintiffs must "establish a profit making structure and begin ordinary current business operations".[17] What is required is some significant activity undertaken as a regular part of the revenue earning process in that type of business.

[67] The defendant submits that while it is not necessary that any revenue is actually earned, the ordinary current business operations must have begun. The point at which the business becomes a breeding business is when the stallion is standing at stud, or at least the marketing of the stud for the purposes of breeding. This is when the thoroughbred is available or offered as a stallion, even though there may not have been any actual service provided. If the stallion has been advertised or marketed as available, it can be said that the taxpayer has begun "ordinary current business operations". In this case, the colt was never advertised, marketed for present or future services, or bred. Therefore no breeding business ever began.

[68] The plaintiffs reject this submission, and point to the history of the legislation which showed a discernible move from a use/mating test to an intention to use test. The legislative tracing at [15]-[24] above covers this point. The change from the use/mating test to the intention test was not for assessing when a breeding business commences, but when bloodstock becomes part of a breeding business so as to enable the taxpayer to claim the prescribed write-down.

[69] The defendant argues that the agreement is consistent with the proposition that breeding the colt was anticipated but was a contingency plan. Clause 18.4

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16 *Case H63* (1986) 8 NZTC 460 at 464.

17 *Calkin v Commissioner of Inland Revenue* [1984] 1 NZLR 440 (CA) at 447.

contains the words "*if* the colt stands at stud" and "*that* business of owning a thoroughbred Stallion at Stud". Clause 19.9 similarly provides the Manager service rights *if* the colt is standing at stud at the time. The defendant therefore posits that the agreement provides for the contingency that the colt will proceed to stand at stud. There was no actual commitment to the business of bloodstock breeding.

[70] The syndicate owned only one colt. This 'scale of operation' is indistinct from a hobby. The defendant submits there is no evidence that the plaintiffs were called upon to make any decision in the nature of a business decision.

[71] The defendant accepts that it is tenably arguable that the nature of the activity was preparatory for a breeding business at a later stage, in a contingent sense. However, a contingent intention is not the current business of breeding.

[72] Ultimately, the defendant argues, a finding that a contingent intention is sufficient would lead to absurdity. It would enable taxpayers to deduct the cost of thoroughbred racehorses without ever doing anything in the nature of the business of breeding bloodstock. Naming a syndicate "stallion" does not make a colt a stallion. Naming a syndicate a "breeding business" does not make it a breeding business.

Analysis

[73] As I have found, the plaintiffs joined the syndicate on the basis that the colt would be used as a stud stallion if that were feasible. The purchase price of the colt ($550,000 plus GST) reflected its pedigree which in turn increased its chances of standing at stud one day. The development of the colt as a racehorse was both to see if it could be successful on the racetrack and to increase its potential as a stud stallion.

[74] This was not a hobby racing syndicate. The plaintiffs intended the purchase and development of the colt to be a commercial venture. However, it was a highly speculative venture. The chances of the colt ever standing at stud were low – statistically perhaps 5%. There is no evidence that all the plaintiffs knew how risky the venture was, but I am satisfied on the balance of probabilities that with their experience in the industry they must have known that this was a speculative venture.

Indeed, I am satisfied that one of the main reasons for the plaintiffs taking shares in the syndicate was that Mr Ellis was the promoter. The plaintiffs knew that he had had success in this area in the past and they were relying on his skill and knowledge to lower the risk.

[75] With this background, can it be said that the plaintiffs, in the income years in question, were in the business of breeding bloodstock?

[76] In my view, the plaintiffs had only a contingent intention to use the colt for breeding purposes. This is consistent with the syndicate agreement. The purchase of the colt was the first step in venturing money towards seeing if the colt would do well enough on the racetrack to found a successful career as a stud stallion. There was no fixed intention to use the colt for breeding. If it had proved to be a good racehorse then it would have had a racing career and then, perhaps, stood at stud. If it had failed on the racetrack then its potential to nevertheless stand at stud would have had to have been evaluated and a decision made based on the commercial prospects.

[77] Gelding the colt was always a possibility, and on the evidence more than a possibility. Clause 18 of the syndicate agreement sets out the "Manager's Powers and Functions". They are, relevantly:

> 18.1 The functions of the Manager are to:
>
> 18.1.1 race and manage the Colt in a manner that is consistent with the best interests of the Members, and the Colt, and which is approved by the Racing Manager. This includes, but is not limited to, the sole right, in the Manager's discretion (but with the consent of the Racing Manager) to make decisions, enter into contracts (including contracts with persons or entities owned by or associated with the Manager) and incur expenditure **without any obligation to consult with the Members**, on matters which relate to the racing and management of the Colt such as (but not exclusively so):
>
> a. the choice of racing programme;
>
> b. training methods;
>
> c. the choice of jockey;
>
> d. the choice of trainer;

e. if the Colt is to be raced outside New Zealand;

f. stud management and breeding policy (including whether the colt is to be gelded);

g. agistment,

provided those decisions are in the best interests of the Members, and are approved by the Racing Manager.

...

18.4 For clarity, if the Colt stands at stud the Manager may exercise any of the powers in clause 18 in relation to that business of owning a thoroughbred Stallion at Stud, without the approval of the Management Committee.

[Emphasis added]

[78] This demonstrates that not only was it contemplated that the colt might be gelded but the decision was left with the Manager. On the evidence, that is what happened. One or more of the plaintiffs might have been informed in advance of the gelding but there was no formal consultation because there was no obligation to do so. In my view, this emphasises that standing the colt at stud was never a fixed intention of the syndicate, it was an intention contingent upon future events.

[79] This contingent intention can be contrasted with the fixed intention of racing the colt. From the moment of acquisition that was the syndicate's intention. It was trained and developed for racing. When its temperament deteriorated it was gelded and its racing career continued.

[80] I also find that the development and training of the colt, although furthering the prospects of the colt one day standing at stud, did not thereby constitute significant activities undertaken as part of a bloodstock breeding business. In my view, what was required was a decision to stand the colt at stud and then activities aimed specifically at implementing that decision. I find that decision was never made and no such activities occurred. While Mr Ellis gave evidence that the colt would have gone to stud regardless of racing ability, the evidence of such a decision and the plan to implement it is lacking. As Richardson J said in *Grieve*, "actions speak louder than words". In this regard, while making a stallion available for stud,

or advertising it as available, would meet this criterion, I do not seek to be prescriptive. There could well be other actions.

[81] As Richardson said in *Calkin v Commissioner of Inland Revenue*:[18]

> Clearly it is not sufficient that the taxpayer has made a commitment to engage in business: he must first establish a profit making structure and begin ordinary current business operations.

[82] Even without considering the legislative position, the acquisition of the colt, followed by the racing of the colt, was preparatory to a breeding business, not an establishment of a breeding business.

[83] I acknowledge the plaintiffs' argument that if they had had an established breeding business then all that they did in acquiring and developing the colt would have been recognised as being pursuant to that business. But that begs the question. It is necessary first to establish a breeding business. Buying a colt with the fixed intention of racing it and a contingent intention of one day standing it at stud does not establish a breeding business. If it did then anyone buying a thoroughbred with the intention of racing it and possibly breeding from it would be in the business of breeding bloodstock.

[84] The evidence establishes that the syndicate members, when acquiring the colt, did so with the desire that it would one day stand at stud and return the members an income in the form of service fees. But I infer there were decisions still to be made which would determine whether, or how, that desire might be achieved. For example, how long would the colt be raced? Who would decide? What if an attractive purchase offer were received? At what stud would the colt (as a stallion) stand?

[85] The fact that the venture of breeding is speculative does not prohibit a breeding business commencing. If that were the case, then no breeding business would ever exist. But in the face of that risk, a commitment to a plan and structure to get the colt from acquisition to the end point of being able to service mares is to be expected. The syndicate agreement speaks more of an objective that the colt be

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[18] Ibid, at 447.

developed so as to be worth as much as possible when the time came to make decisions about its stud future. The decisions actually made went to the best interests of the colt's racing career. The decisions as to any potential stud career were left to the future. This demonstrates a lack of commitment to a profit-making structure for breeding. The only structure actually in place was the structure to seek profit from potential race winnings.

[86] Accordingly, I find that the plaintiffs did not, in the 2008 and 2009 income years, carry on a bloodstock breeding business.

Was there a business at all?

[87] The defendant has argued that there was no business at all. I disagree. On my analysis, there was clearly a racing business. I have read the Adjudication Report from the office of the Chief Tax Counsel dated 23 November 2011. I agree with the conclusion in that regard.

[88] The plaintiffs made an argument based on unconscionability. They had been informed that if the adjudication unit made findings in favour of the plaintiffs then the defendant would have no avenue of appeal. I do not need to decide this argument due to my decision on the merits.

Decision

[89] The plaintiffs' claim is dismissed.

[90] The defendant is to file its memorandum as to costs within three weeks of the date of release of this judgment. The plaintiffs will have a further three weeks to respond. The defendant may file a reply within 14 days.

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Brewer J