THE DEPARTMENT OF INTERNAL AFFAIRS
Te Tari Taiwhenua

Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Bloodstock write-down rates and GST on export of bloodstock

Date:	10 February 2006	**Priority:**	**Ministerial Deadline**
Security Level:	In Confidence	**Report No:**	R&C200600057 T2006/161 PAD2006/16

Action sought

	Action Sought	**Deadline**
Minister of Finance	Agree to recommendations	14 February 2006
Minister for Racing	Agree to recommendations	14 February 2006
Minister of Revenue	Agree to recommendations	14 February 2006
Associate Minister of Finance (Hon Phil Goff)	Note recommendations	None
Associate Minister of Finance (Hon Trevor Mallard)	Note recommendations	None
Associate Minister of Finance (Clayton Cosgrove)	Note recommendations	None

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**	
Stephen Glover	Senior Analyst, Treasury		
Stephen Reilly	Policy Analyst, Internal Affairs		
Deborah Russell	Senior Policy Analyst		

10 February 2006

Minster of Finance
Minister for Racing
Minister of Revenue
cc: Associate Minister of Finance (Hon Phil Goff)
Associate Minister of Finance (Hon Trevor Mallard)
Associate Minister of Finance (Clayton Cosgrove)

Bloodstock write-down rates and GST on export of bloodstock

Executive summary

The Minister for Racing has asked the Minister of Revenue to analyse and cost the implications of accelerating the write-down of bloodstock, and extending the period for which bloodstock sold to overseas buyers may remain in New Zealand without attracting GST.

Bloodstock is currently written down at rates that are based on estimates of economic life, but accelerated by 25%. This is consistent with the depreciation rules applied to other assets. Increasing the rates would accelerate the write-down of bloodstock even further, and increase the disconnection between the economic life of bloodstock, and the amount that may be written down each year. As reported previously (T2000/2185 PAD 2000/305 refers), it would be a tax concession. Tax concessions can be problematic, because they can increase the risk of tax avoidance schemes, and they can encourage uneconomic investment and decision-making.

The New Zealand Thoroughbred Breeders Association (NZTBA) has argued that stallions should be fully written down in the year of purchase, because this would align the tax treatment of New Zealand owned stallions with the tax treatment of leased 'shuttle stallions'. Lease costs are fully deductible in the year in which a shuttle stallion is in New Zealand. According to the NZTBA, aligning the tax treatment would encourage investment in New Zealand owned horses.

Making the purchase cost of a stallion fully deductible in the year of purchase would be a departure from the principle of matching costs over the years in which income, in this case stud fees, is generated. It will tend to encourage investment in stallions even when such investment provides lower (risk adjusted) pre-tax returns than other investments. This is

inefficient. As reported previously (T2000/2185 PAD 2000/305 refers), it is not clear that providing this tax concession would necessarily result in increased investment in New Zealand owned horses.

The fiscal cost of accelerating the write-down of bloodstock, including broodmares is estimated to be:

Fiscal year	**2007**	**2008**	**2009**	**2010**	**2011**
Revenue cost	$0.9m	$0.1m	$0.6m	$1.1m	$1.4m

Inland Revenue and Treasury do not recommend further accelerating the write-down of bloodstock.

GST is zero-rated on goods sold to overseas buyers, provided that the goods leave New Zealand within 28 days. The Commissioner of Inland Revenue has the discretion to vary this period, and has done so with respect to bloodstock, which can be held in New Zealand for up to a year without attracting GST. Further, any services supplied in connection with the zero-rated goods are themselves zero-rated, decreasing Crown revenue. The Minister for Racing has asked for this period to be extended by between 18 and 24 months because of the economic benefits that will accrue to the bloodstock industry.

Inland Revenue and Treasury officials are concerned that extending the zero-rating time period could be perceived as giving non-resident bloodstock owners a tax advantage over New Zealand-owned bloodstock, given that any services supplied in relation to the exported bloodstock will also be zero-rated while it remains in New Zealand. There is also the possibility of an extended period being seen as a precedent by other industries.

Nevertheless, officials do accept that any extension to the 28 day rule needs to be a practical one. Officials therefore consider that, if the NZTBA or other industry representatives can provide sufficient justification based on industry practice for an extended period, the Commissioner review whether the time allowed for exported bloodstock to remain in New Zealand should be further extended.

Officials consider that Ministers should meet to discuss this report and take decisions with respect to the write-down of bloodstock.

Recommended action

It is recommended that you:

a) Agree to meet and discuss what, if any, changes are warranted in the rules for the write-down of bloodstock.

Agree/disagree Agree/disagree Agree/disagree

Following the meeting advised in a), it is recommended that you:

b) Note that write-down rules applied to bloodstock are consistent with the depreciation rules applied to other assets.

Noted Noted Noted

c) Agree that no change should be made to the write-down of bloodstock (Inland Revenue and Treasury preferred option).

Agree/disagree Agree/disagree Agree/disagree

If you do not agree to c), then it is recommended that you:

d) Agree to decrease the write-down period for stallions from four years to two years.

Agree/disagree Agree/disagree Agree/disagree

e) Agree to decrease the write-down period of broodmares under the age of twelve from a maximum of nine years to five years.

Agree/disagree Agree/disagree Agree/disagree

f) Agree to write off in full the cost of broodmares first bred at age twelve or older in the year of first breeding.

Agree/disagree Agree/disagree Agree/disagree

g) Direct officials to include the agreed changes to the write-down of bloodstock to which you have agreed in a Cabinet paper.

Directed Directed Directed

h) Note that Inland Revenue officials will consider the issues with respect to the Commissioner using his discretion to extend the period for which bloodstock sold to overseas buyers can remain in New Zealand without attracting GST if industry representatives raise the matter with Inland Revenue.

Noted Noted Noted

Stephen Glover	**John Markland**	**Mike Nutsford**
for Secretary to	Policy Manager	Policy Manager
the Treasury	Department of Internal Affairs	Inland Revenue Department

Hon Dr Michael Cullen	**Rt Hon Mr Winston Peters**	**Hon Mr Peter Dunne**
Minister of Finance	Minister for Racing	Minster of Revenue

Background

1. The Minister of Revenue, in response to a request from the Minister for Racing, has directed officials to analyse and cost the tax policy and fiscal implications of some proposed changes to the write-down of bloodstock, and to discuss the implications of extending the period for which bloodstock sold to overseas buyers can remain in New Zealand before GST is imposed on the sale.

Bloodstock write-down rates

2. The Minister for Racing's proposed changes to the write-down of bloodstock are:

1 **Write-down the cost of stallions over two years.** Current practice is to write-down the cost over four years.

2 **Write-down the cost of younger broodmares (under age 12) over five years.** Current practice is to write-down cost over up to nine years, with the minimum write-down period being three years. Because the 'cost' used to calculate the annual write-down amount is 125%, the maximum write-down period is just over seven years, with only 2.84% of the mare's value written off in the eighth year of the write-off period. Note that while this proposed change will accelerate the write-down of broodmares aged 2 to 4 in the year of first breeding, it will decelerate the write-down of broodmares aged 5 to 11 in the year of first breeding.

3 **Write-down the full cost of older broodmares (12 years and older) immediately.** Current practice is to write-down older broodmares over three years, but because the 'cost' used to calculate the annual write-down amount is 125% of actual cost, 83% of the mare's value is written-down in the first two years, and the remaining 17% is written-down in the third year.

3. The overall effect of the proposed changes is to accelerate the write-down of bloodstock.

4. In 2000, IRD and Treasury reviewed the write-down of bloodstock (T2000/2185 PAD2000/305 refers). The review included an extensive analysis of the actual useful breeding life of bloodstock. As a result of that work, officials concluded that the rates used for the write-down of stallions were broadly correct, as was the treatment applied to broodmares which started breeding at age 12 or older. However, the write-down rates applied to younger broodmares were too low. At the time younger broodmares were assumed to have an economic life up to 15 years of age, but officials' research showed that an average economic life up to age 11 was more accurate. As a result of that research, the law was changed to increase the write-down rates for younger broodmares.

5. It should be noted that the write-down rates for bloodstock are already accelerated for animals that have not been used previously for breeding in New Zealand, because the 'cost' used as the basis of the annual write-down is 125% of actual cost. This is consistent with general approach to depreciation rules of other assets. In general, depreciation rates are based on economic life, but the rates themselves are increased by a 20% loading.

6. In 2000, officials advised that based on the research discussed above, once the change to the write-down rates for younger broodmares was implemented, the write-down rules for all bloodstock would reflect the economic life of bloodstock (leaving aside the 20% acceleration applied to all assets). At that time, and subsequently, officials have indicated that there might be grounds for reviewing the rates applying to bloodstock if the bloodstock breeding industry provided empirical evidence that demonstrated that the current treatment did not reflect the economic life of bloodstock. In the absence of such evidence, further acceleration of the write-down rates would be a tax concession.

7. Allowing accelerated write-downs on bloodstock will tend to bias investment decisions. It will provide incentives for investment in bloodstock ahead of other investments that generate higher (risk adjusted) pre-tax returns.

8. Allowing tax concessions can also increase the risk of tax avoidance schemes. As previously reported (T2000/2185 PAD2000/305 refers), in the 1980s there were significant tax avoidance schemes incorporating inflated values for bloodstock and no-recourse or limited-recourse loans, which took advantage of the accelerated write-down rates available then. However the tax planning opportunities afforded by the accelerated bloodstock write-down rates have been reduced by the deferred deduction rules. These rules limit the availability of losses to offset against other income from an arrangement that includes a no-recourse or limited-recourse loan.

9. The attractiveness of elaborate tax planning schemes has also decreased because the current highest income tax rate is substantially less than the highest rates applied in the 1980s. Nevertheless, accelerated write-down rates for any assets, including bloodstock, increases the risk of those assets being used in tax avoidance.

10. As reported previously (T2000/2185 PAD2000/305 refers), in addition to biasing investment decision making, and increasing the risk of tax avoidance, tax concessions can be problematic.

- Tax concessions encourage unassisted sectors to waste effort (from the nation's viewpoint) in lobbying for concessions for themselves. (An example in this context could be farmers who may request similar treatment for their breeding livestock.)

- Tax concessions often subsidise activities that would have taken place anyway.

- The dollar amount of the subsidy is arbitrary, being determined not by government decision but by the firms in the sector being aided.

- Tax concessions are less transparent than explicit subsidies — which is a major reason that they are attractive to groups that would have difficulty justifying explicit subsidies.

- A tax system with tax incentives increases compliance costs. While these costs are voluntarily incurred to gain the benefit, they nevertheless represent resources which would have been used in the business for business purposes instead.

- A concession is likely to reduce government revenue, at least in the short to medium term. Thus to obtain the same level of revenue, concessions must be offset by revenue-raising measures elsewhere.

11. The New Zealand Thoroughbred Breeders Association (NZTBA) has argued that a tax concession with respect to stallions is warranted because it would align the tax treatment of owning a stallion with the tax treatment of leasing a 'shuttle stallion' which is brought to New Zealand for a limited time. (It is necessary to bring stallions to New Zealand because the rules for breeding thoroughbreds prohibit the use of artificial insemination.) Shuttle stallion costs and lease fees are deductible in the year in which the stallion is in New Zealand. The NZTBA holds that it is unfair that shuttle stallion costs are fully deductible in the year of use, but the cost of stallions owned in New Zealand must be written down over four years.

12. This ignores the on-going value of owning a stallion as opposed to renting one. A successful New Zealand owned stallion can generate stud fees for up to five years, whereas a leased stallion will generate stud fees only in the year in which it is in New Zealand. Under the matching principle, the cost of a stallion should be spread over the years in which that stallion generates income. This is what is achieved by the current write-down rates for stallions. Properly, the full costs of leasing a stallion are matched against the income generated by that stallion during the time in which it is in New Zealand.

13. The bloodstock industry submits that the rules encourage renting overseas-based stallions rather than investing in New Zealand-owned stallions. This has undermined the stability of the domestic industry, in which there are few world-class sires. To illustrate this, once a shuttle stallion has proven its ability to sire valuable racehorses, it is unlikely to return to New Zealand. The stallion will either remain in the northern hemisphere because it is too valuable to travel, or it will shuttle to Australia where it will command a higher service fee. In contrast, proven New Zealand-owned stallions remain in the country and bolster the domestic breeding industry.

14. Inland Revenue and Treasury do not recommend further accelerating the write-down rates for bloodstock.

Revenue cost

15. Costing the impact of further accelerating the write-down of stallions is difficult given that the outcome is substantially dependent on changes in the behaviour of participants. Using the same model as was used previously to cost the impact of writing off stallions in full

in the year of purchase (T2000/2185 PAD2000/305 refers), and based on the same assumptions, the revenue cost of writing off stallions over two years would be:

Table 1: Revenue cost of further accelerating the write-down of stallions

Fiscal year	**2007**	**2008**	**2009**	**2010**	**2011**
Revenue cost	1.0m	0.3m	0.8m	1.2m	1.3m

16. The underlying assumptions are:

- the industry increasing in size to 1995 levels over three years;
- all tax savings being used to buy additional horses;
- the additional horses generating additional income of which 10 percent of the tax saving is reinvested; and
- no avoidance activity occurring.

17. The proposed changes to the write-down of broodmares are also timing changes only. The changes will further accelerate the write-down of broodmares aged between 2 and 4 in the year of first breeding, and the write down of broodmares aged 12 or older in the year of first breeding, but they will decelerate the write down of broodmares aged between 5 and 11 in the year of first breeding. Since a substantial number of brood mares are aged over 4 in their first year of breeding the proposed changes could raise between $100,000 and $200,000 per annum over the first four years, and will then cost no more than about $100,000 per annum.

18. The total revenue cost of the proposed changes to the write-down of bloodstock would be:

Table 2: Revenue cost of proposed changes to the write-down of bloodstock

Fiscal year	**2007**	**2008**	**2009**	**2010**	**2011**
Revenue cost	$0.9m	$0.1m	$0.6m	$1.1m	$1.4m

GST on export of bloodstock

19. The Minister for Racing has asked that the Commissioner of Inland Revenue investigate whether the Commissioner should use his discretion under the Goods and Services Tax Act 1985 and allow bloodstock (sold to overseas buyers) to remain in New Zealand 18 to 24 months after the date of sale.

Discretion to extend period in which exported goods stay in New Zealand

20. In general, the GST Act zero-rates the supply of goods to overseas buyers. For zero-rating to apply, the GST Act generally requires the goods to be entered for export and exported within 28 days of the goods being supplied (earlier of invoice or payment). If the recipient is in New Zealand when the goods are supplied, GST must apply even if the goods are later removed from New Zealand (duty-free shopping is an exception to this rule).

21. The emphasis on exported goods leaving New Zealand is integral to GST being a broad-based tax on consumption that occurs in New Zealand, and ensures that consumers, including tourists, in New Zealand do not have access to zero-rated goods.

22. Supporting this policy is the requirement that GST be charged on any exported goods that have not left New Zealand after 28 days.[1] The GST Act recognises however that not all goods will be able to leave New Zealand within 28 days and gives the Commissioner discretion, on written application by the supplier, to extend the time in which exported goods may remain in New Zealand. The discretion can be exercised on a case by case basis if:

- events beyond the control of the exporter or recipient prevent the goods from leaving New Zealand within 28 days, or
- the nature of the goods means that it is not practicable for those goods to be exported within 28 days.

23. With effect from 16 August 1999, Inland Revenue allows 12 months as the maximum extended period available for exported bloodstock. A condition of the extension is that horse may not contest a race for prize money according to the New Zealand rules of racing. Previous Inland Revenue policy statements have allowed a maximum period for bloodstock of six months or 10 months for bloodstock exported to Asia.

Extending the period of time in which bloodstock sold to offshore buyers may remain in New Zealand

24. The Minister for Racing has asked that this administrative practice be extended to allow periods of up to 18 to 24 months between sale and export. The Minister notes that there would be considerable benefit to the industry and the economy if this were to happen. Horses sold as yearlings (particularly those destined for Asian markets) could be developed and educated in New Zealand. This would increase employment opportunities at New Zealand horse farms. The horses would be exported in good order to commence racing as 3-year-olds. Good racing results offshore will stimulate interest in, and demand for, New Zealand-bred horses.

25. Officials note that a number of amendments were enacted in 2000 to address concerns raised by the bloodstock industry by zero-rating the supply of horses that die in New Zealand before export and zero-rating services supplied in connection with goods that are to be exported from New Zealand. The second change was made on the expectation that exported goods would not be in New Zealand for an extended period of time. The longer that a horse remains in New Zealand, the greater the range of services provided in relation to the horse such as training and upkeep (agistment) that will be zero-rated. These same services would be subject to GST if supplied to a New Zealand owned horse.

[1] The imposition of GST may be reversed at a later date if the goods are subsequently exported.

26. Officials also note that many racing-orientated activities carried on in New Zealand are treated as hobbies. A consequence of this treatment is that New Zealand bloodstock owners may be treated as final consumers and bear the cost of GST on training and upkeep expenditure.

27. Inland Revenue and Treasury officials are concerned, that an inconsistent GST treatment of bloodstock owned by overseas buyers, compared with bloodstock owned by New Zealand residents, may raise concerns regarding the fairness of the GST system if New Zealanders perceive that overseas buyers are receiving preferential tax treatment. There is also a concern about the implications of a long extended period as a precedent for other industries which should be further considered.

28. Internal Affairs officials consider that horses sold for export are not 'consumed' until they race for stakes, in accordance with the rules of racing. Thus, provided the horse does not race for stakes before it is exported, the objective of GST as a tax on consumption would not be undermined. However, even if this is correct, Inland Revenue and Treasury officials remain concerned, as noted in paragraph 26, about the continued zero-rating of services provided in relation to such goods and the implications as a precedent for other industries of a long extended period.

29. Nevertheless, officials do accept that any extension to the 28 day rule needs to be a workable one. Officials therefore consider that, if the NZTBA or other industry representatives can provide sufficient justification based on industry practice for an extended period, the Commissioner should review whether the time allowed for exported bloodstock to remain in New Zealand should be further extended.

Next steps

30. Officials consider that Ministers should meet and discuss the issues raised in this report with respect to the write-down rules to be applied to bloodstock. Based on the outcome of this discussion, officials, if so directed, will include changes to the bloodstock write-down rules in the Cabinet paper being prepared in respect of the taxation of racing.

31. In relation to the GST matter, we suggest that the NZTBA, or other industry representatives, raise the matter with Inland Revenue to consider extending the period of time in which exported bloodstock may remain in New Zealand.