

# **Regulatory Impact Statement**

## **Specified livestock elections**

### **Agency Disclosure Statement**

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

The question addressed in this RIS is how to prevent the tax rules for specified livestock being used in a way that allows farmers to exit from the herd scheme for a tax advantage. As a measure to protect the tax base, options therefore remove an unintended tax subsidy.

Due to time constraints, this RIS was not prepared and attached to the original Cabinet paper. As such, the purpose of this RIS is to inform consideration of the resultant tax legislation (not to inform Cabinet decision making).

Extensive consultation has been undertaken in two rounds in late 2011. The first round involved publicly releasing an officials' issues paper. The second round of consultation involved an Inland Revenue official presenting to over 800 accountants at 19 sites across New Zealand, and engaging in discussions on a range of primary sector issues. This included significant discussion on the matters raised in the officials' issues paper.

In preparing this Statement there are two assumptions:

1. farmers decide to switch between specified livestock valuation methods predominantly for tax-driven reasons; and
2. the only situation where a change from the herd scheme method is justified is when farmers are changing their operations to a fattening regime.

Other than those stated above, there are no other key gaps, assumptions, dependencies, significant constraints, caveats or uncertainties concerning the analysis. The proposed option does not impair private property rights, reduce market competition, provide disincentives to innovate and invest, or override common law principles.

Dr Craig Latham  
Group Manager, Policy  
Inland Revenue

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## STATUS QUO AND PROBLEM DEFINITION

1. The term “specified livestock” refers to dairy cattle, beef cattle, sheep, deer, goats and pigs. Under the Income Tax Act 2007 there are two main methods that farmers use to value specified livestock. These methods are the herd scheme, and national standard cost. Other (very uncommon) methods are cost price, replacement price and market value. These other methods are not focussed on in this Statement.
2. The herd scheme method of valuation recognises that specified livestock can have characteristics of capital assets (for example, the ability to produce milk and progeny) and, for tax purposes, should be treated as a capital asset. The herd scheme uses annually announced national average market values to value livestock. The effect of using this method is that gains and losses in value are treated as being of a capital nature for tax purposes and are therefore outside the tax base.
3. The national standard cost method treats specified livestock as trading stock that is held on revenue account. This method uses national average costs (except for livestock purchases, where actual costs are used) rather than farm-specific costs. The effect of using the national standard cost method is that gains and losses in value are treated as being of a revenue nature for tax purposes.
4. Currently, farmers are able to move between these two valuation methods. If farmers choose to enter the herd scheme method they can effectively enter it immediately. If they choose to exit the herd scheme method, they can effectively give as little as one day’s notice.<sup>1</sup> For example, if a farmer who is in the herd scheme files a tax return for the 2006-07 year on 31 March 2008, they can elect to exit the herd scheme for the 2008-09 income year, which for farmers using a 31 March balance date, commences on 1 April 2008. The original policy intent for allowing farmers to switch between these methods was to recognise that when there is a change in the type of farming operation, it may be appropriate to change the valuation method.
5. However, the ability to switch methods effectively allows farmers to time their elections in and out of the herd scheme to maximise the tax-free herd scheme gains and the tax-deductible result of exiting from the herd scheme.
6. The tax-driven behaviour of some farmers is particularly evident when looking at the 2008 peak in dairy cattle prices. From Inland Revenue data, it appears that a number of farmers took advantage of the tax result that can be obtained when herd values are high by exiting the herd scheme and using the national standard cost method. For dairy farmers with 300 cows, plus replacements, who exited the herd scheme at the 2008 peak in herd values, the tax deductible write down per farm was in the order of \$500,000.
7. If the status quo is retained, some farmers may continue to switch between the two valuation methods to minimise their tax. Officials are aware of a number of farmers who have switched between the methods for no other reason than to secure a tax advantage and there is anecdotal evidence that there were a number of farmers intending to elect out of the herd scheme for their 2012-13 income year. This is not in line with the original policy intent

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<sup>1</sup> The legislative requirement is that taxpayers must give notice with the tax return for an income year that is at least two years before the income year in which the election is first to apply.

of the specified livestock valuation rules. Retaining the status quo in respect of elections being made to leave the herd scheme for the 2012-13 income year could result in an estimated decrease in baselines of \$275 million over the next six years.

8. The current rules are unfair to the majority of farmers who apply the specified livestock election rules as intended. Furthermore, the current rules are unfair to other business taxpayers who cannot switch between treating assets as being on revenue account in one year and on capital account in another year.

## **OBJECTIVE**

9. The objective is to prevent the tax rules for specified livestock being used in a way that allows farmers to exit from the herd scheme for a tax advantage. If this objective is met, it would ensure that the tax rules around valuation methods for specified livestock are fair for all farmers and taxpayers.

10. If the objective is met it will also protect the tax base by preventing a future loss in revenue. This fiscal reason is why the core change is being made as part of the Budget 2012 package.

## **REGULATORY IMPACT ANALYSIS**

11. There are two options that wholly or partly achieve the objective outlined above. These two options were consulted on in 2011.

12. The first option is the preferred option and involves amending the tax rules so that elections to use the herd scheme method are irrevocable. This option would mean that farmers using other valuation methods are able to elect into the herd scheme method, but once they have elected into it, they are unable to change to another valuation method.

13. As part of option one, an exception is necessary to allow farmers to move out of the herd scheme method if they are fundamentally changing their farming operation to a fattening operation. This exception aligns with the original policy intent which recognises that it may be appropriate to change valuation methods where there is a change in the type of farming operation. From the consultation carried out, it appears that a change to a fattening operation is the only exception that the law should allow for.

14. The second option is to lengthen the notice period required for electing out of the herd scheme method. As noted above, the current notice period is very short and farmers can make very informed elections. If the notice period is sufficiently lengthened, it would significantly minimise elections to exit the herd scheme being used for a tax advantage. This is because the outcome of choosing to exit the herd scheme would be so unpredictable as to be a gamble and the election should not be made unless there is a genuine reason for it.

15. Whether option one or two is chosen, a supporting protection measure and exception are necessary to ensure the integrity of the new rules. These are:

- (a) **Associated person buttress:** Taxpayers who acquire specified livestock from an associated taxpayer who was using the herd scheme are required to use the herd scheme and the vendor's base herd scheme numbers, and

(b) **Exception to associated person buttruss:** The associated person buttruss does not apply when there is a complete change in the ownership of the specified livestock from one generation to the next.

16. A summary of the two options is contained in the table below:

Option	Advantages	Disadvantages
<p><b>One:</b> Election to use the herd scheme method be irrevocable</p> <p>+ Exception for changes to a fattening operation</p> <p>+ Associated person buttruss and exception</p> <p><i>(preferred option)</i></p>	<p>Meets the objective.</p> <p>May result in efficiency gains as farmers will not have an incentive to restructure their business predominantly for tax reasons. This also makes compliance easier for farmers as it is compulsory. That is, the removal of the ability to move between methods reduces compliance costs because it removes a choice that at least some accountants suggest should be reviewed each year.</p> <p>Protects the tax base by not allowing a fiscal loss in future years.</p> <p>Is fair as it best aligns the tax treatment for farmers with other business owners (who do not get similar tax advantages).</p>	<p>The exception for changes to a fattening operation is narrow. There will be no provision for changes to other operations even if, from a policy perspective, there should be (although we are unaware of any other circumstances where an election to exit would be appropriate).</p>
<p><b>Two:</b> Lengthen the election period for electing out of the herd scheme method</p> <p>+ Associated person buttruss and exception</p>	<p>Partially meets the objective as it can substantially reduce the ease with which farmers can obtain tax advantages.</p> <p>At least partially protects the tax base as it reduces the likelihood that the rules will be used to obtain a tax advantage.</p> <p>Fairer than the status quo.</p>	<p>Only partially meets the objective. Farmers may still be able to obtain tax advantages by switching between methods. Compared to option one this results in a fiscal risk.</p> <p>Would be more difficult to back-date due to administrative and compliance implications.</p>

17. The economic, fiscal and compliance impacts of the options are outlined in the table above. Neither of the two options has social, environmental or cultural impacts.

18. The disadvantage of option one is that there is only one statutory exception. However, after considering submissions, officials are not aware of any other reasonable arguments for extending this exception. Further, the tax rules already allow an alternative valuation option method to be used by farmers that reduces concerns in situations which involve decreasing breeding livestock and increasing other livestock. The alternative valuation option method effectively allows farmers to value extra livestock on a class by class basis<sup>2</sup> at cost.

19. A disadvantage of option two (as compared to option one) is that it does not entirely remove the fiscal risk of switching between methods.

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<sup>2</sup> For example, beef cows are a different class to steers.

## CONSULTATION

20. Extensive consultation has been undertaken in two tranches. An officials' issues paper was released for formal consultation in August 2011. The paper outlined the issues around specified livestock valuation elections and two options were put forward (being options one and two in this Statement). Officials suggested that their preferred option was option one, along with the associated person buttness. Feedback was sought on the preferred suggestion and alternatives (the result of this feedback is set out below).

21. Shortly after the officials' issues paper was released a second round of consultation was carried out from late August to early October 2011. This involved an Inland Revenue official presenting on the proposed livestock changes (outlined in the officials' issues paper) to over 800 accountants at 19 centres across New Zealand. Each livestock presentation was approximately 90 minutes in length and included significant discussion with the attendees on a range of issues raised in the issues paper. All attendees were invited to provide written submissions on the issues paper.

22. During the verbal discussions at the presentations, the vast majority of attendees agreed that the status quo was inappropriate as it provided tax advantages (only two disagreed). The minority (two attendees) provided verbal feedback separately that the status quo should be retained because dairy farmers were essential to the New Zealand economy so the unintended subsidy was appropriate.

23. While the large majority of attendees agreed that the status quo was inappropriate, the preference over which option to recommend was not clear-cut. Approximately half of the attendees considered option one to be the best option, while the other half favoured option two.

24. During the consultation the proposed exception to option one (for changes to a fattening regime) and the exception to the associated person buttness (for inter-generational ownership transfers) were raised. Officials considered there was merit in these two exceptions and have therefore included them in the approach.

25. The closing date for submissions to the officials' issues paper was informally extended to 31 October 2011, to ensure that those attendees at the presentations had a chance to provide a written submission. Overall, officials received 12 written submissions to the officials' issues paper. Two of these were from the pre-eminent industry organisations (New Zealand Institute of Chartered Accountants and Federated Farmers), and the rest were from provincial accountants.

26. None of the written submissions received disagreed with the need for a change to the specified livestock election rules. However, a large majority of written submissions considered option two to be the best option, although some of these did have alternatives that proposed option one or amendments to option one.

27. All of the major points that were raised in consultation discussions were also raised in the written submissions. All feedback was taken into account and, as a result, the two exceptions (the proposed exception to option one for changes to a fattening regime and the exception to the associated person buttness for inter-generational ownership transfers) were developed.

28. The Treasury was also consulted and agrees with the preferred solution.

## **CONCLUSIONS AND RECOMMENDATIONS**

29. Option one is the preferred option because, when implemented along with the supporting rules outlined above, it meets the objective. The disadvantages that are identified for this option can be sufficiently addressed.

30. Option two is not recommended because it does not sufficiently achieve the objective.

## **IMPLEMENTATION**

31. Two sets of legislative changes are needed to implement the preferred option (option one):

1. Legislative change to the Income Tax Act 2007 so that an election into the herd scheme method is made irrevocable. It is proposed that this change be made as part of the Budget 2012 legislation, and that it apply from 18 August 2011 (being the date that the officials' issues paper was publicly released).
2. Three supporting legislative changes are required to the Income Tax Act 2007. These supporting legislative changes are the exception for changes to a fattening operation, a buttress for transfers to associated persons, and an exception to the associated person buttress for inter-generational transfers. It is proposed that these changes be made as part of the tax bill that is expected to be introduced in mid-2012, and that they apply from 28 March 2012 (being the date that the Minister of Finance and the Minister of Revenue announced the Government's intention to tighten the specified livestock tax rules). Given that these supporting legislative changes are proposed to be in a mid-2012 tax bill, there will still be an opportunity for submissions to be made on the proposed changes during the select committee stage of the bill.

32. If option one (the preferred option) is adopted, the new rules would be administered by Inland Revenue through existing channels and there would be no other significant administrative issues.

33. Due to the backdated application date, farmers who have elected out of the herd scheme method between 18 August 2011 and the night that the Budget legislation is passed, would have their elections cancelled. This is required to prevent a potential \$46 million decrease to the baselines for each year in the forecast period should the status quo be allowed to continue.

34. If option two is adopted, there may be significant administrative and compliance implications. Those farmers who had elected out of the herd scheme between 18 August 2011 and the date of enactment of the new rules and who had complied with the current notice requirements to cancel their election, would need to be given an opportunity to cancel their election because of the increased uncertainty that a longer period would cause. Depending on the number of farmers in this category, the administrative and compliance implications of this could be significant.

## **MONITORING, EVALUATION AND REVIEW**

35. There are no specific plans to monitor, evaluate and review the changes under the Income Tax Act 2007 following the changes. This is because the reforms are being carried out for reasons of fairness and for protection of the tax base. The supporting legislative

changes (that is, the exception for changes to a fattening operation, a butress for transfers to associated persons, and an exception to the associated person butress for inter-generational transfers) are intended to be introduced as part of the mid-2012 tax bill and, as per the normal process, there would still be an opportunity for submissions to be made on the proposed changes during the select committee stage of the bill.

36. If any detailed concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process.