Herd scheme elections

An officials' issues paper

August 2011

Prepared by the Policy Advice Division of Inland Revenue and the New Zealand Treasury

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Herd scheme elections – an officials' issues paper.
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CHAPTER 1

Overview

1.1 As signalled in Budget 2011, this review of the rules governing livestock valuation elections is driven by a need to ensure greater fairness in the tax system. Suggestions presented here seek to strike a balance between fairness for all taxpayers and fairness for farmers.

1.2 This officials' issues paper looks at problems that have arisen with certain livestock valuation elections rules where the flexibility of the rules is being inappropriately used. This practice was not intended and resulted, for example, in an estimated fiscal cost to the Government of over $100 million of lost tax revenue as a result of the 2007–08 year peak in dairy cow values.

1.3 Put simply, it appears that it is too easy for farmers to exit the herd scheme and there is a significant cyclical fiscal cost associated with this.

1.4 No other livestock valuation matters are considered in this paper.

1.5 Of necessity this paper is technical and is therefore targeted at farm accountants and their farmer clients. Further, while this paper focuses on Friesian dairy cows as an example because of the recent volatility in the market values of dairy cows, it is equally relevant to all specified livestock (sheep, cattle (dairy and beef), deer, goats and pigs).

1.6 This paper discusses the two main livestock valuation methods in Chapter 2, and Chapter 3 presents high-level analysis of the problems. The problems and suggested reforms to the election to exit the herd scheme are discussed in detail in Chapter 4. Chapter 5 considers the problems and suggested reforms when there is a cessation of farming.

Background and problem

1.7 There are two main livestock valuation methods – the herd scheme and national standard cost. The herd scheme views the farm livestock as a machine held on capital account. It uses annually announced national average market values, and makes annual changes in value tax-free by way of adjusting, on capital account, the value of opening livestock to that of closing livestock for each year.

1.8 National standard cost is a more typical inventory regime where changes in values are on tax account, but it uses national average costs rather than farm-specific costs. Farmers can elect to move between these valuation methods.

1.9 The problem is that some farmers are making elections with the apparent objective of taking tax-free herd-scheme gains when livestock values are increasing and tax deductible write-downs as values decrease. The livestock valuation rules and their associated elections were not intended to allow farmers to shelter their ordinary farming taxable income in this fashion.

1.10 The two elections associated with the herd scheme that are causing problems are:

- the election by a continuing farmer to exit from the herd scheme to use another livestock valuation method; and
- the election when a farming enterprise that uses the herd scheme sells its specified livestock and ceases farming. A similar election is available when a farmer dies.

1.11 The concern is an equity issue in the tax system as no other business taxpayers can value a major asset such as trading stock in one year as if it were a machine on capital account, and in another year value it as trading stock under a cost-based regime.

Suggested solutions

1.12 Officials' suggestions to address the identified problems are:

- That, once a farmer has elected to use the herd scheme, the election is irrevocable (as was originally proposed by the consultative document in 1986).[1]
- That, when a farmer has ceased farming and disposed of their livestock to a non-associated person before, say, 31 July of a year, it is compulsory for the vendor to use the herd values issued during that calendar year in the tax return that covers the period of sale (i.e. no opening herd scheme adjustment). Otherwise it is compulsory for the vendor to use the next calendar year's herd values for opening stock (i.e. do the opening herd scheme adjustment).
- For all sales to associated persons, the associated person is bound by any herd scheme election and base herd scheme numbers of the vendor. The vendor must use the year-end herd values in the period covering the sale (i.e. do an opening herd scheme adjustment).
- Where a farmer has died, the same associated persons rule applies.

1.13 Feedback is welcomed on these or alternative suggestions, as long as the tax base is appropriately protected. The main alternative suggestion canvassed in this paper is to extend the notice period for the election to leave the herd scheme. Buttressing of the suggestions by consideration of the treatment of associated persons' transactions will be necessary regardless of which option is chosen.

[1] The March 1986 *Consultative Document on Primary Sector Taxation.*

Application dates

1.14 Given that these are, at this stage, only officials' suggestions and are subject to consultation, no consideration has been given to potential application dates.

Fiscal implications

1.15 A change to prevent future herd-scheme write-downs is a base maintenance measure by nature. The existing baselines do not include livestock valuation fluctuation forecasts. Hence, for budgetary purposes, no fiscal savings arise from these suggestions to prevent farmers swapping between the schemes.

1.16 This does not imply that it is not fiscally important to do this work, since in the absence of the policy change, the Government would instead be facing a negative variance against forecast when such an event occurs again.

Submissions

1.17 Officials invite submissions on the suggested reforms. Submissions should be addressed to:

Herd scheme elections
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington 6140

or email policy.webmaster@ird.govt.nz with "Herd scheme elections" in the subject line. Electronic submissions are encouraged as this increases the efficiency of the analysis process.

1.18 The closing date for submissions is 30 September 2011.

1.19 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for officials to contact those making the submission to discuss the points raised, if required.

1.20 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

The two common valuation methods

2.1 Conceptually, the Income Tax Act treats specified livestock owned by a farming business in a similar fashion to trading stock, notwithstanding the characteristics of the herd scheme. The two most common methods of valuing specified livestock are the herd scheme and the national standard cost (NSC) scheme.

The herd scheme

2.2 The herd scheme effectively treats qualifying livestock as a capital asset, notwithstanding its similarity to trading stock. Changes in herd values (specifically "national average market values" or "NAMVs") from year to year are tax-free, but changes in numbers are on tax revenue account.

2.3 The herd scheme's capital asset treatment is effected by revaluing each year's opening stock to the closing values for that year (the opening value of trading stock is in all other cases the last year's closing values). This revaluation amount is a capital (and therefore non-taxable) gain or loss.

2.4 This revaluation is what makes the herd scheme unique. No other trading stock is subject to such an adjustment. The ability to cease making this adjustment is key to the issues discussed in this paper.

2.5 Example 1 is a simplified example that presumes a dairy farmer has 300 MA (mixed age) Friesian cows and replacement livestock on hand all valued in the herd scheme. The period selected is the years from 2006–07 to 2008–09 as in this period a very large price spike occurred in the value of dairy cows. Unless otherwise specified, the examples in this paper use these numbers and presumptions, although a number of examples are simplified further by referring to MA Friesian cows only.

2.6 Example 1 illustrates the significant tax-free "gain" from the 2006–07 income year to the 2007–08 income year of $344,940. Equally, it illustrates the significant non-deductible "loss" from the 2007–08 income year to the 2008–09 income year of $329,340.

2.7 An opening stock revaluation is generally compulsory in respect of opening livestock that was valued in the herd scheme as closing stock in the previous year. However, there are exceptions discussed in the next chapters.

2.8 What is not illustrated in Example 1 is that changes in the number of herd scheme livestock on hand are on tax revenue account. Thus, for example, if cow numbers being valued in the herd scheme increased during the year, the total closing tax value of the livestock would increase over the opening value and taxable income would result. The alternative valuation option (AVO), which is discussed later, can offer some tax relief in this circumstance.

Example 1: Simplified herd scheme example

	No. on Hand	NAMV $	Value $		Tax-free $
2006–07 income year					
Closing stock					
MA Cows	300	1,245	373,500		
R 2 Heifers	60	1,075	64,500		
R 1 Heifers	60	594	35,640		
				473,640	
2007–08 income year					
Revalued opening stock					
MA Cows	300	2,150	645,000		
R 2 Heifers	60	1,856	111,360		
R 1 Heifers	60	1,037	62,220		
				818,580	
Closing stock					
MA Cows	300	2,150	645,000		
R 2 Heifers	60	1,856	111,360		
R 1 Heifers	60	1,037	62,220		
				818,580	
Change in tax value				Nil	
Tax free gain/(non-deductible loss)					344,940
2008–09 income year					
Revalued opening stock					
MA Cows	300	1,312	393,600		
R 2 Heifers	60	1,083	64,980		
R 1 Heifers	60	511	30,660		
				489,240	
Closing stock					
MA Cows	300	1,312	393,600		
R 2 Heifers	60	1,083	64,980		
R 1 Heifers	60	511	30,660		
				489,240	
Change in tax value				Nil	
Tax free gain/(non-deductible loss)					(329,340)

Example 2: Simplified NSC example

	No. on Hand	NSC $	Value $	
2006–07 income year				
Closing stock – say				
MA Cows	300	755.10	226,530	
R 2 Heifers	60	771.30	46,278	
R 1 Heifers	60	652.00	39,120	
				311,928
2007–08 income year				
Opening stock				
MA Cows	300	755.10	226,530	
R 2 Heifers	60	771.30	46,278	
R 1 Heifers	60	652.00	39,120	
				311,928
Closing stock				
MA Cows	300	758.34	227,502	
R 2 Heifers	60	756.80	45,408	
R 1 Heifers	60	608.60	36,516	
				309,426
Change in tax value – income/(loss)				(2,502)
2008–09 income year				
Opening stock				
MA Cows	300	758.34	227,502	
R 2 Heifers	60	756.80	45,408	
R 1 Heifers	60	608.60	36,516	
				309,426
Closing stock				
MA Cows	300	758.68	227,604	
R 2 Heifers	60	751.20	45,072	
R 1 Heifers	60	787.60	47,256	
				319,932
Change in tax value – income/(loss)				10,506

This example presumes that for ease of calculation the cost of each of the 2006–07 MA cows is $755.10.

National standard cost

2.9 In contrast to the herd scheme, the NSC scheme is a valuation regime similar to one manufacturers would use to value trading stock, except that as a simplification measure it uses national averages to calculate the on-farm costs of breeding, rearing and growing livestock (BRG). Thus, not only are changes in number on tax revenue account, but also changes in value as well.

2.10 Example 2 is a simplified example that presumes a dairy farmer has 300 Friesian cows and replacement homebred livestock on hand all valued using the NSC scheme. The period selected is again the years from 2006–07 to 2008–09 as in this period a very large market price spike occurred. Because NSC reflects on-farm costs rather than the market value of livestock, this spike is not reflected in the NSC values of homebred livestock.

2.11 The examples in this paper presume that the NSC stock flow method used is first-in, first-out (FIFO) rather than weighted average.

Contrast between the methods

2.12 Using the above examples, the differences in year-end values between the herd scheme and NSC are substantial:

Year	Herd values $	NSC cost $	Difference $
2007	473,640	311,928	161,712
2008	818,580	309,426	509,154
2009	489,240	319,931	169,309

2.13 Among other things, this shows clearly the effect of the market value spike in 2008 and the resulting volatility in herd values or NAMVs that occurred in this period. Although this volatility was extreme by historical standards, the graph at the start of Chapter 3 shows that there was another price spike for MA Friesian cows in the last decade. The above table also shows the relative stability of the NSC scheme when replacement livestock is homebred.

The alternative valuation option (AVO)

2.14 This alternative was introduced at the same time as the NSC scheme in the 1992–93 tax year. It allows farmers who are using the herd scheme and whose livestock numbers are expanding to value some or all of those extra numbers at cost. This allows farmers to avoid paying tax on some or all of the write-up from cost to NAMVs on those extra numbers. In a home breeding situation this could be particularly significant. Although the AVO is part of the solution suggested by officials, no changes to it are suggested.

2.15 Example 3 deals with the base herd of 300 MA cows that feature in the above examples and that are valued in the herd scheme. Over time this is increased by home breeding to 340. For simplicity, replacements are ignored.

Example 3: AVO example

Year	Herd numbers opening	Total numbers closing	Minimum closing herd numbers	Maximum numbers in AVO
2007	300	300	300	0
2008	300	325	300	25
2009	300	320	300	20
2010	300	340	300	40

2.16 Presumably the AVO cows will be valued in the NSC scheme. Thus there is no extra tax cost of increasing these numbers, whereas if the extra 40 were valued in the herd scheme extra tax would have been payable.

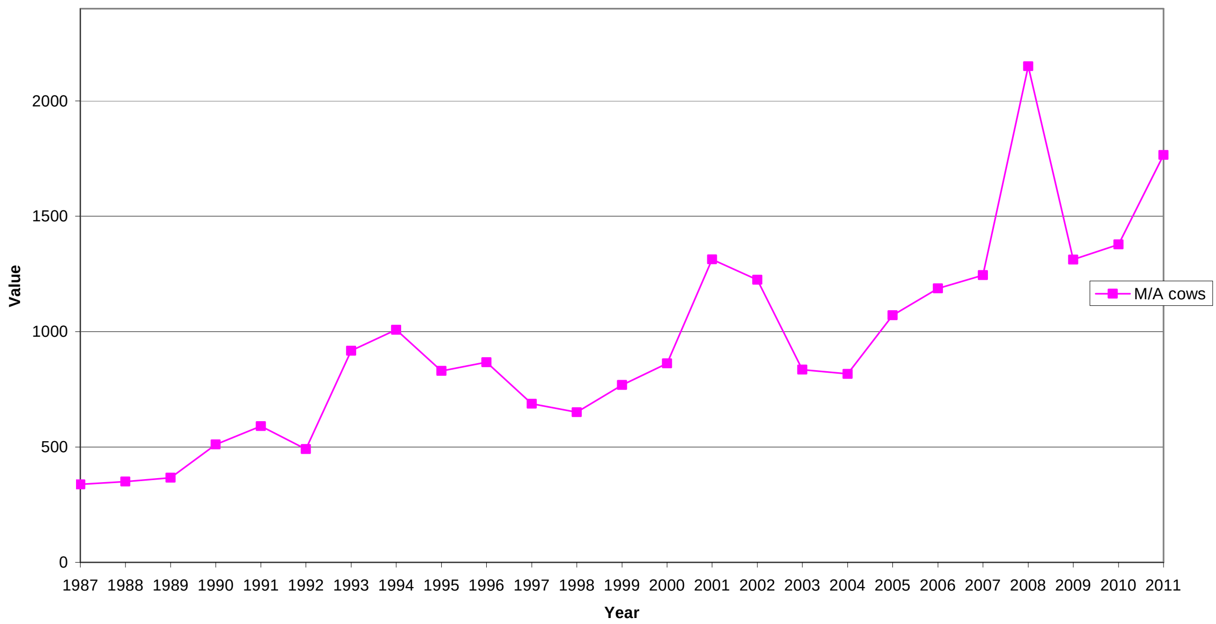
2.17 The maximum AVO numbers presume that the minimum of 300 MA cows were valued in the herd scheme at the end of each of the years. Alternatively, if in 2009 the 320 MA cows had been valued in the herd scheme then only the increase of 20 could be valued using the AVO in 2010.

CHAPTER 3

High-level analysis of the problem

3.1 The following graph of Friesian cow NAMVs from 1987 (when the herd scheme was introduced) to date shows three significant spikes, two of which have been in the last decade. The 1993 spike was mainly caused by the change of valuation methodology that occurred as part of the 1993 reforms.

National Average Market Values – Friesian M/A Cows



3.2 In contrast, as illustrated in paragraph 2.12, the NSC scheme offered, from its introduction in the 1992–93 tax year, substantial stability for a home-breeding operation.

3.3 Theoretically these spikes offered dairy farmers using the herd scheme an incentive to exit it. There is evidence that a number of dairy farmers used these opportunities in relation to either, or perhaps even both, of the spikes in the 2000s with the result that their tax liability has been reduced.

3.4 For example, presuming a farmer with 300 cows successfully exited the herd scheme in the 2008–09 income year, as a number did, they could have obtained about $100,000 of net tax savings over the 2008–09 and subsequent income years. This is because the farmer took a tax-free write-up to the 2007–08 peak, and arranged to obtain a tax deduction for the subsequent write-down.

3.5 It seems a number of farmers also took advantage of the earlier 2001–02 spike. This was described in an article titled “Watch your step when stepping out of the Herd Scheme” in the May 2003 issue of *The Chartered Accountants Journal*. An extract from page 10 of the *Journal* follows.

"As we worked into the 2002 income year, many of us could see that herd values for sheep and beef cattle were also going to peak, and if there was ever a time to quit the Herd Scheme, this was it.

The legislation requires a two-year written notice of election for taxpayers wishing to quit the Herd Scheme. In fact, the timeframe is somewhat less than two years because, provided a written notice of election to quit the scheme was filed before the closing date for filing the 2001 tax return, it was possible to be out of it for the 2003 income year.

Large numbers of taxpayers filed the appropriate elections prior to filing their 2001 tax return – many of which were delayed until the last few days of March 2002. By that time, we had a fair idea of what the 2002 herd values would be. Those 2002 herd values were announced in May 2002 and though dairy cattle had gone just over the crest, it appeared that sheep and beef cattle had peaked in that year.

It is becoming evident that 2003 herd values will be considerably lower than those ruling for 2002. For those continuing with the Herd Scheme, there will be a very large non-tax-deductible devaluation of stock to be brought to account when preparing the 2003 financial statements for farming clients.

Some of that downward market value trend became obvious for dairy cattle by late autumn/early winter of 2002. The downward trend was also beginning to be reflected in sheep and beef cattle prices with the strengthening of the currency in October 2002.

Those who had not filed elections to quit the Herd Scheme prior to filing their 2001 tax returns probably realised that they had "missed the bus".

Through the period from the winter of 2002 to the end of January 2003, many decided to use the alternative route for quitting the Herd Scheme.

That alternative involves selling the livestock to a separate entity (not a related partnership) and having that separate entity make its own decision about which valuation system to use for its new livestock.

The old (selling) entity was able to apply a special provision that flows through under section EL 5(6) of the Income Tax Act 1994. That provision applies where a taxpayer that has previously adopted herd values for livestock has now sold all of the livestock and ceased to derive income from it.

In those circumstances, the selling entity is entitled to file an election no later than 1 February in the income year of sale and cessation to use the herd values for the immediately preceding income year.

….

The result will be that most of these taxpayers will have generated a significant tax loss on disposal of their livestock."

(Reprinted with permission from the New Zealand Institute of Chartered Accountants.)

3.6 This extract highlights a number of potential problems including:

- It was seen as being common practice to try to exit the herd scheme when NAMVs were high.
- “Large numbers” elected out using the election to leave the herd scheme.
- “Many” farmers were delaying filing their tax returns to keep their livestock election options open.
- “Many” farmers used “the alternative route for quitting the herd scheme” (or what this paper calls the “sale cease farming election”).

3.7 While there may have been some exaggeration over the numbers of farmers involved, this extract clearly indicates that there is a series of tax policy and operational problems, all seemingly to do with securing a tax advantage by exiting the herd scheme at an opportune moment.

3.8 It appears that there was considerably more use of these options to leave the herd scheme as a result of the 2008 peak in dairy cow prices than there was in relation to the earlier peak discussed in the extract.

The two elections of concern

3.9 There are a variety of livestock valuation elections that allow farmers to select which livestock valuation regime they wish to use for their specified livestock. In particular, there are two elections that are currently causing concern:

- The election by a continuing farmer to exit from the herd scheme to use another livestock valuation method. This has the practical effect that the opening herd scheme adjustment is not made in the year that the election is effective (thus the opening herd livestock is valued at the last year’s herd values) and another valuation method is used at the end of that year.
- Where a farming enterprise that uses the herd scheme sells its specified livestock and ceases farming, (or a farmer dies (in which case their livestock is deemed to have been sold)), in qualifying circumstances an election can be made for the tax return that includes the sale, that the opening herd scheme adjustment need not be made (the “sale cease farming election”).

3.10 The practical effects of these elections are illustrated by example in the next two chapters of this paper.

3.11 For continuing farmers, the election to exit has been the most common method for farmers to cease using the herd scheme. However, in relation to the 2008 peak in herd values of dairy cows there is evidence that several hundred farming enterprises used the “sale cease farming election” where the “sale” was to an associated person (that is: there was no real change in economic ownership).

Summary

3.12 Of all business taxpayers, it is only farmers of specified livestock that can elect one year to value their stock (typically after land, their biggest asset) as a capital asset (the herd scheme), and in the next year as if it were trading stock held on tax account (the NSC scheme). A number of farmers have used these elections to generate tax savings (from tax-free write-ups and tax-deductible write-downs).

3.13 From a tax policy and fairness perspective, the advantage these farmers are obtaining is inappropriate. A legislative response is required.

CHAPTER 4

Elections to exit the herd scheme

Background

4.1 The original March 1986 *Consultative Document on Primary Sector Taxation* discussed whether elections should be irrevocable and proposed at paragraph 2.7.2: "To avoid these problems [of taxpayers swapping from one valuation method to another to take advantage of movements in values] an election to use the herd scheme will be irrevocable".

4.2 The Consultative Committee agreed with submitters that the proposed irrevocable nature of the election "would be an undue restriction on a taxpayer's flexibility of choice" (at page 20 of the *Report of the Consultative Committee on Primary Sector Taxation*). It proposed 12 months clear notice. The Government did not accept this, and opted for 24 months before the commencement of the year in which the change was to apply.

4.3 At the Select Committee stages of the resultant tax bill later in 1986, this was then adjusted to the "2 years' notice" which required the election to be made by 31 March of the tax year that was two years before the election was to apply. In practice this could be a minimum of a year and a day's notice depending on the farmer's balance date.

4.4 In the 1992 *Report of the Consultative Committee on Livestock Valuation*, a further change was proposed and accepted, for "administrative" reasons. This was a reference to the compliance cost savings that would result from the accountant not having to discuss livestock valuation election options with their farmer client other than as part of the annual financial statements and tax return review. This change provided that, instead of the notice being given by 31 March of a year, it could accompany the tax return for that year. This effectively reduced the period of notice by up to a year.

4.5 The current authority for the election is section EC 14(3) of the Income Tax Act 2007. Section EC 11(3) then requires that this notice be given 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".

4.6 So, for example, an election to exit the herd scheme for the 2008–09 income year could have been given with the 2006–07 tax return, which could have been filed as late as 31 March 2008. (Under the originally enacted "2 years' notice" rule, for the notice to be effective for the 2008–09 year it would have to have been given by 31 March 2007.)

4.7 The effect of this election is that no opening herd scheme revaluation was completed in the 2008–09 income year and NSC could be used to value the closing livestock. Example 4 sets out what would have happened in the 2008–09 income year if appropriate notice had been given with the 2007 tax return.

Example 4: Electing to leave the herd scheme

	No. on Hand	$	Value $		Tax free $
2007–08 income year					
Revalued opening stock					
MA Cows	300	2,150	645,000		
R 2 Heifers	60	1,856	111,360		
R 1 Heifers	60	1,037	62,220		
				818,580	
Closing stock – herd scheme					
MA Cows	300	2,150	645,000		
R 2 Heifers	60	1,856	111,360		
R 1 Heifers	60	1,037	62,220		
				818,580	
Change in tax value				Nil	
Tax free gain/(non-deductible loss)					344,940
2008–09 income year					
Opening stock					
MA Cows	300	2,150	645,000		
R 2 Heifers	60	1,856	111,360		
R 1 Heifers	60	1,037	62,220		
				818,580	
Closing stock - NSC					
MA Cows	300	2,091	627,360		
R 2 Heifers	60	1,180	70,776		
R 1 Heifers	60	788	47,256		
				745,392	
Change in tax value – income/(loss)				(73,188)	
Tax free gain/(non-deductible loss)					(Nil)

4.8 If the farmer had not elected to leave the herd scheme in the 2008–09 year, they would have had a capital (non-deductible) herd scheme loss of $329,340 (as is illustrated in Example 1) instead of a tax deduction of $73,188. However, as illustrated in Example 5 and the discussion immediately below it, this $73,188 deduction is just the start of further deductions as the NSC system applies over subsequent years.

Problem with the election

4.9 Example 4 sets out what would have happened in 2008–09 if the appropriate notice to exit the herd scheme and use NSC had been given with the 2006–07 tax return. This is summarised in Example 5 [gain/(loss)].

Example 5: Election to leave the herd scheme and to use NSC

Year	Valuation election	Opening stock	Closing stock	Tax account	Capital account
2008	Herd	473,640	818,580	Nil	344,940
2009	NSC	818,580	745,392	(73,188)	Nil
2010	NSC	745,392	647,532	(97,860)	Nil

4.10 Over the next four years the NSC value of MA cows would continue to decrease until the effect of the herd values (using the FIFO method) has been "aged out" of the livestock and they would then have been valued at their underlying home-bred BRG (breeding, rearing and growing) cost. Over the 2008–09 and subsequent income years this would yield tax deductions in the order of $500,000 (being the difference between the 2007–08 NAMVs and the underlying BRG of homebred livestock.

4.11 If the farmer had elected back into the herd scheme in the 2009–10 income year (which election could be made with the filing of the tax return for that year) they would have derived a much quicker write-down because the NAMVs for the 2009–10 income year were much lower than the 2008–09 income year NSC values for the MA cows. We understand that a number of farmers did make this election. Example 6 illustrates the results [gain/(loss)].

Example 6: Election back into herd scheme

Year	Valuation election	Opening stock	Closing stock	Tax account	Capital account
2008	Herd	473,640	818,580	Nil	344,940
2009	NSC	818,580	745,392	(73,188)	Nil
2010	Herd	745,392	521,220	(224,172)	Nil

4.12 Further, the analysis of the extract quoted in the previous chapter indicates a compliance and administration problem – that of some farmers deliberately delaying the filing of their tax returns to keep their election options open. This is undesirable from a tax administration perspective.

Potential responses

4.13 The Government's continued emphasis upon fairness in the tax system requires a response to the problem outlined. There is a range of potential responses, varying from lengthening the notice period for the election to, at the other end of the spectrum, repealing the herd scheme.

4.14 Repealing the herd scheme is not justified. From an economic perspective, for a livestock farming operation based on a relatively stable number of mature livestock being used to produce progeny, milk or wool for sale, the mature livestock have significant capital characteristics. The herd scheme properly recognises these capital characteristics.

4.15 This leaves two potential solutions:

- lengthen the notice period for the election; or
- repeal the option to be able to elect to leave the herd scheme.

4.16 The question of a potential extension to the timeframe of the present notice is difficult. The following table summarises the above discussion on the history of the notice period:

	2005–06 year	2006–07 year	2007–08 year	2008–09 year
Original Consultative Document	No election proposed			
As introduced in 1986 Tax Bill	Notice given by 31 March 2006			Election effective
As originally enacted in 1986		Notice given by 31 March 2007		Election effective
As amended in 1993			Notice given with 2007 tax return	Election effective

4.17 Given the advent of the AVO in the 1992–93 tax year, the need for farmers to be able to elect out of the herd scheme because of changed circumstances seems to have largely, if not totally, fallen away. Any extra livestock can be valued at cost. Therefore the concerns raised in paragraph 4.2 are less valid.

4.18 Further, any period of notice that was long enough to make it a real gamble as to the taxation effects of leaving the herd scheme, would result in too long a period for any election to be effective to allow for a farmer's change of circumstances.

4.19 Accordingly it is suggested that the original proposal that there be no election to leave the herd scheme be adopted. That is, the herd scheme election will be irrevocable. This is in the belief that the AVO will offer sufficient flexibility to deal with changes in farmers' circumstances.

4.20 This will have the effect that, once a farmer has elected to treat their livestock as a capital asset, they cannot then change their mind and treat this livestock as if it were trading stock.

4.21 However, both of these options need buttressing to make them work. Presently, as discussed in the extract quoted in the previous chapter, and as is discussed in the next chapter, sales to associated persons can be used to circumvent the effect of repealing the ability to be able to elect out of the herd scheme.

CHAPTER 5

Sale of livestock and cessation of farming

Background

5.1 Sections EC 20 and EC 21 of the Income Tax Act 2007 allow an election to not make an opening herd scheme adjustment where a farmer who is using the herd scheme:

- sells their livestock before 1 February of an income year and ceases to derive income from specified livestock in that income year and makes the election by 1 February in that income year; or
- dies before 1 February of an income year where the tax return to date of death is filed before the NAMVs are announced.

5.2 This is called in this paper the "sale cease farming election".

5.3 These provisions have not been substantially changed since their introduction from 1 April 1989.

5.4 This sale could be to an associated party. For example, in the 2008–09 income year there were a number of sales to associated persons in situations where a "2 years' notice" election to exit the herd scheme had not been made with the 2006–07 tax return.[2] If the "sale cease farming election" was properly made in the 2008–09 income year, it had the same economic and tax result as a timely "2 years' notice" election in that there was no opening herd scheme adjustment in the 2009 income year for the vendor.

Problem with the "sale cease farming election"

5.5 If that sale (and this also applies to all deemed sales upon death) was to an associated person in the 2008–09 income year, the tax outcome could be as illustrated in the example below [gain/(loss)].

Example 7: Sale to an associated person

Year	Valuation election	Opening stock	Closing stock	Tax account	Capital account
2008	Herd	473,640	818,580	Nil	344,940
2009	Herd	818,580	489,240	(329,340)	Nil
2010	Herd	489,240	521,220	Nil	31,980

[2] This policy paper makes no observations on whether these transactions comply with all aspects of the Income Tax Act.

5.6 The example presumes that the “new” farming entity makes an election to use the herd scheme. If the purchaser elected to use NSC, the purchaser and the vendor would still get very significant tax deductions over the next few years, but the precise timing and location of those deductions would depend on the sale and purchase price.

5.7 Note that this example presents the tax outcome of livestock valuation over both the vendor and the purchaser and ignores the actual sale and purchase of the livestock (which can be ignored using a “one economic entity” policy approach). The only effect of the sale price is to determine where the tax losses will arise – the higher the price the more the purchaser will derive the tax loss.

5.8 A similar outcome is achievable by selling the livestock to an associated person in the 2007–08 income year. The vendor would still get the large tax-free herd-scheme write-up in the 2007–08 income year. The purchaser could use the NSC scheme for the 2007–08 income year and revert to the herd scheme in the 2008–09 income year, thereby obtaining a large tax deduction, perhaps even, depending on the facts, an amount in the order of the $329,340 illustrated in Example 7.

5.9 There is a further more generic problem with this election even with genuine third party sales – it presents a choice that often results in farmers being able to make an election about which NAMVs to use depending on NAMV movements from year to year. Where NAMVs increase over the income year, the incentive is not to make the election to lock-in the opening values. Where NAMVs decrease over the income year, the incentive is to make the election. In seems likely that this situation will systemically advantage the farmer and therefore cost the Government. Therefore, this election seems to be inappropriate.

Suggested solutions

General cessation

5.10 The fact that ceasing farmers are allowed a choice puts them in a situation to take a tax advantage by making an election that most suits their perception of how NAMVs will move in the income year of the sale. Further, the nearer the disposal of the livestock is to 31 January, the more its market value is likely to be reflected in year-end NAMVs rather than in the previous year’s NAMVs. Similarly, where the sale is early in the income year, the more its market value is likely to be reflected in the previous year’s NAMVs.

5.11 Thus, while there is an argument to remove the “sale cease farming election” completely, if the disposal is early enough in the year, it seems reasonable to suggest that the opening NAMVs be used – that is, for there to be no herd scheme adjustment. This would reduce tax volatility.

5.12 We suggest that, where the disposal is on or before, say, 31 July of a year (and presuming the “vendor” has a balance date for this income year in the calendar year that is before this date), that it be compulsory for the vendor to use the opening NAMVs without adjustment in the year of disposal. Otherwise the opening herd scheme adjustment should be compulsory.

5.13 However, the associated person's sale rule suggested below overrides this.

Sales to associated persons

5.14 As illustrated above, particular problems arise with transfers to associated persons, whether by way of ceasing farming and the sale of all livestock or as a result of the death of a farmer. Further, where there is any arrangement for the vendor to permanently and significantly reduce their livestock numbers by way of a sale, or a series of sales, to an associated person, similar problems can arise depending on the timing of the transaction and how market values actually move.

5.15 In this context "associated persons" means individuals within two degrees of association, spouses (including civil union and de facto) and the family's trusts, and companies, whether owned by the trusts or by the family directly.

5.16 It is suggested that in respect of herd scheme livestock sold, or deemed to be sold, to associated persons:

- the vendor must do the opening herd scheme adjustment (even if they sell all their livestock); and
- the purchaser must value those livestock in the herd scheme at year-end if the vendor would have had to use the herd scheme for those livestock.

5.17 The purchaser would be able to use the AVO to the extent they have also acquired livestock that are not herd scheme livestock, or that they already owned livestock not valued in the herd scheme. For this to work properly, the vendor's base herd scheme numbers for the year would, as necessary, be attributed to the purchaser.

5.18 The practical effect of this is to retain unchanged the herd scheme tax treatment when herd scheme livestock are sold to an associated purchaser. This has the effect of buttressing, for the family farming enterprise in all its potential combinations and entities, either of the two suggested reforms – a longer notice period, or the irrevocable nature of the herd scheme election. This is illustrated in Example 8 [gain/(loss)].

Example 8: Complete sale

Year	Valuation election	Opening stock	Closing stock	Tax account	Capital account
2008	Herd	473,640	818,580	Nil	344,940
2009	Herd	818,580	489,240	Nil	(329,340)
2010	Herd	489,240	521,220	Nil	31,980

5.19 Note that this example presents the tax outcome of livestock valuation over both the vendor and the purchaser and ignores the actual sale and purchase of the livestock (which again can be ignored under a "one economic entity" policy approach). The only consequence of the quantum of the sale price is where any taxable income positive or negative) will arise – the higher the price the more the purchaser will derive a tax loss, but the vendor will derive equivalent taxable income.

5.20 The result contrasts significantly with the outcome illustrated in Example 7.

5.21 If the purchaser already has dairy cattle valued in say, the NSC scheme, so long as at year-end the purchaser uses the vendor's base herd-scheme numbers, the original cattle can continue to be valued in the NSC scheme under the AVO. This is illustrated in Example 9.

Example 9: The purchaser's use of the AVO

Year	Herd numbers opening	Total numbers closing	Minimum closing herd numbers	Maximum numbers in AVO
2008	0	260	0	260
2009	300	540	300	240
2010	300	560	300	260

5.22 Officials acknowledge that getting the balance right in this area is important and they will be carefully considering points made in submissions. In particular, where there is a complete inter-generational change in the farming organisation as a result of an associated persons' transaction, is there any need for this associated persons rule? This would potentially be on the basis that the vendor would have to totally cease to derive any income from the farming enterprise (except for interest on any loan to the purchaser) and could not be a current or potential beneficiary of any trust involved directly or indirectly in the farming enterprise. Officials welcome any submissions on this issue.