Tax Working Group
Te Awheawhe Tāke

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August 28, 2018

To: TWG

From: Robin Oliver

Livestock Taxation under Proposals to Extent the Taxation of Income from Gains

The taxation of livestock was discussed at the Tax Working Group (TWG) meeting of 17 August. This note sets out some of the issues.

It is recommended that TWG

- **Note** that the herd scheme seems prima facie inconsistent with proposals to extend the taxation of income from gains.
- **Agree** that this requires a review of the livestock tax rules
- **Note** that TWG does not have seem to have adequate expertise to undertake such a review itself
- **Agree** that Ministers should be advised of this with a suggestion that a separate group (advisory group?) be established to undertake a review of livestock tax rules that is resourced by officials with relevant specialist knowledge.
- **Recommend,** given the TWG timeframe (report to be near final form by December this year) TWG, no change to livestock tax rules (the herd scheme continues as is) until the above review is completed even if this means legislation covering an increase in taxation of income from gains comes into effect on 1 April 2021 noting that any livestock tax rule could come into effect from income years after that.

Normal Trading Stock Rules

Livestock are generally regarded as trading stock. Under normal trading stock rules changes in number and value are on revenue account.

For trading stock generally, costs of purchase of trading stock are deductible. Then closing trading stock (assume here valued at cost) is income. Next year's opening closing stock is last year's closing trading stock. Next year's opening value is a deduction (a cost) and so on. Sale proceeds of trading stock are income.

Example: Trading stock bought in Year 1 for $100 (no trading stock at beginning of year). Held until year 2 then sold for $150. In the first year, opening trading stock is zero, the cost of trading stock ($100) is a deduction. Closing trading stock Year 1 is $100 – income offsetting $100 deduction. Opening closing stock Year 2 $100 – a deduction. Trading stock sold for $150 – income. Closing trading stock $0.

Overall income in Year 1 - $0 (cost offset by asset).

Overall income in Year 2 - $50 (sale proceeds less opening trading stock).

In effect the trading stock rules suspend the deduction for cost of buying until trading stock is sold.

Livestock aims to follow trading stock but a significant proportion of additional livestock are from the natural increase – i.e. bred and raised on farm rather than bought. Means hard to measure cost – much easier to estimate.

National Standard Cost Method for Livestock

There are two major methods of taxing livestock. The National Standard Cost (NSC) scheme is, as its name implies, cost based. Apart from the use of standard and not actual costs for breeding, rearing and growing expenses, it is based on the same methodology as all other trading stock. The policy rationale for NSC seems to be a response to the difficulties of measuring actual costs of on-farm bred livestock. Otherwise normal trading stock rules apply.

> Example (using approximate actual NSC numbers etc.)
>
> A farmer with 100 mixed age (that is mature) dairy cows would deduct costs of rearing livestock (food, fertilizer etc.) as normal business expenses.
>
> NSC for 2017 approximately $720 per cow
>
> NSC for 2018 approximately $770 per cow
>
> Opening value of livestock 2018 $72,000 (closing value 2017 being 100 x 720). This is a deduction
>
> Closing value of livestock 2018 $77,000 (100 x 770)
>
> Income is $5,000 less other deductible costs.
>
> If herd sold, all proceeds taxable. Income is sales proceeds less opening value ($72,000) and no closing value. So income is difference between what the herd is sold for and what the herd valued for at beginning of the year ($72,000).

Closing value of livestock under NSC is number of cows times NSC closing value. So under NSC an increase in livestock numbers is income and a reduction (say because of death) is a loss. Thus NSC includes changes in the NSC value per cow plus changes in herd size.

The Herd Scheme Method for Taxing Livestock

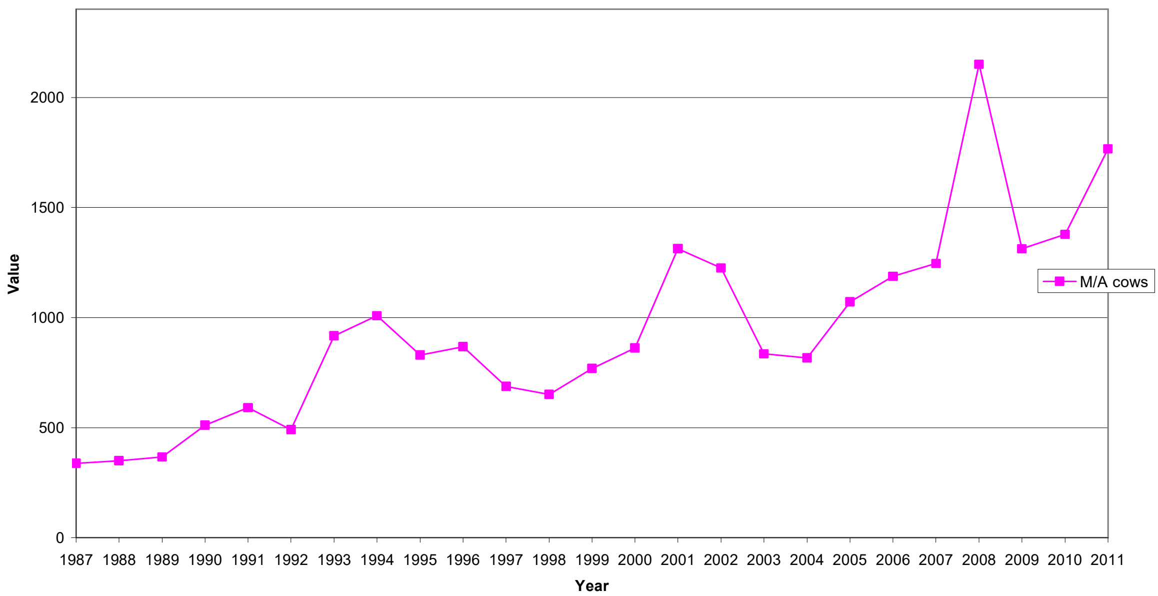
The Herd Scheme views the farm livestock as a machine held on capital account. It uses annually announced national average market values, and makes changes in value tax free by way of adjusting, on capital account, the value of opening livestock to that of closing livestock for each year. Note the herd scheme treats the entire herd as in effect one asset.

Changes in the herd value from National Average Market Value (NAMV) are tax-free capital gains (unlike NSC) and changes in livestock numbers are on revenue account (like NSC). This is achieved by valuing each year's opening stock value at the closing value for that year (not as in NSC or normal trading stock rules the closing value of the prior year).

Note that NAMV values are higher than NSC prices (about double). This reflects difference between market and cost.

> Example. As above a farmer with 100 mixed aged dairy cows.
>
> NAMV 2017 $1,600
>
> NAMV 2018 $1,500
>
> Opening value of livestock 2018 $150,000 ($1,500 x 100) – not $160,000 based on NAMV end of 2017
>
> Closing value of livestock 2018 $150,000 ($1,500 x 100)
>
> The value of the herd measured under NAMV has fallen by $10,000 – in effect a non-deductible capital loss.

While the example illustrates the herd scheme can result in a non-deductible loss, over time NAMV tends to increase. For example from $500 in 1992 to a peak of $2,000 in 2008. See graph:



This increase of $1,500 per cow 1992 to 2008 was a tax-free capital gain under the herd scheme. Under NSC increases over that time would have resulted in income and if the herd was sold any difference between NSC values and sale value would have been taxable income.

If a cow dies and is replaced, under the herd scheme no effect – still 100 cows at NAMV opening and closing value.

If the herd is increased by one cow:

> Opening value 2018 $150,000 (100 x $1,500)
>
> Closing value 2018 $151,500 (101 x $1,500)
>
> Income of $1,500.

If herd sold proceeds are taxable income and opening value ($150,000) deductible. So income/loss on any difference between NAMV and increase in NAMV tax-free gain.

Say the herd is reduced by 10% - 10 cows sold for low value say $1,000 each.

Opening value $150,000 (deductible)

Sale of livestock $10,000 (income)

Closing value $135,000 (90 x $1,500).

The result is a deductible loss of $5,000 being 10 cows sold for $10,000 when NAMV was $15,000 (10 x $1,500)..

This deductible loss arises even if NAMV of cows was originally less than $1,000. So can have livestock with original NAMV of say $800, sold for $1,000 when NAVM $1,500 then although a gain of $200 overall the tax result is a deductible loss of $500. This is because there is a non-taxable gain of $700 (increase in NAMV) and then a deductible loss ($500) being the difference between NAMV (opening value in the year of sale) and the sale price.

On the other hand for a farmer under the NSC scheme that elects into the herd scheme a consequence of electing into the herd scheme is to trigger income arising from the difference between the higher NAMV and the lower NSC.

> Example:
>
> The farmer elects into the herd scheme for 2018.
>
> Closing stock for 2017 valued at NAMV of $1,600 compared to opening 2017 NSC of $720.
>
> Value of 2017 opening stock assuming 100 cows - 100 x $720 (being NSC) - $72,000. This is a deduction.
>
> Value of 2017 closing stock – 100 x $1,600 (NAMV) - $160,000. This is taxable income.
>
> Net income in 2017 of $88,000 as a consequence of electing into the herd scheme.

It should be noted that herd scheme rules do mean that increases in the value of on-farm bred livestock (i.e. a natural increase) in first two years are taxable income – the NAMV values increase over this time and this is income. Also the above is a simplification. Farms in a stable state generally have constant herd numbers so that culled stock are generally replaced by new farm bred stock so that deductible losses are offset by the NAMV of new stock.

Herd Scheme and Proposals to Extend Taxation of Property Gains

On its face the herd scheme seems inconsistent with extending the taxation of property gains given that it allows for tax free capital gains. Following the general principles that have been developed, gains should be taxed on realization (sale of livestock) but those gains accruing up to date of change should remain tax-free. How to achieve this is a matter that would need consideration.

One option would be to remove the herd scheme and allow those on the herd scheme to move on to NSC. The result would be that livestock would be written down from NAMV (for MA cows now $1529) to NSC (now $770). This would give rise to a much lower closing livestock value (about half current value under NAMV) so a substantial deductible loss albeit under current NSC rules this would take a number of years to materialize (NSC requires tracking of livestock and the livestock value would reduce as the initial animals are replaced with on farm bred animals). Arguably the loss would offset any tax under NSC on increasing NSC values or sale proceeds up to the level of tax-free gains accruing under the herd scheme up to the point of change. However, transitional rules would need to be considered as part of any review of the livestock tax rules.

Another option might be to retain the herd scheme but tax gains in NAMV from the date of change but only when the herd is sold. It seems doubtful that farmers would choose such an option given the choice of moving to NSC with substantial deductions when both NSC and herd scheme would then tax gains in livestock when the herd is sold.

Likely Sectoral Reaction

Managing the transition seems critical.

One would anticipate that the reaction to farmers of change along the above lines would be negative. While moving to NSC could give rise to substantial deductible losses, they can choose to do that already, albeit with some restrictions such as notice. Most do not, presumably because the advantages of the herd scheme outweigh such an upfront benefit. Farmers in the herd scheme have presumably reached the view that over time the tax free valuation increases of the herd scheme outweigh the tax costs of joining being not having the lower NSC valuation of livestock leading to lower closing value and income.

The arguments against change seem likely to be as follows:

- Farmers would face a higher tax burden because they would then be taxed on increases in the value of livestock over time. Although NAMV changes showed a capital loss 2017 to 2018 – the long term expectation is an increase in value under the herd scheme that is not now taxed.

- Farmers will likely argue that they "paid" to enter the herd scheme by adopting higher NAMV when they entered. Compared to NSC this gave much higher closing stock values and thus taxable income. This tax could have been paid many years ago.
- Farmers would be exposed to being taxed on the very high variability of stock values (see above graph). Under NSC they might argue that they would be taxed on accrued gains (closing stock valued at rising NSC values) whereas other taxpayers are taxed only on realization. They might argue that NSC is appropriate only for stock turned over within a relatively short period – bobby calves and lambs.
- The NSC scheme is more complex as it requires assumptions as to what livestock are on hand each year (whether bred animals or purchased animals), hence it has a higher compliance cost.

Need for a Review of Livestock Tax Rules

The above suggests that there is a need to review livestock tax rules as part of any proposal to extend the taxation of gains on property. This is quite an extensive task and requires expertise and specialist knowledge beyond it seems what is available to TWG. This suggests that a separate group (maybe an advisory group) be established to undertake a review of livestock tax rules if CGT is progressed. It might be appropriate for such a group to have sectoral representatives. It would also seem to need to be resourced by officials with relevant specialist knowledge

This raises the issue of TWG priorities and resources. Given the TWG timeframe (report to be near final form by December this year) it does not seem likely that TWG could undertake such a review within its timeframes especially given its other work. This may be able to be managed by not recommending any change in the interim to the livestock tax rules (the herd scheme continues as is) until the above review is completed even if this means legislation covering an increase in taxation of income from gains comes into effect on 1 April 2021 noting that any livestock tax rule could come into effect from income years after that.