

# **The Treasury**

## **Budget 2012 Information Release**

### **Release Document**

#### **June 2012**

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**Inland Revenue**  
Te Tari Taake

POLICY ADVICE DIVISION



**THE TREASURY**  
Kaitohutohu Kaupapa Rawa

## **Tax policy report: Livestock elections Cabinet paper**

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<b>Date:</b>	21 March 2012	<b>Priority:</b>	<b>Ministerial Deadline</b>
<b>Security Level:</b>	Budget Sensitive	<b>Report No:</b>	T2012/511 PAD2012/61

## **Action sought**

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	<b>Action Sought</b>	<b>Deadline</b>
Minister of Finance	<b>Agree</b> to recommendations, <b>finalise</b> and <b>sign</b> Cabinet paper	10.00 am Thursday 22 March 2012
Minister of Revenue	<b>Agree</b> to recommendations, <b>finalise</b> and <b>sign</b> Cabinet paper	10.00 am Thursday 22 March 2012

## **Contact for telephone discussion (if required)**

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<b>Name</b>	<b>Position</b>	<b>Telephone</b>
Jim Gordon	Policy Manager, Inland Revenue	[3]
Phil Whittington	Analyst, The Treasury	[3]

21 March 2012

Minister of Finance  
Minister of Revenue

## **Livestock elections Cabinet paper**

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Attached to this report is the draft Cabinet paper on livestock elections. This follows on from the preliminary announcements of the review of certain livestock valuation elections in November 2010 and in Budget 2011. Officials released their issues paper on this on 18 August 2011. This report and the associated draft Cabinet paper flow from this review. They recommend tax law changes to remove the tax opportunity that presently exists for farmers to make windfall gains by exiting the herd scheme when herd values are high.

The detail of our analysis is in the draft paper. The draft paper's recommendations are:

*“We recommend that Cabinet:*

- 1. **Note** that some farmers are deriving an inappropriate tax advantage from their elections to exit the herd scheme.*
- 2. **Agree** that elections to use the herd scheme be irrevocable.*
  - 2.1 **Agree** that there be an exception to this when a farmer fundamentally changes their farming operation to a fattening operation.*
- 3. **Note** that associated persons transactions could undermine Recommendation 2.*
- 4. **Agree** that Recommendation 2 be buttressed by a rule that requires persons who acquire livestock from an associated person who was using the herd scheme to use the herd scheme and the vendor's base herd scheme numbers.*
  - 4.1 **Agree** that there be an exception to this where there is a complete change of ownership of the livestock from one generation to the next.*
- 5. **Note** that because current sheep and beef and dairy cattle values are currently comparatively high there is an opportunity for farmers to have one last election to leave the herd scheme in the 2012–13 year that is estimated to reduce the baselines by \$46 million a year for each of the next 6 years if no action is taken.*

6. ***Agree** that to prevent this baselines impact the above Recommendations 2 and 2.1 be effective from 18 August 2011, the date that the [Officials'] Issues Paper detailing these problems was released.*
7. ***Agree** that Recommendations 4 and 4.1 be effective from the date of announcement of these measures so it does not retrospectively apply to past associated party transactions and to tax payments already made.*
8. ***Note** that agreeing to the above recommendations does not count fiscally, but rather has the effect of reinstating the baselines to what they would have been had these particular elections or transactions not been made.*
9. ***Note** that the above recommendations will only affect the future tax payments of farmers. However, they will be viewed as being retrospective and there will be private sector reaction.*
10. ***Agree** that the Ministers of Finance, Primary Industries and Revenue have the power to settle any detail and the other minor issues that arose during the consultation.*
11. ***Note** that, because of the immediate impact, we intend to announce this as soon as is possible.*
12. ***Note** that we will report back on the legislative process to be followed.*

Of these recommendations the following are worthy of more consideration by Ministers.

### **Recommendation 2 – irrevocable election**

There is agreement that the tax advantage obtained by exiting the herd scheme to use NSC is generally inappropriate and unaffordable. This was almost totally accepted in both formal and informal submissions. The officials' issues paper "*Herd scheme elections*" identified two potential solutions:

- Making the election to use the herd scheme irrevocable (preferred); or
- Lengthening the period for which notice to exit must be given.

The main formal submissions preferred to lengthen the period of notice, but in informal consultation (presentations to over 800 primary sector accountants) the preference was more even. Our position has not changed. In particular, we believe that primary sector accountants and their farmer clients will continue to attempt to obtain tax advantages, even if that is made more difficult by lengthening the notice period.

A third alternative was suggested during consultation – reducing (arbitrarily) the tax write down obtained. Officials have not further considered this because of the uncertainties of arriving at an "appropriate" write down and its arbitrary nature. This is not discussed in the paper.

## **Recommendation 2.1 – exits from the herd scheme**

This recommendation allows in narrow circumstances farmers to continue to elect to exit from the herd scheme. It applies to situations where farmers who have elected to use the herd scheme change their farming operation to a fattening (or buying, fattening and selling) regime, which is more suited to a cost based stock on hand system (almost always “national standard cost” or NSC).

We note that despite Recommendation 2.1, sharemilkers will not be able to elect to exit the herd scheme as they typically down-size their herd to buy their first farm. The tax advantage generated by exiting the herd scheme is often part of the funding analysis that leads to the purchase. We suggest that merely banking the tax opportunity is insufficient reason to allow this.

## **Recommendation 6 – the application date for elections to exit being made ineffective**

We have recommended that this be 18 August 2011 – the date the Issues Paper was released last year. This is to reverse the baseline impact of \$46 million per year for six years that was identified late last month.

Some farmers and their advisors will argue that they have already spent or committed the tax advantages they have sought by making a current election to exit the herd scheme. This could be on repaying loans or on purchasing new capital assets. However, in general, farmers will not receive the tax benefit until well into their 2012–2013 income year, and it is spread over approximately six years. Therefore we consider this complaint is likely to be exaggerated.

Inland Revenue has evidence that several farmers have recently made their second election to exit the herd scheme in the last four years. We suspect that there will be many more such farmers when the analysis can be more completely done later this year. This suggests that the large tax advantages are the primary driver of the behaviour, rather than selecting the most suitable valuation method for the farming operation.

## **Recommendation 7 – the application date for associated persons transactions**

We note that the recommendation that the associated party rules apply from the date of announcement of these changes will only affect future transactions and tax payments.

The alternative application date that we considered was 18 August 2011, the date of release of the Issues Paper. We have recommended the prospective date to avoid affecting past transactions and past tax payments. Officials have no explicit knowledge that tax driven transactions have occurred since 18 August 2011, but it would not surprise them if they had. However, there are unlikely to be very many of them and any fiscal effect is not measurable.

## **Consultation**

Consultation has been both formal and informal. There was almost total acceptance of the proposition that the tax advantage derived by exiting the herd scheme when herd values are high is inappropriate. There was no consensus on which of the options to adopt (further discussed above). There was consensus on the need to consider associated party transactions.

Inland Revenue has had a senior farm accountant peer review this work. He agrees with the problem definition and with the recommended solutions. His analysis is quoted in the paper.

However, the back-dated cancellation of elections will be a complete surprise to the primary sector community. The issues paper explicitly did not discuss application dates and in consultation soft answers were given to questions regarding application dates, with there being a general presumption that application would be prospective.

## Process

We recommend that Ministers' take this Cabinet paper directly to Cabinet on Monday 27 March 2012 because of the uncertainty over the baselines effect, and the need to advise farmers of these changes. Therefore it should be lodged with the Cabinet Office by Thursday 21 March at 10.00.

Should Cabinet approve the recommendations, we recommend that an immediate joint media statement is released so that farmers and their advisers are put on notice. We are currently drafting such a statement for Ministers' consideration.

We will separately discuss the potential legislative options with you in the immediate future when the progress of certain other matters is more certain.

## Recommended action

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We recommend that you:

1. **Note** that some farmers are deriving an inappropriate tax advantage from their elections to exit the herd scheme.

Noted

Noted

2. **Agree** that elections to use the herd scheme be irrevocable.

Agreed/not agreed

Agreed/not agreed

3. **Agree** that there be an exception to this when a farmer fundamentally changes their farming operation to a fattening operation.

Agreed/not agreed

Agreed/not agreed

4. **Note** that associated persons transactions could undermine recommendation 2.

Noted

Noted

5. **Agree** that recommendation 2 be buttressed by a rule that requires persons who acquire livestock from an associated person who was using the herd scheme to use the herd scheme and the vendor's base herd scheme numbers.

Agreed/not agreed

Agreed/not agreed

6. **Agree** that there be an exception to this where there is a complete change of ownership of the livestock from one generation to the next.

Agreed/not agreed

Agreed/not agreed

7. **Note** that because current sheep and beef and dairy cattle values are currently comparatively high there is an opportunity for farmers to have one last election to leave the herd scheme in the 2012–13 year that is estimated to reduce the baselines by \$46 million a year for each of the next 6 years if no action is taken.

Noted

Noted

8. **Agree** that, to prevent this baselines impact noted in 8, recommendations 2 and 3 be effective from 18 August 2011, the date that the Issues Paper detailing these problems was released.

Agreed/not agreed

Agreed/not agreed

9. **Agree** that the associated persons transactions rule (recommendations 6 and 7) be effective from the date of the announcement of these changes so that it does not affect past transactions and tax payments.

Agreed/not agreed

Agreed/not agreed

10. **Note** that agreeing to these recommendations does not count fiscally, but rather has the effect of reinstating the baselines to what they would have been had these particular elections or transactions not been made.

Noted

Noted

11. **Note** that, even though they are backdated, the above recommendations should only affect the future tax payments of farmers.

Noted

Noted

12. **Agree** that the Ministers of Finance, Primary Industries and Revenue have the power to settle any detail and the other minor issues that arose during the consultation.

Agreed/not agreed

Agreed/not agreed

13. **Note** that, because of the immediate impact, your decisions should be announced as soon as possible.

Noted

Noted

14. **Note** that we will report back on options for the legislative process.

Noted

Noted

**Phil Whittington**  
Analyst  
The Treasury

**Jim Gordon**  
Policy Manager  
Inland Revenue

**Hon Bill English**  
Minister of Finance

**Hon Peter Dunne**  
Minister of Revenue