

# **The Treasury**

## **Budget 2012 Information Release**

### **Release Document**

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Cabinet

## **Livestock elections**

### **Proposal**

1. We propose to announce as soon as is possible that livestock valuation elections to exit the herd scheme made since 18 August 2011 that are intended to be effective for the 2012–13 and subsequent years will be cancelled. The urgency arises for fiscal reasons.

### **Executive summary**

2. Budget 2011 signalled several measures intended to make the tax system fairer. This included investigating options for fairer tax rules for livestock valuation elections.

3. On 18 August 2011 tax policy officials released their issues paper, *Herd scheme elections* (the consultation paper) for consultation (CAB 11 (30/8) refers). The major concern was the ability of farmers to exit from the herd scheme for a tax advantage. The herd scheme is based on national average market valuations (or herd values) for livestock. The common alternative, the national cost scheme (NSC), is based on costs of acquiring, breeding, rearing and growing livestock. The tax advantage arises from moving to NSC from the herd scheme with the difference in the two values being allowed as a deductible expense over time. There was almost total acceptance from submitters that this was inappropriate.

4. Two possible solutions were suggested in the consultation paper – either making the election to use the herd scheme irrevocable, or lengthening the election period to exit the herd scheme to make it harder to predict the outcome of exiting. Formal submissions argued for lengthening the notice period to cater for a potential change in the type of farming operations or the owner's circumstances. Informal consultation, however, was more even with some accountants arguing for simplicity, and certainty, and to minimise risk. Our view is that such elections should generally be irrevocable as lengthening the period would make the seeking of tax advantage more difficult, rather than eliminating the opportunity.

### ***Transitional fiscal issue – choice of application date***

5. As well as agreeing a solution to prevent farmers from exiting from the herd scheme for tax advantage, a decision needs to be made on application date. Inland Revenue and Treasury officials have recently become aware that some accountants are seeing the current high beef and dairy cattle prices as one last opportunity to exit the herd scheme in the 2012–13 income year. Elections for this have to be filed by the end of this month and our officials expect there will be a number of such elections, although it is too early to tell how many.

6. It is estimated that allowing farmers one last opportunity to switch between livestock valuation rules could cost \$275 million over the next six years. This has been built into the first cut of the pre-Budget 2012 baselines. We note that a number of broad assumptions have been made in reaching this figure which could be higher or lower, but it will be significant.

7. We recommend that Government address this transitional fiscal issue and have identified two possible solutions:

- not accept (i.e. cancel) elections made since the release of the consultation paper; or
- reduce the tax advantage by artificially and arbitrarily reducing the amount of the tax write down between the 2012 herd values and NSC.

8. The most coherent response is to disallow any elections. In the circumstances we recommend that this would be for any elections to exit the herd scheme made on or after 18 August 2011, the date the officials' consultation paper was released. Certain associated persons transactions would also have to be dealt with (from the date of the announcement on the changes).

9. We acknowledge that back-dated cancellation of elections is likely to be regarded as retrospective and will receive comment from the private sector. However, it was never intended that elections to leave the herd scheme be tax-driven and the action proposed will only affect future tax payments.

10. A decision not to accept elections made since the release of the consultation paper will address the transitional fiscal issue by way of reinstating baselines back to what they were before the \$46 million per year adjustment.

## **Background**

11. There are effectively two ways that farmers value their livestock (mainly beef and dairy cattle, and sheep (but also deer, goats and pigs)) at balance date for tax purposes.

12. The herd scheme treats livestock more as if they were a capital asset by using *national average market values* (commonly called "herd values") with changes in values from year to year on tax free capital account.

13. NSC is similar to a typical trading stock scheme where changes in values from year to year are on tax account. The major difference from a standard trading stock scheme is that on-farm costs for breeding, rearing and growing home-bred livestock are, for simplicity, standardised nationally.

14. As could be expected for a home-bred operation, herd values generally exceed NSC. It is this difference that gives rise to the tax advantage that was the subject of the officials' consultation paper. This difference is tax deductible to a farmer who elects to exit the herd scheme, usually over about six years as replacement livestock are home-bred. Further, farmers can elect out of the herd scheme with a short advance notice period.

15. There is evidence that farmers are timing 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. In particular, this result was evident for the 2008 peak in dairy cattle prices. A

number of farmers (previously usually dairy farmers, but now including sheep and beef farmers) are aware of, and are taking advantage of, the tax result that can be obtained when herd values are high (as they are currently likely to be for the 2011–12 income year) by exiting the herd scheme and using NSC.

16. For dairy farmer with 300 cows plus replacements and who exited the herd scheme at the 2008 peak in herd values, the tax deductible write down was in the order of \$500,000 (the tax effect at 22.54% is \$112,700).

## **Private sector consultation and the resulting recommendations**

### ***The core recommendation***

17. The officials' consultation paper proposition that timing elections in and out of the herd scheme to maximise the tax-free herd scheme gains and tax-deductible losses is inappropriate was almost universally accepted by submitters in both formal and informal consultation. The exception was two accountants who separately argued that dairy farmers were essential to the New Zealand economy and so the unintended subsidy was appropriate.

18. Two solutions to this policy problem were proposed in the consultation paper: that, as was originally proposed in the 1980s consultative document that began the reforms, an election to use the herd scheme should be irrevocable (officials' preferred solution), or that the notice period to exit the herd scheme should be lengthened.

19. Formal submissions to the consultation paper argued for lengthening the notice period to cater for a potential change in the type of farming operations or the owner's circumstances. Informal consultation, involving presentations in 19 centres throughout New Zealand to over 800 accountants was more even with some accountants arguing for simplicity and certainty and to minimise risk.

20. Having now considered submissions, officials' position on the core decision has not substantially changed – that is, the herd scheme election should generally be irrevocable. We have agreed to this and we seek your agreement to this approach. In particular we believe that farmers should not be making shorter term tax-driven decisions about major matters such as livestock valuation.

21. The original intention was that the decision to use the herd scheme was a long-term decision. The original 1986 consultation document proposed that elections be irrevocable. The 1986 Tax Bill as introduced required notice two years before the election was effective. As originally enacted, notice was required one year before it was effective. In 1993, this was amended to election with the prior year's tax return. Certainly it was never envisaged that short-term elections to exit the herd scheme would be made for tax advantage. However, this is what happened for the 2008–09 income year, and is happening now. In particular it was not envisaged that dairy farmers would elect out of the herd scheme for the 2008–09 year, elect back in the next year, and now (before 31 March 2012) be electing out again, this time effective for the 2012–13 income year. Inland Revenue field staff are aware of several examples of this happening and many more such elections seem likely.

### ***Associated recommendations***

22. The only exception to our recommendation that an election to exit the herd scheme be made irrevocable would be if there was a complete change in the type of farming operation, such as to a fattening operation. The best example of this would be a change from beef breeding to beef fattening. It is accepted that what is called the *alternative valuation option* would address most of the problems in this area by allowing a considerable number of the farmer's new livestock to be valued in NSC (which is more appropriate for this type of operation).

23. However, depending on the specific details of the farmer's herd scheme elections, this might not totally solve the problem. Accordingly, we recommend that when there is a change to a fattening operation, the farmer be allowed to elect to exit the herd scheme.

24. We are also recommending amendments to the associated persons transaction rules to buttress the new election rules. In general, when the purchaser is associated with the vendor (frequently by being a beneficiary of the trust that has directly or indirectly acquired the farming operation), the consultation paper suggested that the purchaser should be bound by the vendor's election to use the herd scheme and the vendor's base herd scheme numbers. We endorse this, except when there is a complete change of ownership from one generation to the next. In this case we consider that the incoming farmer should be free to make an immediate one-off election to cease using the herd scheme. There was agreement in the private-sector consultation that associated person proposals were necessary.

25. Submissions were made recommending that sharemilkers be allowed to elect out of the herd scheme when they down-size their herd to buy their first farm. The tax advantage generated by exiting the herd scheme is, we understand, 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.

### **Transitional fiscal issue – choice of application date**

26. As well as agreeing a solution to prevent farmers exiting from the herd scheme for tax advantage, a decision needs to be made on the appropriate application date.

27. Sheep and beef and dairy cattle market values (and therefore herd values) are likely to be comparatively high at 31 March 2012. Inland Revenue and Treasury officials have recently become aware that accountants are seeing the current prices as one last opportunity to exit the herd scheme in the 2012–13 income year. Elections for this would have to be filed by the end of this month. Officials expect there to be a number of these elections, but it is too early to know how many.

28. Inland Revenue has estimated the fiscal cost of allowing farmers one last opportunity to switch between livestock valuation rules. This is based on the following assumptions:

- that the relevant average tax rate is 22.54 percent;
- 65 percent of farmers have elected to use the herd scheme;
- 70 percent of these farmers' livestock is in the herd scheme; and

- 15% of these farmers will elect out of the herd scheme effective for the 2012–13 income year.

29. The result is a decrease in tax revenue of \$275 million, or \$46 million per year for the 2012–13 income year and the next five years (the average period of time to totally age the herd to core NSC costs). This has been incorporated in the first cut of the pre-Budget 2012 baselines. Any action to address this before the baselines are finalised in mid-April will result in a change to the baselines. Any change after mid-April will have fiscal effect.

30. These assumptions are crucial. For example, if either 10 percent of these farmers or 20 percent of them elect out, instead of the assumed 15 percent, the gross decrease in tax revenue would be \$183 million or \$367 million respectively. However, what is clear is that the effect is significant.

31. Should the Government want to address this transitional issue there are legislative options so long as action is taken quickly. Two options have been identified:

- not accepting (i.e. cancelling) these elections; or
- reducing the tax advantage by artificially and arbitrarily reducing the amount of the write down between the 2012 herd values and eventual NSC. This would be done by using values based on more average herd values over the last few years.

32. Consideration will have to be given to recent associated persons transactions (as discussed below).

33. We prefer to cancel the elections. The purpose of the herd scheme is to protect capital livestock from tax on increasing market values over the long-term, and the farming community and their advisers are grateful for the long-term benefit of the herd scheme that accrues through to retirement from farming. The flexibility to exit the herd scheme was never intended to provide a mechanism to engineer significant tax deductions by exiting the herd scheme before retirement at times of high livestock values.

34. The livestock tax legislation includes mechanisms to deal with changes in farming patterns, and it is very difficult to envisage any genuine reason, apart from a complete change in farming regime (say from beef breeding to beef fattening), for on-going farm operations to exit the herd scheme at this time, except to obtain significant tax deductions.

35. The farming community was first put on notice about this issue in the Minister of Revenue's speech to the NZICA Tax Conference in late 2010. It was then referred to in Budget 2011, and the detailed consultation paper was released on 18 August 2011. As a result, all participants will be fully aware that the status quo is not acceptable. An appropriate application date, should this option be agreed to, should be the date of release of the consultation paper.

36. Alternatively, it can be argued that the right to change valuation methods is long-standing (and has been there since the herd scheme rules were first enacted in the 1980s) and should be maintained. Further, notwithstanding the fact that sheep, dairy and beef farmers are having a good year, it will likely be argued that the resultant tax savings of making such an election have already been committed to on-farm expenditure or debt reduction. In some

cases there may be an element of truth in this, but generally this will be the given justification whereas, in officials' opinion, the real reason is much more likely to be tax-driven.

37. We are very reluctant to remove the tax advantage by reducing the amount of the tax write down. This is because the result would be very arbitrary and there would be lobbying on the precise figures to be used. Further, this would likely recoup say half of the tax write downs (depending on the figures used), but not all of them.

38. We acknowledge that back-dated cancellation of elections is likely to be regarded as retrospective and will receive comment from the private sector. However, it was never intended that elections to leave the herd scheme be tax-driven. In addition, the first tax payment that could be affected by this will be the first instalment of 2012–13 provisional tax which will be due for a 31 March balance date farmer on 28 August 2012. Most farmers have later balance dates, and therefore later provisional tax payment dates.

39. Anecdotally, some tax advisers and their farmer clients made explicit decisions not to make elections to exit the herd scheme because of their perception of the wider inappropriateness of such elections.

40. A decision not to accept elections made since the release of the consultation paper will address the transitional fiscal issue by way of reinstating baselines back to what they were before the \$46 million per year adjustment.

### ***Associated persons transactions***

41. When a farmer who is using the herd scheme has sold their farming operation to an associated person (e.g. a trust or a company) in the 2011–12 income year, they can achieve a similar tax write-down advantage if the purchasing entity uses NSC. This could be addressed by requiring the purchaser to use the herd scheme and the vendor's base herd scheme livestock numbers as is discussed above.

42. Officials have no knowledge of whether these transactions have occurred in the period from 18 August 2011 to the present, but in their view a few accountants may have considered that this might be an opportunity. If the change to address this is backdated to 18 August 2011 it will have true retrospective effects – it will affect the past tax payments of past decisions. Given that, we recommend an application of the date of announcement for such associated person transactions.

### **Other associated decisions**

43. There are also several minor improvements to the legislation that have come to our attention during the consultation process (e.g. the Jersey and Friesian classes of dairy cattle could usefully be combined). We ask that Cabinet delegate to the Ministers of Finance, Primary Industries, and Revenue the power to settle these matters, and any detailed issues that emerge out of implementing the recommendations to this paper.

### **Consultation**

44. Budget 2011 signalled several measures intended to make the tax system fairer. This included investigating options for fairer tax rules for livestock valuation elections.

45. On 18 August 2011 tax policy officials released an issues paper entitled “*Herd scheme elections*” for consultation (CAB 11 (30/8) refers). This was followed up with informal consultation, involving presentations in 19 centres throughout New Zealand to over 800 accountants.

46. Inland Revenue has employed a private-sector adviser (a senior provincial accountant) to peer-review officials’ work on this project. He generally agrees with the recommendations and advises that, if Government believes that transitional fiscal issue needs addressing, he agrees with the proposed application date of 18 August 2011.

47. The Ministry of Agriculture and Forestry has been consulted in the preparation of this paper and agrees with its recommendations.

### **Financial implications**

48. This issue was not explicitly incorporated into the last official baseline forecasts (the 2011 Pre-election Economic and Fiscal Update). However, because of the recent strength in stock values and early indications that elections to exit from the herd scheme are starting to increase, the issue will be explicitly incorporated into Budget 2012 baseline forecasts unless action is taken. The recently completed preliminary tax forecasts for Budget 2012 incorporated an assumption that under existing legislation some farmers will minimise their tax obligations through electing out of the herd scheme, thereby reducing income tax by \$46 million per annum for six years commencing 2012–13.

49. Acceptance of the recommendations in this paper reverses this impact.

### **Human rights**

50. There are no human rights implications.

### **Legislative implications**

51. Legislation will be needed – we will further consider this process and report back.

### **Regulatory impact analysis**

52. In the time available no explicit regulatory impact analysis has been completed. What analysis that has been performed is contained in this paper.

### **Publicity**

53. In the circumstances we propose to announce this as soon as possible. As noted above, we expect some adverse reaction, in particular to the transitional measure. However, it was never intended that elections to leave the herd scheme be tax-driven and any impact on tax payments will be prospective.

## Recommendations

54. 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 when there is a complete change of ownership of the livestock from one generation to the next.
5. **Note** that because current sheep, 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 six 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 consultation 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 tax payments already made.
8. **Note** that agreeing to the above recommendations will have no fiscal effect, 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 back-dated cancellation of elections is likely to be regarded as retrospective and will receive comment from the private sector. However, it was never intended that elections to leave the herd scheme be tax-driven and any impact on tax payments will be prospective.
10. **Agree** that the Ministers of Finance, Primary Industries, and Revenue have the power to settle any detail and other minor issues that arose during the consultation.

11. **Note** that, because of the immediate impact, we intend to announce this as soon as possible.
12. **Note** that we will report back on the legislative process to be followed.

**Hon Bill English**  
Minister of Finance

\_\_\_\_\_ March 2012  
Date

**Hon Peter Dunne**  
Minister of Revenue

\_\_\_\_\_ March 2012  
Date