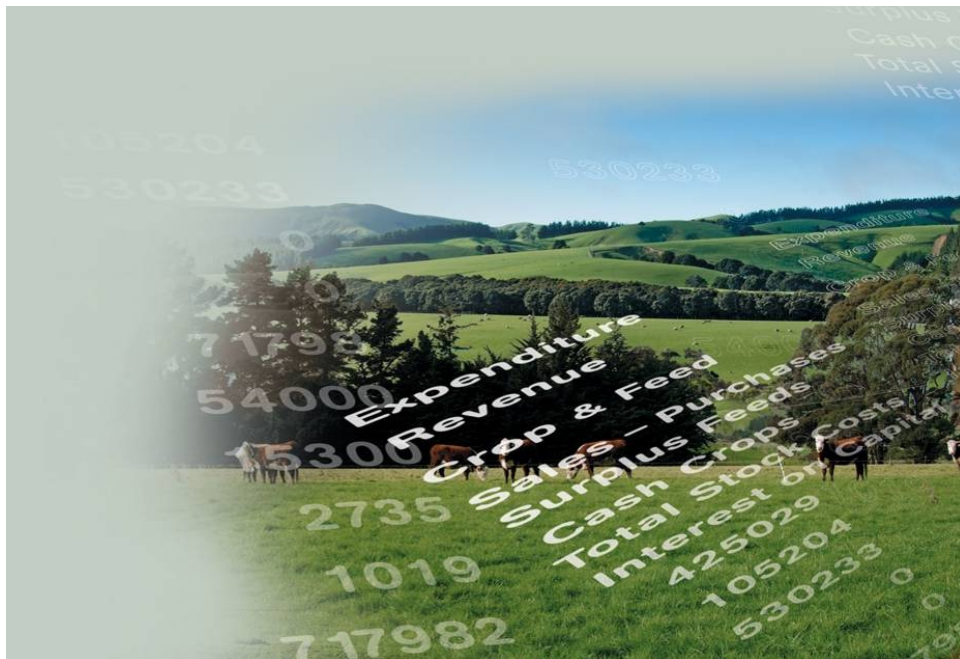




Practical Farm Accounting Issues

Extract from 2006 course paper



Presented by

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2010 Farm Accounting Course

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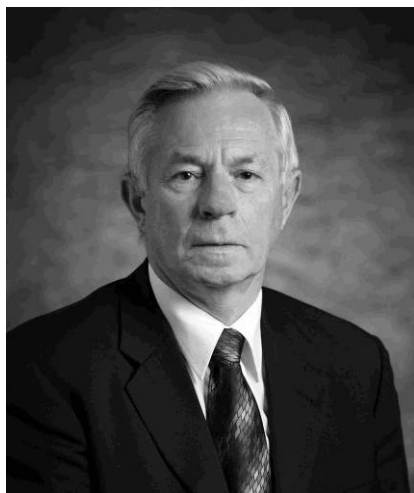
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Introduction – David H Russell



Course presenter David Russell is one of New Zealand's leading specialists in farm accounting and rural sector taxation. He is the author of Farm Accounting, a two monthly publication which is appreciated by more than 500 accounting firms throughout the country.

David was awarded the Delahunty Primary Research Award in 2002 and published a book on **Livestock Valuation for Taxation Purposes** in 2004. He is a regular contributor to the Accountants Journal and various rural sector publications. He has delivered numerous Conference Papers and has conducted eight

nationwide Seminar series.

An articulate and lively presenter David has a knack of reducing complex tax and accounting issues into simple practical solutions. His presentations are peppered with some dry humour and plenty of real life examples of what to do.

This 2006 course paper is a follow-on from the 2005 TEO Training Farm Accounting course, covering more issues relevant to rural practitioners and professionals.

David joined the New Zealand Institute of Chartered Accountants (formerly NZ Society of Accountants) in 1975, serving on its Primary Sector Committee for twelve years, and was chair between 1994 to 2000.

Disclaimer

Neither this 2006 course paper and material that form part of it, purport to be, nor should they be construed to be, specific professional advice in respect of any topic contained in the course material. Independent professional advice should be obtained before relying on any aspect of this course.

No responsibility is taken for out of date material sold post completion of this course.

CHAPTER 1 – DEATH AND TAXES

The taxation treatment of property on the death of a taxpayer has been in a state of disarray for many years:

- The law has been unclear.
- Professional advisors have adopted widely divergent views.
- The taxation authorities have not promoted any "preferred view" of what the law might be.
- The law has been inconsistently applied in various different regions throughout the country.

This has been nightmare territory for professional advisors, particularly when measured against the tax Penalties Regime which was introduced in 1997.

The whole unhappy scene has been somewhat more acute in the rural sector. Farmers tend to "die with their boots on". They do not retire and convert their life's work into a house in town and a bundle of investments. Rather, they retain their investment in land, buildings, forestry, farm plant and equipment, and livestock, i.e. assets that are inside the tax base.

In recent years there has been a major shift towards Company or Trust ownership and operation of farming businesses, but that shift has been implemented by our younger farmers.

The older farmers have continued to hold revenue account assets in their own names, have continued to "die with their boots on" and have therefore left us (accountants and lawyers) to try to correctly determine the tax consequences of death.

The three big issues for farmers when dealing with the tax consequences of death have been:

- Livestock.
- Forestry.
- Depreciated assets (buildings, plant and machinery).

Livestock

This has been one area where the tax legislation has been relatively clear. Back in 1986-87 we completely revamped the taxation law in respect of livestock valuation. One of the new provisions dealt with the valuation of livestock (for tax purposes) at the time of the taxpayer's death – Section 85(4)(c) of the Income Tax Act 1976 read:

"85(4C) [Livestock of deceased taxpayer] Notwithstanding anything in this section, the executor or administrator of any deceased taxpayer who at the date of death was deriving income from livestock shall, in the return of income for the period ending with the date of death of the deceased taxpayer, adopt as the value of any livestock on hand at that date the market value of that livestock."

Virtually identical wording was included in Section EL 1(3) of the Income Tax Act 1994, and similar wording, but identical meaning, is recorded in Section EC 4 of the 2004 Act.

So, for livestock, there was reasonable certainty about the tax effect of death. The deceased was required to account for livestock at current market value as at the date of death. Death constituted a **disposal** at market value – with appropriate tax effect.

There has been one area of uncertainty – namely the acquisition value by the administrator or executor of the deceased. We have assumed that this should also be market value, but there has been no certainty on this issue in previous legislation.

This matter is clarified in new legislation effective 1 October 2005 – details later in this paper.

Forestry (Standing Timber, Farm Woodlots, Plantation Forestry, Forestry Rights)

The tax legislation in respect of forestry was significantly modified and remodified through the mid to late 1980's and had generally settled down by about 1990.

For deceased taxpayers, some uncertainty continued until 24 June 1993 when the income tax definition of **trading stock** was amended to include "timber". Timber is widely defined to include trees which, if they were mature, would be standing timber, forestry rights, and essentially anything in the nature of trees that is a forestry asset.

The inclusion of timber in the definition of trading stock triggered appropriate consequences in relation to its sale, disposition or disposal. A general tenet of tax law is that all sales, dispositions, or disposals of trading stock occur at the current market value of that stock. Death creates a disposal thus triggering the recognition of taxable income.

For the past twelve years there has been massive confusion about this issue. Some taxpayers and their advisors have argued that the law is inequitable, is therefore wrong, and can be ignored. They point to immature plantation forestry, farm woodlots and the like and say that because the "trading stock" cannot be converted to cash it cannot be regarded as taxable income. Others have argued that the value of immature forest assets is nil because there is no realistic market for such assets.

Inland Revenue has (in some cases) suggested that there is a difficulty and they would perhaps not pursue any audit activity in the area of deceased estates and forestry assets.

Overall, appalling confusion, lack of consistency and a potential disaster for any taxation or legal advisors in this area of practice.

I have always taken the view that the law itself was reasonably clear; the real problem was one of valuation.

And, of course, it did seem to be a bit rough in a situation where a farmer taxpayer died in possession of (say) 50 hectares of 20 year old plantation forestry which probably had a value of \$500,000. The tax law would require the \$500,000 to be treated as gross income in the return to date of death, crystallising around \$195,000 of taxation, plus use of money interest charges of a further \$25,000 odd. All of this at a time when it may have been difficult to sell (immature) forestry; at a time when the **real** potential value of the tree growing venture had not yet been realised; and at a time when cash flow from the harvest of the trees was still 5-8 years away.

Depreciated Assets

There was a major change in taxation law in respect of depreciation which came into effect from April 1 1993. Prior to that time depreciation was an allowance based on well established Inland Revenue policy. But there was no statutory authority for depreciation claims.

The 1993 changes incorporated formal statutory authority for depreciation with a whole raft of legislation, definitions and related interpretation guidelines, standard practice statements, and the like.

The new legislation made it clear that any disposal of depreciated assets had to be treated as occurring at the market value of those assets, and we all understood that this would give rise to taxable depreciation recoveries for disposals at greater than the written down book values. Alternatively, there might be a tax deductible loss on disposal on some assets.

The word **disposal** was specifically defined in Section EG 19(9) of the Income Tax Act 1994, but the definition did not confirm whether or not death triggered a disposal. It was clear that a **distribution** was included in the definition of what was a disposal, but it was then argued that the distribution did not occur until ownership of assets transferred from the administrator/executor for the deceased, to the final beneficiaries.

Confusion reigned supreme. Some advisors and some offices of Inland Revenue insisted that death was a disposal (albeit an involuntary disposal) and tax consequences ensued. Other advisors and commentators, and some other offices of Inland Revenue, took the contrary view – death was not a disposal; there were no tax consequences arising from depreciation recoveries; there might be an issue at the time of the distribution of the estate.

Again, this was tax advisors' nightmare which became progressively more acute as Inland Revenue flexed its muscles with the dreaded Penalties Regime.

Clamour For Clarity

The muttering index increased progressively from about 1995 through to the end of the century. By that time there were strident demands for:

- A clear statement of what the law actually meant.
- Consistent application throughout the country.
- Some form of roll-over relief in the case of forestry assets.
- A commonsense approach to the treatment of partnership assets in the event of death of one of the partners.
- If necessary – legislative change.

Leading the demands for clarity, consistency, and change was the Primary Sector Accounting Committee of the Institute of Chartered Accountants. Many of the Committee members act for large numbers of farming clients. All of us were caught up with the difficulties of correctly interpreting the legislation for deceased clients. This has been a long and difficult process – first convincing the Institute's National Taxation Committee that it was a big issue needing attention, then convincing Inland Revenue that the project had to be pushed forward on their work programme.

Following a meeting we had with Inland Revenue representatives in July 2002, plus some further discussions and submissions, we were eventually presented with an official's paper, **Tax Implications of Certain Asset Transfers** which was published in April 2003.

That paper dealt with a wide range of asset transfers, including extensive commentary on the tax consequences of asset transfers as a result of the death of a taxpayer.

In essence, the original paper Tax Implications of Certain Asset Transfers took the view the death was indeed the end – it crystallised taxation liabilities on all assets in the tax base, everything was to be valued at the date of death. Further, there were two points at which taxation liabilities crystallise – at the time of death, and at the time assets were distributed from administrator/executor to the final beneficiaries.

Extensive submissions followed. We sought relief for simple estates. We asked for some concessions where assets were bequeathed direct to surviving spouses. We asked for roll-over relief on forestry assets, i.e. delay the recognition of income (and tax) until the trees were sold or harvested.

New Legislation

Comprehensive new legislation has been enacted and received the royal assent on 21 June 2005. The legislation relating to asset transfers is generally prospective – effective from 1 October 2005. There are some transitional provisions in respect of:

- Disposal of property to an administrator arising from a death prior to 1 October 2005.
- Distribution of property by an administrator, executor or trustee to a beneficiary prior to 1 October 2005.

These transitional provisions are contained in Section FI 9 and FI 10 of the Income Tax Act 2004. Because of the limited application of these new transitional rules I have not discussed them in any detail in this paper.

The new legislation is contained in a new Subpart – FI of the 2004 Act. It extends to a wide range of asset transfers including:

- A distribution made by a trustee of a trust to a beneficiary of that trust.
- A distribution in kind made by a Company –
 - » To a shareholder of that company, or to a person in a shareholding relationship with that company; and
 - » To which Section CD 5 applies; and
 - » That is a transfer of value to which Section CD 3(1)(a) refers.
- A gift made by one person to another person.
- A transfer of an estate of a deceased person to an administrator or executor of the estate occurring as a result of the death of a person.
- A distribution of property made by an administrator, executor, or trustee of the estate of a deceased person to a person who is beneficially entitled to receive property under a will or an intestacy.
- A settlement of property by one trust on another trust, if authorised –
 - » Under a trust instrument as a power of advancement or resettlement.
 - » Under Section 41 of the Trustees Act 1956 as the payment of money or the application of property.

The new generic rules provided by the new Subpart FI of the Income Tax Act 2004 require that assets and liabilities disposed of, distributed, resettled, gifted or transferred are deemed to be a **disposal and acquisition at market value**.

It should also be noted that in respect of a deceased individual's estate there are two points at which a market value transfer occurs:

- At the time of death, when the assets transfer from the deceased to the administrator/executor.

- At the point when the administrator/executor transfers the assets to the final beneficiaries.

There has been some commentary that suggests this represents "double dipping" by the Revenue collectors. Not true – the legislation makes it clear that the first transfer creates a deemed acquisition at market value, so the second transfer would only create a tax charge on any incremental value in trading stock or a recovery of depreciation on assets that had been claimed as a deduction during the time period between the two transfers.

Of greater concern to tax commentators has been the possibility of a significant **decrease** in the value of trading stock during the period of administration of the deceased estate. This could give rise to a tax loss which would effectively follow the deceased into their grave. Inability to access tax losses and the final loss of tax losses always troubles tax advisors.

The new legislation provides some relief from the situation (in some restricted circumstances). Details later.

Having established the generic rule that assets and liabilities distributed or transferred are deemed to be a disposal and acquisition at market value, the legislation then goes on to provide some exceptions.

The First Exception (Section FI 4)

Property that passes to a spouse or defacto partner on the death of a taxpayer is transferred from the deceased to the administrator, and then from the administrator to the spouse or defacto partner at tax book values, **provided** any other bequests of other property that is within the deceased's tax base are limited to family members who are within the second degree of relationship of the deceased person (parent, child, grandparent, grandchild, brother, sister).

Assets that are not in the tax base can be disregarded for the purposes of this exception.

This is a relief provision which effectively replicates the conditions that can be achieved in relation to asset transfers under Subpart FF of the Income Tax Act 2004 and the Property (Relationship) Act 1976. It only applies to those assets which are bequeathed to the spouse or defacto partner of the deceased.

The assets which pass directly to the spouse/defacto partner move through both points of transfer at tax book value – no tax cost.

Those assets which pass to close relatives (within the second degree) will, of course, move from the deceased to the administrator/executor at market value with appropriate tax consequences.

The distribution from administrator/executor to the final beneficiaries (the second transfer) will also occur at market values and tax consequences will apply. There is,

however, a second exception to the rule which may provide relief on this second transfer. (Refer below).

Note: This first exception only protects asset transfers from taxation when the relevant assets are bequeathed to the spouse or defacto partner of the deceased. Further, if there are any other assets that are within the tax base, those other assets must be bequeathed within the second degree of relationship of the deceased. Otherwise, the relief provision for the assets transferring to the spouse are lost.

The Second Exception (Section FI 5)

Subject to certain conditions, a distribution from the administrator/executor to the beneficiaries (the second point of transfer) may occur at tax book values. There are four conditions that must be met:

- The only beneficiaries of an estate are persons related to the deceased within the second degree, or are charities; and
- The estate does not establish any life interests; and
- The terms of the will or intestacy require that no property of the deceased taxpayer be held in trust; and
- In a tax year during which the property is subject to administration or executorship or in which the property is held in trust for this purpose, the net income of the estate is distributed beneficially to the maximum extent possible.

Again, assets that are not in the tax base can be disregarded for the purposes of this exception.

Note: Assets that are in the tax base include:

- Revenue account property.
- An interest in a foreign investment fund.
- Financial arrangements which were not accounted for by the deceased as a cash-basis person.
- Assets on which depreciation has been claimed.

Revenue account property is defined as property which is trading stock or otherwise property in respect of which an amount derived on disposition would be gross income.

This second exception to the generic rule (all disposals and acquisitions at market value) is effectively a minor concession to simple estates. The compliance costs of revaluations of trading stock at the time of the second transfer (from administrator/executor to final beneficiaries) are eliminated, provided the necessary conditions are met – close relatives, no life tenants, no Trusts established, beneficial distribution of income.

Obviously, the first transfer of these assets (from deceased to administrator/executor) will have occurred at market value, thus establishing a new tax book value which need not be further adjusted to a fresh market value for the second point of transfer.

The Third Exception – Timber (Section FI 6)

Where timber, standing timber or forestry rights owned by a taxpayer pass to a person who is within the second degree of relationship, both the transfers (from deceased to administrator/executor and from administrator/executor to the beneficiaries) are at tax book value.

This exception provides full roll-over relief. No taxable income comes to account until the beneficiaries sell the standing timber or rights, or harvest the trees.

Miscellaneous

A new provision contained in Section FI 7 confirms that the 10 year "tainting" rules under Subpart CB (land sales) do not apply to land transferred pursuant to a will or an intestacy, provided the property passes to a person within the second degree of relationship.

Property that is subject to Section EA 3 (Prepayments) is valued at cost, rather than market value, when it is transferred to the administrator or executor and when it is subsequently transferred to the beneficiary. The valuation date is treated as the end of an income year. (Section FI 8).

Financial arrangements will be valued at cost, both upon the death of the taxpayer, and at the time of distribution to beneficiaries, if the deceased taxpayer's estate is a cash-basis person. In order for the estate to be treated as a cash-basis person, the deceased taxpayer would need to be a cash-basis person at the date of death. (Section FI 11).

An amendment to Section 120C of the Tax Administration Act 1994 will restrict the imposition of use of money interest on a deceased taxpayer's tax liability in the year of death.

There are a number of consequential repeals and amendments of various other Sections of the Act which have either been made redundant by the new legislation, or needed to be adjusted to give full effect of the new rules.

Other Related Tax Issues

There are two other items that have caused some tax grief in relation to asset transfers. One has been (substantially) fixed for deceased estates with amending legislation; the other was fixed by the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Bill that was enacted at the end of March 2006.

Section EG 17 of the Income Tax Act 1994 (now rewritten as Sections EE 34 to EE 36 in the 2004 Act) deals with depreciable property transfers between associated persons. Another Section has required that the transfer be at market value with consequent taxation issues arising on the depreciation recovered; EG 17 (now EE 34-36) has limited the acquirer's depreciation base to the **lesser** of the market value cost of acquisition, or the historical cost of the asset as incurred (often many years ago) by the associated person.

This provision is causing some serious concern when, for example, Mum and Dad transfer the farm to a Family Trust. Mum and Dad pay tax on large chunks of depreciation recovered; the new owner (the Trust) is unable to use its new cost of acquisition for depreciation purposes.

The issue has been resolved for associated person transfers of property pursuant to a will or intestacy. The disposal and acquisition is, of course, at market values (unless one of the exceptions applies); the disposer may be caught with depreciation

recovered, but the recipient will be able to use the market value acquisition "cost" as a base for future depreciation claims. This relief applies only to **bequests** of property.

The second issue relates to GST. For a number of years we have been aware that the distribution of property from a GST registered person is a taxable supply on which the supplier must charge and account for GST.

There is no GST problem at the point of death. Assets move from the GST registered deceased person to the administrator/executor with no GST consequences – under Section 57(2)(e) of the GST Act 1985. But GST has to be accounted for at the second point of transfer – from the administrator/executor to the final beneficiaries, or to the Trustee in the case of a life interest.

The person(s) receiving the bequest may well be GST registered, but they have been unable to claim a GST input tax deduction because the cost of the property acquired is nil.

The net result has been a GST mismatch – the supplier required to account for GST; the recipient unable to claim.

The problem was remedied by an amendment to Section 10(3)(b) and the insertion of a new Subsection (3AB) in the GST Act 1985. The term "*associated supply*" has been defined – where the supplier and recipient are associated persons, and the new Subsection allows the asset to pass from the administrator/executor to the associated recipient for no consideration for GST purposes, provided the recipient applies the goods/services for the purpose of making taxable supplies, i.e. the Estate transfers the asset for nil consideration and therefore no GST liability; the beneficiary receives the asset for nil consideration and therefore cannot make a GST input tax claim.

Summary

- All of this new legislation is long overdue. Lack of certainty in the law over the past twelve years has caused some serious grief.
- The new legislation came into full effect on 1 October 2005. There are some transitional provisions for the period prior to that date.
- A new generic rule requires that property disposals, distributions, resettlements, gifts and transfers are deemed to be a disposal and acquisition at market value.
- For deceased estates there are two points at which the market value transfer occurs – the transfer from the deceased to the administrator/executor AND the transfer from the administrator/executor to the final beneficiaries.
- The law then provides three main exceptions to the generic rules:
 - A. Subject to certain conditions assets can transfer to a spouse or defacto partner of the deceased at tax book value (both transfers).

- B. Subject to further conditions assets can transfer from the administrator/executor to persons within the second degree of relationship of the deceased at tax book value (second transfer only).
 - C. Forestry assets (timber) can transfer to persons within the second degree of relationship of the deceased (includes a spouse) at tax book value (both transfers).
- There are other miscellaneous tax changes and the usual range of consequential amendments to existing legislation.

A Few Further Thoughts – Tax Planning

- Death is a tax event for individuals who hold revenue account assets and assets on which depreciation has been claimed.
- Direct bequests to spouses delay the crystallisation of taxable income on those assets.
- Tax on forestry assets can be delayed until the forest asset is sold or the trees harvested.
- To achieve this the forest asset must be bequeathed (or transferred through an intestacy) directly to persons within the second degree of relationship to the deceased.
- Establishing a Trust as the beneficiary for revenue account assets and depreciated assets is not the best tax planning idea. It is a very bad idea for forestry assets.
- If a farm was to be bequeathed directly to a trust any forestry asset should be separated from the farm – by registering a forestry right, and that forestry right should be bequeathed directly to the spouse, children, grandchildren, etc.
- Family Trusts do not yield the best tax results for passing on farm assets as part of an intergenerational succession plan.
- The company structure yields a better tax result for wealth transfer and succession planning (transfer the shares, not the assets).

CHAPTER 2 – LIVESTOCK VALUATION

Choice

A key feature of the legislation in relation to the valuation of livestock is the range of choice that is given to taxpayers. The fact that there is a lot of choice in turn means that accountants and advisers need to have a good understanding of all of the rules so that they can make appropriate choices which will yield tax benefits for their clients.

For specified livestock (sheep, beef cattle, dairy cattle, deer, goats and pigs) there are four options:

- The Herd Scheme.
- National Standard Cost.
- Market Value or Replacement Price
- Self Assessed Cost.

There are a couple of variations on the herd scheme, namely the use of herd value ratios and Chatham Island ratios. The latter enables livestock that are farmed on the Chatham Islands to be valued at 30% of the national average market values (Herd scheme values).

The herd value ratios enables any taxpayer in New Zealand to adopt herd values as low as 90% of national average market values or as high as 130% of national average market values. There are some relatively complex valuation requirements and notice requirements, and to my knowledge no one actually uses herd value ratios.

There are some entirely separate rules for high priced livestock. These effectively stand outside the normal valuation methods listed above.

Any specified livestock that is used in dealing has to be valued using cost, market valuation or replacement price. All non specified livestock (e.g. alpacas, ostriches, laying fowls) is valued using the taxpayer's choice of cost, market value, or replacement price. There is a provision in the legislation for the Commissioner to allow a standard value for non specified livestock but to date the Commissioner has not exercised his discretion to provide for any standard values for these types of livestock.

A further element of choice in the valuation of specified livestock is that individual taxpayers may use several of the four choices listed above at any one time. In our practice we would typically have (for a dairy farmer) some of the mixed age cows and rising two year old in-calf heifers on the Herd scheme and some valued using national standard cost, and the rising one year old dairy heifers valued using market value/replacement price.

Specific Prohibitions

There are some specific prohibitions in relation to livestock valuation methods:

- A taxpayer cannot use national standard cost and self assessed cost at the same time.
- For bailed livestock the bailor cannot use either national standard cost or self assessed cost for any long term bailment. National standard cost or self assessed cost could be used for a short term bailment. *Note: Short term bailments are defined in Section EC 27 of the Income Tax Act 2004.*
- A taxpayer cannot use both national standard cost and market value/replacement price within the same inventory group.
- If the Herd scheme is used for any livestock within a livestock type, then all herd sires must be valued using the herd scheme.
- There are some separate rules for high priced specified livestock which effectively means that they stand outside the normal valuation methods.

Allowable Combinations

Having determined what is prohibited we can make up a list of the allowable combinations of livestock valuation methods. These are:

- Herd scheme and National Standard Cost.
- Herd scheme and Market Value/Replacement Price.
- Herd scheme and Self Assessed Cost.
- Herd scheme and National Standard Cost and Market Value/Replacement Price.
- National Standard Cost and Market Value/Replacement price (but not within the same inventory group).

Movement From One Method To Another

We then need to consider how it is that we commence using a particular valuation method and more particularly what needs to be done if we wish to switch from one valuation method to another. In some cases the election to commence using a livestock valuation or the election to switch from one valuation to another is done by way of a formal written notice which must be lodged with the Commissioner of Inland Revenue as much as two years before the change in method can be effected.

In other cases, formality is dispensed with and the taxpayer gives notice of a change by the simple expedient of using the relevant method in the annual Financial Statements.

The term "*two year written notice*" is something of a misnomer. It must certainly be in writing but in practice the time period works out at considerably less than two years.

What the legislation actually says in respect of two year written notice is that "... .. a person must give notice by the date of filing their return of income for an income year that is at least two income years before the income year in which the election is first to apply" (Section EC 11(3)).

This means that if a taxpayer wished to make a change which was going to require a two year written notice which was to apply for the 2007-2008 income year, the appropriate written election would need to be filed before the date of filing the 2005-2006 tax return.

As a general rule, any taxpayer with appropriate extension of time arrangements is not required to file the 2005-2006 tax return until as late as March 31 2007.

On this basis, someone wishing to quit the Herd scheme is effectively looking ahead about fourteen months to see where livestock values are likely to be and whether or not it is appropriate to file an election to quit the Herd scheme, i.e. they are making a decision before March 31 2007 as to what the Herd scheme values will be when they are announced at about May 20 2008 in respect of the 2007-2008 income year.

The following table sets out details of what is required when moving from one valuation method to another valuation method:

MOVING FROM	MOVING TO	NOTICE REQUIRED
Herd	NSC	2 Year
	MV/RP	2 Year
	SAC	2 Year
NSC	Herd	Same Year
	MV/RP	Same Year
	SAC	Same Year
MV/RP	Herd	Same Year
	NSC	Same Year
	SAC	Same Year
SAC	Herd	Same Year
	NSC	2 Year
	MV/RP	Same Year
Key:	Herd	Herd Scheme
	NSC	National Standard Cost
	MV/RP	Market Value or Replacement Price
	SAC	Self Assessed Cost

Obviously, two year written notices to change from one valuation method to another requires the taxpayer to specify the year in which the election is first to apply and also to specify the types and classes of stock for which a particular valuation system will no longer apply, and the proposed valuation methods under the new arrangement that will apply to those same types and classes of livestock.

When electing to cease using the Herd scheme the election must apply for all of the classes of livestock within a particular livestock type.

If a taxpayer was seeking to quit the Herd scheme they also need to specify the valuation method or methods that will be used for the relevant livestock under the new arrangement.

It is possible to file an election which would enable market value/replacement price to be used for one inventory group (e.g. rising one year old animals), and national standard cost for all of the animals which would be included in the mature inventory group (e.g. rising two year old in-calf heifers and mixed age cows).

Following this very brief synopsis of the rules that govern the valuation of specified livestock, we now turn our attention to how we might apply those rules to generate tax advantage for our farming clients.

Herd Scheme Basics

Perhaps the first thing we should do is to consider the efficacy or otherwise of the Herd scheme. The scheme rests on the annual revaluation to national average market values of specified livestock (6 types of livestock, 65 classes of livestock).

Average market values are collected (nationwide) at about the end of April each year. The figures are weighted, collated, averaged and reviewed through a robust and reliable process which results in the Commissioner of Inland Revenue publishing an annual Determination of National Average Market Values (Herd scheme values) for specified livestock, usually about May 20th each year. The values are for the income year just ended or (for late balance date taxpayers) the year just about to end.

The Herd scheme legislation overrides the normal rule that the opening value of trading stock at the start of the income year must be the same as the closing value of trading stock at the end of the previous income year.

In effect then, taxpayers wait until about the end of their income year to get the Herd scheme values for that year, then go back to the start of that year and restate the opening value of livestock on hand (valued using the Herd scheme method) to the new herd values. The revaluation of opening livestock values is tax free/non tax deductible.

From a tax planning perspective this appears to be a dream come true whenever values increase – a tax free capital revaluation of a revenue item.

Obviously, the reverse applies when values fall, but over time we expect inflation to progressively drive values up so it seems that the Herd scheme must be a good idea, especially when compared to the other valuation methods.

Under the other valuation methods, national standard cost, self assessed cost, market value/replacement price, increases in value are not tax free. They give rise to the recognition of taxable income and consequently deliver a tax bill.

The problem with the Herd scheme is that it delivers a negative benefit if livestock values fall, and no benefit if livestock prices remain relatively static over a period of years.

Further, the Herd scheme generally incurs a tax cost at the time additional animals are added to Herd scheme livestock. This arises from the fact that the acquisition cost of those livestock, especially if they arise from natural increase in the operation of the farming business, is considerably less than the published Herd scheme values for that income year.

For example, the national standard cost that might be attributed to some additional two tooth ewes that have been bred, reared and grown on the property will be about \$38; the Herd scheme value of the same class of animals is more than \$100.

So in a situation where an existing farmer has (say) 500 two tooth ewes all valued using the Herd scheme but now decides to increase the size of his flock and does so through natural increase and growing the relevant animals through to two tooth ewes, that farmer is faced with a choice of valuing the extra two tooth ewes either under the Herd scheme or perhaps using national standard cost.

If he uses Herd scheme values for say 20 additional animals, those 20 additional animals will need to be recorded in his books at year end at a value of more than \$100 per head; if he chooses to use national standard cost those extra 20 animals will be brought to account in his books at a tax value of less than \$40 per head.

Tax Entry Cost

The difference in value is more than \$60 per head and at a 33¢ tax rate the additional tax that will be incurred by using the Herd scheme values will be more than \$20 per animal.

We refer to this as the "*tax entry cost*" of adding extra animals to the Herd scheme livestock on hand.

The taxpayer has a choice and must decide whether they wish to pay an additional \$20 of tax now, or whether they will simply take the lower value of livestock into their books at this stage and pay an additional lump of tax when they finally quit farming and sell up all of their livestock. Additional tax now generally has an interest cost; that interest cost effectively runs on forever, either as a direct cost of interest as an opportunity cost based on the time value of money.

A study of Herd scheme values versus national standard cost values over the past 10-15 years suggests that the tax entry cost of adding additional animals to the Herd scheme has yielded virtually nil benefit for sheep.

For deer, adding additional livestock to the Herd scheme has been a tax planning disaster; for dairy cattle it has generally yielded negative returns and for beef cattle there has been nil benefit unless those additional beef cattle were added to the Herd scheme during the years 1995 through 1999.

With the Herd scheme it is absolutely essential to try and arrange things so that additional animals are only added to the Herd scheme when:

- Herd scheme values are very low.
- National standard cost values are relatively high.
- The individual taxpayer's tax rate is very low.
- There is a reasonable expectation of a significant increase in Herd scheme values in subsequent years.
- There is some plan to exit the Herd scheme when Herd scheme values are very high **and** the proposed exit from the Herd scheme is within a relatively short timeframe.

Market Value/Replacement Price

An issue that is often overlooked is the use of market value/replacement price. The main restriction on this method is where the Herd scheme is being used the taxpayer must maintain the base number in each class of livestock. But for additional numbers (above base) the market value/replacement price option is generally available on a "*same year*" notice basis.

There is one further restriction to the use of market value/replacement price, namely that the method cannot be used in conjunction with national standard cost **within the same inventory group**. For a different inventory group there is no restriction, so it would be possible, for example, to have some base numbers of various classes of livestock valued under the Herd scheme, some livestock in the **mature** inventory group valued using national standard cost, and some of the **immature** inventory group valued using market value/replacement price.

Note, there is additional flexibility within the dairy cattle and beef cattle livestock types because there are four inventory group classifications for each of those types of livestock:

- Rising one year cattle (immature).
- Rising two year male non breeding cattle.
- Rising three year and older male non breeding cattle.

- The rest (rising two year heifers, mixed age cows and (possibly) breeding bulls).

We often use market value/replacement price when we want to increase taxable income to meet a specific tax situation for a particular client, e.g. to fully utilise the low tax bracket (up to \$38,000 of income) **this** year and to get some sort of offset against next year's profit when income will push the client into the 33% or 39% tax bracket.

A typical example could be where national standard cost has been used for rising two year old steers; the NSC value is \$343.20, the Herd scheme value is \$697.00 and market value/replacement price is around \$700.00. The taxpayer may not wish to add this class of animal to the Herd scheme because of future inflexibility (two year written notice to get out AND the need to take out **all** of the livestock of that type). The use of market value/replacement price on a line of (say) 60 rising two year steers could increase taxable income by about \$21,000 this year and allow a tax deductible decrease of about \$21,000 next year.

In our practice we use market value/replacement price extensively for rising one year dairy heifers, largely because the national standard cost values appear to be unrealistic. We do not use Herd scheme values for rising one year olds because we do not want a **theoretical** national standard cost value to feed into next year's mature intake national standard cost.

Valuation Requirements

The requirements for market value/replacement price were published in Public Information Bulletin, No. 162, Appendix B, Page 11, April 1987. These read as follows:

MARKET VALUE OR REPLACEMENT PRICE

The requirement of these options will be relatively straightforward.

Market Value

The market value of livestock can be used as an alternative to cost price. Market value is the value that the livestock would be worth on the open market if they were available for sale in the normal course of business to an arms-length party at balance date.

Market value should **not** be reduced by any selling costs such as the cost of transport from farm to sale yards or slaughterhouse.

What will be required is a Valuation Certificate for each class of livestock from a competent independent valuer. The Certificate must include stock numbers and either the market value or replacement price as at balance date.

Replacement Price

The replacement price of livestock is the price the taxpayer would pay at balance date for livestock of the same class and quality as the livestock on hand at that balance date which are to be valued at replacement price.

What will be required is a Valuation Certificate for each class of livestock from a competent independent valuer. The Certificate must include stock numbers and either the market value or replacement price as at balance date.

National Standard Cost

The method is widely used but some aspects of it are not well understood and are therefore poorly applied. National standard cost should be relatively easy to calculate. It is a simple cost accounting exercise and is made easy by the fact that Government gives us annual "*standard cost*" figures for breeding, rearing and growing each of the livestock types through to rising one year olds, and further "*standard cost*" figures for rearing and growing those animals through to maturity.

Pigs are deemed to achieve maturity at one year old; other types of animals (sheep, cattle, deer, goats) are treated as mature at two year old. There is a minor variation with male non breeding cattle which are deemed to reach maturity at three years.

It is not the objective of this Paper to work through the detail of how national standard costs are calculated, but a brief overview might be helpful in understanding the opportunities that the method delivers for tax planning purposes.

As mentioned above, national standard cost is simple cost accounting. For the immature inventory group (rising one year olds) we add together the national standard costs (provided by Government) for those animals bred, reared and grown on the farm, plus the cost of any purchases of animals that are (or would have been if still on hand at the end of the year) rising one year olds, and in the case of bought in bobby calves, a rearing cost.

All of those costs are aggregated and then divided by the number of animals involved in the process to give a unit cost. This is the national standard cost (per rising one year animal) for that farmer for that year. No further costs are added to animals bought in during the year for any further rearing or growing costs.

For the mature inventory group, we add together the cost of the animal at the start of the year (the cost of the rising one year old), plus a rearing and growing cost (provided by Government), plus any purchase costs of maturing or mature animals of the relevant type.

These total costs are divided by the number of animals involved in the process to give us a national standard cost for the animals that are taken into the mature herd or flock for the year.

There is an extended calculation for male non breeding cattle which are not considered to be mature until they are three year olds.

Again, no further costs are added to any animals that are bought in during the year.

Depending on the farming policy, it is possible to have widely different national standard costs from one farm to another. One of the more acute examples is rising one year old dairy cattle:

- If they are all homebred (no purchases) the national standard cost this year will be: \$678
- If they were all bought in as bobby calves at a cost of (say) \$120 we would need to add the bobby rearing cost and would calculate a national standard cost of: \$259
- If we bought in weaned calves in about November the national standard cost would be equal to their purchase cost: (Say) \$350
- If we bought in 8-10 month old animals next autumn their national standard cost would be equal to their purchase cost: (Say) \$500

The above example is slightly unusual. For most other livestock the national standard cost (homebred) tends to be about 40%-60% of their Herd scheme values. Where the farming policy involves buying in some livestock the purchase costs will tend to push up the national standard cost for that farmer.

Tax Planning Opportunities

Most taxpayers actively seek ways to value their trading stock at the lowest possible levels. In fact, most of us have seen or heard of examples where the logic used to reduce trading stock values has its genesis in flights of fancy, or in some cases downright dishonesty.

Farming taxpayers do not have to pursue those dangerous courses of action; the legislation actually allows them to choose between at least four valuation options. Two are value based – the Herd scheme and market value/replacement price; two are cost based – national standard cost and self assessed cost.

For one each of those options, Government actually produces the information for us. Herd scheme values are determined and published about May 20th each year. National standard cost figures are determined and published about the end of January each year.

It is then over to each farming taxpayer to weigh up the published information, have a think about market value/replacement price or possibly self assessed cost and then make a **choice** as to what methods will be used for which livestock.

Obviously, the taxpayer must work within the rules, but subject to that constraint the range of choice is quite extensive. We also need to be able to "*read the markets*" to work out when livestock values are likely to trend upwards and more particularly when they are likely to decline significantly. And it is not just a case of following what has happened – rather, we need to be able to look forward sufficiently far

enough to cope with one of those two year written notices that are required to get out of the Herd scheme.

Looking back over the years, the choices we should have made have been:

- 1987
 - » All qualifying classes of sheep and cattle should have been valued using the Herd scheme.
 - » Deer, pigs and goats should not have been valued using the Herd scheme.
- 1993 (the Herd scheme was extended to include all classes of all specified livestock).
 - » Given the choice between adding additional animals to the Herd scheme, or using national standard cost, we should have opted for national standard cost.
- 1996
 - » Herd scheme values for female beef cattle hit a cyclical low. All female beef cattle should have been added to the Herd scheme.
- 2001
 - » Dairy cow values peaked at \$1,313 (Friesians) and \$1,248 (Jerseys). If we had "*read the market*" correctly we would have filed election notices to quit the Herd scheme before filing the 1999 tax returns.
- 2002
 - » Dairy cow values remained high at \$1,225 and \$1,174 respectively. There was a mass exodus from the Herd scheme by taxpayers who had filed elections to quit the scheme before filing the 2000 tax returns.
 - » Similar conditions prevailed for beef cattle and sheep – a good year to be getting out of the Herd scheme.
- 2003
 - » Dairy cow values crashed. Time to rejoin or add more stock to the Herd scheme.
- Since 2002
 - » National standard cost figures for rising one year dairy cattle have gone into orbit. We should be using market value/replacement price.
- And
 - » We should be considering market value/replacement price as a "*holding pattern*" arrangement following the purchase of a new herd or flock.
 - » There are many occasions when market value/replacement price can be used to achieve a useful tax result.

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