

Impact Summary: Mycoplasma bovis tax issue

Section 1: General information

Purpose

Inland Revenue is solely responsible for the analysis and advice set out in this Impact Summary, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by or on behalf of Cabinet.

Key Limitations or Constraints on Analysis

Range of options considered

A more long-term generic process or provision for handling severe adverse events and future biosecurity incursions affecting livestock has not been considered. Given the timeframe for addressing the current *Mycoplasma bovis* issue (taxpayers that are clients of tax agents with a valid extension of time are due to file tax returns for the 2018/19 income tax year by 31 March 2020) a specific solution is required as it would not be possible to fully consider a longer-term solution.

Consultation

Consultation has been focussed on discussing the issue and potential solutions with Federated Farmers and Chartered Accountants Australia and New Zealand (CA ANZ). Given the timeframe for addressing this issue other groups have not been consulted at this stage. Officials will consider whether other groups should also be consulted as we work through the detailed design of the proposal before legislation is introduced and at the select committee stage.

Responsible Manager (signature and date):

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To be completed by quality assurers:

Quality Assurance Reviewing Agency:

Inland Revenue

Quality Assurance Assessment:

The Quality Assurance reviewer at Inland Revenue has reviewed the *Mycoplasma bovis tax issue* RIA and considers that the information and analysis summarised in it **meets** the quality criteria of the Regulatory Impact Analysis framework.

Reviewer Comments and Recommendations:

The reviewer's comments on earlier versions of this RIA have been incorporated into this version.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Overview

Some farmers that have had their livestock culled owing to the Government's attempts to eradicate *Mycoplasma bovis* from New Zealand have faced an unexpected and significant tax liability as a result. This tax liability may impede their ability to replace their culled herd and is contrary to a key principle of the Biosecurity Act 1993 that no person is made better or worse off owing to the Crown's use of its powers under that Act.

Background

Mycoplasma bovis is a bacterium that can cause a range of serious conditions in cattle. The disease may be dormant in an animal – causing no symptoms at all. But in times of stress (for example, calving, drying-off, transporting, or being exposed to extreme weather), the animal may shed bacteria in milk and nasal secretions. As a result, other animals may be infected and become ill or carriers themselves.

The presence of *Mycoplasma bovis* in New Zealand was first detected in 2017. The Government, in partnership with the dairy and beef sectors, has decided to try to eradicate *Mycoplasma bovis* from New Zealand. As a result, Biosecurity New Zealand can require all the stock on a farm where *Mycoplasma bovis* has been found to be culled. In exchange, the Government pays compensation to the affected farmers for the difference between the normal market value of the stock and the amount received when the stock is slaughtered. This compensation is intended to leave farmers in no better or worse position than a person whose property is not directly affected by the exercise of the powers.

To date, around 200 properties have been cleared of stock with a similar number being monitored for the presence of *Mycoplasma bovis*. These have been predominantly dairy farms although *Mycoplasma bovis* is increasingly being found on beef farms that acquired young stock from affected dairy farms before the disease was identified. Of the total 90,000 stock culled and compensated for by the end of January 2020, 52,000 were dairy cattle and 38,000 were beef cattle, with the bulk of the beef cattle being from fattening operations rather than breeding operations.¹

For income tax purposes livestock must be valued annually to establish its opening and closing values as part of determining the cost of sales. A farmer has the choice of several valuation options. Many use the national standard cost (NSC) scheme which values the animals at:

- a standard cost (determined by the Commissioner of Inland Revenue), if the animal is homebred, for the respective age and type of animal that reflects average home breeding costs; or
- at its purchase cost if the animal is purchased.

¹ Fattening operations involve the growing of animals for meat. Such operations have much quicker turnover of stock than breeding operations as the stock will be slaughtered within 1-2 years. Conversely, breeding operations involve the rearing of animals for the ultimate replacement of existing herd animals and the sale of any excess. The quicker turnover of stock for fattening operations means the tax issue discussed in this impact summary is less significant for fattening operations.

A few farmers also use the self-assessed cost scheme which involves farmers using their own farm costs rather than standard costs.

Policy problem in detail

When breeding livestock has been valued under either the NSC scheme or the self-assessed cost scheme, culling the herd can result in a significant and unexpected tax liability that can impede a farmer's ability to restock their farm. This is because the compensation payments plus slaughter receipts are income, and there is no immediate comparable deduction in relation to the replacement stock to offset that income. The replacement stock value for NSC and self-assessed cost purposes is its purchase price and this stock value is only gradually written down (over the next five or so years) as the stock ages and is itself replaced from homebred animals.

Although this is a tax timing issue, there are potential cash flow problems and interest costs for farmers in the meantime that can impede the recovery process.

Simplified example

Cow A with a market value of \$1,500 is culled because of *Mycoplasma bovis*. The farmer receives \$1,500 for the cow from a combination of compensation and slaughter receipts.

For tax purposes, as cow A was valued under the NSC scheme at \$700, there is taxable income of \$800 from its cull.

The \$1,500 is used to buy replacement cow B. Under NSC, cow B is valued at its purchase price of \$1,500.

Cow B remains in the herd for five years before being slaughtered and is replaced by a cow bred up through the herd (cow C) which has a NSC of \$700 (its homebred cost). There is a tax deduction of \$800 at that point, being the difference between the cost of cow B and the cost of cow C.

If there had been no *Mycoplasma bovis* cull, cow A would have remained in the herd and been replaced by the equivalent of cow C with no NSC implications given that both cow A and cow C have a NSC value of \$700.

As farmers will have a herd made up of different age cows that will be progressively slaughtered the single \$800 deduction in this example will result in a deduction each year when considered on a whole of herd basis.

For fattening stock valued under the NSC scheme or self-assessed cost scheme, the tax issue is less acute as the livestock turn-over much more regularly so that normal tax rules should apply. In that case, or when other valuation methods (such as the herd scheme) are used to value the herd, the income equalisation deposit scheme should provide sufficient flexibility to manage any tax issues.

The income equalisation scheme enables the recognition of income to be deferred by up to five years if the income is deposited into the scheme. The income equalisation scheme will not provide sufficient flexibility to deal with the tax issues created by the culling of breeding animals that are valued under NSC or self-assessed cost because the deposit would need to be withdrawn to pay for replacement stock, at which point the income is recognised.

2.2 Who is affected and how?

The affected parties are farmers that use the NSC scheme or the self-assessed cost scheme to value their breeding stock on hand for tax purposes and have had their herds culled and replaced because of *Mycoplasma bovis*. Overall, possibly up to 50 farmers to date could have unexpected tax liabilities because they value their dairy and/or beef breeding animals under the NSC or self-assessed cost schemes. The impact is most severe for those with a high proportion of mixed-age cows as, under normal circumstances, they would be relying on holding those animals for several years and on using them to breed replacement stock. Sharemilkers would be particularly affected as their main asset is livestock.

Since very few farmers use the self-assessed cost scheme, because of its complexity, it may be that none of the farmers affected by *Mycoplasma bovis* are using it. However, if they have there would be a sizeable tax liability as a result of the cull.

Federated Farmers wrote to the Minister of Revenue in December 2019 asking for this issue to be addressed. Chartered Accountants Australia and New Zealand (CA ANZ) also supports the proposals.

2.3 What are the objectives sought in relation to the identified problem?

A core principle of the Biosecurity Act 1993 is that no person should be any better or worse off because of the Crown's use of its powers under that Act. The objective of the proposal is to ensure that farmers are not made worse off because of a tax liability arising from the culling of *Mycoplasma bovis* infected livestock.

Section 3: Options identification

3.1 What options have been considered?

The following criteria have been used to assess the options:

- Equity – the option should result in farmers using the NSC or self-assessed cost scheme not being made worse off as a result of their herds being culled or better off than farmers who have used other valuation methods.
- Timeliness – the option should be able to be enacted as soon as possible to provide certainty to farmers with culled and replaced herds
- Compliance and administration costs – the option should be as simple as possible.

Option 1: No law change (Status quo)

The status quo would not be an equitable option as farmers using the NSC scheme would face a significant and unexpected tax liability owing to their herds being culled because of the presence of *Mycoplasma bovis*. This is contrary to the principle of the Biosecurity Act 1993 that no person should be made better or worse off owing to the Crown's use of its powers under that act.

Option 2: Spreading the additional income (preferred option)

Under this option, the additional taxable income arising from culling and replacing a herd would be able to be spread evenly over subsequent income years. This would allow the income to be offset each year by the increased deductions arising from the reducing cost of the stock on hand.

The ideal length of this spread for farmers would be between 5 and 7 years depending on the profile of their herds. Therefore, for simplicity the length of the spread would be 6 years, starting from the income year after the income originally arose.

Certain requirements would need to be met for the income to be spread:

- The business would need to be subject to Biosecurity Security New Zealand requiring a cull of *Mycoplasma bovis* affected stock.
- Stock would need to be substantially replaced with equivalent stock within a reasonable timeframe, say twelve months. Farmers that choose not to replace their stock after a cull are in a similar position to a farmer that sells their stock to exit the industry.
- The business would need to be a dairy or a beef breeding operation, with the breeding stock valued under the NSC or self-assessed cost schemes.
- Only the income derived from the culling of the breeding stock valued under the NSC or the self-assessed cost schemes could be spread. Income derived from culling fattening stock would not be able to be spread as the tax issue is less acute owing to the more frequent turnover of stock.

- The replacement stock must continue to be valued using, as relevant, NSC or self-assessed cost. This is to ensure that farmers cannot enter the herd scheme on more advantageous terms than those not affected by Mycoplasma bovis.

Analysis of option

This option increases equity as it would ensure affected farmers do not suffer from an unexpected tax burden and associated cash flow issues. This is consistent with the core principle of the Biosecurity Act 1993 that no person should be made better or worse off owing to the Crown's use of its powers under that act.

This option would also be a more timely solution to the problem as it could be announced by the Minister of Revenue prior to the 31 March 2020 due date for 2018/19 income tax returns for clients of tax agents with a valid extension of time. This will help to provide certainty to farmers and their tax advisers.

This option is not expected to have a significant impact on compliance costs for affected farmers. Farmers intending to spread the additional income will be required to advise Inland Revenue when filing their returns so that their files can be manually adjusted.

Given the relatively low number of affected farmers, the costs associated with administering this option for Inland Revenue should be minimal and could be absorbed within existing baselines.

Option 3: Offset the taxable income against the cost of replacement stock

This option would involve offsetting the taxable income against the cost of the replacement livestock, which would essentially write down the purchase price to what the NSC would have been had the incident not occurred.

While this option would conceptually achieve the desired outcome, it would be complex to achieve in practice as it would require an exact matching of the culled stock with the replacement stock, and rules about adjustments where that did not arise. Therefore, this option was not preferred as the option of spreading the income evenly over a number of income years is simpler.

Option 4: Amending the income equalisation scheme

This option would involve enabling deposits made in relation to Mycoplasma bovis to be withdrawn from the income equalisation scheme without being treated as income. This option would compromise the integrity of the scheme and is, therefore, not preferred.

3.2 Which of these options is the proposed approach?

The proposed approach is spreading the additional income arising from culling and replacing a herd affected by *Mycoplasma bovis*. Spreading the income over the six subsequent income years offsets the income against the expected increased deductions, in effect leaving the farmer in a similar position to if no unexpected income had arisen.

This is the proposed approach as it is the only option that can be implemented in a timely manner and is consistent with the principle of the Biosecurity Act 1993 that no one is made better or worse off owing to the Crown's use of its powers under that Act.

The proposed approach is compatible with the Government's "Expectations for the design of regulatory systems".

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties (identify)	Comment: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	Impact <i>\$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts</i>
Additional costs of proposed approach, compared to taking no action		
Regulated parties (Farmers)	Additional compliance costs from informing Inland Revenue that they are spreading the additional income	Low
Regulators (Inland Revenue)	Minimal administration costs that will be absorbed within existing baselines.	Low
Wider government	Upfront fiscal cost of \$1.5 million offset by fiscal gains over the following years from already filed returns being adjusted. There will also be a small but unquantified fiscal cost arising from affected taxpayers that have not yet filed returns for the tax year in which the cull occurred, spreading the additional income. This fiscal cost is already included in forecast baselines.	Already filed returns: PV ₂₀₂₁ = \$0.236 million Returns not yet filed: Low but unquantified
Total Monetised Cost		PV ₂₀₂₁ = \$0.236 million
Non-monetised costs		Low
Expected benefits of proposed approach, compared to taking no action		
Regulated parties (Farmers)	Cash flow benefit from spreading taxable income over 6 years	Already filed returns: PV ₂₀₂₁ = \$0.236 million Returns not yet filed: Low but unquantified
Total Monetised Benefit		PV ₂₀₂₁ = \$0.236 million
Non-monetised benefits		Low

NB. Monetary impacts are calculated by assuming the proposal will result in a fiscal loss of \$1.5 million in 2020/21 offset by a gain of \$300,000 in each of the following 5 years (as returns are being adjusted the fiscal loss and first year of income being spread will occur in the same fiscal year). A 6% discount rate has been used.

4.2 What other impacts is this approach likely to have?

No other impacts have been identified from the proposed option. Federated Farmers and Chartered Accountants Australia and New Zealand (CA ANZ) will continue to be consulted on the detailed design of the proposal to ensure there are no unintended impacts.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

This issue was raised by Federated Farmers in a letter sent to the Minister of Revenue in December 2019. Since then officials have worked with Federated Farmers and CA ANZ on developing a solution to the issue.

Federated Farmers and CA ANZ both consider that an immediate solution is required and support the proposed income spreading option.

Officials, CA ANZ and Federated Farmers have established a working team to work through the detailed detail of the proposed spreading option.

Given the urgent timeline for addressing this issue the focus has been on consulting with Federated Farmers and CA ANZ. However, officials will consider whether other groups should also be consulted as we work through the detailed design before legislation is introduced and at the select committee stage.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

The proposal will require amendments to the Income Tax Act 2007. These amendments would be included in a Supplementary Order Paper (SOP) to an omnibus taxation Bill scheduled to be introduced in April 2020. The SOP would be released at the Finance and Expenditure Committee stage in time for submissions to be made on the proposed amendments. Guidance material will be published on the amendments following the Bill's enactment.

Following Cabinet approving the proposed option the Minister of Revenue will issue a press release advising of Cabinet's decision and the process for affected 2018/19 returns due by 31 March 2020. This will help to provide certainty for farmers and their tax advisers.

Already filed returns

Although the bulk of the impact to date will be in relation to 2018/19 income tax, as the culls began in late 2017, this option would be backdated to include the effects of the cull in the 2017/18 income year. Affected farmers who have already filed returns for 2017/18 or 2018/19 would have the option of applying the spread retrospectively and having their returns reassessed. However, some may instead choose to leave their returns as is as there may be some impact on farmers social assistance entitlements and liabilities if the additional income is now spread. For this to be effective, the Commissioner of Inland Revenue will have to be allowed to make associated adjustments to the farmers' tax positions.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

Inland Revenue will monitor the outcomes to confirm that they match the policy objectives. This will be facilitated by farmers who choose to spread their additional income being required to advise Inland Revenue of their intention to do so.

The proposed option has been developed alongside Federated Farmers and CA ANZ. Officials expect that, once the proposals are enacted, these two groups will raise any concerns affected farmers are having with the rules in practice. Any necessary changes identified as a result would be recommended for addition to the Government's tax policy work programme.

7.2 When and how will the new arrangements be reviewed?

The review will be the monitoring described in section 7.1 above.