

Tax issues for livestock producers during and after drought

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DISCLAIMER

While the content of this article is considered accurate, conflicting comments were received from the accounting profession. In addition, the Australian Taxation Office (ATO) was not prepared to give an opinion on a general article such as this.

Individuals should seek specialist advice from their tax advisers, which specifically applies to their particular situation. If doubt still exists, an individual ruling can be sought from the ATO.

Introduction

A number of tax concessions are available to livestock producers experiencing drought. These concessions generally defer tax liabilities to later years. This can be particularly important for livestock producers who are faced with a situation of increased costs in handling the drought, and limited funds for drought recovery.

Farmers can apply for these concessions when their area has been officially 'drought declared'.

Options for declaring income from forced livestock sales

Producers who sell breeding stock during a drought have a number of options in the way they declare the income from the forced sales, and also in their restocking strategy. These options include:

Option 1

Include the whole of the proceeds from the disposal of the animals in the year of disposal, and repurchase breeders when the drought is over.

Option 2

Include 20% of the proceeds in the year of income and a further 20% of the proceeds in each of the

following 4 years, i.e. the profit from the forced disposal is spread over 5 years.

Option 3

Defer declaring the sale of animals until after replacement stock have been purchased.

Option 4

As per option 3, but only a portion of the number of replacements are purchased in the year following the drought. Additional heifer replacements would then be retained to increase the herd to the original size.

How livestock trading profits are calculated

It is necessary to understand the livestock trading account system that is used to calculate profit or losses made from livestock enterprises. A simplified trading account calculation follows

| | | |
|----------------|-------|---------------------------------------|
| Trading profit | = | gross sales |
| | plus | value of stock on hand at end of year |
| | plus | value of stock killed for rations |
| | minus | value of stock at start of year |
| | minus | value of purchases |

A complete livestock trading schedule also includes a section to cover losses or deaths. However, this information has been omitted here because the impact is negligible and would be the same for each option. The value of stock on hand includes valuing any natural increase (i.e. calves bred on the farm during the year). Natural increases of stock during the year can be valued at cost, at market selling value, or at replacement value. Cost is whichever of the following you elect:

- actual cost of the calf;
OR
- cost prescribed by the regulations:
 - cattle, horses and deer \$20



- pigs \$12
- emus \$8
- goats and sheep \$4
- poultry 35c.

Most farmers tend to record the value of natural increase at the minimum prescribed by the regulations. This reduces tax in the year of declaration, but, when the progeny are actually sold at much higher values, they incur additional tax in that year. For farmers who have valued their natural increase at higher rates, more tax is paid initially but less tax is paid in the future. The value of the animals as submitted to the tax office is commonly termed the **book value**.

As trading profit is calculated in this way, an apparent loss in market value due to drought does not automatically result in a loss for tax purposes. In fact, when book values for stock are low, the reverse can happen. For example, if the market value of animals prior to drought was \$600 per head but they are sold for \$400 per head on a low market, there is not necessarily a \$200 loss for tax purposes. If the book value is, say, \$20 per head less than the \$400 sale price, then the transaction will in fact show as a profit of \$380 per head. However, in some cases, if losses are made in the overall farm operation, there would not be a tax bill, but losses carried forward into future years would be less. To demonstrate the tax effect of each of the four options listed above, two 'example' cattle herds are described:

- Both herds have 100 cows.
- Both have the same sale prices (\$500).

- Both have the same repurchase prices (\$600).
- The herds have different book values (\$40 in example 1 and \$300 in example 2).

| | Example 1 | Example 2 |
|--|-----------|-----------|
| Book value of cows at start of year 1 | \$40 | \$300 |
| Sale price during year | \$500 | \$500 |
| Repurchase price in financial year 2 | \$600 | \$600 |

Method used in calculating taxable profit

To demonstrate the method used in calculating taxable profit, details of calculations for options 1–4 are given at the end of this Primefact. A summary of results of all options follows below.

Effect of high replacement costs on future tax liabilities

When **stock are repurchased at high values**, it may be assumed that this will reduce the tax liability in the year of purchase. In this case, however, the closing stock value also rises by the same value as the purchases, meaning that there is no impact on tax if the animals are retained past the end of the financial year. In subsequent years, though, breeding replacements can be introduced at a low value, which will thereby reduce closing stock values and, effectively, defer tax until the replacement animals are sold from the herd or flock.

Summary of results

Example 1. Effect on taxable profit of forced sale of stock where book value is \$40.

| Option* | Year 1 (\$) | Year 2 (\$) | Year 3 (\$) | Year 4 (\$) | Year 5 (\$) |
|--|-------------|-------------|-------------|-------------|-------------|
| 1. Declare all income up front. Buy replacement cows in year 2. | 46 000 | 0 | 0 | 0 | 0 |
| 2. Profit on forced disposal spread over 5 years. Replacements bought in year 2. | 9200 | 9200 | 9200 | 9200 | 9200 |
| 3. Deferred tax profit. All replacement stock purchased in year 2. | 0 | 46 000 | 0 | 0 | 0 |
| 4. Deferred tax profit. Half replacement stock purchased in year 2. | 0 | 23 000 | 0 | 0 | 23 000 |

* With trading stock options, total taxable profit over the 5-year period is higher than the alternatives because buying and selling steers has, in this example situation, generated more income.

Example 2. Effect on taxable profit of forced sale of stock where book value is \$300

| Option* | Year 1 (\$) | Year 2 (\$) | Year 3 (\$) | Year 4 (\$) | Year 5 (\$) |
|---|-------------|-------------|-------------|-------------|-------------|
| 1. Declare all income up front. | 20 000 | 0 | 0 | 0 | 0 |
| 2. Profit on forced disposal spread over 5 years. | 4000 | 4000 | 4000 | 4000 | 4000 |
| 3. Deferred tax profit. All replacement stock purchased in year 2. | 0 | 20 000 | 0 | 0 | 0 |
| 4. Deferred tax profit. Half replacement stock purchased in year 2. | 0 | 10 000 | 0 | 0 | 10 000 |

* With trading stock options, total taxable profit over the 5-year period is higher than the alternatives because buying and selling steers has, in this example situation, generated more income.

Conclusions

When selling stock and restocking after a drought, the taxation consequences will depend on the original book values of stock. Tax can be deferred by either declaring 20% of the income over the next 5 years, or declaring the income from forced stock sales after replacement stock have been purchased. In most circumstances, deferring tax would be the preferred option, but:

- if tax rates are the **same** in each year, the same amount of tax is paid at the end of the 5-year period and tax deferment is the only advantage;
- if tax rates **vary** from year to year, there could be a variation in total tax paid, depending on the option used and the pattern of the tax rates over the 5 years.

There can be circumstances where **delaying the tax may result in more tax being paid in the long run**. The option of purchasing only a portion of the stock can delay tax, but may not be a good strategy if it means that the property is understocked and not generating as much income as possible. Therefore, if your country is suited to growing out steers, it would generally be better to buy steers or run sheep rather than leave the land idle. Farmers should ensure, however, that the replacement price of trading stock is reasonable when compared to the likely price that the stock are expected to receive when a sale is contemplated. The use of 'futures' should be considered as a means of reducing this risk.

A producer whose herd breeds its own replacements can still opt to value future replacement animals at a low value and defer future tax liabilities.

This document is an overview of the taxation consequences of each option; however, each farming situation varies, and your accountant is in the best position to recommend the best course of action for you. If doubts exist about the outcome of a particular course of action, an individual tax ruling can be applied for from the Australian Taxation Office.

Option 1 calculations

The entire proceeds from the disposal of the animals is declared in the year of disposal.

Financial year 1

| Financial year 1 | Book value of stock before sale, \$40 (Example 1) | | Book value of stock before sale, \$300 (Example 2) | |
|----------------------------|---|------------|--|------------|
| | Number | Value (\$) | Number | Value (\$) |
| Opening stock on hand (=A) | 100 | 4000 | 100 | 30 000 |
| Purchases (=B) | – | – | – | – |
| Gross sales (=C) | 100 | 50 000 | 100 | 50 000 |
| Closing stock on hand (=D) | 0 | – | 0 | – |
| Taxable profit (C+D–A–B) | | 46 000 | | 20 000 |

Financial years 2–5

| Financial years 2–5 | Book value of stock before sale, \$40 (Example 1) | | Book value of stock before sale, \$300 (Example 2) | |
|----------------------------|---|------------|--|------------|
| | Number | Value (\$) | Number | Value (\$) |
| Opening stock on hand (=A) | 0 | – | 0 | – |
| Purchases (=B) | 100 | 60 000 | 100 | 60 000 |
| Gross sales (=C) | 0 | 0 | 0 | 0 |
| Closing stock on hand (=D) | 100 | 60 000 | 100 | 60 000 |
| Taxable profit (C+D–A–B) | | 0 | | 0 |

Option 2 calculations

Profit from forced disposal is spread over 5 years (a decision to use this option can be made at the end of the financial year).

Financial year 1

| Financial year 1 | Book value of stock before sale, \$40 (Example 1) | | Book value of stock before sale, \$300 (Example 2) | |
|-------------------------------|---|------------|--|------------|
| | Number | Value (\$) | Number | Value (\$) |
| Opening stock on hand (=A) | 100 | 4000 | 100 | 30 000 |
| Purchases (=B) | – | – | – | – |
| Gross sales (=C) | 100 | 50 000 | 100 | 50 000 |
| Closing stock on hand (=D) | 0 | – | 0 | – |
| Profit on sale (C+D–A–B) | | 46 000 | | 20 000 |
| Less: deferred profit on sale | | –36 800* | | –16 000† |
| Taxable profit on sale | | 9200 | | 4000 |

* Four-fifths of \$46 000

† Four-fifths of \$20 000

Financial years 2–5

| Financial years 2–5 | Book value of stock before sale, \$40 (Example 1) | | Book value of stock before sale, \$300 (Example 2) | |
|--------------------------------|---|------------|--|------------|
| | Number | Value (\$) | Number | Value (\$) |
| Opening stock on hand (=A) | 0 | – | 0 | – |
| Purchases (=B) | 100 | 60 000 | 100 | 60 000 |
| Gross sales (=C) | 0 | – | 0 | – |
| Closing stock on hand (=D) | 100 | 60 000 | 100 | 60 000 |
| Profit on sale (C+D–A–B) | | 0 | | 0 |
| Plus: deferred profit on sale* | | 9200* | | 4000† |
| Taxable profit on sale | | 9200 | | 4000 |

* One-fifth of \$46 000

† One-fifth of \$20 000

Option 3 calculations

Declaration of income from sale of breeding stock is deferred until replacement stock are repurchased in year 2 (100 sold in year 1; 100 purchased in year 2).

Financial year 1

| Financial year 1 | Book value of stock before sale, \$40 (Example 1) | | Book value of stock before sale, \$300 (Example 2) | |
|-------------------------------|---|------------|--|------------|
| | Number | Value (\$) | Number | Value (\$) |
| Opening stock on hand (=A) | 100 | 4000 | 100 | 30 000 |
| Purchases (=B) | – | – | – | – |
| Gross sales (=C) | 100 | 50 000 | 100 | 50 000 |
| Closing stock on hand (=D) | 0 | – | 0 | – |
| Profit on sale (C+D–A–B) | | 46 000 | | 20 000 |
| Less: deferred profit on sale | | –46 000 | | –20 000 |
| Taxable profit on sale | | 0 | | 0 |

Financial year 2

| Financial year 2 | Book value of stock before sale, \$40 (Example 1) | | Book value of stock before sale, \$300 (Example 2) | |
|----------------------------|---|------------|--|------------|
| | Number | Value (\$) | Number | Value (\$) |
| Opening stock on hand (=A) | 0 | – | 0 | – |
| Purchases (=B) | 100 | 60 000 | 100 | 60 000 |
| Gross sales (=C) | – | – | – | – |
| Closing stock on hand (=D) | 100 | 60 000 | 100 | 60 000 |
| Profit on sale (C+D–A–B) | | 0 | | 0 |
| Plus: deferred profit | | 46 000 | | 20 000 |
| Taxable profit on trading | | 46 000 | | 20 000 |

Financial years 3–5

| Financial years 3–5 | Book value of stock before sale, \$40 (Example 1) | | Book value of stock before sale, \$300 (Example 2) | |
|----------------------------|---|------------|--|------------|
| | Number | Value (\$) | Number | Value (\$) |
| Opening stock on hand (=A) | 100 | 60 000 | 100 | 60 000 |
| Purchases (=B) | – | – | – | – |
| Gross sales (=C) | – | – | – | – |
| Closing stock on hand (=D) | 100 | 60 000 | 100 | 60 000 |
| Taxable profit (C+D–A–B) | | 0 | | 0 |

Option 4 calculations:

Declaration of breeding stock sale income is deferred until replacement stock are purchased (100 are sold in year 1; 50 are purchased in year 2).

Financial year 1

| Financial year 1 | Book value of stock before sale, \$40 (Example 1) | | Book value of stock before sale, \$300 (Example 2) | |
|-------------------------------|---|------------|--|------------|
| | Number | Value (\$) | Number | Value (\$) |
| Opening stock on hand (=A) | 100 | 4000 | 100 | 30 000 |
| Purchases (=B) | – | – | – | – |
| Gross sales (=C) | 100 | 50 000 | 100 | 50 000 |
| Closing stock on hand (=D) | 0 | – | 0 | – |
| Profit on sale (C+D–A–B) | | 46 000 | | 20 000 |
| Less: deferred profit on sale | | –46 000 | | –20 000 |
| Taxable profit on sale | | 0 | | 0 |

Financial year 2

| Financial year 2 | Book value of stock before sale, \$40 (Example 1) | | Book value of stock before sale, \$300 (Example 2) | |
|----------------------------|---|------------|--|------------|
| | Number | Value (\$) | Number | Value (\$) |
| Opening stock on hand (=A) | 0 | 0 | 0 | 0 |
| Purchases (=B) | 50 | 30 000 | 50 | 30 000 |
| Gross sales (=C) | 0 | 0 | 0 | 0 |
| Closing stock on hand (=D) | 50 | 30 000 | 50 | 30 000 |
| Profit on sale (C+D–A–B) | | 0 | | 0 |
| Plus: deferred profit | | 23 000* | | 10 000† |
| Taxable profit on trading | 50 | 23 000 | 50 | 10 000 |

* One-half of \$46 000, as \$46 000 is deferred in year 1, but only half the replacement cattle are purchased.

† One-half of \$20 000.

Financial years 3–4

| Financial years 3–4 | Book value of stock before sale, \$40 (Example 1) | | Book value of stock before sale, \$300 (Example 2) | |
|----------------------------------|---|------------|--|------------|
| | Number | Value (\$) | Number | Value (\$) |
| Opening stock on hand (=A) | 50 | 30 000 | 50 | 30 000 |
| Purchases (=B) | – | – | – | – |
| Gross sales (=C) | – | – | – | – |
| Closing stock on hand (=D) | 50 | 30 000 | 50 | 30 000 |
| Taxable profit (C+D–A–B) | | 0 | | 0 |

Financial year 5

| Financial year 5 | Book value of stock before sale, \$40 (Example 1) | | Book value of stock before sale, \$300 (Example 2) | |
|--|---|------------|--|------------|
| | Number | Value (\$) | Number | Value (\$) |
| Opening stock on hand (=A) | 50 | 30 000 | 50 | 30 000 |
| Purchases (=B) | – | – | – | – |
| Gross sales (=C) | – | – | – | – |
| Closing stock on hand (=D) | 50 | 30 000 | 50 | 30 000 |
| Profit on sales (C+D–A–B) | | 0 | | 0 |
| Balance of deferred profit brought to account | | 23 000 | | 10 000 |
| Taxable profit for the year | | 23 000 | | 10 000 |

Further information

- Financial considerations following drought
www.dpi.nsw.gov.au/reader/financial-recovery/17244
- Financial considerations in drought
www.dpi.nsw.gov.au/reader/financial-recovery/1920

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