

INCOME TAX (TRADING AND OTHER INCOME) ACT 2005

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 2: Trading income

Chapter 8: Trade profits: Herd basis rules

Overview

452. This Chapter gives the rules for what is commonly known as the “herd basis”. It is based on Schedule 5 to ICTA. The object of the herd basis is to treat a herd of animals in a similar fashion to a capital asset. Without the election the individual animals in the herd would be treated as separate items of trading stock. With the election:
- there is no tax allowance for the initial cost of, or any subsequent increase in the size of, the herd;
 - the net cost of replacing animals in the herd is allowable;
 - any profit or loss on the sale of a single animal or a small number of animals from the herd without replacement is included in the profits of the trade; and
 - if the whole, or a substantial part of the herd, is sold and not replaced the resulting profit or loss is not included in the profits of the trade.
453. An election can be made only in respect of animals kept for their produce.

Section 111: Election for application of herd basis rules

454. This section allows a taxpayer to elect for the “herd basis rules” to apply and introduces some basic concepts. It is based on paragraphs 1(2), 1(3), 2(1), 3(1) and 9(1) of Schedule 5 to ICTA.
455. *Subsection (1)* allows a taxpayer to make a “herd basis election” if he or she keeps, or has kept, a “production herd”. “Production herd” is defined in section 112(1)(c). The effect of a “herd basis election” is that the “herd basis rules” apply. These rules are set out in sections 114 to 123. The time limits for making the election are set out in sections 124 to 126. Section 878(3) and (4) of this Act sets out general rules for making claims and elections.
456. *Subsection (4)* makes clear that the Chapter has no application to a herd kept in circumstances that do not amount to the carrying on of a trade.

Section 112: Meaning of “animal”, “herd”, “production herd” etc.

457. This section provides various definitions used in the Chapter. It is based on paragraphs 8 and 9 of Schedule 5 to ICTA.

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458. This section would be the natural home for the rule in paragraphs 7 and 9(5) of Schedule 5 to ICTA that prevents the herd basis rules applying to working animals. Paragraphs 7 and 9(5) of Schedule 5 to ICTA exclude certain animals from being part of a production herd. These are animals kept for the work they do in connection with the trade or those kept for public exhibition, or racing or other competitive purposes. In practice this rule is unnecessary since animals in a production herd must be kept wholly or mainly for the sake of their produce. So the exclusions are not rewritten.
459. *Subsection (1)(a)* rewrites the definition of animal in paragraph 9 of Schedule 5 to ICTA. Most of the definitions in paragraph 9 of Schedule 5 to ICTA refer to “animals and other living creatures”. The main reason for the reference to “other living creatures” is to make clear that the Schedule applies to birds.
460. *Subsection (1)(c)* rewrites the definition of “production herd” in paragraph 8(5) of Schedule 5 to ICTA. Herd basis elections are made by reference to classes of production herd. See section 124. Section 113(2) identifies when different production herds are treated as being of the same class.
461. *Subsection (3)* gives the general rule that immature animals are not treated as part of the herd for tax purposes even if they are, in practice, kept in the herd; for example, calves kept with cows.
462. *Subsection (4)* sets out the exception to the general rule in subsection (3). It will usually apply only to certain flocks of sheep, commonly known as “hefted flocks”, kept under particular natural conditions on mountain, hill or heath land.
463. *Subsection (6)* makes clear that an immature animal can be treated as added to the herd when it becomes mature. There is a definition of maturity for female animals in section 113(5).

Section 113: Other interpretative provisions

464. This section provides further definitions. It is based on paragraphs 3, 8 and 9 of Schedule 5 to ICTA.
465. *Subsection (2)(a)* applies if production herds of animals of different species are kept for the same product; for example, a herd of cows and a herd of goats both kept for milk production. Each herd satisfies the definition of production herd. Subsection (2) (a) prevents them being treated as of the same class.
466. *Subsection (2)(b)* prevents animals of the same species being treated as of the same class if they are kept for different products; for example, one herd of cows kept for milk production and another herd of cows kept for its calves.
467. *Subsection (6)* clarifies what is meant by “a substantial part of the herd”. This is a question of fact depending on the circumstances. But 20% of the herd will always be regarded as substantial. See *Change 32* in Annex 1. The following sections refer to “a substantial part of the herd”.
- Section 118(1) (sale of animals from the herd);
 - Section 119(1) (sale of whole or substantial part of herd);
 - Section 120(4) and (5) (acquisition of new herd begun within 5 years of sale);
 - Section 122(1) (replacement of part sold within 5 years of sale); and
 - Section 126(1) (slaughter under disease control order).

Section 114: Initial cost of herd and value of herd

468. This section sets out the treatment of the initial cost, and value, of the herd. It is based on paragraph 3(2) of Schedule 5 to ICTA.

469. No deduction is allowed for the initial cost of the herd. Neither is the value of the herd taken into account in calculating the profits of the trade.

Section 115: Addition of animals to herd

470. This section sets out the treatment of additions to the herd. It is based on paragraph 3(2) and (3) of Schedule 5 to ICTA.
471. *Subsection (1)* makes clear that there is a difference between additions, to which this section applies, and replacements dealt with in section 116.
472. *Subsection (2)* prevents a deduction for the cost of the additional animal. It is a similar rule to section 114(1) and is also based on paragraph 3(2) of Schedule 5 to ICTA.
473. *Subsections (3) and (4)* deal with the case in which the additional animal was part of the trading stock immediately before it became part of the herd. *Subsection (3)* requires the farmer to add an amount called “the balancing amount” to his or her trade receipts. The balancing amount is defined in *subsection (4)* and is intended to recover the costs that will already have been allowed as a trading expense.

Section 116: Replacement of animals in herd

474. This section sets out the treatment if an animal in the herd is replaced. It is based on paragraph 3(4) and (5) of Schedule 5 to ICTA.
475. *Subsection (1)* introduces the terms “old animal” to describe an animal leaving the herd and “new animal” to describe the animal that replaces it. The circumstances in which an animal is treated as sold and the meaning of “sale proceeds” are extended by the definitions in section 113(3) and (4).
476. *Subsection (2)* sets out the basic rule that any sale proceeds of the old animal are included in the farmer's trade receipts. This rule is subject to a number of exceptions:
- if the animal is slaughtered under a disease control order and the new animal is of a worse quality (see section 117);
 - if the farmer acquires, or begins to acquire, a new herd within five years of the old herd being sold (see section 120); and
 - if a substantial part of the herd is sold and the farmer acquires or begins to acquire replacement animals within five years (see section 122).
477. *Subsection (4)* deals with the deduction due for the replacement animal. The basic principle in paragraph 3(4)(b) of Schedule 5 to ICTA is that the cost of the second animal is deducted as a trading expense. But paragraph 3(4)(b) of Schedule 5 to ICTA provides for an exception - “in so far as that cost consists of such costs as are allowable apart from the provisions of this Schedule as deductions in computing profits of farming under Case I of Schedule D”.
478. It is not clear from ICTA what these costs are. In fact the exception is aimed at the case where the replacement animal comes from trading stock. Here the costs of breeding or acquiring it and, if relevant, rearing it to maturity have already been allowed. The farmer is not allowed a double deduction for costs that have already been allowed.
479. This section does not reproduce that part of paragraph 3(4)(b) of Schedule 5 to ICTA which refers to the cost of the new animal being subject to paragraph 3(6) of Schedule 5 to ICTA. This reference appears to be an error made in the 1988 consolidation of ICTA. It is generally accepted that it is the rule in paragraph 3(4)(a), and not paragraph 3(4)(b), of Schedule 5 to ICTA which should be qualified by paragraph 3(6) of Schedule 5 to ICTA.

Section 117: Amount of receipt if old animal slaughtered under disease control order

480. This section limits the amount of the receipt taxed under section 116 if the old animal is slaughtered under a disease control order. It is based on paragraph 3(6) of Schedule 5 to ICTA.
481. Paragraph 3(6) of Schedule 5 to ICTA restricts the amount of the receipt to “the amount allowable as a deduction”. It is not immediately clear what this amount is. This section makes clear that it is the amount allowable as a deduction in respect of the new animal. This is called “the equivalent amount for the new animal”.
482. *Subsections (4) and (5)* define “the equivalent amount for the new animal”. Subsection (4) deals with the case in which the replacement animal comes from the farmer’s trading stock. Subsection (5) deals with all other cases.

Section 118: Sale of animals from herd

483. This section sets out the rules that apply if an animal is sold from the herd and not replaced. It is based on paragraph 3(10) of Schedule 5 to ICTA.
484. *Subsection (1)* identifies the scope of the section. References to the sale of an animal include references to its death or destruction. See section 113(3). An explanation of what is meant by “substantial part of the herd” is given in section 113(6).
485. *Subsections (2) and (3)* explain that profits are included as trade receipts and losses are allowed as trade deductions.
486. *Subsection (4)* sets out how to calculate the profit or loss. The definition of “deductible amount for the animal” is in *subsection (5)*.

Section 119: Sale of whole or substantial part of herd

487. This is the first of three sections that set out the rules relating to the sale of all or a substantial part the herd within 12 months. It is based on paragraph 3(8) of Schedule 5 to ICTA.
488. The section merges the rules in paragraph 3(7) to (9) of Schedule 5 to ICTA. See *Change 33* in Annex 1. An explanation of what is meant by “substantial part of the herd” is given in section 113(6).
489. *Subsection (2)* sets out the general rule. If the herd, or a substantial part of the herd, is sold within a year no profit is taxed as a trade receipt and no loss is allowed as a trade deduction. This overrides the rule in section 118(2) and (3) (sale of animals from herd).

Section 120: Acquisition of new herd begun within 5 years of sale

490. This section sets out the rules that apply if, following the sale of the herd (either all at once or within 12 months), the farmer begins to acquire a new herd within five years. It is based on paragraph 3 of Schedule 5 to ICTA.
491. *Subsection (2)* sets out the general rule. The section treats what is really an acquisition as a replacement by applying section 116 (replacement of animals in herd) unless the sale was for reasons outside the farmer’s control.
492. *Subsection (3)* identifies the time when the sale proceeds of the animal in the old herd are brought into account as a trade receipt.
493. *Subsection (4)* applies if the number of animals in the new herd is smaller than the number of animals in the old herd but the difference is not substantial. See *Change 33* in Annex 1.

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494. *Subsection (5)* applies if the number of animals in the new herd is smaller than the number of animals in the old herd and the difference is substantial. The effect is that the difference between the number of animals in the old herd and the new herd is treated as the disposal of part of a herd. Section 119 will apply if there are no further replacements. Section 122 will apply if there are further replacements within five years.
495. *Subsection (6)* applies if the number of animals in the new herd is larger than the number of animals in the old herd. The effect is that the difference between the number of animals in the old herd and the new herd is treated as an addition to the herd and section 115 applies.
496. *Subsection (7)* clarifies what is meant by a “substantial part of the herd”. See *Change 32* in Annex 1.

Section 121: Section 120: sale outside farmer's control

497. This section limits the amount taxed as a trade receipt under section 120 if the sale is for reasons outside the farmer's control and the replacement animal is of a worse quality. It is based on paragraph 3(9)(a) of Schedule 5 to ICTA.
498. The section is similar to section 117 although it is not limited, as that section is, to disposals under a disease control order. The source legislation for both sections refers to the amount of the trading receipt being restricted to “the amount allowable as a deduction”. It is not immediately clear what this amount is.
499. *Subsection (2)* makes clear that it is the amount allowable as a deduction in respect of the new animal. The section calls this “the equivalent amount for the new animal”.
500. *Subsections (3)* and *(4)* define “the equivalent amount for the new animal”. *Subsection (3)* deals with the case in which the replacement animal comes from the farmer's trading stock. *Subsection (4)* deals with all other cases.

Section 122: Replacement of part sold begun within 5 years of sale

501. This section sets out the rules that apply if, following the sale of a substantial part of a herd (either all at once or within a year), the farmer begins to replace it within five years. It is based on paragraph 3(8) and (9) of Schedule 5 to ICTA.
502. *Subsection (1)* sets out the conditions for the section to apply. An explanation of what is meant by “substantial part of the herd” is given in section 113(6).
503. *Subsection (2)* applies section 116 (replacement of animals in herd). The sale proceeds of the old animal are brought into account as a trade receipt. This is subject to the exception given in section 123 if the sale was for a reason outside the farmer's control.
504. *Subsection (3)* provides the sale proceeds are not recognised until the new animal is acquired.
505. *Subsection (4)* deals with the case where not all the animals sold are replaced. No profit or loss arising from the sale is brought into account as a trade receipt.

Section 123: Section 122: sale outside farmer's control

506. This section limits the amount taxed as a trade receipt under section 122 if the sale is for reasons outside the farmer's control and the new animal is of a worse quality. It is based on paragraph 3(9)(a) of Schedule 5 to ICTA.
507. The section is similar to section 117 although it is not limited, as that section is, to disposals under a disease control order. The source legislation for both sections refers to the amount of the trading receipt being restricted to “the amount allowable as a deduction”. It is not immediately clear what this amount is.

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508. *Subsection (2)* makes clear that it is the amount allowable as a deduction in respect of the new animal. The section calls this “the equivalent amount for the new animal”.
509. *Subsections (3)* and *(4)* define “the equivalent amount for the new animal”. *Subsection (3)* deals with the case in which the replacement animal comes from the farmer’s trading stock. *Subsection (4)* deals with all other cases.

Section 124: Herd basis elections

510. This section sets out the rules for the making of herd basis elections. It is based on paragraph 2 of Schedule 5 to ICTA.
511. The section does not specify that the election is to be made to “the inspector”. Section 878(4) draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to “an officer of the Board”.
512. *Subsection (2)* sets out the time limit for making the election. It merges the rules for partnerships and all other taxpayers with one exception. See *Change 34*. The exception is the extension to the time limit given to taxpayers other than partnerships by paragraph 2(5) of Schedule 5 to ICTA. This extension is preserved in subsection (2)(b).
513. *Subsection (3)* defines “the first relevant period of account”. See *Change 34* in Annex 1.
514. *Subsection (4)* expands on subsection (1), which provides that an election must specify the class of production herd to which it relates. This means separate elections must be made for each class of production herd and that an election may not relate to more than one class of production herd. Separate elections may be made for different classes.
515. *Subsection (6)* identifies the production herds to which the election applies.
516. *Subsection (7)* identifies the periods of account to which the election applies. See *Change 35* in Annex 1. Section 129 allows earlier years to be re-opened to give effect to an election.
517. *Subsection (8)* deals with the case in which the farmer is a firm and there is a change in the partners in the firm. Paragraph 2 of Schedule 5 to ICTA refers to “the farmer making the election”. If the farming trade is carried on in partnership, the “farmer” means the firm. If there is a change in the members of a firm, the question arises whether there is a new “farmer”. *Subsection (8)* makes clear that there is.

Section 125: Five year gap in which no production herd kept

518. This section deals with the case where there is a period of at least five years when the farmer does not keep a production herd of the particular class for which he or she has made a herd basis election. It is based on paragraph 4 of Schedule 5 to ICTA.
519. *Subsection (2)* explains the consequences for the herd basis rules if the farmer starts to keep another production herd of the same class after the end of the five year period. See *Change 36* in Annex 1.

Section 126: Slaughter under disease control order

520. This section sets out the rules for making an election outside the normal time limits following slaughter under a disease control order. It is based on paragraph 6 of Schedule 5 to ICTA.
521. *Subsection (1)* sets out the conditions for the section to apply. An explanation of what is meant by “substantial part of the herd” is given in section 113(6).
522. *Subsection (2)* allows the farmer to make a herd basis election in respect of the class of production herd involved in the slaughter and identifies the relevant time limits.

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523. In line with the approach adopted in the rewrite of the ordinary time limits in section 124 this section merges the rules for partnerships and all other taxpayers and applies the longer time limits given to partnerships. See *Change 37* in Annex 1.

524. *Subsection (3)* identifies the periods of account to which the election applies.

Section 127: Preventing abuse of the herd basis rules

525. This section provides anti-avoidance rules that may apply if a farmer transfers the whole or part of a production herd in a transaction that is not an open market sale. It is based on paragraph 5 of Schedule 5 to ICTA.

526. *Subsection (1)* sets out the conditions for the section to apply. If the transfer is not an open market sale the section will apply if either the “control condition” or the “herd basis benefit condition” are met.

527. *Subsection (2)* defines the relationship that must exist between the parties to the transfer for the “control condition” to apply.

528. *Subsection (4)* sets out the conditions for the “herd basis benefit condition” to apply.

529. *Subsection (6)* gives the counter-action that applies if either the “control condition” or the “herd basis benefit condition” are met. The animals are treated as sold at their open market value. Section 175(3) in Chapter 12 of Part 2 of this Act (trade profits: valuation of stock and work in progress) makes clear that this section takes priority over the provisions of that Chapter.

Section 128: Information if election made

530. This section gives the Inland Revenue power to obtain information about the animals kept for the purposes of the trade. It is based on paragraph 10 of Schedule 5 to ICTA.

531. Only the person carrying on the trade can be required to deliver a return. The reference to “inspector” has been changed to “Inland Revenue”. See *Change 149* in Annex 1.

Section 129: Further assessment etc. if herd basis rules apply

532. This section enables effect to be given to a herd basis election made after an assessment has become final, either by amendment or by repayment of tax. It is based on paragraph 11 of Schedule 5 to ICTA.