

PRIMARY PRODUCTION AND RELATED TAX ISSUES

(A White Paper authored by
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This White Paper has been specifically written for the purposes of explaining the tax implications that arise in the circumstances of a taxpayer conducting business as a primary producer and the tax rules that apply to such a business. It is general in nature, not tax advice and should not be relied upon in the absence of proper professional advice on how these implications and rules would apply in particular circumstances.

1. Are you a hobby farmer or the real deal?

A primary producer is an entity (i.e. an individual, partnership company or trust) that carries on a primary production business. A "primary production business" is defined, for tax purposes, to mean carrying on a business of:

1. Plant and animal cultivation:
 - cultivating or propagating plants, fungi or their products or parts (including seeds, spores, bulbs and similar things) in any physical environment;
 - maintaining animals for the purpose of selling them or their bodily produce, including natural increase;
 - manufacturing dairy produce from raw material that you produced.
2. Fishing and pearling:
 - conducting operations relating directly to taking or catching fish, turtles, dugong, beche-de-mer, crustaceans or aquatic molluscs;
 - conducting operations relating directly to taking or culturing pearls or pearl shell.
3. Tree farming and felling:
 - planting or tending trees in a plantation or forest that are intended to be felled;
 - felling trees in a plantation or forest;
 - transporting trees or parts of trees that you felled in a plantation or forest to the place where they are first to be milled or processed from which they are to be transported to the place where they are first to be milled or processed.

In order to determine whether any activities of the above nature or character constitute a business, it is constructive but not conclusive to consider the views on the topic as set out by the ATO in their Ruling (Taxation Ruling 97/11). The Ruling, inter alia, makes the following points:

There are no hard and fast rules for determining whether a taxpayer's activities amount to the carrying on of a business of primary production – the facts of each case must be examined together with all the surrounding circumstances. There have been numerous cases come before the Courts on the general issue of whether or not business of primary production is being carried on and from the judgments, it is clear that the relevant indicators are:

- does the activity have a significant commercial purpose or character?
- does the taxpayer have more than a mere intention to engage in business?
- is there an intention to make a profit or a genuine belief that a profit will be made and when will the activity become profitable?
- is there repetition and regularity in the activity i.e. how often is the activity engaged in and how much time does the taxpayer spend on the activity?
- is the activity of the same kind and carried on in a similar way to that of the ordinary trade?
- is the activity organized in a businesslike manner?
- what is the size and scale of the activity?
- is the activity better described as a hobby, a form of recreation or a sporting activity?

There is no one factor that is decisive on the question and the determination is eventually based on the large or general impression gained from all the relevant facts and circumstances.

2.

Although primary producers are subject to all the general rules in the tax legislation relating to assessable income and allowable deductions (and including the capital gains tax provisions), they (and certain other landholders) receive various special concessions under that legislation. These concessions are:

- Profits may be taxed on a concessional basis in the case of:
 - forced sales and death or destruction of livestock;
(the legislation allows either a spreading of the tax profit over five (5) years or, if the profit is mainly used for replacement stock of the same species, a deferral of that tax profit by reducing the cost of replacement stock over a six (6) year period – the disposal year and the next five (5) years); and
 - Insurance recoveries on loss of livestock or loss of trees by fire.
(the taxpayer may elect to include otherwise assessable insurance recoveries as to 20% for the income year of receipt and 20% for each of the next four (4) years).
- Net income from a double/second woolclip caused by fire, drought or flood can elect to include that amount in the following year of income.
- Special provisions apply to the treatment of natural increase in livestock and horse breeding stock in calculating closing values for such stock. If natural increase of livestock is valued at cost, the taxpayer may choose either the actual cost or the cost prescribed by the regulations for each animal class e.g.

Cattle and horses	\$20
Sheep and Goats	\$4.
- Standing or growing crops, crop stools or trees that have been planted and tended for the purpose of sale that are included in a sale or disposal of a business or that devolve on death are treated as trading stock. There are also special provisions that apply where there has been a change of ownership or interests in livestock upon the formation or dissolution or variation in a primary production partnership. There are deductions available for capital costs of acquiring land carrying trees or a right to fell trees.
- A deduction is allowable for depreciation for fences and certain other structural improvements. This is in addition to the general deductions available for the decline in value of depreciating assets.
- Capital expenditure in establishing grapevines and other horticultural plants is deductible over the effective life of the vine or plants.
- Capital expenditure on a water facility is deductible over three (3) years. A water facility is plant or a structural improvement or an alteration, addition or extension to plant or a structural improvement that is primarily and principally for the purpose of conserving or conveying water. The term also includes a repair of a capital nature to such plant or structural improvement. Examples include a dam, earth tank, underground tank, concrete tank, metal tank, tank stand, bore, well, irrigation channel (or similar improvement), pipe, pump, water tower, windmill and extensions or improvements to any of these items and an overhead sprinkler system used solely for the purpose of frost protection. A deduction is not available for expenditure on acquiring a water facility if any other person has deducted or is entitled to a deduction for such a facility.
- Capital expenditure incurred in connecting power to land or in upgrading the connection is deductible over ten (10) years if, when the expenditure is incurred, the taxpayer has an interest in the land or is a share-farmer carrying on a business on the land. In addition, the taxpayer or another person must intend the use the electricity in carrying on a business at the time when the taxpayer has an interest in the land, or is a share-farmer carrying on a business on the land. Note that land need not be used for primary production.
- Capital expenditure on a landcare operation (not otherwise deductible above) for primary production land is deductible. Such expenditure must be carried out in accordance with an approved management plan prepared by an authorised officer of an Australian government agency responsible for land conservation.
- Investments made after 30 June 2007 in certain forestry managed investment schemes are deductible.
- The capital costs incurred in establishing tress in a qualifying carbon sink forest are deductible if the forest is established for the primary and principal purpose of sequestering carbon from the atmosphere. There are numerous other conditions.

Tax concessions (cont)

- The incomes of primary producers may be eligible for averaging tax offsets. The provisions are designed to relieve the burden that would otherwise be imposed if primary producers were exposed to high marginal tax rates in “good” years that are not representative of their income over a longer period. The result is achieved through a formula that averages a taxpayer’s primary production income and other limited amounts of income over a period not exceeding five (5) years. The formula will result in either a tax offset (i.e. rebate) or extra income tax depending on whether the taxable income is above or below the average income.
- The Farm Management Deposits (FMD) Scheme allows primary producers (with a limited amount of off-farm income) to claim deductions for FMDs made in the year of deposit (with a consequent reduction in PAYG instalments). When FMDs are withdrawn, the amount previously deducted will be included in assessable income and PAYG instalments. An FMD is defined as a deposit of money made under an agreement between the depositor and an Australian Deposit-taking Institution (ADI) or an entity carrying on in Australia a banking business or a business of taking deposits (provided the repayment of deposits is guaranteed by the Commonwealth or a State or Territory government). Note that pastoral agents are not within that definition because they are not ADIs and their deposits are not government guaranteed.

3. Non-commercial losses and primary production

In addition to the general issues set out above relating to the question of whether a taxpayer is conducting a business of primary production, there are further “integrity rules” that can apply in certain circumstances and these are termed the “Non-Commercial Loss Provisions” that contain two (2) layers of tests that are applied thus:

1. The first test layer provides that an individual derive “adjusted taxable income” of less than \$250,000 with that quoted term being the sum of:

- taxable income (before deducting any purported primary production losses;
- reportable fringe benefits;
- reportable superannuation contributions; and
- total net investment losses i.e. net rental property losses and net losses on financial investments – shares, interests in managed investment schemes including forestry managed investment schemes, rights or options in respect of such shares and interests and any investment of a like nature)

In that event, any losses will be quarantined and carried forward for deduction against assessable income derived from the relevant activity.

2. The second test layer provides that the individual satisfies one of the following “commerciality tests”:

- Assessable income test – the assessable income from the business activity for the relevant income year must be at least \$20,000 or reasonably estimated to be that sum if the activity were carried on for the whole year (generally speaking, sales excluding GST);
- Profits test – the activity has made a tax profit in at least three (3) of the past five (5) income years including the current year (in the case of a partnership, it is the taxpayer’s share of the net income of the partnership that is taken into account);
- Real property test – the total value of real property, or interests in real property, used on a continuing basis in carrying on the activity is at least \$500,000. The higher of market value or reduced cost base is used and worked out at the end of the income year or, if appropriate, when the business activity ceased or the asset was disposed of. Dwellings and adjacent land used in association with the dwelling and used mainly for private purposes are excluded along with any tenant’s fixtures; and
- Other assets test – the total value of other assets (excluding cars, motorcycles and similar vehicles) used on a continuing basis in carrying on the activity is at least \$10,000. Such assets are depreciable assets, trading stock, assets leased from another entity and, if relevant, trademarks, patents, copyright and similar rights. The value of an asset depends on what type it is i.e. written down value if a depreciating asset, closing value if trading stock and reduced cost base if intellectual property. The timing of the valuation is the same as that for real property. For the purpose of this test, All Terrain Vehicles (ATVs) and agricultural motorcycles (ag-bikes) are motorcycles however a 2-tonne truck is not a car or similar vehicle.

There are two (2) further circumstances where the non-commercial losses provisions do not apply;

- where the loss arises from a primary production business and assessable income from other sources is less than \$40,000; and
- the Commissioner exercises his discretion not to apply those provisions.