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SELLING THE FARM PIECEMEAL – THE TAX ISSUES

(A Paper authored by Paul Dowd FCA CTA M Tax

Tax Counsel, Morse Group)

This Paper has been specifically written for the purpose of explaining the tax implications that arise in the circumstances of a taxpayer who has carried on a farming/grazing business and is contemplating a partial sell-off of that land. The Paper 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 the rules would apply in particular circumstances.

Preamble

In many regional areas, it is not uncommon for farmers and graziers to reduce the area that had been previously devoted to those primary production activities. In addition some Local Councils will rezone certain lands from rural to residential to accommodate the expanding population of the region's townships. In some cases, such rezoning will be done on the Council's own volition and, in others, it will be as a result of the relevant owner making an application to the Council. An owner of such rural land then has the opportunity to turn some, or perhaps all, of that land to such residential use and derive a substantial gain or profit on the sale of that land.

The significant tax issue that will arise in such a case is whether such activity falls to be considered as on revenue account or on capital account.

1. Is the activity on revenue account or capital account? – general observations

The issue that will arise, almost invariably, is whether the activity carried out by the taxpayer is on revenue account such that any profits are assessable as ordinary income and taxed at marginal rates of income tax, or whether sales proceeds should be subject to the Capital Gains Tax (CGT) provisions apply and, if so, whether certain concessions may be available.

Income Tax Ruling TR 92/3 – "whether profits on isolated transactions are income" remains the leading exposition of ATO views on the revenue/capital distinction. Notwithstanding the age of the Ruling, most of its reasoning emanates from cases that could be considered good law today. A more contemporary insight into ATO thinking on the issue can be found in *Miscellaneous Taxation Ruling MT 2006/1* titled "the meaning of 'entity carrying on an enterprise' for the purposes of entitlement to an Australian Business Number" even though it is concerned with definitions under the Goods and Services Tax (GST) Act. In particular, the latter canvasses the concept of "an adventure or concern in the nature of trade".

Both of the above Rulings are lengthy and contain observations about many cases that have come before the Courts over the years and are too long to produce relevant extracts in this Paper. However, it can be said with some degree of certainty that the distinction to be drawn falls into whether the activity of the taxpayer is one of:

- a profit making undertaking or scheme; or
- the mere realisation of a capital asset.

The determination as to whether the activity in question falls into one or the other of these categories is necessarily one of fact and degree with no one fact being decisive and, as one UK Judge observed, it is necessary to "look at the whole picture and ask the question – was this (activity) an adventure in the nature of trade" or a profit making undertaking or scheme?

Such a profit making scheme can include an isolated business venture and requires an answer to the (two part) question – what is the scheme and what gives it its commercial or business character? The indicators that will be relevant to concluding that an activity involving, say, a subdivision carried out by the land owner falls into the first category will be considered under the next heading.

However, it can be said with a high degree of certainty that a "simple" sale of a parcel of land (not acquired for resale at a profit or gain) that has historically been used for farming or agricultural activities for some time will constitute a mere realisation of a capital asset. Such a sale or disposal will thus fall for consideration as to its tax consequences under the CGT provisions of the Act and will be considered later herein.

There have been many cases concerning whether an activity of a taxpayer amounts to a profit making undertaking or scheme but in at least two (2) – *Statham & Anor.* (89 ATC 4070) and *Casimaty* (97 ATC

5135) – farm land was subdivided and sold and, on the particular facts, the Courts held the sales were not part of a business but rather a mere realisation of a capital asset.

2. Is the activity an "adventure in the nature of trade"?

MT 2006/1 (at para. 265) states that from the *Statham* and *Casimaty* cases a list of factors can be ascertained that provide assistance in determining whether activities are a business or an adventure or concern in the nature of trade/a profit-making undertaking or scheme. If several of these factors are present it may be an indication that a business or a profit-making scheme is being carried on. These factors are as follows:

- there is a change of purpose for which the land is held;
- additional land is acquired to be added to the original parcel of land;
- the parcel of land is brought into account as a business asset;
- there is a coherent plan for the subdivision of the land;
- there is a business organisation e.g. a manager, an office and letterhead;
- borrowed funds financed the acquisition or subdivision;
- interest on money borrowed to defray subdivisional costs was claimed as a business expense;
- there is a level of development of the land beyond that necessary to secure council approval for the subdivision; and
- buildings have been erected on the land.

The Ruling goes on to say (in para. 266) that in determining the "enterprise/capital account" question:

> "it is necessary to examine the facts and circumstances of each particular case. This may require a consideration of the factors outlined above however there may also be other relevant factors that need to be weighed up as part of the process of reaching an overall conclusion. No single factor will be determinative rather it will be a combination of factors that will lead to a conclusion as to the character of the activities".

The Ruling also notes the observation of Foster J in *AB v FC of T* (97 ATC 4945) at p 4961:

> "It is clear, in my view that before the label 'adventure in the nature of trade' can be applied it is necessary to isolate with clarity the particular matters which are the subject of its application. ... Accepting as I do, that the phrase means 'an isolated business venture' questions must be asked as to what was the venture and what gave it its commercial character".

From the foregoing, it can be seen that there are no "hard and fast" rules where one might have a list where some boxes on the list would be "ticked", others "crossed" and then a total taken of each that would then give the answer to the question based on a mathematical comparison of the "ticks" and "crosses".

MT 2006/1 contains a number of examples where there is a conclusion that an enterprise is being conducted and has others where the conclusion is that an enterprise is not being conducted. Examples in ATO Rulings generally are self-serving and often lack sufficient detail of surrounding facts and circumstances that might lead to a different conclusion and, particularly, where the conclusion to be made is that of an independent Tribunal or a Court.

Whilst it may be accepted that *enterprise* is a lower threshold than *business* in the eyes of the ATO, any such distinction is becoming blurred. Indeed some commentators feel that the ATO take the view that anything that makes a gain is on revenue account and anything that results in a loss would be on capital account – that is a very cynical view but for some ATO officers may be correct insofar as some views are concluded on the economic outcome of the activities i.e. a large profit or gain is clearly on revenue account.

As noted above, the leading exposition of the ATO view on the revenue/capital distinction remains *Taxation Ruling TR 92/3 – Income Tax: whether profits on isolated transactions are income* that was issued following the High Court decision in *FCT v The Myer Emporium Ltd* (87 ATC 4363).

The Ruling states that, in general terms, the activities will have the character of a business operation or commercial transaction if the said activities would constitute the carrying on of a business in its own right.

3. Is there a business operation or commercial transaction?

Some key indicators that may be relevant in considering whether the isolated transaction i.e. the sell-down of the farming/grazing land, amounts to a business operation on revenue account are:

- the nature of the entity involved;
- the nature and scale of other activities undertaken by the relevant entity;
- the amount of money involved in the operation or transaction and the magnitude of the profit sought or obtained;
- the nature, scale and complexity of the operation or transaction;
- the manner in which the operation or transaction was entered into or carried out;
- the nature of any connection between the relevant taxpayer and any other party to the operation;
- if the transaction involves the acquisition and disposal of property, the nature of the property; and
- the timing of or the various steps in the transaction.

To summarise the Ruling, profits from the sale of property will be on revenue account if

- there was a profit making intention on the part of the taxpayer when entering into the transaction; and
- the transaction was entered into, and the profit made, in the course of either carrying on a business or in carrying out a business operation or commercial transaction.

Where a property transaction is neither:

- part of a taxpayer's normal business; nor
- commercial in nature,

then, unless the property was acquired with a profit making intention, any subsequent disposal of the property is likely to be a "mere realisation" of the asset and, as such, on capital account under the Ruling.

The Ruling states that it is usually, but not always, necessary that the taxpayer had a profit making intention when the property was acquired.

The Ruling concludes with a number of reasonably simplistic examples that are not reproduced here for the reason that the facts and circumstances posited are somewhat self serving, as are the conclusions that can be seen to accord with the overall approach of the ATO to advance their "revenue-skewed" views on the stated assumptions.

It must also be recalled that ATO Rulings are not law and are no more (or less) than the ATO view as to how the law should be applied in the circumstances. Then again, to take a differing view of the application of the law as expressed in a Public Ruling by the ATO in very similar circumstances to those set out, may expose a taxpayer to penalties for incorrect tax returns.

An important point to note in relation to a case where it is found that the activity engaged in by the taxpayer is on revenue account, is that the land or the part that is taken to be "ventured" into the profit making scheme will be "uplifted" to its market value at the time of the commencement of the said profit making scheme. This "rule" that applies to the calculation of any revenue gain emanates from a decision of the High Court in *FCT v Whitford's Beach Pty Ltd* (82 ATC 4031).

Thus, it may be critical (particularly where the activity could be taken to be on revenue account) for the taxpayer/farmer to obtain an independent valuation of the subject land in order to properly ascertain that revenue (and hence taxable) gain based on the "uplifted" value.

Notwithstanding the caveat on adopting principles from simple examples, it would be fair to say that where a farmer/grazier does no more than excise some part of the farming land in a sale to, say, a neighbouring farmer, then any gain would more than likely be on capital account. However, where the same taxpayer undertakes extensive activities to obtain a rezoning of the land from rural to residential by carrying out major earthworks, putting in roads and streets with kerbing and guttering along with relevant drainage activities and perhaps creating some parklands and then conducts a huge marketing campaign and engages numerous sales agents, etc. it is more than likely that any profits or gains would be seen to be on revenue account.

In between those two (2) extremes, there will be cases where there will be a real issue as to where the line is drawn between a profit making scheme and a mere realisation of a capital asset. In the latter case, the "normal" CGT provisions will apply.

4. Capital Gains Tax (CGT) issues

Where the relevant land or part thereof is subject to treatment on capital account, then it becomes necessary to examine the transaction for its CGT implications.

Even though the CGT provisions are now some thirty (30) years old and have undergone a substantial rewrite into the 1997 tax Act, it is still the case that assets acquired before 19 September 1985 remain outside those provisions. Thus where the farmer has held the land since before that date any gain made on disposal of such land remains outside the "CGT net" and is not subject to tax.

Where the farming land has been acquired (including by way of an inheritance) after 19 September 1985, then any disposal (or other CGT event) will fall for consideration under the CGT provisions. In the case where the land has been owned for a period in excess of twelve (12) months, then a 50% discount on any gain by individual(s) or a trust will apply subject to the particular relevant rules being satisfied (a 33 1/3% discount would apply where the owner was a super fund).

Where the farm has been added to over the years by purchasing further lands, it is only that part or parts of the farm acquired subsequent to September 1985 that will be subject to CGT. It could also be the case that the "Main Residence" concession could apply where the old "homestead" that sat on the pre-CGT part of the land was demolished (or even left standing) and a new Main Residence erected on the post-CGT part. In that event, part of the gain on the post-CGT land that encompasses the Main Residence would fall for consideration under those particular provisions.

In addition, where the land has been used in the farming business, it may be possible to gain relief under the Small Business CGT provisions. Those provisions are outside the scope of this Paper.

Any taxpayer contemplating a partial sell down of a farm as described in this Paper (particularly where rezoning and/or subdivision is likely) would be well advised to seek proper tax advice well before any activities are commenced and, certainly, it will be too late to tailor any such activities after the event. Thus pre-planning is vital.

To quote Benjamin Franklin: "If you fail to plan, you are planning to fail!"