29 March 2004

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ATTENTION: Mr Vernan Joice
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Board of Taxation – Post-implementation Review of the Non-commercial Loss Provisions

Thank you for the invitation to Australian Forest Growers to contribute to the post-implementation review of the non-commercial loss (NCL) provisions, and for the extra time in which to make this submission.

Australian Forest Growers is the national organisation representing and promoting the interests of private forestry in Australia – from the owner of the smallest woodlot, through farm forestry and agroforestry at all scales and configurations, native forest management on private land, family and small company plantations, some corporate industrial forest growers, and the managed investment afforestation companies and their thousands of growers. All in all, nearly 1,200 directly-paying members representing the interests of around 13,000 private growers. Membership also includes other industry participants, such as consultants, suppliers, knowledge brokers, educators, and other subscribers.

By far the majority of these private forest growers have off-farm income greater than the $40,000 primary production exception threshold in the non-commercial loss provisions, and are also subject to the requirement to apply for the Commissioner's discretion under the 'lead time' provision. Leaving aside the many 'absentee' growers whose woodlots are managed by timber investment managers, a majority of private forest growers live on their properties and carry on their farm forestry as an integral part of a mixed farming enterprise. Where the overall operation is relatively small-scale, these growers may also be affected by other NCL provisions.

AFG represented the private forest growing sector during the life of the ATO Tax Practitioner Forum (non-commercial business losses), and carries on that representation in the ATO Primary Production Industry Partnership. Combined with the broader mixed farming interests of many growers, noted above, this enables AFG to feel well-qualified to offer comment on a range of implementation matters affecting small-scale primary producers generally – important, given that National Farmers Federation didn't make a submission to your review.

Criterion #1: The extent to which the legislation gives effect to the Government's policy intent, with compliance and administration costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure.

The Government's policy intent was clear at the time of the Treasurer's announcement on 11 November 1999. Unfortunately, in the process of drafting the legislation and, a year later, the public ruling (TR 2001/14), the Government's original intent was 'interpreted' more narrowly and severely than appeared in the Treasurer's announcement. Examples of these interpretations are offered under Criteria #3 and #4 below.

Generally, the ATPF (NCL) group records reveal many issues that needed to be resolved in the implementation stage after the legislation was passed. Overall, the ATO did an admirable job in interpreting a difficult and untidy piece of legislation (see under Criterion #2). However, the ATO still left a number of issues unresolved – either because it decided that they were more in the nature of 'policy', to be taken up with Treasury and the Government, or because it seemed determined to take the narrowest possible interpretation of the legislation and its ruling.

Two comments can be made here about policy intent and compliance costs.

1. Policy intent: 'real property' and 'other assets' tests

With respect to so-called 'hobby farms', the **'real property'** and '**other assets'** tests discriminate **in favour of** a class of 'hobby farmers' that the legislation was supposedly meant to target.

The 'real property' test allows high wealth individuals to claim ongoing losses from small farms on high-priced land served by a freeway within 80-100 kilometres of a capital city, while still being classified 'commercial' for the purposes of Division 35. Furthermore, the dramatic increase in such land values since the legislation was conceived and passed has made passing this test so much easier for so many more people with the resources to do so. By contrast, genuine smaller-scale operators and even many large-scale operators in more distant rural areas (indeed in whole shires) find the 'real property' test insurmountable.

The 'other assets' test similarly discriminates in favour of those with the wealth or borrowing power to purchase farm implements and equipment, and against those who prefer to hire equipment or engage contractors rather than hold depreciating assets, which is no less commercial a practice. Indeed, there is ample evidence that NOT owning any but the most basic farm implements is economically more sensible for many farm enterprises. Serious attempts to pass the 'other assets' test would lead to overcapitalisation of many small farms, while also denying the multiplier effect of cashflow injections into the local contracting industry.

***Recommendation**: The 'real property test' and the 'other assets test' should be abolished. They are not measures of commerciality or even commercial purpose, they discriminate in favour of the already wealthy, and they can actually increase rather than prevent tax abuse.*

Other comments about the perversion of the policy intent of the 'other assets' test with respect motor vehicles is discussed under Criterion #3.

2. Compliance costs

Compliance costs associated with applications for the **Commissioner's discretion** have become onerous, particularly for a particular class of primary producers. While acknowledging that the application should be necessary only once for a farm forestry enterprise with a lead time under s35-55(2), Australian Forest Growers has received communications from members whose applications have involved expenditure on accountants and forest consultants amounting to over $6,000, and in one case up to $8,000. This has been required to satisfy the follow-up questions from ATO officers who (not unexpectedly) are not well-versed in the peculiarities of farm forestry. The particular class of applicants are mostly small-scale farm forestry enterprises with multi-species forest and/or mixed agriculture/farm forestry operations.

The latter category is dealt with in more detail under criteria #3 and #4.

The challenge for multi-species farm forestry, particularly hardwood and high-value cabinet timber enterprises, is that there is very little 'independent evidence' about the growth rates, yields and sale prices to enable the sort of straightforward responses that are possible with the more conventional pine and blue gum plantations. Many small-scale farm forestry enterprises are pioneering and innovative with regard to species selection, planting configuration and silvicultural treatment, but because of this 'novelty', are forced to go to very substantial trouble and expense to make numerous 'extrapolations' from diverse 'independent' sources in order to satisfy the ATO's follow-up questions about the growers' peculiarly specific enterprises.

The fact that these applicants tend to be awarded the Commissioner's discretion eventually does not ameliorate the very substantial personal and financial costs the applicants incur in demonstrating the period that is 'commercially viable' for the industry concerned, when, in reality, there is no such industry standard.

Recommendation: ***ATO case officers should be offered training to better understand the complexities and individual differences of small-scale, multi-species (and often multi-purpose) farm forestry.***

Recommendation: ***ATO should work with industry groups such as Australian Forest Growers to develop acceptable surrogate 'independent evidence' for innovative and pioneering enterprises for which where there is no 'industry standard'.***

Criterion #2: The extent to which the legislation is expressed in a clear, simple, comprehensible and workable manner.

The evidence for a negative response to this criterion must surely lie in the size of the ATO's issues log that evolved in the period between the passage of legislation and the wrapping up of the ATPF (Non-commercial business losses) in 2003. The number of issues, the time taken for the Centre of Expertise and/or the Tax Counsel network to respond, and the ongoing/recurring disputes and discussions within the ATPF (NCL) all point to difficulties the ATO and the affected taxpayer sectors had in interpreting and applying the law.

In the end – and a cynical view would be that Treasury and the other architects of the NCL provision know this will eventually occur – the affected sectors simply get worn down by the stonewalling and resistance of the government agencies. Business taxpayers have to get on with their business, and cannot devote endless resources to the fight for common sense and fair play. So they just eventually give in and get on with life under the new tax regime, ever more resentful towards the Government, the Treasury and the ATO – a regrettable and unproductive outcome. This is what has happened with the NCL legislation.

Criterion #3: The extent to which the legislation avoids unintended consequences of a substantive nature.

Criteria #3 and #4 are not easily distinguishable. This submission has identified three unintended consequences under Criterion #3.

1. The anomaly in s35-55(2)

S35-55(2) in the 2000 legislation contained an anomaly that penalised and discriminated against long-rotation multi-thinned forestry enterprises – and any other small-scale business with lead times that might experience intermittent or unexpected spikes in assessable income (including, ironically, receipt of a farm innovation grant).

The ATO acknowledged this anomaly during the drafting of the public ruling, but sought to exhaust all options for an administrative solution, rather than go straight to a TLAB.

The anomaly was eventually removed in Taxation Laws Amendment Bill (No 1) 2002, using precisely the solution offered by AFG since 2000 – ie, simply delete the offending paragraph and make other minor consequential changes.

The point being made here is that this anomaly could have been identified and fixed in advance if Treasury had actually conducted the promised consultation with the relevant taxpayer sectors during the drafting of the Bill. AFG identified the anomaly as soon as the Bill was introduced, but was ignored during the Government's rush to pass the Bill before 30 June.

Recommendation: ***The Treasurer should commit to genuine consultation with relevant affected taxpayer sectors on such legislation as a matter of course.***

2. 'Other assets' test consequences

The original policy intent of **'other assets' test** appears to have been perverted in the legislation and later interpretations by the ATO. Two examples raised in the ATPF (NCL) concerned **specialised farm vehicles** and **on-farm use of primary produce**.

2(i) Specialised farm vehicles

The Treasurer's announcement of 11 November 1999 states **"...**or $100,000 of other assets **excluding passenger motor vehicles"** [my emphasis].

However, the legislation took this further. Section 35-45(4) of the ITAA 1997 expresses this intention as "cars, motorcycles and similar vehicles". Although ITAA 1997 contains a definition of 'car', it does not contain definitions of motor cycles and similar vehicles. This left open the question of how the ATO would treat farm vehicles such as three and four-wheel motorbikes, agricultural bikes, other all-terrain vehicles (ATVs), bullcatchers and the like.

All of these categories of motor vehicles are unregistrable for use on public roads, except in very restricted special circumstances. None could be seriously considered as 'passenger motor vehicles' as stated in the Treasurer's announcement. Nevertheless, in response to a submission from the National Farmers Federation and to subsequent repeated debate in the ATPF (NCL), the ATO's response was to take a very narrow interpretation and determine that such vehicles should be excluded from the 'other assets' test by virtue of falling within the meaning of "motor cycles and similar vehicles". The matter was therefore set aside as a 'policy issue' to be raised with the Government.

AFG supported and supports the NFF's position.

<u>Recommendation</u>: ***The original intention of the Treasurer's announcement should be interpreted more accurately, such that mostly unregistrable specialised farm vehicles can properly and realistically be counted for the purposes of the 'other assets' test.***

2(ii) On-farm use of farm produce

Another issue not (to AFG's knowledge) considered in the policy or the legislation is the use of on-farm produce. This is a subject just as easily considered under Criteron #4.

A straightforward example concerns **hay or fodder production**. It is not uncommon for small-scale primary producers to combine livestock grazing and fodder production for sale, and thus be carrying on a commercial enterprise by virtue of generating an assessable income greater than $20,000.

In very dry seasons with low available standing feed, it could be more commercially viable for the enterprise to retain some or all of the fodder production to feed livestock on the farm. But by not making fodder sales, such a decision could reduce the assessable income to below the $20,000 threshold, thus bringing the enterprise within the clutches of the non-commercial loss provisions.

To get around that problem, the enterprise could instead continue to sell the fodder on the market, but then purchase fodder from the market for on-farm use. The 'assessable income' test could still be passed, but a less commercial return realised. This is not only a perverse outcome, it is also impractical and contrary to normal commercial practice. Surely it was not foreseen in the legislation.

Nevertheless, despite submissions and debate within the ATPF (NCL), the ATO set this matter aside as a policy issue to be taken up directly with the Government.

<u>Recommendation</u>: ***The Government should consider the perverse and impractical solution some landholders will be forced to adopt as a result of the ATO's interpretation, and take appropriate action to enable on-farm use of farm produce to be counted for the 'assessable income' and 'profit' tests in certain circumstances.***

3. Narrow ATO interpretation of 'because of its nature'

Taxation Ruling TR 2001/14 devotes paragraphs 106 to 113 to interpreting the meaning of 'because of its nature' (pars 106-111) and rejecting the 'alternative view' (pars 112-113) that the interpretation was too narrow.

The key to the ATO's thinking at the time was the importance of the Note to paragraph 35-55(1)(b) of the ITAA 1997, which states in its first sentence: "This paragraph is intended to cover a business activity that has a lead time between the commencement of the activity and the production of **any** assessable income." (Emphasis added.)

Paragraph 35-55(1)(b)(ii) itself requires only that "...the activity will either meet one of those tests or will produce assessable income for an income year greater than the deductions attributable to it for that year...".

The policy intention apparent in the Treasurer's announcement was, once again, somewhat broader than appeared in the legislation and ruling: that the loss arises "from an activity with a significant commercial purpose of character"; and "[S]tart-up expenditure, particularly in relation to an activity with a long lead-time..."

The Note in the legislation unfortunately was drafted in the context of the most high profile examples of lead-time business activities – for agricultural activities, these are timber plantations, horticultural crops, and some new livestock breeding enterprises, all of which produce NO assessable income for a few or many years.

Within the ATPF (NCL) in 2002, the ATO eventually accepted another class of enterprises where there is an innate/inherent lead-time ('because of its nature'), but where assessable income can still be made every year during that lead time. Although this category could comply with paragraph 35-55(1)(b)(ii), it would appear to be excluded by a strict interpretation of the paragraph Note, which prevents the activity earning ANY assessable income.

The example repeatedly offered to the ATO is very common in NSW tablelands properties, where livestock grazing on native pastures is one of the very few suitable enterprises, but where years of unsustainable grazing and pasture management has led to a decline in the carrying capacity of the properties. In this depauperate condition, small farms (around 80 to 100 hectares) created by property subdivision around major regional centres cannot pass the 'assessable income' test without a lot of work and investment. They can, however, produce SOME income every year from sales of wool and livestock, and can thus be excluded by the paragraph Note as interpreted in TR 2001/14.

The NSW Agriculture Department evidence adopted in a scenario paper being prepared for the Rulings Panel is that several years of strategic fertiliser application, more paddock subdivision, and more intensive grazing and pasture management can increase carrying capacity to a level that could enable the 'assessable income' test to be passed on a regular basis on an 80 to 100 hectare property. In this scenario, 'because of its nature' applies to the inherent lack of carrying capacity of the land initially, and the lead-time is the time required for that carrying capacity to be raised to at least the threshold assessable income level.

The question to be asked is whether the Note should be seen as narrower than the provision itself, and more senior, or merely illustrative of one type of case, in the same way as a true 'example'. If the former, it would appear that legislative change is required. If the latter, an administrative solution seems possible. Either way, the uncertainty can and must be ended.

Recommendation: ***ATO and the Rulings Panel should determine that the Note to paragraph 35-55(1)(b) is merely illustrative, in the same way as a true 'example', and junior to the provision itself, thus enabling land-restoring grazing enterprises to access the lead-time arm of the Commissioner's discretion.***

Criterion #4: The extent to which the legislation takes account of actual taxpayer circumstances and commercial practices

Four issues have arisen that would sit against Criterion #4, and they are described below.

1. 'Policy issues'

After having been raised by participants in the ATPF (NCL), two particular issues were determined by ATO to be 'policy', to be taken up with Treasury.

1(i) Primary production exception in farm family partnerships

The $40,000 primary production exception is too low, and limits participants to relatively low-paid part-time or casual work. NSW Agriculture claims that over 60% of all grazing families on the Southern Tablelands and Monaro rely heavily on off-farm income, often for both partners in the (usual) husband and wife farm partnership.

It was regarded by most ATPF participants to be an unnecessary contrivance in such circumstances; ie, where the two partners could respectively earn just above or just below the arbitrary $40,000 threshold, but only the one just below could escape the NCL legislation. Pooled incomes are so common in family farm partnerships that the primary production exception should be modified to account for that practical reality.

Recommendation: ***The primary producer exception should be modified to enable husband and wife partnerships to pool any off-farm incomes for the purposes of the NCL legislation; ie, $80,000 combined for the partnership, rather than $40,000 each.***

1(ii) Converting to a company structure

More than once, ATPF (NCL) debated the unfair outcome that would result from a common commercial practice – ie, converting from a sole trader/partnership structure to a proprietory company. In this situation, under the legislation, any non-commercial business loss being carried forward by a sole trader or partnership will be forfeited once the new company takes over the business.

The ATO tax law design group reported to the ATPF (NCL) that this was not an unintended consequence, and was a policy matter to be taken up with Treasury. The Institute of Chartered Accountants did so.

ATO said that this does not appear to be a significant issue. Such a remark is somewhat disingenuous, since it doesn't acknowledge that, for the most part, people will not take an action if they are deterred from or penalised for doing so.

This deterrent to a family farm taking a common decision about the most appropriate business structure is inequitable, unnecessary, unfair and discriminatory.

Recommendation: ***Appropriate action should be taken to prevent a primary production sole trader or partnership being forced to forfeit a carried forward non-commercial business loss when converting to a proprietory company structure.***

2. Reducing loan interest

It is not clear in either the legislation or the tax ruling that reducing the interest on a loan over time can be a factor in determining 'commerciality'. This is most relevant to the 'profit' test, which could be passed not only by generating more income, but also by reducing deductible costs.

Other things being equal, as a business loan is progressively paid off, the declining paid interest eventually allows a loss-making enterprise to cross over into profit. The lead-time for this to occur should be acknowledged in determining the Commissioner's discretion.

<u>Recommendation</u>: ***Appropriate action should be taken to clarify that the lead-time to reduce the amount of claimable interest on a business loan so that the business activity can move from loss to profit can be a factor in determining the Commissioner's discretion.***

3. Interpretation of 'use of land'/'use of real property'

Contradictions exist among: the legislation and second reading speech; the tax ruling; the ATO fact sheets; the ATO questions and answers; and an opinion given by the ATO to the ATPF, as to the meaning of 'use of land'.

From an initially broad interpretation which did not necessarily require ownership or title, the ATO moved (apparently, at least) to a requirement that the only land that can contribute to the 'real property' test is land over which the taxpayer has legal title (including leasehold). But this interpretation is not consistent across the various documents, and leaves open the prospect that a primary production business activity could be conducted for years on valuable neighbouring land under a simple licence or agreement (as is quite common practice), with a risk that the ATO could disallow the deductions later if it determined that such an arrangement was inadequate.

This issue would disappear if the recommendation to abolish the 'real property' test were to be implemented.

<u>Recommendation</u>: ***If the 'real property' test is not abolished (as has been recommended), then the ATO and/or Treasury should amend all relevant documents to be universally consistent in respect of the meaning of 'the value of real property used in carrying on the business'. The broadest meaning possible should be adopted, NOT requiring title or paid lease, so as to reduce the advantage the current 'real property' test offers to the already wealthy.***

4. 'Similar' and 'separate' business activities and mixed enterprises on farms

ATO's interpretation of the legislation with respect to 'similar' and 'separate' activities, as reflected in TR 2001/14 and other discussions in ATPF (NCL), is complex and largely nonsensical, and can lead to discriminatory and perverse outcomes that bear little relationship to actual commercial practices and taxpayer circumstances. It also militates against innovation and entrepreneurship.

One particular example that typifies small-scale integrated farm forestry has been brought to the ATO's attention and rejected as 'tough luck'. In brief, it covers a mixed farming scenario where one activity (eg, grazing) that makes annual income but on its own fails all tests is being carried on in combination with another similar activity (eg, integrated farm forestry) that requires the Commissioner's discretion for many years before it makes a profit.

A full description is <u>attached</u> here to aid the review team's understanding of the complex real-life situations the legislation and the ATO's interpretation cannot seem to cope with.

More broadly, the ATO's interpretations of 'similar' and 'separate' business activities fails to recognise that diverse enterprises on small-scale (and sometimes large-scale) farms are mostly undertaken in order to 'make the farm pay', and often involve innovative, entrepreneurial investment that should not be thwarted. Supplementing 'conventional' primary production with farm tourism, on-farm processing and other value-adding activities is commonplace on many farms and can make the entire business viable, but sometimes only if the combination is treated as one 'mixed enterprise' business activity.

It is nonsensical and perverse for such activities to be treated as separate and fail to pass the tests individually, when together the overall diverse business can be a profitable and taxpaying operation.

<u>Recommendation</u>: ***The 'similar activity' interpretations should be re-considered and amended so that attempts to 'make the farm pay' by combining diverse and often innovative farm business activities can be successful.***

Finally . . .

It is admirable to seek to reduce or eliminate abuse of tax relief available for legitimate business expenditure.

The non-commercial loss provisions have an appeal of seeming to be relatively simple, objective and easy to understand. However, they were constructed without genuine proper consultation with affected sectors (despite the misleading claims made in the Regulatory Impact Statement), and there was no 'regional impact assessment', as had been promised by the Prime Minister. Problems in implementation, as described in this submission, reflect that lack of proper consultation in the detailed drafting stages of the legislation.

Although the broad policy intent might be acceptable, there is much to criticise in the legislation that attempts to give effect to the policy. The ATO's interpretations likewise deserve criticism, although to be fair, they reflect deficiencies in the underlying policy and legislation. ATO has always been playing with a handicap.

Nevertheless, AFG believes it is possible to make some changes to the law and its interpretation that can lead to the Government's policy intent being realised more effectively yet more equitably.

If the Review hasn't received a copy already, I would commend a recent conference paper for your consideration...

Rick Lacey and Alistair Watson (2004). *Economic effects of income-tax law on investment in Australian agriculture: with particular reference to managed investment schemes and Division 35 of the Income Tax Act.* 48th Conference of the Australian Agricultural and Resource Economics Society, Feb 11-13 2004, Melbourne.

You also sought assistance with your proposed study of the compliance cost impact of the provisions, in particular a survey of a sample of parties affected by the legislation. AFG can offer a sample of individual farm forestry growers (who submit their own Commissioner's discretion applications), as well as one or more of the afforestation managed investment scheme managers, who prepare such applications on behalf of all their investors as part of the product ruling process.

Please let me know when you need to have those contact details.

Once again, please accept AFG's thanks for the extra time allowed to make this submission (with two attachments).

I am available for further discussion on any of the points raised in this submission. I can be reached on 02 6285 3833, 0407 488 927, and email: alan.cummine@afg.asn.au.

Yours sincerely

ALAN CUMMINE
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Treefarm Investment Managers Australia
(A special branch of Australian Forest Growers)