MEMO TO: Jennifer Ostler, DATE: 30 October 2000
Small Business Centre of Expertise, ATO, Adelaide

FROM: Alan Cummine, Australian Forest Growers, Canberra

Cc Phil Townsend, Forests Branch, AFFA
Su McCluskey, NFF

SUBJECT: ATO treatment of mixed farming under the non-commercial losses legislation – interpretation to ensure consistency and fairness

Dear Jennifer

Further to our several phone conversations about the ATO's thinking on this subject, I offer an example, based on very common circumstances, to help in your deliberations.

Please let me know what you and your colleagues think about this. It would be iniquitous if the ATO were to insist that Enterprise A in the A+C example below should be treated separately (and thus be denied otherwise legitimate deductions). Such an outcome would also threaten the decision to proceed with Enterprise C at all. I'm sure that would be regarded as an 'unintended consequence' and not what the ATO (or the Government) would wish to see happen – correct?

Sincerely

ALAN CUMMINE

Example of mixed farming with and without farm forestry on a small holding (say 90-100 hectares on the NSW Southern Tablelands)

The business activity comprises a mix of primary production enterprises – very common on both large and small properties. Both landholder partners earn off-farm income greater than $40,000. Passing either the 'real property' or the 'other assets' test is out of the question. Annual interest on the mortgage is about $12,000, making it difficult in all but the best years to pass the 'profit' test. All that remains is the 'assessable income' test or 'the Commissioner's discretion'.

(The only likelihood of the business activity passing either of the two assets tests, which in any case are not tests of 'commerciality', would be if the owner buys one or more neighbouring farms, or overcapitalises the farm machinery, or is lucky enough to have a property within 100 kms of Sydney served by a freeway.)

Enterprises A and B are carried out on the same property. 'A' is a grazing enterprise – say, to produce fine wool or beef (not simply 'trading' cattle to artificially push up the annual business turnover). Enterprise B is a cropping enterprise (say, to grow and cut lucerne hay for sale in large round bales or small square bales). Both comply with tax ruling TR 97/11, and both generate annual income.

Neither A nor B, on its own, passes either the 'assessable income' or 'profit' test. But taken together, they pass the 'assessable income' test in all or most years, and would also pass the 'profit' test but for the mortgage interest.

The ATO has indicated that such a mixed farming business would be treated as <u>one</u> primary production business activity for the purposes of the non-commercial losses legislation. (In other words, the ATO accepts the principle of mixed farming.) This is consistent with the undertaking given on 13 December 1999 by both Treasury and ATO officials before the legislation was drafted.

After some years, the partnership finds that lucerne hay production is unacceptably depleting the potassium levels in the soils in the lucerne paddocks, and that continued haybale production is in any case becoming increasingly difficult to fit into the partnership's calendar of operations. The

partnership seeks another farm enterprise to combine with the sheep or cattle grazing. The search has become especially urgent because the Government's new non-commercial losses legislation has created tests that the grazing enterprise, on its own, won't pass. (In this example, the annual wool cheque is between $7,000 and $14,000, and the annual costs, when the $12,000 mortgage interest is included, are about $20,000.)

Farm forestry is being heavily promoted as a desirable farm enterprise in the Southern Tablelands – by the Commonwealth and State Governments, the Murray Darling Basin Commission, the various catchment management committees and landcare groups, and farm forestry representative groups such as Australian Forest Growers. There are already established markets for radiata pine sawlogs and small roundwood (preservation logs), and there is a growing expectation that markets for hardwood sawlogs will re-emerge in the future once there is a critical mass of forest being grown on enough farms.

The partners choose farm forestry (enterprise C), and commence it in a way that complies with tax rulings TR 97/11 and TR 95/6. The farm plan is revised to integrate farm forestry – ie new plantings of commercially prospective species, at a rate of a few hectares per year, along fencelines as shelterbelts, on previously cleared stony ridges (groundwater recharge zones), around the contours at the break of slopes above waterlogged or saline areas, and in north-south alleys through several paddocks; and a silviculture plan to also manage several hectares of natural regrowth for future sawlog production. The grazing enterprise will benefit from the improved shade, shelter and land repair offered by the forest plantings and management.

Because of the lead time in farm forestry (which applies whether planting new trees or managing native regrowth), each partner must apply for 'the Commissioner's discretion'. If the farm forestry were to be grown for pulpwood, the discretion period sought would be about ten years. In this case, it is for softwood or hardwood sawlogs, and the discretion period sought would be between 20 and 35 years (notwithstanding the anomaly in s35-55(2) that discriminates against multi-thinned sawlog forests).

The partnership is still carrying on a single mixed farming business activity comprising two related enterprises. The ATO has already acknowledged such an arrangement as legitimate for the purposes of the legislation. The only difference now is that one of the enterprises (farm forestry) will not generate an annual return (at least not for many years), but qualifies for 'the Commissioner's discretion' in the expectation of producing assessable income greater than attributable deductions in a future income year.

The fundamental question is – How will the ATO interpret the legislation so that the grazing enterprise continues to be recognised as a legitimate part of the mixed farming business activity during the period of discretion for the farm forestry enterprise?

Summary

Enterprise A (alone)	Fails all tests (but would pass 'profit', but for mortgage interest)
Enterprise B (alone)	Fails all tests (but would pass 'profit', but for mortgage interest)
Enterprises A+B	Passes 'assessable income' test most years, and maybe 'profit' in a rare year (and would pass 'profit' regularly but for mortgage interest)
Enterprise C	With 'the Commissioner's discretion', will pass 'assessable income' and 'profit' in one or several future income years
Enterprises A+C	Combined, will pass 'assessable income' and 'profit' in some future years [HOW WILL THE ATO ENSURE SUCH A COMBINATION IS ENABLED TO BE CONTINUED AND IS NOT DISCRIMINATED AGAINST ?]