Submission to the

Board of Taxation Post-implementation review of the quality and effectiveness of the small business capital gains tax (CGT) concessions

Australian Government Department of Agriculture, Fisheries and Forestry (DAFF)

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Executive Summary

The Australian Government Department of Agriculture, Fisheries and Forestry (DAFF) believes that the current CGT small business concessions are generally working quite well, however the Department has concerns in two particular areas;

- The definition of an “Active Asset” used in the current legislation; and
- The criteria for access to the small business CGT concessions.

DAFF would like to see two changes to the existing legislation;

- A change to the definition of an “Active Asset” to;
  - remove the complexity inherent in the current definition; and
  - better recognise periods of active business use of an asset where the asset remains in the same ownership but has ceased to be an active asset (eg is leased by the current owner) at the time of the CGT event;

- A change to the criteria for access to the small business CGT concessions to;
  - provide more certainty for farmers;
  - reduce the cost of compliance; and
  - bring them into line with other small business taxation provisions such as the Simplified Taxation System (STS).

DAFF believes that these changes would not alter the original policy intent of the small business CGT measures and would assist the measures in meeting their original policy objectives.

Background

The small business CGT concessions are based on a recommendation of the *Review of Business Taxation* (the Ralph Report) chaired by Mr John Ralph AO. The changes were announced by the Treasurer in a media release dated 21 September 1999, which is the effective date for the operation of most of the provisions subsequently enacted. The Treasurer’s media release set out the policy objectives of the measures and included objectives such as:

- To increase the level of benefits available to small business taxpayers; and
- To provide small business people with access to funds for retirement or expansion.

The concessions included in this measure are;

(a) the 15-year exemption;
(b) the 50% reduction;
(c) the retirement concession;
(d) the roll-over.

The CGT concessions are available to businesses with net assets not exceeding $5,000,000 in value at the time of the relevant CGT event. The definition of net assets extends to all business assets including land and improvements, trading stock (livestock for a farmer) and business plant and machinery. The value of business liabilities are deducted to reach the net asset value.

The concessions apply exclusively to assets defined as “Active Assets” (ie an asset actively used in the operation of a business). The definition of an “Active Asset” is quite complex in its attempt to recognise earlier non-business use of an asset. Currently, an asset must, in effect, be actively used in a business at the date of the CGT event (usually the sale of the asset).

DAFF's Role

The role of DAFF is to increase the profitability, competitiveness and sustainability of Australia's agricultural, food, fisheries and forestry industries and enhance the natural resource base to achieve greater national wealth and stronger rural and regional communities.

DAFF's Interest in the Review

Retirement and succession planning plays an important role in facilitating structural adjustment and improving the overall competitiveness of Australia's agricultural industries. Taxation provisions, particularly capital gains tax issues, have a significant impact on the retirement and succession planning decisions made by farmers.

Background - Retirement and Succession Planning Issues

Age profile of farmers and impacts on farming productivity

Available statistics on retirement and succession planning for farmers indicate that the average age of farmers in Australia is well in excess of 50 years. Those aged 65 years or more make up around 15% of all farmers, a proportion that is significantly above other industry sectors. The average age of farmers and the proportion of farmers over 65 years of age have increased significantly over the last ten to 15 years. At the same time, the proportion of farmers under 35 years of age has declined to around 12% compared with 19% in 1986.

The age profile of Australian farmers suggests that many primary producers continue working into old age and perpetuate inefficient farming operations with low productivity and profitability. There are now, as a consequence of the lack of attention to retirement and succession planning, a number of small farms that are too small to pass on to the next generation. These are operated by older semi-active farmers who have essentially "retired".

Various farm-based surveys indicated that, in general, older farmers, when compared to younger farmers, are likely to be less educated, less innovative and may well lack the vigour to face the challenges of current economic and social changes and to adopt modern and improved farm management practices. The non-adoption of sound, up-to-date farm management practices can often lead to overworking of farmland and the gradual degradation of land quality raising environmental concerns.

Strategies to address the impacts of an aging farming community

Leasing the farm

Leasing arrangements provide the opportunity for a younger farmer, who is unlikely to have access to the necessary capital to purchase a farming property, to operate and manage a farming enterprise while providing an income stream to support an older farmer in retirement.

Interaction with CGT small business concessions

The current CGT small business concessions can act as an impediment to older farmers leasing their farms. Anecdotal evidence suggests that the prospect of losing access to the CGT concessions (particularly the 15 year exemption and the retirement concession) is likely to dissuade older farmers from considering leasing options.

The problem arises as a consequence of the existing definition of an "Active Asset" which, apart from being unnecessarily complex, requires the asset to be actively employed in a business "just before" the CGT event (usually the sale of the asset). This means that a farmer who has owned and operated the farm for many years but has leased that farm for the last 18 months, for example, would not be eligible for the CGT concessions should he finally choose to sell the property or pass it on to the next generation. A farmer could, in some circumstances, circumvent the existing provisions by terminating the lease and recommencing the farming business for a period prior to the sale of the property. However, DAFF believes that it is inappropriate for taxation considerations to dictate a return to business for a retired farmer.

DAFF Recommendation
This difficulty could be overcome by extending the definition of an "Active Asset" to include an asset that, while not an active asset at the date of sale has been an active asset of the current owner for a stated period or proportion of the ownership period. The defined period or proportion of "active ownership" would need to be set at a level that would guard against exploitation of the provision.

Such an amendment should not change the original policy objective of the small business CGT concessions.

Another Area of Concern

Criteria for access to small business CGT concessions
Currently, the small business CGT concessions are available to businesses with "a net value of CGT assets not exceeding $5 million at the time of the CGT event". Significant increases in the value of some rural properties has pushed some farmers, who would usually be considered to be operating a "small business", beyond the $5 million threshold. This is particularly the case for farming in peri-urban areas where property prices are often largely driven by valuations based on lifestyle considerations rather than agricultural productive capacity.

The most recent farm performance figures from ABARE[1] indicate that average equity at 30 June 2004 for all broadacre farms was $2,147,820, with capital appreciation over the previous year averaging over $200,000 per property. In 2003-04, farm cash incomes for broadacre properties averaged $67,040; a figure that by definition excludes the imputed value of owner-labour and depreciation on plant and equipment.

It could be argued that the existing threshold of $5 million unfairly disadvantages farmers whose properties are valued on a non-agricultural basis despite being used for primary production.

[1] ABARE Australian Commodities, 05.01 March Quarter

It is quite feasible that a farming business that would meet all (or most) of the generally accepted concepts of what constitutes a small business (eg turnover levels), could lose access to the CGT concessions as a consequence of rising land values.

The value of land can fluctuate markedly over relatively short periods. Farmers with net assets approaching the current threshold may incur significant compliance costs (ie the cost of a proper valuation of their property) in assessing their eligibility for the concessions should they be considering selling their farm.

The Simplified Taxation System (STS) threshold (ie an annual turnover not exceeding $1 million and depreciable assets not exceeding $3 million) is a threshold that;

- better defines a "small business"; and
- for farmers contemplating the sale of farming property;
    - would provide a better level of certainty; and
    - would reduce the compliance effort and cost.

It could also be argued that all taxation provisions directed towards "small business" should have identical (or at least similar) access criteria.

DAFF Recommendation
DAFF recommends that the criteria for access to small business CGT concessions be amended to provide a threshold similar to the STS threshold. Again, DAFF believes that such an amendment would not change the original policy objectives of the small business CGT concessions.