



4 March, 2005

The Board of Taxation
c/o Mr Bruce Paine,
Secretary, Board of Taxation
Treasury Building, Langton Crescent
PARKES ACT 2600

Dear Mr Paine

Thank you for your letter dated 6th December 2004, inviting comment on whether the small business capital gains tax (CGT) concessions are having their intended effect and whether their implementation can be improved. The small business capital gains tax concessions provide many farmers with potential access to highly beneficial tax measures which reduce impediments to investment and can assist in orderly succession planning. However, the National Farmers' Federation (NFF) has some significant issues regarding the legislation's failure to achieve the Government's policy intent notably – to increase the level of benefits available to small business and to provide greater flexibility in how small businesses can access the various provisions. These limitations have considerably disadvantaged many of our members.

NFF understands that the Board of Taxation has established criteria against which it will assess the legislation in question and that it is not the purpose of this review to change the policy intent of the legislation. In this regard, NFF has narrowed its consideration of how current arrangements can be improved to only provide recommendations on how better to achieve the policy intent of the legislation in question, rather than any changes to policy more generally.

However, NFF would still like to take this opportunity to inform the Board of the strain that the CGT rules which cover property gifting is having on farm families when dealing with intergenerational planning. In practice, the only way a farmer can pass his or her property on to their son or daughter without CGT being paid is to die and transfer it in their will. This is clearly a very poor approach to succession planning and causes significant emotional, social and economic stress for those farm families confronted with succession planning issues. NFF would welcome the opportunity to provide the Board with further information on this and should they consider such an issue falls within the scope of this review, NFF would be pleased to provide a further submission.

Current arrangements

There are four CGT concessions that are specifically available to small business only and which are very relevant for farmers. They are:



1. **The small business 15 year exemption** provides a total exemption for a capital gain on a CGT asset if a business has continuously owned the asset for at least 15 years and where the taxpayer is at least 55 years old and is retiring.
2. **The small business 50 per cent active asset reduction** provides a 50 per cent reduction of a capital gain if the basic conditions are satisfied.
3. **The small business retirement exemption** provides an exemption for capital gains up to a lifetime limit of \$500,000 if the conditions for the exemption are satisfied. If the taxpayer is under 55, the amount must be paid into a superannuation (or similar fund).
4. **The small business rollover** provides a deferral of a capital gain if a replacement asset is acquired and other conditions are satisfied. However, you may make a capital gain equal to the deferred gain if the replacement asset is disposed of or its use changes in particular ways. In this case the deferred capital gain is in addition to any capital gain made on the disposal of the replacement asset.

To qualify for these exemptions a tax payer must satisfy the following basic conditions:

- Have **net CGT assets of less than \$5 million**. For example, this includes real estate, plant and equipment and livestock.
- Satisfy the **Active Asset Test**. This test requires that the assets (including farm land) for which the exemption is being sought must be used in carrying on the business itself. Investment assets such as rental properties do not generally qualify as active assets.
- Where the CGT asset is a share in a company or interest in a trust, the **controlling individual test**.

Assessing these arrangements against the evaluation criteria

The Board of Taxation has established the following criteria that it will use to evaluate the extent the legislation:

Criteria 1: *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;*

Criteria 2: *is expressed in a clear, simple, comprehensible and workable manner;*

Criteria 3: *Avoids unintended consequences of a substantive nature; and*

Criteria 4: *Takes account of actual taxpayer circumstances and commercial practices.*



Criteria 5: *is consistent with other legislation; and*

Criteria 6: *provides certainty*

NFF has used these criteria as a basis for providing the following comment and recommendations:

The 15 year exemption requirements

It is NFF's strong view that aspects of the active asset test significantly limit the Government's policy intent. Specifically, **the requirement that an asset must be effectively "active" at the point of sale notwithstanding that it has been held for more than 15 years.** This creates the policy absurdity of a farmer who before retirement has leased out his property for a short number of years, having to come out of retirement and work the farm again to qualify for the CGT exemption.

For example:

Ben is farmer who has owned and worked his farm for over 15 years and decides to lease his farm out while still living on the property before he retires. The land value of Ben's farm has appreciated in considerably nominal terms over this time but he is still under the \$5 million threshold and once inflation is factored in his real return is quite low. The farm has been leased for 5 years before Ben decides he wants to transfer ownership to his son. Unless Ben cancels the lease and farms the land again himself as a business so that it is "active" he will have to pay CGT on the proceeds of the sale. Clearly there is a large incentive for him to avoid this and pay no CGT by coming out of retirement.

This is an obvious distortion of the intent of the 15 year rule which was designed to provide incentives to business that have held assets for a very long time and wish to sell and not be penalised by capital appreciation over time, which in real terms may be very low. In this example, if Ben has to pay CGT his real return on his assets may indeed be negative. Such a circumstance would be a disincentive to investment for small business. This runs contrary to the policy statement in attachment E of the material you provided that "...capital gains will no longer be an impedient to investment by small business."

Therefore NFF recommends that:

Recommendation 1

The Board of Taxation drop the condition that to qualify for the small business CGT exemptions a taxpayer must have an active asset at the time of the sale of the asset or other CGT event. Provided the taxpayer satisfies the other conditions covering the length of time the taxpayer has held the "active asset" dropping this



condition would not interfere with the original policy intent of government and significantly increase the benefits of the exemptions to farmers.

If adopted such a recommendation would address this unintended consequence of the legislation, making it more workable and practical to take account of actual farmer circumstances.

The \$5 million CGT asset threshold

Another area of significant concern to the NFF is the appropriateness of the \$5 million CGT asset threshold that must not be exceeded in order to access the small business concessions.

NFF considers the main weaknesses with the \$5 million CGT asset threshold are that it:

- Unfairly discriminates against farmers whose businesses have a high level of capital due to the importance of land in farming, relative to say a tradesman or retail business who runs their enterprise with lower unavoidable capital costs.
- Undermines the consistency and integrity of the legislation as it exposes taxpayers to variable and subjective property valuations, which can fluctuate significantly depending on market conditions. This means that timing of a sale will be very significant factor, particularly for those close to the threshold. In such circumstances a taxpayer will have a major change in return and incentives when their assets get close to \$5 million.
- In practice, with the appreciation of farmland, many farmers are finding themselves over this limit, particularly farmers close to urban centres. However, by other measures such as turnover, profit, staffing and market power, they would be a “small business” even as defined by other Commonwealth legislation, such as the Trade Practices Act.

For example:

Peter is a horticulture farmer who has owned and farmed his land for 20 years. During this time changing land use has seen the value of his land appreciate above the \$5 million threshold due to expanding urbanisation of the nearby town. Peter wishes to pass on his farm to his son who intends on continuing farming the land, however despite having small business status for other tax purposes such as for the simplified tax system and for collective negotiation under the Trade Practices Act he finds that he cannot pass ownership to his son without a hefty CGT bill.

Accordingly, NFF recommends that:



Recommendation 2:

The Board of Taxation reconsiders the \$5 million threshold to allow more farm businesses access to the small business CGT exemptions.

NFF notes that the eligibility criteria for the Simplified Tax System is a potential model i.e. that to qualify a small business must have turnover less than \$1 million and have *depreciable* assets of under \$3 million. One of the problems of the STS model is that the turnover limit excludes many farmers who are legitimate small businesses but due to the nature of farming have a high turnover, but low profit margin. Another issue is that turnover has no relationship to capital or profit.

Another more simple alternative is to lift the CGT asset threshold higher than \$5 million. Significant time that has elapsed since the \$5 million threshold was set and property prices for many farms have increased by a factor of two or three. Given this, there is a strong case for a significant inflation of the threshold level, and then ideally having it indexed to some measure of farm land price inflation to address some of the subjectivity and discriminatory concerns that NFF has raised.

Given that there is limited data readily available to NFF to assess these proposals and their likely impacts on the accessibility of the exemption to farmers, NFF considers a degree of caution should be exercised with any change. Consequently, we would welcome the opportunity to participate or provide comment on any proposal by the Board or Treasury to lift or otherwise change the threshold.

As this problem aligns with all 6 of the Board of Taxation's criteria for improvements NFF considers there is a strong case for making a change.

A third recommendation NFF would like to put to the Board of Taxation is:

Recommendation 3:

That the definition of an active asset is simplified

For example, the current legislation provides an exemption to the general rule that to qualify as an active asset the asset in question must not be, among other things, leased. This exemption applies when the asset's main use for deriving rent was only temporary.

An example of an active asset is given:

“A company uses a house purely as an investment property and rents it out. The house is not an active asset because the company is not using the house in the course of carrying on a business. If, on the other hand, the company ran the house



as a guest house the house would be an active asset because the company would be using it to carry on a business and not to derive rent.”

NFF considers that where a farmer leases out a property, it should still qualify as an active asset. In particular if it is only leased on a temporary basis for a short period while the farmer takes a break from actively farming himself, then the case for still considering it an active asset is particularly strong.

The current definitions and explanatory material of an “active asset” leave these matters ambiguous. NFF would like to see greater certainty in this area so farmers can plan with confidence.

NFF believes that the issues raised in this submission constitute a strong case for change for the rules governing the small business CGT exemptions. Should the Board and Treasury wish to take them further NFF would welcome the opportunity to comment on any proposed amendments.

I would like to thank you again for the opportunity to comment on the efficiency of the small business CGT exemptions and how they can be improved. The exemptions passed by government can be very beneficial to the farm sector and small business however, NFF feel they can be significantly improved by the adoption of the recommendations discussed above. If you have any further questions, please do not hesitate to call Mr Nicholas Howarth, Economics Policy Manager, NFF on 02 6273 3855.

Yours sincerely

[signed]

CHARLES BURKE

NFF Vice President

Chairman, NFF Farm Business and Economics Committee