

Dear Sir,

Thank you for the opportunity to make a submission to the Agricultural Competitiveness Green Paper. This submission will focus on taxation issues.

Tax concessions hurt industries

Dr Ken Henry told the 1996 Rural Finance Summit¹:

... there are more special tax provisions for farmers than any other sector of the economy.

... Granting a tax concession to a sector within the economy does not benefit the whole sector. And it acts to the disadvantage of the rest of the economy. Initially, the tax concession will increase the after-tax rate of return from investment in the tax-favoured sector. Other investors will take advantage of the higher post-tax rate of return by acquiring assets in this sector. The usual effect is that asset prices in the tax-favoured sector will increase, even though the pre-tax rate of return from the investment has not changed. Asset prices will increase until the post-tax rate of return in the tax-favoured sector matches until the post-tax rate of return in the other sectors of the economy. The pre-tax rate of return in the tax-favoured sector will be less than prevailing elsewhere. An industry with many tax concessions is likely to have high asset prices and low pre-tax returns from investment.

... Because the Australian tax system has progressive rates, a tax concession will be of most value to high income taxpayers, and the least value to low income taxpayers. Those investors who move resources into a tax-favoured sector will be taxpayers with high income against which to use the tax concession. Low income earners will be forced from the sector; they receive pre-tax returns that are lower than those applying in the rest of the economy, and obtain little value from the benefit. Put bluntly, Pitt and Collins St farmers push up rural property prices and depress pre-tax returns — to the cost of full-time farmers, particularly low income full-time farmers.

Prominent US agricultural economist Bruce Gardener described this effect:

In the long run ... all farm capital that cannot take advantage of tax breaks goes to other (non tax-sheltered) sectors. This is the structural worry about the favourable tax treatment of nonfarm investment in agriculture².

Dr Henry also noted that livestock tax concessions provide significant tax deferrals, this is discussed later.

¹ Dr K Henry, *Taxation and the Farm Sector*, Address to the Rural Finance Summit, 3 July 1996. A copy of Dr Henry's paper is attached.

² B L Gardener 1990 *The Economics of Agricultural Policies*. McGraw-Hill, New York

How much income tax is paid by primary producers?

Table 1 shows selected items of primary production income and deductions reported in *Taxation Statistics 2011-12 Individuals: Table 8. Individuals, Selected items by fine and broad industry 2011-12.*

Table 1
Selected items from Australian Taxation Statistics for Individuals 2011-12

Item	Total \$
Total business income primary production	8,475,264,406
Total business expenses primary production	-9,102,438,232
Tax losses of earlier income years non primary production losses claimed this income year	-1,144,232,828
Net farm management deposits or repayments	-282,461,585
Calculated possible tax loss from primary production	-2,053,868,239

Assuming a 30 per cent average tax rate, the possible tax loss could cause around a \$600 million cost to the revenue. In the same year, the Taxation Statistics reported companies in the Agriculture Fishing and Forestry industries paid about \$450 million in net tax on income from **all** sources. The net income of partnerships and trusts is normally distributed to individuals and companies. It is possible little, if any, income tax is paid on primary production income. The Australian Taxation Office should be asked to provide estimates of the net tax paid on primary production income each year in the Annual Tax Statistics.

Taxation of livestock

Tax concessions related to livestock provide large tax deferrals, and provide an example of how some tax concessions favour new entrants over mature businesses. Tax law defines livestock as 'trading stock', and farmers (like other taxpayers) can choose to value trading stock at cost, market or replacement values. Taxation regulations prescribe the minimum cost of natural increase at \$20 for cattle, horses and deer, \$12 for pigs, \$8 for emus, \$4 for goats and sheep, and 35 cents for poultry.

These minimum costs have not been revised for decades, and are probably well below the cost of production. In New Zealand, an annual survey of the costs of animal production provides a basis for the New Zealand National Standard Cost scheme. The New Zealand standard costs for 2014 are shown at Table 2. Note that the costs for older animals are additive, and that a 2 year old sheep has a standard cost of \$62.40 (\$37.70 + \$24.70).

Table 2
New Zealand National standard costs for specified livestock determination 2014

Kind of Livestock	Category of Livestock	National Standard Cost
		\$
Sheep		
	Rising 1 year	37.70
	Rising 2 year	24.70
Dairy Cattle		
	Purchased bobby calves	170.10
	Rising 1 year	510.00
	Rising 2 year	225.60
Beef Cattle		
	Rising 1 year	369.70
	Rising 2 year	207.80
	Rising 3 year male non-breeding cattle (all breeds)	207.80
Deer		
	Rising 1 year	124.00
	Rising 2 year	62.10
Goats (Meat and Fibre)		
	Rising 1 year	29.00
	Rising 2 year	19.90
Goats (Dairy)		
	Rising 1 year	162.30
	Rising 2 year	28.00
Pigs		
	Weaners to 10 weeks of age	112.10
	Growing pigs 10 to 17 weeks of age	92.60

Source: <http://www.ird.govt.nz/technical-tax/determinations/livestock/national-standard/livestock-nationalstandardvalues-2014.html> accessed 27 October 2014.

If it was assumed that the Australian cost of production for beef cattle is similar to the New Zealand Standard Cost of approximately \$370 per head, then the Australian prescribed value of \$20 is about \$350 per head less than the cost of production. ABARES estimates that there are over 5 million beef cattle in Australia. If it was further assumed that about 3 million (or 60%) of the beef cattle in Australia were bred by the owner, then the value of the beef cattle herd alone for taxation purposes would be about \$950 million less than the cost of production, and payment of tax on that amount would be permanently deferred.

Glau³ (1971) noted that the use of arbitrary low costs for the natural increase of livestock favoured investment in self-replacing herds, and that:

... when all replacement animals are bred on the property the limiting value (of closing stock) is the arbitrary cost price used for natural increase (p.54).

Douglas⁴ (1996) showed that the deferral is greatest in the initial years of operating a livestock business, and results in significant reductions in taxable income. About 10 years after buying a self-replacing livestock herd its average cost will approach the Prescribed Cost, and nearly all of the proceeds of selling livestock will be taxable. The effect is that a new entrant into the livestock industry will pay significantly less tax on the sale of livestock than a mature business, giving the new entrant a competitive advantage. Similar effects occur with other species of livestock.

Further, the mature business will find it difficult to change enterprises, for example changing from grazing cattle to grazing sheep will generally result in a large tax liability. Similarly the potential tax liability may discourage destocking during drought, but that disincentive would be reduced by tax elections available for disposal of livestock because of drought, fire or flood.

The low prescribed values of natural increase of livestock also enables the easy transfer of losses of companies and trusts to individuals and partnerships. For example, livestock could be sold by a company with tax losses to an individual at 'market value', so generating profits large enough to extinguish available losses in the company. The individual then benefits from further tax deferrals. This may be a minor challenge to the integrity of the tax system.

The policy problem is not the use of Prescribed Values. Calculating the cost of the natural increase of livestock is difficult, so 'Prescribed Values' (or 'Standard Costs') are a practical method of reducing compliance costs. Prescribed Costs should be reviewed annually.

³ T E Glau (1971) *The Impact of Tax Policy on Agricultural Investment in Australia*, Department of Agricultural Economics Mimeographed Report no 5, University of Sydney, Sydney.

⁴ R Douglas (1995), *Improving the Efficiency of the Taxation of Livestock in Australia*, Review of Marketing and Agricultural Economics, 1995, vol. 63, issue 01

The Prescribed Costs of natural Increase of livestock are such a small percentage of the likely production costs that increasing the Prescribed Cost of the natural increase of beef cattle from \$20 to (say) \$370 is likely to be politically unpalatable. The Government should consider writing off some, or all, of the embedded tax in self-replacing livestock herds as a means for more closely aligning the tax value of livestock with production costs.

A further potential issue with the taxation of livestock is the possibility of some primary producers 'double dipping' by using both livestock elections to defer taxation of the proceeds of the forced sale of livestock, and Farm Management Deposit (FMD) simultaneously. There will be a natural 'check' in that the livestock election will reduce primary production income, and so reduce the amount that can be deposited in FMD. However it is possible to envisage circumstances where a primary producer could benefit from both deferring the income of a forced sale, and also using the proceeds of the sale to make an FMD.

Depreciating farm plant and equipment

The Green Paper mentions stakeholder requests for further accelerated depreciation. Accelerated depreciation provides cost savings for corporate farmers. However, it may impose cost the large number of farmers who are subject to the progressive tax rates applying to individuals. This effect is illustrated in Example 1 of Douglas *et al*⁵. Douglas *et al* used farm-level data from ABARE's survey of broadacre agriculture to calculate the extent and distribution for benefits for various levels of depreciation. They concluded:

... accelerated depreciation is estimated to provide little benefit to farmers. In the experiments conducted, ... the difference in tax benefits received from depreciation rates between 12.5 and 100 per cent was estimated to be less than 1 per cent of capital invested for those using the averaging scheme.

Economic theory predicts that at least some of the tax savings arising from accelerated depreciation and investment allowances will be passed back to machinery dealers, who will charge higher prices for machinery.

Zone tax offsets are probably unconstitutional

The comments on zone tax offsets in Green Paper are incomplete. Section 51(ii) of the Constitution gives the Commonwealth powers with respect to:

*Taxation; but so as not to discriminate between States **or parts of States**: (emphasis added).*

⁵ R Douglas, D Peterson, P Kovic and B Parameswaran (1995) *A Note on Accelerated Depreciation and Investment Allowances*. Review of Marketing and Agricultural Economics, Vol.63, No. 1, April 1995, PartII.

This is reinforced by Section 99 of the Constitution:

*The Commonwealth shall not, by any law or regulation of trade, commerce, or revenue, give preference to one State **or any part thereof** over another State or **any part thereof** (emphasis added).*

The late Peter Clyne⁶ challenged the constitutionality of the precursor of Zone Tax Offsets in 1957 and 1958, and argued their existence made the entire Income Tax Act unconstitutional. Dixon CJ described Clyne's case in these terms:

It is based on the assertion that there is a failure to observe both the condition of the power given by s. 51(ii.) that there shall be no discrimination between States or parts of States and the command of s. 99 of the Constitution that the Commonwealth shall not by any law or regulation of revenue give preference to one State or any part thereof over another State or any part thereof. The discrimination or preference which the defendant claims to have discovered has nothing to do with the circumstances of his particular case but, of course, he can as a person sued for tax rely upon it if it be true that it brings down the whole edifice of income tax. It lies in s. 79A of the Assessment Act, a section which few persons in the more populous parts of Australia have occasion to read or notice. Section 79A (1) states that for the purpose of granting residents of the prescribed area an income tax concession in recognition of the disadvantages to which they are subject because of the uncongenial conditions and high cost of living in a zone called A and to a lesser extent in a zone called B in comparison with parts of Australia not included in the prescribed area, an amount ascertained in accordance with the section should be an allowable deduction.

Dixon CJ decided:

I repeat that I assume that s. 79A of the schedule does attempt to give such a preference and so to discriminate. But this can affect the validity of the Taxing Acts only if s. 79A ever became part of the Assessment Act upon which the Taxing Acts operated. In my opinion this hypothesis or condition never was fulfilled. My opinion is that s. 79A was invalid ab initio and never became a valid portion of the Assessment Act. Let it be assumed to the full that the provisions of s. 79A would involve a preference forbidden by s. 99 once the Taxing Act operated upon them. It appears to me that, because s. 79A would if valid necessarily involve such a preference once the Taxing Act operated upon it, the consequence must be that it never was within the competence of the Parliament to enact s. 79A. It must therefore be treated as void. It is, I think, equally true that without s. 99 s. 79A on the hypothesis stated would be outside the competence of Parliament because it would conflict with the condition

⁶ Federal Commissioner of Taxation v Clyne [1958] 100 CLR 246 (2 April 1958)

expressed in s. 51 (ii.) that a law with respect to taxation must not discriminate between States or parts of States.

While this decision was based on the precursor of the Zone Rebate offset, it is probable that the current Zone Allowance system is also unconstitutional, and does not form a valid part of the tax law. Section 99 of the Constitution may also make Drought Relief Payments invalid.

Farm Management Deposits

There appears to be little evidence that Farm Management Deposits (FMD) actually increase net farm cash reserves. There is nothing to prevent a primary producer from borrowing to fund a FMD deposit. The interest spread between loan and deposit is likely to be small (say 2 per cent per year), so the interest cost will be significantly less than the tax saved.

The FMD scheme appears to be an expensive method of encouraging primary producers to increase cash reserves, as is shown in Table 3. Between 2004-05 and 2013-14, tax expenditures of \$1.14 Billion were required to increase FMD holdings by \$1.25 Billion. The net increase in farm cash reserves was approximately the revenue cost.

Table 3
Annual Change in FMD Holding and Estimated Revenue Cost

Quarter ending	Total FMD (\$Million)	Annual Change (\$Million)	Tax Expenditure (\$Million)
June 2013	3,720	188	155
June 2012	3,532	316	150
June 2011	3,216	433	230
June 2010	2,783	-59	30
June 2009	2,842	-36	95
June 2008	2,878	97	100
June 2007	2,781	147	95
June 2006	2,634	-158	75
June 2005	2,792	174	115
June 2004	2,618	138	95
June 2003	2,480		
Totals		1240	1140

Source: <http://www.agriculture.gov.au/agriculture-food/drought/assistance/fmd/statistics> (accessed 8 November 2014) and Treasury, Tax Expenditure Statements 2008 and 2013.

Note that the 2013-14 Tax expenditure is a forward estimate, and subject to revision. Note also that the tax effect occurs the year after the economic activity giving rise to it, e.g., a 2012-13 FMD deposit affects tax paid in 2013-14. For this reason, the tax expenditures shown in Table 2 are lagged one year behind the change in FMD balances.

There does not appear to be a strong correlation between changes in overall FMD balances in Table 3 and the tax expenditure. ABARES should be requested to investigate the extent to which FMD actually increase net farm cash reserves, and also the relationship between annual changes in FMD balances and the tax expenditure.

There is little merit in increasing the cap on FMD holding. Most farm business structures involve more than one person. A husband and wife partnership could each hold \$400,000 enabling a total of \$800,000 FMD for the farm business; if two children were also involved in the business the FMD available could increase to \$1,600,000. Increasing the cap to \$1 million per primary producer would increase those amounts to \$2 million and \$4 million respectively. ABARES estimated that the average farm had FMD holdings of \$41,200 in 2012-13⁷. The Cap on FMD holdings is not an issue for average primary producers.

The current \$400,000 FMD cap is only slightly less than the \$ 430,777 estimated median wealth of adult Australians⁸. ABARES estimated the average Australian farm business had equity of about \$3.3 million in 2012-13. There does not appear to be case for providing further assistance to multi-millionaires.

Averaging

Income averaging was introduced to address period inequity, the perceived additional tax that may be paid over a period of time on a fluctuating income compared to a more stable income. It should be noted that period inequity only exists if a normative judgment is made that a year is an inadequate period to judge tax equity, and a longer period is more suitable. If period inequity is judged to exist, it is likely that it would also affect other groups, including woman of child bearing age, the frequently unemployed, students entering the workforce, and retirees leaving the work force.

Primary producers have many means of dealing with period inequity; including:

- altering the timing of sales of produce;
- altering the timing of purchasing inputs,
- purchasing capital items that qualify for accelerated rates of write-off;
- using elections to defer tax of 'forced' sales of livestock; and
- using the FMD scheme.

⁷ ABARES 2014 [Australian farm survey results 20-11 to 2013-14](#) accessed 8 November 2014

⁸ Credit Suisse 2014 [Global Wealth Report 2014](#)

Perceived period inequity was more common when there were numerous tax brackets with top marginal rates approaching 100 per cent, such as during World War II. In comparison, Australia now has just 5 income tax brackets, and the top marginal rate is 49 per cent (including the Medicare and Budget Repair levies). Period inequity is less of an issue now.

Douglas and Davenport⁹ analysed a sample of 455 primary producer income streams supplied by the ATO. They found that only about 10 per cent of primary producers suffered 'serious' period inequity (defined as more than \$500 per annum, or \$2,500 over the 5 years examined). They also found that about 30 per cent of the sample benefited from negative period inequity because their incomes were rising at a time when tax rates were falling. They further found that the averaging system was regressive, on average failing to fully compensate primary producers with taxable incomes of less than \$25,000 for average period inequity incurred, but overcompensating those primary producers with taxable incomes over \$35,000.

Averaging also results in distorted marginal tax rates. Douglas (1993)¹⁰ provided examples where a primary producer using averaging could have a marginal tax rates ranging from -30% to +80%. The reduction in tax rates since the paper was written would reduce, but not eliminate, distorted marginal tax rates.

Stakeholders have argued for the right to re-enter the averaging scheme after leaving it. Primary producers were entitled to leave and re-enter the averaging system in the late 1970's and early 1980's. Reintroducing such a policy would cost the revenue about \$45 million per year, the cost of Complementary Tax foregone.

More importantly, one of the reasons the old Income Equalisation Scheme (a precursor to FMD) was abolished was that some primary producers were using the combination of voluntary averaging and IEDs to deliberately destabilise taxable income as a means of tax minimisation.

Conclusions

Primary producers have many tax provisions, many of which attempt to defer the taxation of income, and/or overcome the perceived effect of period inequity. It is probable that the FMD scheme can meet most, if not all of these objectives. It is recommended that the Productivity Commission be requested to examine how the numerous special income tax provisions interact, and to report on how the taxation of primary producers could be simplified.

⁹ R A Douglas and S V Davenport (1995) [*A Case for Re-evaluation of Averaging for Primary Producers*](#) Review of Marketing and Agricultural Economics, Vol 63, no.1, April 1995.

¹⁰ R A Douglas 1993 *Extreme Marginal Tax Rates with Tax Averaging*, Butterworths Weekly Tax Bulletin, Issue 11, 9 March 1993.