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FORUM

PART-TIME FARMING AND INCOME TAXATION

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*“Pleasure is far sweeter as a
recreation, than as a business”.*

R. D. Hitchcock

Many people in receipt of non-farm income are purchasing (usually small) farms and operating them on a part-time basis. These people will be referred to, in this paper, as part-time farmers. Such farmers are becoming an increasingly important feature of the Australian countryside [2, 3, 7, 12, 14, 15]. The increase in their numbers has prompted calls for the “protection” of agricultural land from subdivision for part-time farming, both in Australia [3, 6, 14], and overseas [16]. Their proliferation has been claimed to reduce agricultural production [3, 11, 13, 14] and cause other “undesirable” consequences [3, 11, 14]. There have been calls for the denial of taxation concessions to part-time farmers [3, p. 10].

Any effort to reduce the primary production income tax concessions available to part-time farmers hinges upon the definition of a primary producer. Some people engaged in primary production are deemed to do so purely as a hobby. They are therefore not classified as primary producers and consequently are not eligible for the corresponding tax concessions. These “hobby farmers” will almost always be part-time farmers. This paper begins with an examination of the distinction between hobby farmers, and primary producers from the viewpoint of income tax assessment. Part-time farmers are classified as one or the other. The appropriateness of the current definition of a primary producer is then questioned. Finally a more discriminatory definition is discussed which would reduce the availability of income tax concessions to part-time farmers.

WHAT IS THE DEFINITION OF A PRIMARY PRODUCER FOR INCOME TAX PURPOSES?

The simple definition of a primary producer for income tax purposes is—“someone engaged in the business of primary production” [1, p. 3]. For taxation purposes, “primary production” is regarded as production resulting directly from: (a) the cultivation of land; or (b) the maintenance of animals or poultry for the purpose of selling them for their bodily produce, including natural increase. There are other categories of primary producers but these are not relevant to the distinction between primary producers and hobby farmers.

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On the other hand, the meaning of the word "business" is not so clear. Primary production is classified as a business "provided it is not simply a hobby" [1, p. 3]. It is the clarification of the term "business" in relation to hobby farming with which the first section of this paper is concerned. Reference is made to the circumstances surrounding various appeals which have been made against the judgment of the Commissioner of Taxation. A review of the relevant cases yields the following guidelines and conclusions:¹

1. As a general principle there is no discrimination against part-time primary producers whether they live on the rural property or in the city. However, it does appear that the increased numbers of rural retreats has led the Commissioner of Taxation to examine claims for "primary producer" status somewhat more carefully now compared with the past.²
2. To qualify as a business, the primary production activity must be of a commercial nature. A hobby or pastime, no matter how intensively carried on, does not qualify as primary production, if it is not run as a commercial operation. A yardstick in gauging the commerciality of an operation is its similarity to other commercial enterprises.
3. The presence of a profit motive is generally regarded as being essential to the definition of a business. The selling of produce to friends at well below retail prices can be construed as indicating a lack of profit motive. An interesting example of lack of profit motive concerned a doctor engaged at fishing on weekends. Although other factors were also involved, the low income derived from fishing relative to the doctor's professional income potential suggested a lack of profit motive in the primary production (fishing) activity.
4. Not only must the profit *motive* be present, but a "reasonable" prospect of making the profit must also exist. Furthermore this expectation of profit must arise from primary production activities (as opposed to land speculation). Following from the previous points, it is clear that a number of consecutive years of tax losses from primary production (especially if coupled with high levels of deductions) will lead to doubts as to the "commerciality" of the primary production enterprise. Soundly based projections of future profits will be essential in these circumstances.
5. A very small operation (relative to normal commercial practice) has almost invariably led to the non-assignment of primary producer status to the taxpayer. These are situations involving the running of a few beasts, or the cultivation of a small area of ground. Furthermore, a business must not only be of a significant size, but should also be of a systematic and continuous nature. However, large size may compensate for lack of continuity, as one single attempt at primary production can be sufficient to earn "primary producer" status.

¹ The author was guided towards these cases by listings in [5, 8], but the interpretations are his own.

² For example, in New South Wales a taxpayer with another principal source of income must provide certain additional information in support of his claim [10].

6. Although the achievement of a harvest is not necessary for establishing that primary production is a business, there does seem to be a danger of having activities declared “experimental” or “preparatory to engaging in business” rather than as a business. Considerable weight appears to be given to the fact that some actual production is attempted.

7. Lack of expertise on the part of the primary producer has been deemed not relevant to the definition of a business. So long as the profit motive and reasonable expectation of achieving that profit exist, failure to actually achieve the profit due to managerial incompetence has not prevented the “primary producer” status being granted. However one would imagine that should the managerial incompetence persist over an extended period of time, then the “reasonable” expectation of profit would vanish.

8. It is possible, on a particular property, for some primary production activities to be classified as a business whereas others are not. Where 100 per cent of income is derived from full-time primary production, the running of a few non-commercial sidelines is not likely to be seriously questioned by the Commissioner of Taxation. However, as the primary production becomes less commercial in nature, it is more likely that discrimination between activities will be made.

From the above list of points, it can be seen that no firm conclusions can be reached regarding the classification of hobby farmers as primary producers from the point of view of income tax legislation. This is so because the Income Tax Assessment Act lays down no specific conditions. Therefore decisions are made on the facts of each case. The above list of guidelines from income tax appeal cases allows a clearer picture to be gained to the definition of primary producer and hobby farmer from the point of view of income tax assessment. Current Australian legislation (or interpretation of legislation) seems quite generous from the point of view of the part-time farmer who is only classified as a hobby farmer where the primary production activity is patently not a business. Furthermore, once defined as a primary producer, the full primary producer tax concessions are available regardless of the proportion of total income received from primary production.

The key elements in the definition of primary producer appear to be size, the fact that some *production* was attempted, a “reasonable” expectation of profit, and a similarity with other commercial enterprises of the same type. Weight is also given to *documentary* evidence of sound planning (both agricultural and economic) and “businesslike” activities.

WHAT SPECIAL TAXATION CONSIDERATIONS ARE AVAILABLE TO FARMERS DEFINED AS PRIMARY PRODUCERS?

In general, special taxation concessions will be of most benefit to those primary producers whose income is highest, since these people pay the highest rates of tax. Currently the maximum marginal income tax rate is 60 per cent, at a taxable income of \$32,000. The major taxation concessions available to primary producers are listed below.

Income averaging: When averaging provisions apply, fluctuations in taxable income can be eliminated and total tax payments reduced. Therefore individuals with highly fluctuating total taxable incomes can derive significant financial benefit by achieving primary producer status. The recent removal of the upper income limit on averaging and other changes in the provisions appear to have increased the value of this concession to primary producers, especially those in the higher income bracket. On the other hand, the condensing of the tax scales into only four (including zero) marginal rates means that the likelihood of moving into a different scale as a result of a given fluctuation in income is reduced.

Income Equalization Deposits: As the name implies, I.E.D.'s are designed to reduce income fluctuations affecting primary producers. However they are useful as an investment vehicle as well. As an investment, they are worth more to higher income earners. The interest rate paid on I.E.D.'s is 5 per cent, but since this interest is paid on investments of income before tax is taken out, the effective rate of interest is $\frac{5}{1-t}$ where t is the percentage of tax taken out of income. At the highest income bracket the effective rate of interest is almost 15 per cent. This would be higher than most other forms of fixed interest rate deposits available to investors, and could provide an incentive for classification as a primary producer. However there are restrictions on the amounts of I.E.D.'s to be purchased (relative both to income from primary production and other income). Where a sharp fall in taxable income is anticipated (e.g., upon retirement), the gains from using I.E.D.'s would be large and access to them, via classification as a primary producer would be attractive.

Investment Allowance, Depreciation, Deductibility of Operating Expenses, Income Splitting: Although not uniquely available to primary producers, these taxation concessions nevertheless provide substantial incentive for part-time farmers to achieve primary producer status.

The overall tax savings of an individual depend upon his particular circumstances, and, even if these were known, considerable analysis would be required to obtain an accurate figure. However, it is obvious that *potential* tax savings for earners of large off-farm incomes are high, although not as high as before the 1973 Budget changes. Where the value of tax concessions for part-time farmers has been studied in detail [4, 15] their tax savings have been found to be significant. Few farmers reported in [15] gave income tax concessions as their major reason for undertaking part-time farming. However they were taking advantage of the concessions available, lowering their costs significantly. It is not possible to gauge the extent to which taxation concessions have been responsible for the increase in the number of part-time farms in Australia, but it seems safe to conclude that there has been an overall positive effect. To reduce taxes, some private companies have been purchasing farmlands to give to executives or to provide recreational facilities for them in lieu of cash [9]. While an overall lower cost may not provide *the* motivation for buying something, it is obviously a key factor in the decision to purchase. It is recognized that not all part-time farmers receive income

tax concessions—namely those defined as hobby farmers under the above guidelines.

SHOULD PART-TIME FARMERS BE GRANTED FULL PRIMARY PRODUCER INCOME TAX CONCESSIONS?

The encouragement of agricultural production has been offered as a reason for granting taxation concessions to primary producers [3]. This does not seem an especially appropriate goal of taxation concessions under current economic conditions. In any case, where large farms are broken up into farmlets for part-time operation, total production from the area may decrease [2, 11, 13, 14], although there was no evidence of this in [15]. In so far as more scope for using taxation concessions is offered by undeveloped land, and since farmlets tend to be concentrated near large cities, the concessions may hasten elimination of natural bushland in these areas [4]. Other undesirable consequences which have been attributed to farmlets have been: (i) the destruction of the traditional rural social way of life [14]; (ii) the elimination of commercial agriculture from the vicinity of cities.³

Against these “negative” aspects, the increase in the number of part-time farms may have helped to achieve certain socially desirable objectives. One is to boost decentralization, although most hobby farms are concentrated around large cities. Another is to alleviate rural poverty by raising farm land values. The third is to provide an alternative life style for city dwellers.

Thus it appears that there are both positive and negative aspects of the part-time farming explosion; however, the net effects are uncertain. Where particular social objectives have been met via small farm development, it is not clear that taxation concessions have provided the most efficient means of meeting these goals. Taxation concessions are indirect and unselective in their impact. One could imagine more cost effective policies for achieving specific objectives, or even the retention of taxation concessions on a selective regional or enterprise basis, where development was desired.

Possible methods for reducing taxation concessions to farmers with multiple sources of income are discussed in [4]. One of these methods is to grant “proportional” primary producer status, that is, to make primary production taxation concessions only in proportion to the amount of total income earned from primary production. Such a proviso currently exists in relation to income equalization deposits. A difficulty with this approach is that many “genuine” farmers are forced by financial necessity to seek part-time off-farm employment. A lowering of taxation concessions would exacerbate their problems.⁴

³ Via various mechanisms such as increasing rates, more concern over pollution from farms, and others [11].

⁴ However, since their deductions are at the marginal rate of taxation the deductions are worth significantly less to these people than to high income hobby farmers. This raises the broader question of taxation rebates *v.* deductions, a question which is not pursued here.

A modified version of proportional status would eliminate this undesirable feature. The lower the total income of a primary producer with additional income source the nearer he would be allowed to achieve full primary producer status. For example, a taxpayer with a total income of \$5,000 could be given full primary producer status regardless of the percentage of his income derived from primary production (i.e., he would be treated as the law currently stands). At a total income of, say \$20,000 or above, a taxpayer would be on full proportionality. That is, he could use the taxation concessions for primary producers, but only in the same proportion as the ratio of primary production income to total income.

CONCLUSIONS

Unless farms are run "purely as a hobby" then their owners are classified as primary producers. The current application of Australian income tax legislation is quite generous in terms of allowing part-time farmers to be defined as primary producers. A more discriminatory approach to the granting of primary production tax concessions to part-time farmers would lessen the attractiveness of this kind of operation. In so far as part-time farming has adverse social consequences, these would be reduced. If it is desired to promote part-time farming in particular regions or enterprises, then taxation concessions could remain, on a selective basis.

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