Agribusiness Intensive

Session 13: Taxation issues arising from alternative land use of primary production land.

Presented at the Agribusiness Intensive on 15-16 June 2023 Brisbane

David Hall CTA

Tax Partner Findex

Contents

1. **Overview** 5

2. **Conservation Covenants** 6

    2.1 Division 31: the tax deduction 6

        2.1.1 Eligibility 6

        2.1.2 Example: 7

        2.1.3 The deduction: 7

        2.1.4 Eligibility in detail 8

    2.2 Capital gains tax outcome 9

        2.2.1 D4 event 9

        2.2.2 CGT event D1 12

        2.2.3 Small Business CGT concessions? 12

    2.3 Other payments received in relation to conservation covenants 12

3. **Biodiversity Agreements and credits** 13

    3.1 D4 event 14

    3.2 Division 31 deduction? 15

    3.3 Biodiversity credits A1 event on sale? 15

        3.3.1 Proceeds 15

        3.3.2 Cost base of credits 15

        3.3.3 Small business CGT concessions 15

        3.3.4 Could the credits be on the income account? 16

    3.4 Other payments under the agreement: 16

4. **Carbon** 17

    4.1 Tax accounting for ACCUs 17

        4.1.1 Example: 17

    4.2 Treasury Laws Amendment (2023 Measures No. 2) Bill 2023 18

        4.2.1 Comparison of new and current law 19

    4.3 Carbon Sequestration rights: plant or manage forests: 20

4.4 Carbon sink forest deductions: 21

4.4.1 Requirements for deduction 21

4.4.2 What can you claim? 21

4.4.3 What can't you claim? 22

5. Wind and Solar Farms 23

5.1 D2 granting options to lease 23

5.2 Lease income 23

5.3 Restructuring property 23

5.4 Access to small business CGT concessions 24

5.4.1 Active asset? 24

5.4.2 Passively held? 24

5.5 Landowner conducts windfarm business. 24

5.5.1 Denmark Community Windfarm Ltd v Commissioner of Taxation 25

6. Lease, assignment, concurrent, residual 26

6.1 A concurrent lease 26

7. Farm stays/Agri tourism 29

7.1 Tax considerations 29

7.1.1 Income treatment: 29

7.1.2 Expenses: 31

*7.2 Identifying separate *business activities* 32

7.3 *A common-sense approach* 33

8. Compensation 34

8.1 The Practical 35

8.1.1 Factors and examples impacting the detriment to the surrounding land: 36

8.2 The technical: 37

8.2.1 Permanent damage or reduction in value of land 37

8.2.2 The look through approach 40

8.2.3 Underlying asset 40

8.2.4 Easements (D1 or A1) 44

8.2.5 Right to seek compensation: 45

8.2.6 Other amounts that are identified as part of the compensation: 46

1. Overview

Primary producers are looking to diversify their income stream with opportunities to supplement their on-farm income to increase profitability and buffer them in bad seasons. In addition, many primary producers see themselves as custodians of the land and are quick to identify, take advantage of and even champion environmental and sustainability initiatives.

At the same time primary producers are under increasing pressure from mining, coal seam gas, transport and electricity authorities who all want to access and impose on their land.

All these activities, whilst generating income and compensation, create taxation issues that need to be addressed.

This paper looks at several of these issues and highlights and addresses practical and commercial considerations, issues arising and the resultant tax issues including dealing with those tax issues.

There have been several excellent papers presented at the Tax Institute by Tom Delaney on many of these issues. This paper does not try to replicate Tom's work but instead looks to add onto some of the issues identified and work through several practical issues arising.

This paper considers conservation agreements, what they are and the tax considerations. Conservation agreements have been around for a few years now, but they are underutilised and, in many cases, correlate with primary producers' intentions on some of the tracts on their land. Covenants can also be quite useful in property development projects where early implementation of these covenants may reduce holding costs such as land tax and rates and may also enable the landowners to generate carbon credits or biodiversity credits.

The paper then considers Bio-diversity agreements, looking at the NSW scheme and tax outcomes before venturing into carbon credits and carbon sequestration. Attention is also focussed on the current Bill before parliament whereby the sale of ACCU's may attract a different tax treatment and be included in primary production income.

The paper then considers aspects of property owners leasing part of their property for solar and windfarms along with the tax issues and outcomes and then provides some practical considerations and planning. The paper then considers the tax outcome of property owners entering into concurrent leases over these installations.

Farm stays and agri-tourism and the taxation issues arising is addressed n the paper.

Quite a large part of the paper deals with compensation for damage to underlying land from mining, coal seam gas etc, and compulsory acquisitions. It is quite common for me to see landowners' agreements not getting things quite right and providing disadvantageous outcomes for the landowner. So, I spend some time on this topic and highlight some practical considerations that need to be considered as well as the tax implications.

2. Conservation Covenants

Many property owners have large tracts of land that they recognise have unique or special native flora and fauna or cultural significance that they wish to protect. In a lot of cases the owner of the land sees themself as multi-generational custodians.

Permanent protection can be achieved by entering into a conservation covenant over the land. As well as achieving environmental benefits, a conservation covenant may provide a tax deduction, but also trigger a capital gain or loss.

To obtain a deduction it is not just a matter of creating the covenant, but it must meet certain criteria and must be under a program approved by the Environment Minister.

These covenants can be entered into directly by the landowner with the government or with organisations under a program which the organisation (including DGR's) has successfully applied for approval in writing by the environment minister.

This paper is not intended to provide an exhaustive source of the programs, but some of these can be found here:[1]

2.1 Division 31: the tax deduction

s31.5(5) ITAA 1997

> *A* conservation covenant over *land is a covenant that:*
>
> *(a) restricts or prohibits certain activities on the land that could degrade the environmental* value *of the land; and*
>
> *(b) is permanent and registered on the title to the land (if registration is possible); and*
>
> *(c) is approved in writing by, or is entered into* under *a program approved in writing by, the* * *Environment Minister.*

Division 31 can provide for a deduction equal to the decrease in value of the land as a result of entering into the conservation covenant.

To be eligible for the deduction there are certain eligibility requirements (31-5,10,15).

2.1.1 Eligibility

You enter into the conservation covenant with a fund, authority or institution that satisfies subdivision 30-B "deductible gifts" or the commonwealth, state, territory or local governing body or a Commonwealth, State or territory authority.

1. The covenant must be:
   - On land you own (excludes leasehold),

[1] Approved conservation covenanting programs - DCCEEW

- perpetual, and registered on the title to the land if possible.
- restricts or prohibits activities on the land that could degrade the environmental value of the land,
- is either approved in writing by, or is entered into under a program that is approved in writing by, the Minister for the Environment and Heritage

2. You must not receive any money, property, or *material benefit* **<u>for entering into the covenant.</u>**

3. There must be a decrease in the market value of the land **<u>as a result of</u>** entering into the covenant.
    - The decrease in value must be more than $5,000 unless the land was acquired within 12 months.
    - Note Commissioner determines the decrease in market value, by providing a valuation certificate[2], the cost of the valuation is passed onto the applicant[3].

2.1.2 Example:

Bill & Mathilda own a cattle property that they purchased for $5M and which currently has a market value of $10M. They apply for a conservation covenanting program[4] and receive approval and then enters into a conservation covenant directly with the commonwealth government, the Environment Minister approves the covenant and Bill & Mathilda lodge a request for valuation – conservation covenant program form[5] with the ATO and pay a non-refundable application fee of $241.

The Commissioner provides a valuation certificate to them outlining the loss in value, as a result of the covenant as being $1M.
Providing all requirements are met, under s31-5, they can claim the $1M deduction in the current year or elect[6] to spread the deduction over 5 years.

2.1.3 The deduction:

The election, to spread the deduction, must be lodged before you lodge your tax return for the year you entered into the covenant[7]. The election does not require you to spread the deduction equally over the 5 years but does require you to stipulate the deduction for each year[8]. This is important as the deduction cannot result in a loss for the year[9]. You can vary the election[10] at any time, but only in relation to income years not yet lodged.

Let's revisit some of the requirements for a tax deduction.

---

[2] Section 31-15.08(1) Income Tax (1997 Act) Regulations 2021
[3] See section 31-15.03(1) Income Tax (1997 Act) Regulations 2021
[4] How to apply - DCCEEW
[5] Request_for_valuation_conservation_covenant_program.pdf (ato.gov.au)
[6] Conservation covenant deductions apportionment Election Form (dcceew.gov.au) & s30-248 ITAA 1997.
[7] See section 30-248 (3) ITAA 1997.
[8] See section 30-249 ITAA 1997.
[9] See section 26-55 ITAA 1997
[10] See section 30-248(4) ITAA 1997

2.1.4 Eligibility in detail

To obtain the deduction you must not receive any money, property or material benefit for entering into the covenant. The first two are obvious, but material benefit is a subjective term. The other important aspect is that these payments etc must be in relation to "for entering into the covenant". Therefore, at face value you may be able to receive funds to maintain that conservation area without falling foul.

Landowners who entering into a covenant under a biodiversity scheme (discussed later in this paper) and in return received biodiversity credits will be considered to have received a material benefit and will be denied the Division 31 deduction. This may differ for situations where you enter into the covenant, but separately apply to enter into a carbon credit scheme, on the same land. As the carbon credits were not provided for entering into the conservation covenant it arguably would not be considered a material benefit for entering into the conservation covenant.

The ATO does provide some guidance with ATOID 2002/678[11] on "material benefit", and TR 2005/13 *Income tax: tax deductible gifts - what is a gift*, and also private binding ruling 1051903212989[12] provides a more recent indication of the Commissioner's thinking.

The facts in the ATOID are:

> *The DGR has paid for all administrative costs for the covenant.*
> *It has also reimbursed the landowner's legal costs for the covenant.*
> *At the time of the covenant, the landowner and the DGR also entered into a management agreement.*
> *Under the agreement, the DGR provides advice, expertise and services in relation to the covenanted land.*
> *The landowner receives a fencing grant under a government program for land subject to conservation covenant.*
> *The local government rates payable by the landowner on the covenanted land are lowered because of the covenant.*
> *The landowner entered into the covenant to improve the saleability of other land it is developing on the other side of the road.*
> *The value of the developed land has increased because of the covenant.*

The reason for decision:

> *While the landowner has benefited from the lower rates and the fencing grant, they were not received 'for entering into the covenant'.*
> *It is not enough that a conservation covenant is merely prerequisite to receiving an otherwise unrelated benefit. Accordingly, the rate reduction and fencing grant do not prevent a deduction under Division 31.*
> *Any increase in the value of the land on the other side of the road is not a 'material benefit for entering into the covenant'. While there has been an increase in the value of the other land because of the covenant, this is not sufficient to conclude that a material benefit has been received for entering into the covenant.*
> *Also, the landowner's motive of improving the saleability of the other land does not prevent a deduction. A philanthropic or altruistic motive or intention is not a requirement for deduction under Division 31.*

---

[11] ATO ID 2002/678 Link: https://www.ato.gov.au/law/view/document?DocID=AID/AID2002678/00001&PiT=99991231235958

[12] Edited private advice 2021 Authorisation Number 1051903212989 "Conservation covenant" Link: https://www.ato.gov.au/law/view/document?DocID=EV/1051903212989&PiT=99991231235958

> *Any benefit to the landowner from the DGR under the management agreement is too remote from the covenant. The advice, expertise and services are not 'for entering into the covenant'. Accordingly, they do not prevent deduction under Division 31.*
> *On the facts, the agreement was not made pursuant to a non-arms' length arrangement between the landowner and the DGR to disguise consideration for the covenant.*
> *The meeting or reimbursing of the legal and administrative costs by the DGR is not considered to preclude deduction under Division 31.*

As can be seen from this ATOID, there may be other benefits that arise for the landowner that have some connection to the covenant, but this is not necessarily a material benefit for entering into the covenant.

2.2 Capital gains tax outcome

Separate from the tax deduction under Division 31 there is a possible D4 or D1 event for entering into the covenant agreement. Gains under both events are not excluded from access to the small business CGT concessions.

2.2.1 D4 event

The requirements, for a D4 event, are found at section 104.47[13]:

- You enter into the conservation covenant on land you own[14], and
- The time of the CGT event is when you enter into the covenant.[15]

While the D4 event has a broad reach there are exceptions, in which case a D1 event will result. These exceptions are found at section 104-47(6):

> *Section 104-47 Exceptions*
>
> *(6) ** ***CGT event*** *D4 does not happen if:*
>
> *(a) you did not receive any ** ***capital proceeds*** *for entering into the covenant; and*
>
> *(b) you cannot* ***deduct*** *an* ***amount under*** *Division 31 for entering into the covenant.*
>
> *Note: In this case,* ***CGT event*** *D1 will apply.*
>
> *(7) A ** ***capital gain*** *or ** ***capital loss*** *you* ***make*** *is disregarded if you ** ***acquired*** *the land before 20 September 1985.*

The exception means a D4 does not happen where the landowner did not receive any ***capital proceeds for entering into the covenant*** and is ***denied a deduction under section 31-5***[16]. That is the landowner must meet the requirements of both paragraphs for the exception to apply. In understanding the reasoning for this exemption, a little bit of contemplation and navel gazing should reveal to you that if you have no capital proceeds and denied a s 31-5 deduction, then you have no capital gain to deal with.

[13] ITAA 1997
[14] S104.47(1) ITAA 1997
[15] Section 104.47 (2) ITAA 1997
[16] Section 31 ITAA 1997

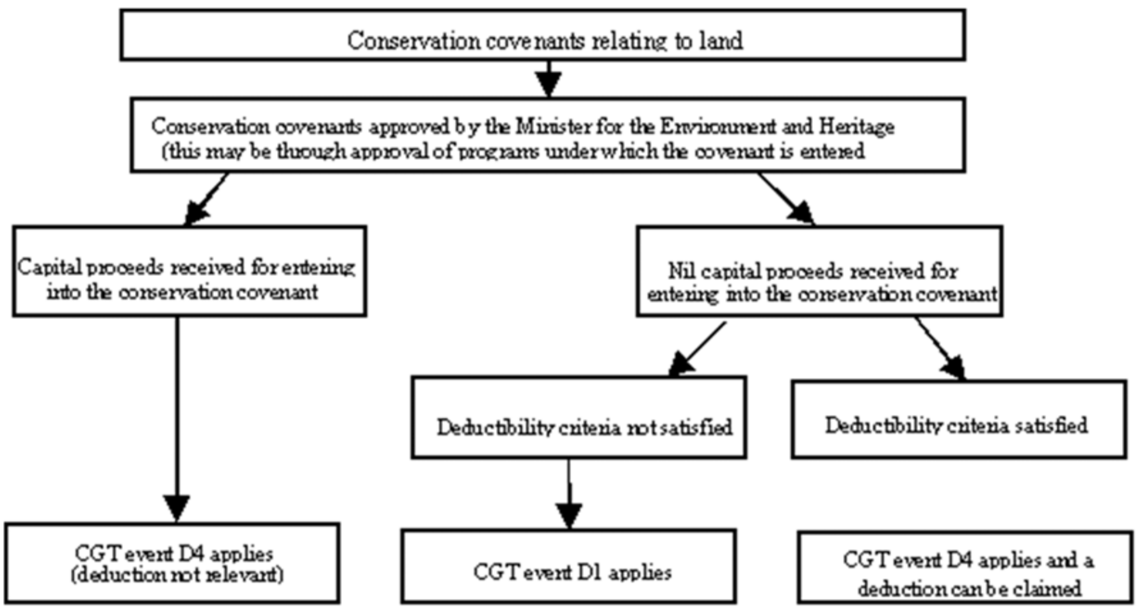
All possible scenarios are:

- No capital proceeds and no Div 31 deduction- exception applies – therefore D1 applies.
- No capital proceeds and Div 31 deduction- no exception applies – therefore D4 applies.
- Capital proceeds and no Div 31 deduction- no exception applies – therefore D4 applies.

(Capital proceeds and Div 31 deduction is not a possible outcome, because the Div 31 deduction can only be allowed if no material benefit is received.)

The Supplementary Explanatory Memorandum – SEN to the Taxation Laws Amendment Act (No. 2) 2001[17] provides some clarity on this: *CGT event D4 applies where a conservation covenant is entered into for capital proceeds, or for nil capital proceeds if a deduction is available.*

The Explanatory Memorandum provides a useful diagram:



Calculating the capital gain for D4 event

We need to then calculate the capital gain. Therefore, it is essential to determine what the proceeds are and the cost base along with any basis for apportionment.

Section 104-47(3) prescribes how the capital gain is calculated:

> *Section 104.47(3) You **make** a * **capital gain** if the * **capital proceeds** from entering into the covenant are more than that **part** of the * **cost base** of the land that is apportioned to the covenant. You **make** a * **capital loss** if those **capital proceeds** are less than the **part** of the * **reduced cost base** of the land that is apportioned to the covenant.*
>
> > ***Note:** The capital proceeds from entering into the covenant are modified if you do not receive anything for entering into the covenant: see section 116- 105.*

[17] https://www.ato.gov.au/law/view/document?DocID=NEM/SM200118/NAT/ATO/00003&PiT=99991231235958

*(4) The **part** of the * **cost base** of the land that is apportioned to the covenant is worked out in this way:*

$$\text{*Cost base of land} \times \frac{\text{*Capital proceeds from entering into the covenant}}{\text{Those capital proceeds plus the *market value of the land just after you enter into the covenant}}$$

*The **part** of the * **reduced cost base** of the land that is apportioned to the covenant is worked out similarly.*

*(5) The * **cost base** and * **reduced cost base** of the land are reduced by the **part** of the **cost base** or **reduced cost base** of the land that is apportioned to the covenant.*

Section 116-105 **Conservation covenants**

*If * **CGT event** D4 happens because you enter into a * **conservation covenant over** land you own and you can **deduct** an **amount under** Division 31 because you enter into the covenant, the * **capital proceeds** from the event are the **amount** you can **deduct**.*

*Note: To get a **deduction under** Division 31, you must not receive **money**, property or other material benefit for entering into the covenant.*

Example 2:

In simple terms and using Bill and Mathilda's example:

- *Original cost base $5M*
- *Division 31 deduction $1M*
- *Market value of property after covenant granted $9M*
- *Market value of property before covenant granted $10M*

$1M (capital proceeds ie Division 31 deduction) less ($5m / ($1M plus $9M)) = $500,000 capital gain.

Because the gain is from CGT event D4 the general 50% discount may apply.

Example 3:

Varying example 2 such that Bill & Mathilda received capital proceeds of $500,000.

As a result of receiving the capital proceeds, the modification to capital proceeds under section 116-105 does not apply and they would also be denied the Division 31 $1M deduction.

Therefore, they would still have a D4 event and the capital gain would be worked out as follows:

$$\$500{,}000 - \$5M \times \frac{\$500{,}000}{\$500{,}000 \text{ plus } \$9m} = \$236{,}842$$

2.2.2 CGT event D1

If you fail the D4 event requirements, then D1 may apply[18].For a D1 event, the capital gain will equal the capital proceeds from creating the right less the incidental costs of creating the rights[19]. There is no general 50% discount as the right is a newly created asset and specifically excluded as a discount capital gain[20].

The time of the event is when the right is created[21].

2.2.3 Small Business CGT concessions?

D4 Event

Providing the landowner meets the other requirements to the small business CGT concessions; you are entitled to reduce the capital gain by these concessions.

In example 3:

The $236,842 capital gain can be reduced potentially to nil.

D1 Event

The small business CGT concessions may apply but note s152-12 whereby you don't need to meet the requirements of 152-10(1)(a) and (d). That is, the CGT event doesn't have to happen in relation to an asset of yours and you do not need to meet the active asset ownership requirements under s152-35.

2.3 Other payments received in relation to conservation covenants

Other amounts may be received by the landowner that relate to the ongoing covenant, such as for ongoing maintenance and management of the covenanted area or for fencing requirements. These maybe treated as s 6-5 ordinary income, or s 20-20(2) indemnity or other assessable recoupment and potentially deductible under s8-1.

[18] See note in section 104-47(6)

[19] Section 104-35(3) ITAA 1997

[20] Section 115-25(3)(a) ITAA 1997

[21] Section 104-35(2) ITAA 1997

3. Biodiversity Agreements and credits

Several states have a biodiversity scheme with the federal government announcing a new national scheme, which is yet to be passed into law. The federal scheme is intended to involve issuing one Biodiversity certificate per project. The certificate will be considered personal property that is transferrable. The certificate will contain the details of the project to allow the market to value the certificate based on the project's attributes. The carbon credit system is intended to operate in tandem with this scheme.

For this paper I have looked at the NSW biodiversity credit system whereby landowners can enter into a Biodiversity stewardship agreement with the NSW Biodiversity Conservation Trust (BCT), in return for receiving biodiversity credits. The scheme involves entering into in-perpetuity agreements to permanently protect and manage an area of land.

Therefore, the scheme may meet the requirements of D4 in relation to the land.

A quick explanation on how this scheme works is required so to understand the potential tax outcomes.

On entering into the biodiversity agreement, the landowner provides:

- details of the specific actions that the landowner agrees to take to protect and manage the biodiversity values of the site including restricting certain activities.
- the number of credits created for the management actions.
- the amount of the Total Fund Deposit – which is the present value of the total of all the detailed scheduled managements payments in the agreement.

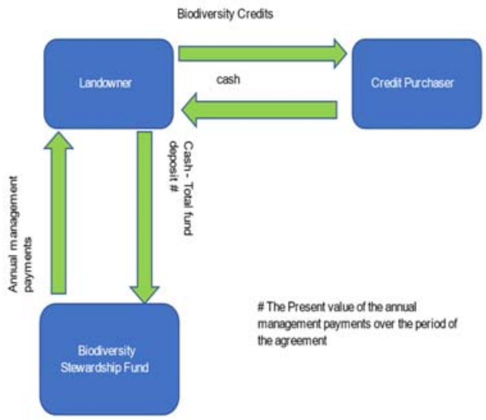
Once agreed the agreement provides the best estimate of the market value of the credits at the creation time. The value of these credits establishes the consideration for entering into the agreement and the cost base of the credits themselves.

These credits will be registered for sale on a public register. The seller and buyer will agree on a selling price. The selling price will obviously be the proceeds for the sale of the credits (less the Total Fund Deposit) and the cost base being the market value of the credits at issue. The capital gain being the difference.

Before those credits can be transferred to the buyer, an amount is required to be deposited to the Total Fund Deposit. The amount required depends on the proportion of credits sold. That is if there is 100% sold, then the required amount to be paid is 100% of the Total Fund deposit requirement.

The landowner, as part of the legal obligations under the agreement, will undertake management actions being both passive and active actions.

Once 80% of the Total Funds deposit is met, the active management actions are required to be done as per the agreed schedule. An annual report is submitted by the landowners and a schedule payment under the agreement is made to the landowner.



3.1 D4 event

The ATO, in a number of private rulings[22] has accepted that entering into a biodiversity scheme triggers an D4 event. The commissioner's view is also reflected in Class Ruling CR 2009/77. A CGT event D4[23] occurs upon entry into a Biodiversity stewardship agreement ("BSA") which can result in a capital gain or loss in relation to the land. As the biodiversity credits are a tradeable asset and would be considered property[24], the market value of those credits on initial issue, will be counted towards determining the capital proceeds[25].

The cost base of the covenant agreement is that portion of the land cost base that is attributed to the covenant[26].

Any resulting capital gain may be eligible to the 50% discount and potentially the small business CGT concessions.

Interestingly, the commissioner's view in CR 2009/77 makes no allowance for the liability to pay the Total Fund Deposit amount[27] However, the actual payment to the Total Fund Deposit is taken into account in determining the proceeds on the sale of the credits. However, the Commissioner in a number of private rulings[28] has indicated the opposite view that the payment of the Total Fund Deposit is an incidental cost to register the transfer and therefore are considered part of the cost base of the biodiversity credits.

There may be other incidental costs involved for entering into the agreement that would be included in the cost base.

[22] 1051831742603, 1051883788251, 1051875359264
[23] Section 104-47 ITAA 1997
[24] Section 108-5(1)(a) ITAA 1997
[25] Section 116-20(1)(b) & 103-10 ITAA 1997
[26] E 104-47 ITAA 1997.
[27] See Class Ruling CR 2009/77 &
[28] Authorisation Number: 1052083545411, Authorisation Number: 1051865289508, Authorisation Number: 1051875359264, Authorisation Number: 1051883788251,

3.2 Division 31 deduction?

Whilst the biodiversity credits are considered proceeds for determining any capital gain or loss for the D4 event, the receipt of the biodiversity credits has required the entering into the covenant on the land and therefore a deduction would be denied under Division 31.

3.3 Biodiversity credits A1 event on sale?

Biodiversity credits are a CGT asset[29].When selling the credits an A1 event[30] occurs for the landowner/owner of the credits, with a potential capital gain or loss occurring depending on the capital proceeds received[31] and the cost base of the credits[32].

3.3.1 Proceeds

The proceeds would be the consideration received from the sale. The Commissioner in CR 2009/77 excludes the amount required to be paid to the Total Fund Deposit[33] before the transfer can be registered. There is contrasting views in the number of private rulings previously mention, where the commissioner forms the view the payment to the Total Fund is incidental costs for the transfer of the credits when sold.

3.3.2 Cost base of credits

Section 110-25(2)[34] for determining the cost base of a CGT asset provides that the

> *first element is the total of:*
> *a) the money you paid, or are required to pay in respect of acquiring it; and*
> *b) the market value of any other property you gave, or are required to give, in respect of acquiring it (worked out at the time of the acquisition)*

The CGT asset we are dealing with at this stage are the biodiversity credits, which has an already established cost base. However, there would have been money's paid to acquire the credits, including application fees, consultant and legal fees[35]. Whether there has been a capital gain or loss on the D4 event has already been established. Therefore, the cost base of the credits would be expected to be the value at issue plus the incidents. As previous mention the commissioner's view in several private rulings is that the payment to the Total Fund is an incidental cost base item.

3.3.3 Small business CGT concessions

In determining eligibility for the small business CGT concessions, one of the conditions is the active asset requirement.

[29] Section 108-5 ITAA 1997
[30] Section 104-10 ITAA 1997
[31] Section 116-20(1)
[32] Section 110-25(2) ITAA 1997
[33] See Class Ruling CR 2009/77 paragraph 68
[34] ITAA 1997
[35] Section 110-35 ITAA 1997

A biodiversity credit would generally fail the active asset requirement of being used in the course of carrying on a business.

However, there is an alternative test for intangible assets.

The Commissioner has issued a number of private rulings[36] that are consistent with biodiversity credits being active assets, by meeting the alternative test for intangibles.

> *Extract from* 1051976577326
> *It must be demonstrated that, under paragraph 152-40(1)(b) of the ITAA 1997, the credits, as an intangible asset, are inherently connected with the farming business that is carried on (whether alone or in partnership) by you, your affiliate, or another entity that is connected with you.*
> *The conservation covenant is a permanent burden on the land, that would also burden the purchaser should the land be sold at a future point in time.*
> *The credits would not be received but for the conservation covenant on the land, which is used in the farming business. The credits are therefore inherently connected with that business and the land it uses to undertake that business. As the land is used in the farming, it is an active asset for the purposes of Section 152-40 of the ITAA 1997.*
> *As a result, the credits will be active assets under paragraph 152-40(1)(b) of the ITAA 1997 for the purpose of the small business CGT concessions.*

Also, the Commissioner has not claimed biodiversity credits would fail the active asset requirement as financial instruments.

3.3.4 Could the credits be on the income account?

The assumption above is that the creation of the credits and ownership of the property were all on capital account.

Should the property have been acquired to enter into a scheme to acquire the credits for sale, then potentially section 6-5[37] applies whether that is from carrying on a business[38] or profit from isolated transactions[39]. As the credits are a tradeable asset and can be readily convertible to cash section 21 and section 21A[40] would apply.

Section 118-20[41] would also apply to reduce any capital gain under the D4 or A1 event to the extent it has been included as income under s 6-5.

3.4 Other payments under the agreement:

Biodiversity stewardship payments made from the BCT are generally for performance of services and would normally be ordinary income of the landowner[42]. Any expenses incurred in performing those services would be generally deductible under s8-1[43].

GST applies to these payments as they do for the sale of the credits.

[36] Authorisation Number: 1051976577326; Dated: 27 April 2022, Authorisation Number: 1051782123023
[37] ITAA 1997
[38] Taxation Ruling TR 97/11
[39] Taxation Ruling TR 92/3
[40] ITAA 1936
[41] ITAA 1997
[42] Section 6-5 ITAA 1997
[43] ITAA 1997

4. Carbon

There are a number of carbon farming initiatives which can provide farmers an income stream. In this paper we will look at a number of these and the tax implications.

An Australian Carbon Credit Unit (ACCU) represents one tonne of carbon dioxide stored or avoided by the project or scheme.

4.1 Tax accounting for ACCUs

Division 420 [44] provides a taxing mechanism in dealing with the acquisition, holding and surrendering of emission units (which include ACCUs and Kyoto units). Section 420-5 outlines four key features of tax accounting for the emission units:

> *(1) You bring your gross expenditure and gross proceeds to account, not your net profits and losses on disposal of a registered emissions unit.*
>
> *(2) The gross expenditure is deductible.*
>
> *(3) The gross proceeds are assessable income.*
>
> *(4) You must bring to account any difference between the value of your registered emissions units held at the start and at the end of the income year. This is done in such a way that:*
>
> > *(a) any increase in value is included in assessable income; and*
> >
> > *(b) any decrease in value is a deduction.*

The emission units are not trading stock, but you bring to account as income any increase in value at year end. That is, you compare the value of the units at the beginning of the year and at the end of the year, the difference is either assessable income (gain) or a deduction (loss).

When you sell the units, the amount will be included as assessable income under s420-45.

There are three valuation methods to value the units at the end of the first year: FIFO[45], actual cost method[46], and the market value[47].In the first year you can choose any method, but the default is FIFO. In the following years you can continue to choose any method[48] except you are precluded[49] from using the cost method if the previous year you used FIFO.

4.1.1 Example:

> *Jim bought 200 ACCUs at $50 each (for $10,000) in January 2020. A deduction is available to Jim for the $10,000 for the 19/20 year. The value of a unit was $60 as at 30 June 2020. Jim*

[44] ITAA 1997
[45] See section 420-52, ITAA 1997
[46] See section 420-53, ITAA 1997
[47] See section 420-54, ITAA 1997
[48] See section 420-57, ITAA 1997
[49] See section 420-57(6), ITAA 1997

chooses the market value method to value the units at year end. Jim compares the value of the units at the start of the year ($nil) to the value at the end of the year ($12,000). Jim includes the $12,000 as income in the 19/20 year. Jim's taxable income is $2,000.

In the 20/21-year Jim sells the units for $70 each, Jim then needs to include $14,000 (200 x $70) as assessable income in that year. Jim then compares the value of the units at the beginning of the year $60 and the value $nil at the end of 20/21. Jim is entitled to a deduction of $12,000. Jim's assessable income will be $2,000 ($14,000 less $12,000).

As you can see from the above example, there is no great tax surprise along the way for taxpayers who purchase units, but what about a landowner who acquires units from their activities? They do not have a purchase price! The landowner can only deduct, under Division 420, the costs associated in becoming the holder of the ACCU (except for issue costs). These expenses are expressly limited to cost incurred in preparing and lodging an application for a certificate of entitlement or an offset report[50]. Therefore, the landowner would need to look to s8-1 for potential deduction for expenditure incurred. Consideration can be given to the primary producer deductions under 40-F and 40-F being water facilities, fencing assets, Landcare operations etc. However, the deductibility under these provisions are premised on the requirement[51] that the capital expenditure must have been incurred primarily and principally for use in carrying on a primary production business

Applying the consideration of the above into the example:

Example 2

Jim is issued 200 units instead of buying the units with a market value of $50 each.

As he was issued the ACCUs, he has no deduction for purchase and is limited to the costs such as his application and lodgement fees.

He had no ACCUs at the beginning of the year.

He needs to value the units at year end. He can choose any of the three methods:

- *For the cost method, cost is the market value at issue[52] which was $50.*
- *Market value at year end is $60*
- *FIFO is $50*

As he held no ACCUs at the beginning of the year, he would need to include $10,000 (200x $50) or $12,000 (200 x $60) as income in that year.

When he sells them in 20/21 for $70, he would include the $14,000 as income and claim the $10,000 or $12,000 as a deduction.

4.2 Treasury Laws Amendment (2023 Measures No. 2) Bill 2023

The government has a current bill[53] before parliament, which has passed the House of representatives and yet to be tabled in the Upper House. The Bill applies to **individual** primary

[50] S 420-15(4), ITAA97
[51] S 40-525 ITAA97
[52] S420-60(3) ITAA 1997
[53] Treasury Laws Amendment (2023 Measures No. 2) Bill 2023

producers, who first hold new ACCU's (first held on or after 1 July 2022). The Bill intends to treat the net proceeds from the sale of carbon credits as primary production income for the purposes of the Farm management Deposits and averaging provisions. Additionally, the legislation intends to change (for primary producers) the taxing point on the ACCU's to when they are sold. The treatment as primary production income will also extend to farm abatement activities. The Bill also makes it clear that the concessional treatment only applies to the landowner.

Interestingly, as we know FMD's and averaging only applies to individuals, the new law intends the changes will only apply at the individual level. This is as expected for the FMD's and averaging. But the bringing to account the net proceeds from ACCUs, only on sale, can only apply to an individual.

4.2.1 Comparison of new and current law[54]

New Law	Current Law
Proceeds from selling ACCUs and income derived from farm abatement activities supporting such units, are treated as primary production income for primary producers' eligibility for concessional tax treatment under the FMD Scheme and tax averaging.	Proceeds from selling ACCUs and income derived from farm abatement activities supporting such units are treated as non-primary production income and, accordingly, do not automatically qualify for concessional tax treatment under the FMD Scheme and tax averaging. Eligibility depends on the total amount of non-primary production income.
Holders of ACCUs that are carrying on a primary production business are taxed based on the net gain from their ACCUs in the year they are sold. Subdivision 420-D is still applicable to trusts. Individual beneficiaries will be taxed on the changes of the value of the Australian carbon credit units which are held by the trust.	Holders of ACCUs are taxed based on changes in the value of their ACCUs each year.

There are a number of exclusions[55] the new treatment:

> *3.23 Concessional tax treatment is only intended to apply to units issued under the Carbon Credits (Carbon Farming Initiative) Act 2011 in relation to an 'eligible offsets project'. Concessional tax treatment* ***will not apply to subsequent holdings of units*** *- if a primary producer disposes of a unit, and that unit is later acquired by a new holder or reacquired by the same primary producer, concessional tax treatment is not available for that unit.*
>
> *3.24 Incorporated farms are excluded, which essentially maintains the current arrangements in relation to eligibility for the Farm Management Deposit Scheme - that is, companies are not eligible for a Farm Management Deposit. The tax treatment set out in existing subdivision 420-D is intended to continue to apply for units held by companies and trusts.* ***When Australian carbon credit units are held by trusts and not disposed of,***

[54] Explanatory Memorandum to Treasury Laws Amendment (2023 Measures No. 2) Bill 2023
[55] Paragraph 3.23 of Explanatory Memorandum to Treasury Laws Amendment (2023 Measures No. 2) Bill 2023

> ***the beneficiaries will be subject to the existing treatment under Division 420-D in which the Australian carbon credit units will be taxed based on the increase or decrease in the value of the Australian carbon credit units. The derived income from the trusts by beneficiaries in this circumstance will not be considered primary production income.***

The intent of the above Bill makes it clear that for an individual, they are only taxed when the unit is sold. The averaging and FMDs will apply to the income from the sale.

But for entities including partnerships and trusts, the individual or partner will continue to be taxed on the increase in value, rather than when the unit is sold. The amount included as income will not be available to the individual for averaging and FMDs.

When the partnership or trust eventually sells the unit, the amount included as income of that entity will be included as income for that beneficiary (their share) or partner and that amount will be available for averaging and FMDs.

Example 3:

Applying the facts from example 2:

Jim would only be assessed in 20/21 year for the $14,000 when he sold them.

Jim can include in his primary production income $14,000 and also utilise FMDs to defer the income.

Clearly, this will remove the problems for taxpayers such as landowners where they are issued the ACCUs.

However, if Jim operated through a family trust, he would have been assessed under the current law.

Example 4

Jim's family trust owns the land and was issued the ACCUs worth $50 each in 2024 year.

At year end the units were worth $60 each

The family trust would need to include either $10,000 or $12,000 as income in the year.

Jim, as the only beneficiary of the trust, includes the $10,00/$12,000 as income. He cannot treat this amount as primary production income.

When the trustee sells the ACCUs in 2025 for $70 each, Jim includes the $14,000 as income and can claim the $10,000 or $12,000 as a deduction. Leaving him $4,000 or $2,000 as income and to which he can treat as primary production income.

4.3 Carbon Sequestration rights: plant or manage forests:

Under state government arrangements, farmers and landowners may mange or plant forests to participate in carbon sequestration activities.

In contrast to the tax treatment of ACCUs, CGT treatment can be available for carbon sequestration rights which are CGT assets.

Accordingly, the small business CGT concessions may be available.

4.4 Carbon sink forest deductions:

Tax deductions for capital expenditure can be available for establishing or acquiring a carbon sink forest (subdivision 40-J ITAA 1997). A carbon sink forest is established for the purpose of carbon sequestration, and not for felling or commercial horticulture. Carbon sequestration involves the trees absorbing and storing atmospheric carbon dioxide.

The deduction can apply whether you own or lease the land[56] with the establishment expenditure deductible at 7% per year for 14 years and 105 days.

.

4.4.1 Requirements for deduction

You or another entity must incur capital expenditure for establishing the trees in the income year or an earlier year, and you are carrying on a business in the income year at the time you hold the interest or rights in the trees.

You must use the land and forest for the primary and principal purpose of carbon sequestration by the trees and not for the purpose of felling the trees or using for commercial horticulture and not for use in a managed investment scheme or forestry managed investment scheme.

Trees must meet the requisite forestry characteristics and adhere to certain environmental and natural resource management guidelines.

At the end of the income year the trees must occupy in Australia, a continuous land area of 0.2 hectares or more andat the time the trees are established, it must be more likely than not, that the trees attain a crown cover of 20% or more and reach a height of 2 metres.

To claim the deduction you must complete the form *Notice of establishment of trees in a carbon sink forest* (NAT 72196)[57] and lodge it with your income tax return or 5 months after the end of the income year, whichever comes first.

4.4.2 What can you claim?

The capital costs that can be claimed as a deduction include:

- Acquiring trees or seed
- Raising tree seedlings in pots and potting mixtures
- Grafting and germinating
- Allowing seeds to germinate
- Preparing the area for planting
- Planting and
- Surveying the planted area.

[56] Section 40-1010 ITAA 1997

[57] https://www.ato.gov.au/uploadedFiles/Content/ITX/downloads/Carbon%20sink%20forest%20form%20n72196-10-2010.pdf

- The deduction rate is 7% of the relevant capital expenditure for 14 years and 105 days.
- The period starts from the first day of the income year in which the trees are established, with the 105 days claimed in the 15 year.

ATO example:

[Claiming a deduction for carbon sink forest expenses | Australian Taxation Office (ato.gov.au)]

> **Example**
>
> Nativ established a carbon sink forest in September 2015. He worked out that the establishment expenses were $20,000.
>
> The first year he can claim a deduction is the 2015–16 financial year. For the first year he can claim 7% of his establishment expenditure:
>
> - $20,000 × 7% = $1,400
>
> He can claim the same amount ($1,400) for the following 13 years, as long as he continues to use the land for carbon sequestration. In the 15th year he can claim the remaining amount, which is $20,000 – ($1,400 × 14) = $400.

4.4.3 What can't you claim?

Capital costs that cannot be claimed as a carbon sink deduction include:

- Access rights
- The land – see ATOID 2009/60
- Draining swamps or low-lying land or clearing land[58]
- Assets separate from the trees such as: fencing, water facilities, roads within forest, fire breaks, and
- Carbon credits to be traded in the future.

In situations where requirements for carbon sink deductibility are not met, other deduction provisions may potentially apply. For example:

- Section 8-1 may apply where trees are planted and maintained in the ordinary course of forestry activities (see ATOID 2004/78), or
- Subdivision 40-G may apply for Landcare operations (see ATOID 2004/714).

[58] Section 40-1020 ITAA 1997

5. Wind and Solar Farms

Landowners are generally approached by the energy provider to lease a portion of the land. Unlike mining, electricity providers and coal seam gas providers, who may acquire the land under threat of compulsion, the windfarm and solar providers, lacking any compulsive power, will look to merely lease the property. Generally, for a lease period of 30 years.

However, obtaining government approvals and permissions generally take some time and so the energy provider will want to lock in the site, which is critical in any application process. The energy provider, rather than purchase the property outright or immediately lease the portion of the property, may enter into an option agreement to convert the option into a lease once the relevant approvals have been obtained.

5.1 D2 granting options to lease

The granting of the option for a lease is a CGT event D2[59], the time of the CGT event is when it is granted. The proceeds are the consideration received by the landowner for entering into the agreement. The cost base would be expected to be the associated legals costs etc. As the option is newly created it would not be a discount capital gain.

The D2 event is disregarded[60] if the option is later exercised.

As the option may not be exercised, it is recommended a suitable option fee be negotiated.

5.2 Lease income

Lease income received would be ordinary income and not considered primary production income[61].

Care should be taken when entering these leases to ensure that the landowner is able to on-charge for rates and land tax as the change of use may change the rating and classification resulting in higher charges.

5.3 Restructuring property

Some thought should be given to have the land subdivided out from the remainder of the farm, to avoid problems with later finance, maintaining the future income stream after retirement, and sale of the remainder of the farm. The property could be held by the same or another entity. One option could be transferring the property to a superfund. This would allow an income stream to be generated in the superfund to fund retirement, separate from the other farm income activities and could be part of an effective estate and succession plan.

[59] Section 104-40 ITAA 1997

[60] Subsection 104-40(5) ITAA 1997

[61] Taxation Determination TD 2013/2

5.4 Access to small business CGT concessions

Should access to small business CGT concessions be available, a choice of a different entity owner may be considered for estate planning and handling future income streams. Moving the property to your superfund, separate from the farming entity, could provide the landowner with an effective estate planning strategy.

5.4.1 Active asset?

In utilising the small business CGT concessions, one of the basic conditions is for the property to be an active asset. Once the property starts to be rented, it would cease to be an active asset[62] but the active asset test[63] is over the ownership period.[64] Subdividing the property is not a CGT event[65] and doesn't restart your ownership period[66], so potential for the property to continue to access the concessions.

Consideration should be given as to whether in keeping the lease land on the same title, puts at risk future access to the small business CGT concessions on the whole farm. Depending on farm size and solar farm size, the mainly for rent exclusion[67] from active asset test could be problematic, depending on how long the property was owned before the portion was rented to the solar farm provider. Noting though the test is over the ownership period, so properties that have been owned in excess of 7 & ½ years[68] may not be at risk, but more recently purchased properties may have a critical transfer before date.

5.4.2 Passively held?

Care also needs to be taken, if the land has been subdivided, commenced being rented and then looking to transfer. If the landowner is wanting to rely on the passively held asset test[69] to access the $2M turnover test through the CGT small business entity, that is its connected entity or affiliate. Once the use is severed from that entity, then the passively held asset test is not available[70].

5.5 Landowner conducts windfarm business.

If the landowner undertook the wind farm themselves the activity would not fall under the definition of a *primary production business*[71].

---

[62] Subsection 152-40(4)(e) ITAA 1997
[63] Section 152-35(1) ITAA 1997
[64] Section 152-35(2) ITAA 1997
[65] Section 112-25 ITAA 1997
[66] Taxation Determination TD 97/3
[67] Section 152-40(4) ITAA 1997
[68] Section 152—35(1) ITAA 1997
[69] Section 152-10(1A) ITAA 1997
[70] Section 152-10(1A)(d) ITAA 1997
[71] Section 995-1(1) ITAA 1997

5.5.1 Denmark Community Windfarm Ltd v Commissioner of Taxation

Given the extent of alternate energy grants and subsidies it is useful to draw your attention to *Denmark Community Windfarm Ltd v Commissioner of Taxation*[72]. In this case the taxpayer argued that the grant they received was not an assessable recoupment because they claimed depreciation under Subdiv 328-D instead of under Div 40. Subdivision 328 was not listed in the table in 20-30.

The court found that either:

- 20-20(2) assessable recoupment by way of an indemnity applied which only required that you can deduct….. under any provision of the Act, or
- 20-20(3) other recoupment applied because the test merely required that you can claim a deduction under Division 40 being one of the provisions in the table under 20-30.

> *39. In the present case, the amounts received by Denmark under the Grant were received pursuant to the Agreement dated 18 May 2011. The Agreement provided that the Grant was to meet 50% of the Eligible Project Costs to be incurred by Denmark in the construction of two wind turbines, up to a maximum of $2,487,800. The Grant was payable in instalments on the completion of identified project milestones. In these circumstances, the amounts received by Denmark fell within the ordinary meaning of the word "indemnity", which includes, as noted by the primary judge at [50], "a sum of money paid to compensate a person for liability, loss or expense incurred by the person". The fact that the amounts were a government subsidy or rebate does not affect the position. The amounts nevertheless bear the character of compensation for a liability, loss or expense incurred.*[73]

Timing of bringing to account the indemnity.

So, what was the impact of the Grant as far as timing of the income under an indemnity?
Section 20-40[74] provides for the assessable recoupment to be brought to account to the extent of the deductions being claimed for the loss or outgoing.

In Denmark Community Windfarm it would have been claiming depreciation under Division 328. The facts from the case were *50% of the Eligible Project Costs to be incurred by Denmark in the construction of two wind turbines, up to a maximum of $2,487,800.*

Each year as the company claimed depreciation on those two wind turbines, they would need to bring to account a proportion of the indemnity. Subsection 20-40 (2) provides a method statement for calculating the amount of the assessable recoupment you need to bring to account.

[72] [2018] FCAFC 11
[73] Denmark Community Windfarm Ltd v Commissioner of Taxation [2018] FCAFC 11

[74] ITAA 1997

6. Lease, assignment, concurrent, residual

It is not uncommon for a landowner to be approached to lease a portion of their property, for example Telco telephone towers, wind farms, solar farms, etc. The tax treatment is relatively straight forward:- income is assessable, income is not primary production income, rental use is not an active asset- albeit a small portion of the farm may not put at risk the active asset status.

It is not unusual once these leases are in place for the landowner to be approached by a third party to take a concurrent lease so as to receive the lease payments, and lease the landowners' reversionary interest. The third party offers an upfront payment, and the underlying use of the land will revert back to the landowner at the end of the original lease.

These arrangements are concurrent leases.

6.1 A concurrent lease

A concurrent lease is a lease of your reversionary interest, that is your interest as a landlord in the lease, as well as your interest when that lease comes to an end.

To make it clearer this is the where the rights of the landlord, under the existing lease, passes to the new lessee under the concurrent lease. A new lessee steps into the shoes of the landlord and entitles them to the rental income under the original lease.

The concurrent lease may go shorter or longer than the original lease. If the concurrent lease goes longer, it may allow the lessee under the concurrent lease to take possession of the leased premises for the balance of time.

Note that some more recent Telco leases, the landowner may not have rights to enter into a concurrent lease without consent.

> *Example:*
>
> *Sue owns a property, and enters into a 10-year lease agreement, with 2 x 5 options, with Telstra.*
>
> *Telstra will install a phone tower.*
>
> *Sue is paid $15,000 a year.*
>
> *Consolidated Investments Pty Ltd approaches Sue and offers her $130,000 upfront to take over the lease for 15 years.*
>
> *Sue takes the money, as it is upfront, and any risk that Telstra may cancel the lease, now rests with Consolidated Investments Pty Ltd.*
>
> *Consolidated Investments Pty Ltd benefits from an ongoing revenue stream, that they purchased at a discount rate, and will take possession of the land for the remaining 5 years. The extra 5 years may allow them to re-negotiate a new lease with Telstra or another carrier as the old one expires.*

> *Consolidated Investments package up a number of these leases and sells them to a Canadian superfund.*

What is the tax outcome for Sue?

Sue will be assessed, as income, on the lump sum payment in the year of receipt.

Taxation Ruling TR 92/3

> *B - Conversion of stream of income to a lump sum*
>
> *Example 10*
>
> *95. A company carried on a manufacturing business and also derived income from the rental of a large number of properties. The company assigned to an unrelated party its right to receive rental income from the properties in return for a lump sum.*
>
> *96. The lump sum received is income. There has been a transfer of a right to a stream of income from property without the underlying property. The company has converted future income to present income.*

The High court in *Myer Emporium*[75] ruled that the consideration paid for the transfer of a right to future interest income was itself assessable income.

The Full Federal court in *Henry Jones (IXL)*[76] held the lump sum received for assigning its rights to royalties over a 10 year was assessable income:

> *``Where, however, a taxpayer assigns a chose in action, being a right to receive periodical sums, which when received would be income derived from underlying property which is retained and assigns that right in consideration of an amount which is calculated as the present value of that income stream, then I am of the view that that consideration should be seen as being as much income as the stream which it replaces, notwithstanding that it is paid in a lump sum rather than by periodical payments that are in substitution for the income stream."*[77]

In *Perron Investments*[78] Hill J:

> *In the present case, and to the extent that it is appropriate to refer to the royalty income as deriving from property at all, the property from which the income is derived (ie, the chose in action) cannot, without qualification, be said to continue in the ownership of the assignor. A part only of the rights encompassed by the equitable chose in action, which the appellant had, has been assigned. The assignments are limited both as to quantum and as to period. Subject to the terms of the assignments, the underlying right to take action against the payer of the royalty remains with the assignor. In that sense it can be said that there was an assignment of a right to receive periodical sums which when received would be income, in circumstances where the underlying chose in action is retained subject to the assignment and the right is assigned in consideration of an amount calculated as the present value of the*

[75] 87 ATC 4363; [1987] HCA 18,

[76] 91 ATC 4663; [1991] FCA 488,

[77] ATC 4675-4676; FCR 79

[78] PERRON INVESTMENTS PTY LIMITED v FC of T 93 ATC 4170

> *income stream. In my view, in those circumstances, the consideration should be as much seen as being income replacing the income stream assigned as was the consideration for the assignment in Henry Jones (IXL).*

7. Farm stays/Agri tourism

Farmers are looking to diversify their income stream and farm stays and Agri-tourism have become more popular as people want to experience the on-farm experience.

What does this look like?

Farm Stays

Generally, we are talking about using existing housing or conversion of out buildings and/or new or alternate accommodation (glamping) to provide short stay accommodation and the farm experience to visitors for a fee.

Agri-tourism

May involve farm stays, but can include farm tours, educational sessions to engage the visitors with the farm, employees and produce. Sale of produce may also occur.

7.1 Tax considerations

What are the tax considerations that your clients need to be aware of?

The farm stay income, at face value, would not be primary production income. Therefore, this opens a number of issues around recording the income and expenditure separately, apportioning deductions and may even cause some problems around non-commercial losses as it may be considered a separately identified business.

Can the farm stay income be treated a primary production income? Clearly providing short stay bed and breakfast and accommodation to guests would not meet the definition of a primary production business[79] and therefore would fail to be treated as primary production income. However, maybe there is an argument depending on scale and degree.

7.1.1 Income treatment:

SECT 392.80

Work out your taxable primary production income

Assessable primary production income

*(2) Your **assessable primary production income** for the * current year is the amount of your * basic assessable income for the current year that was * derived from, or resulted from, your carrying on a * primary production business.*

Section 995(1) ITAA 1997

"assessable primary production income" has the meaning given by subsection 392-80(2).

[79] S995-1 ITAA 1997

*"primary production business" : you carry on a primary production business if you carry on a * business of:*

(a) cultivating or propagating plants, fungi or their products or parts (including seeds, spores, bulbs and similar things), in any physical environment; or

(b) maintaining animals for the purpose of selling them or their bodily produce (including natural increase); or

(c) manufacturing dairy produce from raw material that you produced; or

In AAT Case 6254; AAT Case X82 21 ATR 3708; 90 ATC 599, Dr Gerber observed:

'The term 'in consequence of' connotes causality. It was a question of fact whether the interest was 'caused' to be derived as the 'predominant' or 'proximate' or 'direct' result of the carrying on of the business of primary production.'

The following two rulings provide some tacit support where the income activity is insignificant and perhaps where existing facilities are being utilised.

Taxation Ruling IT 210 *Application of averaging provisions - income from hire of farm plant:*

The position would, however, be different if, as an incidental part of carrying on his farming operations, a canegrower were to derive income through helping out a neighbour on occasions by hiring out or using his own harvester to harvest the neighbour's cane.

Taxation Ruling IT 225 *Primary production - agistment income:*

where income arises from the use of the assets of a business of primary production and the particular use is a recognised incident of carrying on that sort of business, the income may be regarded as forming part of the proceeds of the business.

3. While there may be some doubt that a general proposition such as this would cover every conceivable situation it would certainly cover the variety of circumstances in which primary producers derive income from the occasional use of the assets of their businesses in the course of carrying on those businesses. Examples would include:

(i) the grant of short term agistment rights to other primary producers;
(ii) short term hiring of plant from one primary producer to another;
(iii) amounts received for the use of stud stock.

4. On the other hand, however, the general proposition would not extend to a situation where property or a substantial part of a property is used solely for agistment, nor would it include receipts for the use of plant by a primary producer in general contract work.

One could see an argument in a situation where the farm stay utilises existing structures and is minor and not regular. But little support would be there, on the other end of the scale, where specialist buildings have been constructed, the activity is regular and significant.

What about agri-tourism

There may be a greater argument that this activity has more connection to the primary production business. It may promote their product to the market and encourage the sale of their product on the day or on-line. Certainly, for the sale of the produce it would meet the requirements of primary production business and the encouragement of the sale of their produce may be an incidental but and closely aligned part of the same business.

7.1.2 Expenses:

If you have established that there is a separate business, the need to separately identify the income and expenses become self-explanatory. Therefore, apportionment of shared buildings, plant & equipment, bank interest, employees, etc all come into play.

Taking this to its logical conclusion, if the farm stay business activity makes a loss or the primary production business makes a loss and the farm stay makes a profit, is it a sufficiently different business from the primary production business such that Division 35?[80] The non-commercial loss rules could be problematic for individuals?

What happens where an individual or partnership has two business activities one with a loss and one with a profit? We know that section 35 -10(3)[81] allows us to *group business activities of a similar kind.*

We can look to the Commissioner's ruling TR 2001/14[82] for some guidance on his interpretation. A useful table can be found in the ruling:

Factor	**"for" there being separate and distinct *business activities**	**"against" there being separate and distinct *business activities**
Location	Different types of activities carried on at different locations	Different types of activities carried on but all at the same location
Assets used	Different types of assets used in carrying on separate activities, with no, or very little, crossover or commonality of use	Some different assets used in carrying on separate activities but many assets common to all
Goods/Services produced (incl. market conditions)	Significant differences in the type of goods/services produced from the separate activities and in the conditions affecting their sale	Different types of goods/services produced but significant similarities in the manner produced and/or marketed

[80] Division 35 ITAA 1997
[81] ITAA 1997
[82] Taxation Ruling IR 2001/14 Div 35 non-commercial losses

Interdependency	No, or very little, interdependency between the separate activities	Separate activities carried on but significant level of interdependency between them in terms, for example, of working capital support, customer base, manner in which activities carried on
Commercial links	One set of activities inherently unprofitable and has no, or only minimal, commercial basis on which it could support the other activities	One set of activities may be inherently unprofitable but it supports the other activities, for example through increasing their sales base

TR 2001/14 provides some useful insight

*7.2 **Identifying separate *business activities***

*40. In Allied Mills Industries Pty Ltd v FC of T 88 ATC 4852 at 4864; (1988) 19 ATR 1724 at 1737, Gummow J acknowledged that a taxpayer might carry on "several distinct *businesses". Gummow J stated:*

*"Viewed in the light of the conduct of *business of the taxpayer as a whole, one cannot sensibly say that the taxpayer went out of *business or that the taxpayer parted with a substantial part of its *business undertaking, or that its profit-making apparatus was materially crippled.*

*It may be that activities of a taxpayer are so disparate in character and so discrete in the manner they are conducted, that one properly asks questions of the type posed by the facts of this case by reference to some but not the whole of those activities; examples of several distinct *businesses conducted by one taxpayer may be provided by the Board of Review decisions Case H100 (1956) 8 T.B.R.D. 457 (retail jeweller and real estate letting agent) and Case N38 (1962) 13 T.B.R.D. 161 (printer and seller of goods on commission). But, in my view, for the reasons I have given, the present is not such a case."*

*41. The same may be said for Division 35 about an individual taxpayer carrying on the one *business. In certain situations their *business activities may be so discrete in character and in the manner they are conducted that the question arises whether they are carrying on separate and distinct *business activities for Division 35 purposes. Whether this is so is clearly a question of fact and overall impression, like the question of whether they are carrying on a *business.*

*42. Given the purpose and context in which "*business activity" appears in Division 35, as noted already, such situations would also need to be ones where the separate *business activities were each capable in their own right of producing assessable income and having attributed to them amounts that would otherwise be deductible.*

*43. Further, and most importantly, to be identified as a separate *business activity for Division 35, within the statutory scheme referred to, the activity (or set of activities) will need to exhibit the following:*

> *• it produces a loss, in the sense that looked at as a separate activity there is clearly assessable income produced, or intended to be produced, from it, and otherwise allowable deductions attributable to carrying it on in excess of that income (otherwise Division 35 has no relevance);*
>
> *• its conduct is not motivated by factors connected with supporting in any commercial way the carrying on of the individual's other *business activities; and*
>
> *• it shows signs in its own right that it is unlikely to ever be profitable.*

*44. All these requirements need to be satisfied, though the greatest weight would typically be given to the last two. For example, an activity might exhibit the first, and the last, but not the second requirement, because it assists in a genuinely commercial way, the carrying on of the individual's other *business activity: see **Example 1** (paragraphs 120 to 123) in the Examples part of this Ruling. Such an activity would not be identified as a separate *business activity for Division 35 purposes.*

7.3 *A common-sense approach*

*47. To sum up, identification of what are the individual taxpayer's relevant *business activities is to be done on a common-sense basis without looking to create artificial distinctions between various parts of their overall *business. This will often mean that the relevant *business activity is the individual's whole *business.*

*48. However, where an individual taxpayer carries on several distinct *businesses it follows that they carry on several distinct *business activities for Division 35 purposes.*

The conclusion is that it is possible for the business activities to be grouped for determining whether Division 35 would deny a loss in one of the activities. But is it very much a factual question.

The agri-tourism business may have a stronger case, but it will depend on the facts and circumstances of the business.

8. Compensation

Many farmers are subject to non-farm impositions on their properties such as power lines, telephone towers, pipelines, coal seam gas, mining, exploration, road access etc. The relevant legislation and authorities may provide for compulsory acquisition or access to the land, recognition of permanent damage to the land, but the various legislation requires those entities to provide reasonable compensation to the landowners.

The tax outcomes for compensation received by farmers can differ significantly, depending on a range of tax and non-tax factors.

Characterisation of the compensation will be critical to the tax outcomes.

Compensation in relation to …	Tax Outcome
The underlying asset that is being disposed of	Capital (A1 event) – apportionment of land cost base
The underlying asset that is expected to suffer permanent damage or has been permanently reduced in value	Capital – no CGT event, but reduction of cost base of property s110-40(3) & s110-45(3)
Right to seek compensation, with no underlying asset	Capital – C2 event upon termination of right – but may have little cost base other than legals
Whether an asset is being disposed v creation of a right	Capital - D1 event or D2 for creation - no 50% discount, little cost base. Capital - A1 for disposal, apportionment of cost base.
Loss of future and current income	Income- s 6-5.
Disruption to business operations	Income- s 6-5.
Compensation for or reimbursement of additional costs	Income – s 20-20 (assessable recoupment), s 6-5. Capital?- detriment to value of the land? If so potential s110-40 or 110-45 if permanent
Reimbursement for work and services to be performed by landowner on behalf of acquirer.	Income – s6-5, s20-20 (assessable recoupment).

With tax outcomes varying from ordinary income (the worst tax outcome), to CGT on a part disposal of land (with potential CGT discount and small business CGT concessions), to no ordinary income and no CGT (the best tax outcome), tax advisers have the opportunity to help farmers in negotiating their compensation packages.

8.1 The Practical

Generally, the landowner is eligible for compensation for the damage and imposition on their land. The impost can take the form of full resumption, creation of an easement, right of access or both and generally restricts the landowner from the full use of the land or provides for restricted use.

This practical discussion is about where possible, formalising the identification and quantification of the components of a compensation agreement. It is my view that this is extremely important and therefore I have chosen to put this to the front of the discussion, before providing greater detail on the tax outcomes and the need to identify the underlying asset in compensation agreements.

It is critical the compensation agreement provides for the correct and best outcome for the landowner. But the landowner's tax outcomes and the components of the compensation payment may not be a high priority for the mining company, authority etc and their legal advisers. I like to think this is more about expediency and having one agreement model.

First and foremost, the landowner should seek a valuation, which may be required to be funded under the relevant legislation.

Second, it is important that the valuer is fully informed of the issues that will arise and the concerns of the landowner. Some of the issues raised may not change the values or apportionment but bringing them to the attention of the valuer puts the valuer in the best position to make an informed valuation.

In my experience, ensuring the valuer is fully briefed along with the property owner's legal and tax adviser will mean that a more accurate picture of the impact on the property including the various components are identified. The landowner may not receive any more compensation from this process, but it will allow a more accurate identification and attribution of the components of the compensation.

Once this process is complete, ideally any agreement will incorporate the identification of the compensation opponents, but even if this is not achieved, the valuation process itself may be relied upon to identify the components and value attributed.

Factors that are important in any agreement:

- Identifying the detriment to the surrounding land and underlying land and obtaining correct valuations considering the true detriment.
- that the agreement is being done under the threat of a compulsory power
- apportioning the values appropriately between the detriment to the surrounding land, damage and or detriment to the underlying land, any easement and right of way and compensation for any increased costs.

I should highlight in mining compensation cases, much of the compensation rightly does relate to the permanent damage to the underlying land whether there is damage to the underlying land or diminution of the value of the surrounding land- the same tax outcome occurs. So, I have chosen to not concentrate on the subtleties between them.

I want to spend some time now on the practicality of determining the detriment to the surrounding land or damage to the underlying land, as quite often this is the major result and therefore major component of any compensation. However, in my experience where compulsory acquisitions or compulsory easements are concerned not enough consideration is given to the impact this has on the surrounding land. Yet the value attributed to the damage to the underlying land or detriment to the value of the surrounding has the best tax outcome.

8.1.1 Factors and examples impacting the detriment to the surrounding land:

Factors that should be considered in seeking compensation for permanent reduction in value or permanent damage to farmland – for example where an easement is to be granted – include:

- Free roaming of livestock does not occur (property split in two), requiring more intensive livestock management to move cattle.
- Traffic onto the property is uncontrolled and introduction of weeds and pests is more probable.
- Potential unsupervised and unsighted use of chemicals on property.
- Depending on use of easement ie power lines etc there may be restricted use of Mustering helicopters within a greater range.
- Restricted use of electric fences within range of power lines, both resulting in increased livestock management.
- Split property or restricted use may require logistical issues for movement of equipment.
- Required change of harvesting techniques- split property or obstacles
- Potential contaminated water
- Risk to organic farming accreditation and tick eradication.

Certainly, the above list is not exhaustive and no doubt when talking to the landowner many more issues may arise.

And this same discussion is relevant to situations where no easement is created, but the use of land is otherwise restricted or used by other parties such as for mining and coal seam gas.

Importantly, don't fall into the trap that increased identified costs means income compensation. These increased costs may also mean there has been a detriment to the property value because the costs, to farm on that particular property, have increased.

The answer to this question – of whether there has been a reduction in the value of surrounding land, or merely an increase in ongoing business costs – s best answered in the following illustration:

Bob is a prospective purchaser of one of two properties on the market.

Both properties sit side by side and have the same characteristics.

One of the properties; York, has an easement created on the property, by the electricity authority, for high voltage power lines.

The property next door has no such easement.

All things considered would you expect Bob, as an astute buyer, to pay marketable different prices for the properties if he considered the issues as having a real impact on how he conducts his business?

If the answer is yes, then the surrounding land has had detriment.

The market will clearly reflect the fact that such impositions on land can harm the value of surrounding farmland.

So why is the apportionment of any compensation between the detriment to surrounding land, permanent damage to the underlying land and the creating of the easement and other components important?

The receipt of compensation payments has different tax outcomes, and generally follows the character of what is being replaced. Sometimes it is not clear what the compensation is for, especially where the parties are in dispute, resulting in a compromised amount. The importance of the agreement and the valuation becomes paramount but must be factually supported.

8.2 The technical:

8.2.1 Permanent damage or reduction in value of land

Permanent damage or diminution of the land is not a disposal of an asset and therefore not a CGT event. The Commission deals with this in Taxation Ruling 95/35[83] and treats the amount attributed to the damage or diminution as a partial recoupment of the purchase price of the property. Subsection 110-45(3) & subsection 110-30(3) are the modern equivalents of subsection 160ZH(11). The result is that rather than generating a capital gain, the property's cost base is reduced by the amount of the compensation and any excess will be a windfall gain.

> *Compensation for permanent damage to, or permanent reduction in the value of, the underlying asset*
>
> *6. If an amount of compensation is received by a taxpayer wholly in respect of permanent damage suffered to a post-CGT underlying asset of the taxpayer or for a permanent reduction in the value of a post-CGT underlying asset of the taxpayer, and there is no disposal of that underlying asset at the time of the receipt, we consider that the amount represents a recoupment of all or part of the total acquisition costs of the asset.*
>
> *7. Accordingly, the total acquisition costs of the post-CGT asset should be reduced in terms of subsection 160ZH(11) by the amount of the compensation. No capital gain or loss arises in respect of that asset until the taxpayer actually disposes of the underlying asset. If, in the case of a post-CGT underlying asset, the compensation amount exceeds the total unindexed acquisition costs (including a deemed cost base) of the underlying asset, there are no CGT consequences in respect of the excess compensation amount.*
>
> *8. The adjustment of the total acquisition costs effectively reduces those costs by the amount of the recoupment as if those costs had not been incurred. This means that indexation is not available in respect of the recouped amount. Refer to Examples 3 to 6 in this Ruling.*
>
> *9. Compensation received by a taxpayer has no CGT consequences if the underlying asset which has suffered permanent damage or a permanent reduction in value was acquired by the taxpayer before 20 September 1985 or is any other exempt CGT asset.*

[83] Paragraph 6-9 of Taxation Ruling 95/35

It is worth noting that a compensation amount attributed to the easement would be taken into account in determining a capital gain, whilst the amount attributed to the permanent damage or reduction in value of the surrounding land merely reduces the cost base of that land and may create a tax-free windfall.

It must be recognised that the in-coming party may want to emphasise the easement or access area, and the landowner may be incentivised to identify and maximise the value attributed to the easement, in many cases it is the surrounding land that has suffered the greater impact.

Note there may be detriment to landowners and their tax outcomes if the valuations used by compensation-payers are accepted uncritically. Valuations which are more specific to landowner circumstances, and which take into account the range of effects on the surrounding land, can be beneficial in terms of negotiating with compensation-payers and also achieving more appropriate tax outcomes.

Where the compensation-payer is reluctant to identify a specific amount for detriment to surrounding land or seeks to attribute an excessive amount to the easement/access area, it is important that the compensation agreement does not include terms that could prevent the landowner from making an appropriate allocation of the compensation received.

One response to these difficulties can be for an agreed *en globo* compensation amount. In this situation the landowner will be able to ensure a reasonable attribution on the basis of a valuation or other reasonable grounds.

Another response can be to ensure no overstatement occurs for specific amounts required of the compensation-payer – for an easement, for loss of income, etc as set out in the compensation agreement. In this situation the balance of the agreed compensation can be referred to in more general terms in the agreement, if the compensation-payer is averse to referring directly to the damage etc to surrounding land. Again, this will permit the landowner to make a reasonable attribution.

The courts have over time provided some useful guidance in determining how these compensation agreements are to be applied in a tax environment. In addition, the commissioner issued Taxation Ruling TR 95/35 which provides a useful guide on the commissioner's view.

Fullager J, in FCT v Dixon[84] *stated:*

> *"It acquires the character of that for which it is substituted and that which is added"*

To put the earlier discussion into perspective, the heavy lifting has been done following the practical approach. The technical discussion highlights the need to look through the agreement and identify the underlying assets in a compensation agreement and resulting tax outcomes.

Importantly, the existence of ambit claims during negotiation does not set the scene, nor dictate what the final compensation components are made up of. Quite often a settled amount is agreed to that does not bear any semblance to the claim.

McLaurin v Federal Commissioner of Taxation[85]: Is a useful case as it highlights this issue.

In the case, the landowner received an undissected lump sum amount for compensation resulting from a fire caused by the Railway. The case involved claims for negligence and damages, the claim of

[84] *(1952) 86 CLR 540*

[85] 104 CLR 381 1961 - 0307C - HCA

PD30,000 by the landowner listed a number of items that were both income and capital in nature. The parties settled instead for PD12,350 as an undissected amount. The commissioner initially argued that the amount received should be apportioned based on the initial claim and then argued the whole amount should be income.

The court found:

> *It is difficult in these circumstances to see how the dissection which the respondent has made can possibly be justified. All that has been urged in support of it is that the Commissioner for Railways should be considered to have paid the PD12,350 as the total of the separate amounts which were allowed in Mr. Cameron's list, and that each of those amounts must be separately included in or excluded from the appellant's assessable income upon consideration of the nature of the item to which it related in the list. The submission neither accords with fact nor squares with legal principle. It does not accord with fact, for an account of the manner in which Mr. Cameron reached his total is only an account of his reasons for the recommendation he made to the Assistant Solicitor for Railways; and even though those reasons may have been adopted by that officer, or even by the Commissioner for Railways himself, the offer that was made was not of a total of itemized amounts, but was of a single undissected amount. And in point of law it would plainly be unsound to allow a determination of the character of a receipt in the hands of the recipient to be affected by a consideration of the uncommunicated reasoning which led the payer to agree to pay it.*
>
> *It is true that in a proper case a single payment or receipt of a mixed nature may be apportioned amongst the several heads to which it relates and an income or non-income nature attributed to portions of it accordingly: Texas Co (Australasia) Ltd v Federal Commissioner of Taxation;* [86] *Ronpibon Tin N. L. and Tongkah Compound N.L. v Federal Commissioner of Taxation;* [87] *The National Mutual Life Association of Australasia Ltd v Federal Commissioner of Taxation.*[88] *But while it may be appropriate to follow such a course where the payment or receipt is in settlement of distinct claims of which some at least are liquidated, cf. Carter v Wadman,*[89] *or are otherwise ascertainable by calculation: cf. Tilley v Wales,*[90] *it cannot be appropriate where the payment or receipt is in respect of a claim or claims for unliquidated damages only and is made or accepted under a compromise which treats it as a single, undissected amount of damages. In such a case the amount must be considered as a whole: Du Cros v Ryall.*[91]
>
> *The answer to the question in the case stated must be that no part of the sum of PD10,640 should be treated as included in the appellant's assessable income.*

[86] (1940) 63 C.L.R. 382, at p. 466
[87] (1949) 78 C.L.R. 47, at p. 55
[88] (1959) 102 C.L.R. 29 , at p. 50
[89] (1946) 28 Tax Cas. 41
[90] [1943] A.C. 386
[91] (1935) 19 Tax Cas. 444, at p. 453

8.2.2 The look through approach

The above approach to surrounding land is supported by the "look through" approach.

Taxation Ruling TR 95/35 ***Income tax: capital gains: treatment of compensation receipts*** supports the view that you look through the agreement to identify the underlying asset/s the compensation is for.

Fundamentally a look through approach would involve looking through the compensation agreement and identifying all possible assets in order to determining which assets the compensation is most likely related. It there are a number of affected assets it would be reasonable to apportion the compensation across those assets. However, this is not to say the compensation was for all affected assets and is especially important where the compensation falls well short of the expected amount. It may be that the landowner was only able to sustain an argument for compensation on some items.

Davies J in *FC of T v Northumberland Development* Co said:[92]

> *It is not in dispute that a sum or sums received as compensation for the compulsory acquisition of property can be dissected or apportioned into capital and income elements if there is an appropriate basis for doing so.*

Taxation Ruling TR 95/35 refers to a number of cases that whilst assisting in identifying the underlying asset also address issues such as whether regularity changes the nature of the payment.

> *The look-through approach is the process of identifying the most relevant asset. It requires an analysis of all of the possible assets of the taxpayer in order to determine the asset to which the compensation amount is most directly related. It is also referred to in this Ruling as the underlying asset approach.*[93]
>
> *70. Warner J in Zim Properties v. Procter (Inspector of Taxes) [1985] STC 90; 58 TC 371…. His Honour considered that the choice of which was the most relevant asset depended on the 'reality of the matter'.*

8.2.3 Underlying asset

Identifying the underlying asset is essential in using the look through approach.

Taxation Ruling TR 95/35[94]

> *Underlying asset*
>
> *The underlying asset is the asset that, using the 'look-through' approach, is disposed of or has suffered permanent damage or has been permanently reduced in value because of some act, happening, transaction, occurrence or event which has resulted in a right to seek compensation from the person or entity causing that damage or loss in value or against any other person or*

[92] 95 ATC 4486

[93] Taxation Ruling TR/95/35 key term

[94] definition in its *Key Terms*:

> *entity. If there is more than one underlying asset, the relevant underlying asset is the asset which leads directly to the payment of the amount of compensation. For example, if a taxpayer receives an amount of compensation for the destruction of his or her truck, the truck is the underlying asset.*

Barrett v FC of T (1968) 118 CLR 666, is a useful case in identifying the underlying asset. It involved an agreement by a mining company to compensate, on a biannual basis, the landowner for damage and loss of value to the property because of the mining operations. The compensation was to be paid on a tonnage basis; of soap stone removed. The judge found that the payment was not a royalty, and the payment was for the damage and loss of value.

> *It is true that the amounts paid to the appellant were calculated on the basis of the tonnage of soapstone mined in each year but, in my opinion, they are not for this reason to be regarded as payments of royalties. The soapstone belonged to the Midland Company and not to the appellant and a royalty - when one is speaking of mining operations - is a "payment to the owner of minerals for the right of working the same on every ton or other weight raised"*[95]

The above case would be considered a partial reimbursement of the cost of the property and therefore cost base reduction under s110-40(3) & s110-45(3)

TR 95/35 identifies another case *Carborundum* where the damages resulted from negligence in inspecting and reporting on a property. This resulted in the plaintiff paying too much for the property. The underlying asset would be the property and the compensation would be a partial reimbursement of the cost base.

> *78. ….., in Carborundum Realty Pty Ltd v. RAIA Archicentre Pty Ltd and Graeme McDonald 93 ATC 4418; (1993) 25 ATR 192, Harper J suggested that the compensation receipt should be linked to the underlying asset in determining whether the plaintiff had received any capital gain. Harper J found that the defendant was liable to pay damages as compensation for the defendant's negligence in inspecting and reporting on the condition of a residential property owned by the plaintiff.*

The income v capital debate:

Identifying the underlying asset will potentially arrive at the income v capital debate and very much it gets down to identifying what is the compensation for.

In *G.P. International Pipecoaters Pty. Ltd. v. Federal Commissioner of Taxation (1990) 170 CLR 124; 90 ATC 4413; (1990) 21 ATR 1* (*GP International*) the High Court stated that:

> *'To determine whether a receipt is of an income or a capital nature, various factors may be relevant. Sometimes, the character of receipts will be revealed most clearly by their periodicity, regularity or recurrence; sometimes, by the character of a right or thing disposed*

[95] paragraph 6 Barrett v FC of T (1968) 118 CLR 666

> *of in exchange for the receipt; sometimes by the scope of the transaction, venture or business in or by reason of which money is received and by the recipient's purpose in engaging in the transaction, venture or business.'*

Loss of income

TR 95/35[96] provides a useful guide on income compensation. In particular, the following cases extracted from the ruling identify that the loss of income was the most relevant asset.

> *74. In* Case Z21 *92 ATC 218;*Case 7870 *(1992) 23 ATR 1162, the Administrative Appeals Tribunal (P W Johnston, Deputy President) accepted that $165,000, received on the termination of a management agreement, was compensation for loss of future earnings, and therefore assessable income. The amount was received as compensation for the repudiation of the agreement, and was paid to avoid paying damages arising as a result of the termination of the agreement. The Tribunal found that the receipt stood in the place of damages to compensate for the loss of future profits, and not for the loss or destruction of the facility or business asset which the company would have exploited to earn those management fees.*
>
> *75. Although it considered it strictly unnecessary to do so, the Tribunal also made some observations about the application of the CGT provisions. The Tribunal expressed the opinion that the relevant asset was the right of the company to receive management fees while the agreement continued.*

Federal Commissioner of Taxation v. Inkster[97] : Compensation payments which substitute income have been held by the courts to be income under ordinary concepts.

A lump sum compensation amount for the loss of a future income stream will generally be considered assessable income[98]

Taxation Ruling TR 92/3: *An amount received for the transfer of a right to an income stream severed from the property to which it relates is income according to ordinary concepts. Future income is simply converted into present income.*

---

[96] definition in its *Key Terms*:

[97] *(1989) 24 FCR 53; (1989) 20 ATR 1516; 89 ATC 5142*

[98] FCT v The Myer Emporium Ltd (1987) 163 CLR 199; 87 ATC 4363; 18 ATR 693

Loss of Capital

The ruling[99] at paragraph 79 refers to Tuite[100], the underlying asset was the *"reduction in the capital value of the shares in the Wenmar business"* caused by an exiting shareholder breaching a restraint of trade agreement and becoming a direct competitor. *Shepherdson at 93 ATC 4299; 25 ATR 91:*

> *'If the contract had been performed Cradex would not have existed and been trading in competition with Wenmar at 19 June 1991 ... [T]he first plaintiffs are entitled to damages for the reduction in the capital value of the shares in the Wenmar business.'*

In *Nullaga Pastoral*[101] the court found that a single lump sum or a series of payments shows no support for it to be treated as income to the extent the amounts are referable to a diminution in the value of the land.

Nullaga entered into an agreement with two companies who held a right to explore the property for bauxite. Under the agreement Nullaga was to be paid $10,000 a year for 5 years for compensation for deprivation of possession of the land and for interference in its farming activities. If they ceased during that period, the full $50,000 was still payable. If mining operations commenced Nullaga would receive 5 cents per ton up to a maximum of $400,000. To date only $20,000 had been received.

The commissioner argued the amount received was income because of its periodic nature and was analogous to payments for a lease or license therefore income as rent[102]. Wickham J[103] following the earlier decision of Barrett[104] concluded that after considering the terms of the agreement: '*I think that these payments were patently paid and received as compensation to the taxpayer for interference with and damage to the land and diminution in its value resulting from operations carried on or proposed to be carried on'*.[105]

The commissioner also provided his views in Taxation Determination TD 93/58:

> *1.It is assessable income under subsection 25(1) of the Income Tax Assessment Act 1936 (ITAA):*
>
> > *(a) if the payment is compensation for loss of income only e.g. past year profits, and/or interest (even when the basis of the calculation of the lump sum cannot be determined); or*
> >
> > *(b) to the extent that a portion of the lump sum payment is identifiable and quantifiable as income. This will be possible where the parties either expressly or impliedly agree that a certain portion of the payment relates to a loss of an income nature [cf. Mc Laurin v. FC of T (1961) 104 CLR 381; (1961) 8 AITR 180 and Allsop v. FC of T(1965) 113 CLR 341; (1965) 9 AITR 724].*
>
> *……………………...*

[99] Taxation Ruling TR95/35
[100] *Tuite v. Exelby* 93 ATC 4293; (1992) 25 ATR 81
[101] Nullaga Pastoral Co Pty Ltd v FC of T 78 ATC 4329
[102] 78 ATC 4329, 4331.
[103] Supreme Court Western Australia
[104] Barrett v FC of T (1968) 118 CLR 666
[105] 78 ATC 4329, 4331

3. In the circumstances of paragraph 1 (a) there is a receipt of income only, that is, there is no capital component in the payment. It is therefore not relevant that the basis of the calculation of the lump sum cannot be determined.

4. In the circumstances of paragraph 1 (b) there is included in the lump sum a receipt of a capital nature, but the `ingredients' of the payment can be identified, and therefore the portion of the payment which relates to income is assessable

The above cases reflect the concept that you need to identify the underlying asset, let us now look at some of these underlying assets and their tax treatment.

8.2.4 Easements (D1 or A1)

A common compensation claim is for the granting of an easement. However, the granting of the easement is considered by the Commissioner[106] to be a D1 event[107] "creation of a right" with little no cost base[108] other than the cost of granting the right. Being a newly granted right, it is not a discount capital gain[109], nor can it be pre-cgt. However, D1 is a CGT event that is not excluded from the small business CGT concessions and does not necessarily need to meet the active asset test[110], but needs to be inherently connected with the active asset that entity owns[111].

The commissioner's view[112] is different (A1 event) where the easement is acquired through compulsory acquisition, by an authority or even by agreement with the authority, where that authority has the statutory power to compulsory acquire the easement[113]. The commissioner's view[114] also extends to situations where the authority imposes a limitation on the owner's use of the land.

Taxation ruling TR 97/3 Deals with compensation received by landowners from public authorities.

4. Compensation in respect of an easement created by statute in favour of a public authority cannot be said to have been received for the grant of the easement. The Land Acquisition (Just Terms Compensation) Act 1991 (NSW) and similar Acts in other jurisdictions [F1] enable public authorities to take land or an interest in land (including an easement) for specified purposes and confer on the affected landowner a right to compensation. In these circumstances, the landowner cannot be said to have created an asset as required for subsection 160M(6) of the Act to apply. The easement is created by operation of the relevant statute and is vested in the public authority. This constitutes a compulsory acquisition of the easement.

The compulsory acquisition, or threat of, by a public authority with the power of compulsory acquisition, of an easement is an example of where the commissioner considers[115] there has been a disposal of an asset being (the right to exclude all others) which is considered an A1 event for the partial disposal of

[106] Taxation Determination TD 2018/5
[107] Section 104-35 ITAA 1997
[108] Section 110-10 ITAA 1997
[109] Section 115-25(3) ITAA 1997
[110] See note in section 152-10(1)(d) ITAA 1997
[111] section 152-12 ITAA 1997
[112] Taxation Ruling TR 97/3 & TD 2018/15 paragraph 18 & TD 2001/19
[113] Paragraph 9 & 10 Taxation Ruling TR97/3
[114] Paragraph 12-14, Taxation Ruling TR 97/3
[115] Taxation Ruling TR 97/3 & Taxation DetermininationTD 2001/9

land and therefore TR 95/35 is applicable, and we are able to take into account the cost base of that underlying land.

This clearly is a significant issue (the ability to compulsory acquire the property) as it changes the potential tax outcome from a D1 event to A1 and the ability to include a portion of the land's cost base .

We then need to put our mind to calculating the capital gain. To do that we first determine the capital proceeds, this would be, in the absence of any other facts, the total compensation payment. The cost base would be a reasonable apportionment of the cost base of the property.

A reasonable basis may be by determining the total cost base of the whole property on a per hectare price and apportion this over the easement based on the easements size.

However, there may be other factors that may support a higher or lower value. For example, the aspect of that portion of the land may have attracted a higher value. The use of a valuer may be very important to establish the value of the easement land as compared to the remaining land.

The above is the relatively simple vanilla approach, but it fails to account for the impact on the surrounding land. This was discussed earlier in this paper.

I should also mention the compulsory acquisition would also lend itself to the availability of the replacement asset rollovers under subdivision 124-B.

8.2.5 Right to seek compensation:

If there is no underlying asset capable of being identified, then what remains is the right to sue.

TR95/35 provides some useful discussion on this:

> *71. Warner J in* Zim Properties v. Procter (Inspector of Taxes) *[1985] STC 90; 58 TC 371 applied this look-through approach in determining from which asset the settlement sum was derived. His Honour considered that the choice of which was the most relevant asset depended on the 'reality of the matter'. There, the taxpayer had contracted to sell certain property. However, the buyer was able to repudiate the contract because the taxpayer could not show good title to the property. The taxpayer then sued its solicitors for negligence and was awarded an amount of compensation for that negligence.*
>
> *72. Warner J held that the settlement amounts paid by the solicitors were not derived from the real estate but were derived from the right to sue, which was itself an asset.*
>
> *73. It is important to note that, in the* Zim Properties *case, there was no disposal of the real estate.*

Taxation Ruling TR 95/35 defines in its *Key Terms*:

> *The right to seek compensation is the right of action arising at law or in equity and vesting in the taxpayer on the occurrence of any breach of contract, personal injury or other compensable damage or injury. A right to seek compensation is an asset for the purposes of Part IIIA. The right to seek compensation is acquired at the time of the compensable wrong or injury, and includes all of the rights arising during the process of pursuing the compensation claim. The right to seek compensation is disposed of when it is satisfied, surrendered, released or discharged*

The cost base of the right to compensation will depend on the circumstances but is generally limited to the incidental costs such as the legal costs but may include the loss that brought about the right to seek compensation. TR 95/35 provides a detailed discussion on the commissioners view on the cost base, generally, legal fees and charges connected with the proceedings may be included in the cost base of the asset[116] However, the commissioner also has the wider view that costs that brought about the right can also be taken into account. For example,[117] a claim for loss of money due to theft may have a cost base equal to the stolen money plus legal fees.

8.2.6 Other amounts that are identified as part of the compensation:

It is not uncommon, for compulsory easement agreements to provide for the landowner to undertake maintenance services and be compensated or reimbursed for this. Typically, this could include such things as weed control, access road maintenance, maintaining fences etc. Whether this amount is paid in advance or paid each year, the amount would be expected to be included as assessable income under Section 6-1[118] and or Subdivision 20-A *Indemnity and other recoupment for deductible expenses*[119] and expenses incurred deductible. Amounts received in advance may be able to be deferred until the obligation is met (depending on the agreement) or the expense is incurred.

See HR Sinclair v FCT (1966) 114 CLR 5379 where Taylor J, in his decision stated: *"… to obtain a refund of amounts which it contended had been exacted as the result of the misapplication of the formula were just as much an activity of the business as would have been an attempt to avoid an overcharge in the first instance and the amount recovered in the year ended under review must be taken to have formed part of the [taxpayer's] income for that year."*

[116]Paragraph 157 of Taxation Ruling TR 95/35

[117] See example 27 in TR 95/35

[118] ITAA 1997

[119] ITAA 1997