
Taxation of Live Stock in Australia: A Critical Review of Tax Law and Policy

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One of the fundamental aims of any income tax system is to measure the net income earned by taxpayers during a given financial year. This can be difficult for primary production businesses involving live animals because animals are inherently different from other kinds of assets. Whereas previously Australia's tax system allowed primary producers to use either a market valuation or cost-based valuation to assess the value of their animals, the Income Tax Assessment Act 1997 (Cth) introduced changes that brought live animals under the rules for ordinary trading stock. This article offers a critique of the policies embodied in the Act and its approach to taxing animals in primary production. In particular, it highlights the outdated prescribed values given to live stock acquired through natural increase (ie offspring) and biased tax concessions that apply to certain types of animals. These tax rules have not been reviewed in decades and urgently need to be reassessed.

I. INTRODUCTION

When federal income tax was first introduced in Australia, live stock¹ used in primary production was taxed under a special regime. Beginning in 1922, taxpayers were given the option of using either a market valuation or a cost-based valuation for accounting their live stock, regardless of how the animals were used. In addition, animal offspring were given a prescribed (ie deemed) value, which gave effect to neutralise, though only to a limited extent, inconsistencies in the value of bred stock compared to purchased stock. This system was reviewed by various government committees over the years, which made minor legislative changes. Overall, the application of one or both valuation methods in the special live stock rules was endorsed by government and the primary production industry.

The rules were re-examined in the 1990s, when the government established the Tax Law Improvement Project to simplify the structure and language of Australia's income tax laws. With little regard for the unique economic character of live stock or the primary production industry's support for the two existing valuation methods, the committee responsible for drafting the *Income Tax Assessment Act 1997 (Cth) (ITAA 1997)*, which arose from the Project, concluded that having special tax rules for live stock added unnecessary complexity to the system and that, for tax purposes, live stock should be treated the same as ordinary trading stock.² The government accepted this view and merged the live stock rules with the trading stock regime.³

The revised tax system has been in operation for more than 20 years and has attracted little criticism from taxpayers and tax administrators. However, it is not clear whether the current rules for live stock are appropriate from a neutrality perspective. The cycle involved in breeding an animal, growing it into a working asset (eg breeding stock) and eventually selling it is an entirely different process from the depreciation or appreciation of value in an ordinary tangible asset, which can be sold at a readily

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¹ While its common usage is "livestock", Australian tax legislation has always separated the term into two words, "live stock".

² "There is no compelling reason why live stock should be treated differently from other trading stock. Having different rules for what is exactly the same process is unnecessary complexity": Tax Law Improvement Project, *Exposure Draft No 5 – Assessable Income: Trading Stock* (AGPS, 1995) 10.

³ Currently *Income Tax Assessment Act 1997 (Cth)* Div 70.



calculable profit or loss. The original purchase price or final sale price of an animal may not adequately reflect the costs involved in raising it and its offspring. Live stock may grow over time in contrast to its declining value, despite its measurable value in the market.

This article seeks appropriate tax treatment of live stock. Part II discusses benchmark tax treatment of live stock upon its character. Unlike other capital assets or ordinary trading stock, animals' ability to breed makes them self-renewing assets. It is difficult to calculate the operational costs involved in growing an animal to full size and when that animal reproduces it is unclear if, and by how much, producing offspring affects the value of the parent. Unlike manufacturing, operating costs are not absorbed in the value of live stock whereas the increased value of live stock may be beyond the acquisition costs of live stock. These factors are considered in the discussion of tax policies towards achieving a neutral tax base.

Part III reviews the history of tax law concerning, in particular, the valuation methods of live stock in Australia. Valuation has been one of the fundamental difficulties of setting live stock rules, as market value that represents the taxpayer's wealth in live stock most accurately may not be practical to apply in practice. Demand to trace individual animals is unfeasible in a mass production context and often stock is counted without knowing whether it was purchased or bred. The pre-1997 live stock rules had an alternative cost-based method accompanied by prescribed values for natural increase. It operated efficiently, and the revision in 1997 may be unjustifiable.

Part IV further examines and highlights other areas, including tax expenditures, as valuation is not the only issue of concern in regard to establishing a neutral tax base. The following areas are particularly in need of attention: first, the outdated prescribed values given to live stock acquired through natural increase (ie offspring); and, secondly, the biased tax deductions and concessions available for certain types of live stock, which have never been reviewed. Specifically, unlike other live stock, horses used in horse-breeding business are deemed to be depreciable assets. Unlike in other industries, special concessions for primary producers allow the value of live stock to be transferred to replacement stock without recognising the net gains that can result from sales and other disposal of animals in certain circumstances. Part V concludes.

II. CONCEPTUAL FRAMEWORK

Calculating the net income earned by a taxpayer during the financial year is an essential first step in taxation. It is not easy to do when it comes to taxing gains on live stock in primary production industries because animals have the ability to grow and reproduce. The accrued value that primary producers generate by raising young animals to full size and breeding animals to produce more animals may not reasonably be measurable. Further, live stock may also be lost to sudden disease or natural disaster and taxpayers may not have the liquidity to meet their tax liabilities while waiting for value to accrue in their live stock while it is being raised, between acquisition and sale or other disposal. Because of these factors, the income produced by live stock may need to be allocated arbitrarily to more than one financial year.

This results in considerable difficulty in calculating deductions for expenses and losses involving live stock. Conventional tax practice requires deductions to be claimed in the year the economic losses were sustained, but this is not always effective for taxing live stock because it is not like ordinary trading stock or plant (or like both ordinary stock and plant in duality). During the lifecycle of birth, growth, reproduction and death, some animals are used for meat and other animal products, some for labour and some purely for breeding. These uses are not mutually exclusive, such as in the case of sheep used for both meat and wool, and chickens used for both meat and eggs. The multipurpose characteristics of live stock raise questions about when to recognise acquisitions for tax purposes and how to treat expenses such as feed and other farm operating costs.

Trading stock rules have been used in Australian taxation to recognise accrued income and allow deductions for costs incurred in purchasing live stock. It is, however, arguable that depreciation deductions may be more appropriate based on the character that individual animals, once reaching their full-service potential, decline in value. This part begins with an examination of the character of live stock and, upon an understanding of that character, the appropriate tax treatment of live stock in an efficient tax system.

A. The Dual Economic Character of Live Stock

Unlike ordinary trading stock, live stock can function as both trading stock and a capital asset. Animals can reproduce and create new trading stock, new depreciable assets or new multipurpose assets. Getting an accurate picture of the future economic use of new offspring is often only possible later, when their potential for breeding can be assessed. Some stock may be unsuitable for breeding, or older breeding stock may need to be retired and, subsequently, sold. Live stock less suitable for breeding may be sold earlier than anticipated to make room for younger stock, which may also generate profits.

Devising a simple and principled model for taxing live stock poses a unique challenge for several reasons. One is the sheer breadth of the subject matter, ranging from farm animals like cows, sheep and pigs to horses and greyhounds bred for racing, bees for honey-making, dogs, cats and goldfish bred as pets, and mice for biomedical research. In some circumstances, like in specialised live stock trading, animals are no more than trading stock used to generate profits through acquisitions and sales.⁴ However, there are a vast number of uses for animals. Some are bred as working animals, others for racing, food and other animal products, some for wool and some exclusively for breeding. Sometimes they are used like plant or equipment, for a specific purpose or carrying out a specific duty, like police dogs, guard dogs or birds in a tourist park.⁵ Until recently in Australia, guide dogs were categorised as medical aids.⁶ It is possible that some of these uses may not be contemplated until long after the animals are acquired. Animals purchased to produce goods such as eggs, wool or milk can later be sold for meat. Similarly, a horse bought for racing has a limited working life and conventional tax theory would treat it as an acquisition of a depreciating asset, with deductions available for certain expenses and losses over the course of its expected racing career. However, if the horse wins consistently, a new purpose will likely emerge for it – namely, breeding. If it is a winner, breeding this so-called depreciated asset may cause its value to soar well beyond its initial purchase price.

The Commissioner of Taxation has provided guidelines to help with the valuation of certain live stock for tax purposes, such as bees, which are counted by the number of live hives.⁷ However, the wide range of animals involved in primary production requires in-depth policy analysis to ensure appropriate and consistent taxation across industries. For ordinary trading stock, profit or loss is calculated by comparing the value added to or subtracted from an asset during the holding period or, in other mathematical terms, the difference between the costs incurred in acquiring and producing goods and the price received from selling the goods or disposing of them in some other way. However, this approach can mischaracterise animals used as productive assets as being akin to plant – namely “a source of trading stock”,⁸ rather than actually being trading stock. Similarly, depreciation deductions can also underestimate the role of recurring sales in the live stock business. Selling animals and animal products at various stages of their lifecycle generates systematic repeat profits for some primary producers.

Another challenge for the tax system is accurately estimating the operational costs attributable to live stock. With manufactured trading stock, the cost of materials, labour and overheads are factored into its base sale price (minimum costs necessary to recoup upon sale). This is not necessarily the case with animals. Many producers carry on mixed farming and cannot calculate costs for crops and live stock

⁴ This refers to non-primary production traders such as live sheep exporters, as specified in ATO, *Live Sheep Export*, TD 93/95, 1993.

⁵ See, eg, the deductions available for police dogs, guard dogs, other working dogs and birds for display in tourist parks, explained in the following Australian Taxation Office rulings and decisions: ATO, *Income Tax: Employee Police Officers – Allowance, Reimbursements and Work-related Deductions*, TR 95/13, 1995 [157]–[160]; ATO, *Deductions: Guard Dog Expenses*, ID 2011/18, 2011; ATO, *Income Tax: Employee Truck Drivers – Allowances, Reimbursements and Work-related Deductions*, TR 95/18, 1995; ATO, *Trading Stock: Live Stock – Working Beast – Birds for Display in a Tourist Park*, ID 2009/25, 2009.

⁶ At one stage, tax offsets were available for expenses relating to guide dogs as medical aids under the *Income Tax Assessment Act 1936* (Cth) s 159P. See also Commonwealth Committee on Taxation (Chair GC Ligertwood), *Report of the Commonwealth Committee on Taxation*, Report No 100 (1961) 80 [404]–[405] (Ligertwood Committee Report). However, as of the 2019/2020 financial year, that concession is no longer available unless the expenses are incurred in carrying on a business.

⁷ ATO, *Law Administration Practice Statement*, LA 2008/4 (GA), 2008.

⁸ As referred to in ICF Spry, “Confusions Relating to Sources of Trading Stock” (1992) 21(1) AT Rev 8.

separately, or for different types of live stock. Allowing deductions for operational costs separately from live stock enables primary producers to recoup expenses that would otherwise not be recoverable until the animals are sold. Thus, in terms of timing, the deductions available for running costs and depreciable assets relating to live stock are more generous than deductions based on the imputed cost of live stock. Further, offspring have partial acquisition costs of parents in addition to costs for feeding and caring for parents attributed to them. Using a national average for calculating production costs to assign a value to the offspring to neutralise the bias between purchased animals and bred stock would create inequity between small and large enterprises, and between businesses carried out in different regions of Australia. Any proposed solution to the challenges of calculating costs would need to be fair to all taxpayers.

B. Choosing a Suitable Approach to Valuation

As far as its economic uses, live stock is a hybrid, somewhere between trading stock and a productive capital asset. However, for tax purposes, trading stock and capital assets (like plant) are mutually exclusive categories.⁹ An appropriate approach to taxing live stock must sufficiently account for the unique economic character of animals. In this regard, the rules that apply to trading stock are preferable to the rules governing deductions for depreciating assets because the trading stock rules can be used to assess natural increase. They also allow for a group of animals to be treated as one asset or grouped into units, which is helpful when accounting for the movement or turnover of certain live stock – such as live bee hives, for example, which are counted by number of hives. In contrast, depreciation almost always applies to the individual asset only, which requires a reliable way to calculate the value of individual animals. Technology for tagging and marking farm animals is constantly improving, but how far it needs to go to enable primary producers to calculate the value and depreciation of individual animals including offspring is uncertain, especially for small animals such as fish and bees. When it comes to valuing live stock, giving taxpayers a choice between the trading stock rules and the depreciation approach promotes inconsistency because it relies on self-assessment and allows taxpayers to switch between valuation methods too easily.

The trading stock rules, though preferable to the depreciation approach, are not adequate because live stock does not have the same economic character as ordinary trading stock. However, the trading stock framework can be adopted as a starting point for formulating new rules for taxing live stock. Trading stock rules provide a systematic and consistent way of accounting for natural increase, irrespective of the type of asset – in this case, animals. Under the trading stock rules, costs are accounted for at the time of sale or disposal, at which time income, if any, is also assessable. The same approach can be applied to live stock, when it passes from vendor to purchaser. Disposal may also be taken to have occurred when a negotiation concludes, when a contract is executed, or when live stock dies, is lost or converted into something else.¹⁰ A rollover concession may be available when live stock is transferred from one tax-paying entity to another but remains under the same ownership and control.¹¹ A market value substitution may apply to non-arm's length dealing or when a transaction is entered into for a value that is not "fair and reasonable".¹²

⁹ The mutually exclusive nature of trading stock and capital assets was discussed in *Case C20* (1971) 71 ATC 91.

¹⁰ See the timing of disposal determined by the Court in: *Case J43* (1958) 9 TBRD 217, where disposal occurred when possession took place; *Case E16* (1954) 5 TBRD 88, where disposal occurred when consideration was received by way of an annuity; *Commissioner of Taxation (Cth) v McConochie* (1960) 102 CLR 561, where disposal occurred when the parties agreed to sell sheep, not when the sheep were delivered. This principle concerning the timing of disposal also applies to animal products like wool: ATO, *Income Tax: Sale of Wool*, TR 97/9, 1997; ATO, *Income Tax: Meaning of "Trading Stock on Hand"*, TR IT 2670, 1992; *Farnsworth v Commissioner of Taxation* (1949) 78 CLR 504 (fruit pooled to marketing authorities).

¹¹ See, eg, *Purcell v Commissioner of Taxation* [1927] St R Qd 293; [1927] QWN 46; *Case 250* (1964) 14 TBRD P54. See also ATO, *Income Tax: Can Section 36A of the Income Tax Assessment Act 1936 Apply If a Sole Trader Who Owns Trading Assets Declares Himself or Herself to Be a Trustee of a Discretionary Trust over the Assets?*, TD 96/2, 1996; ATO, *Income Tax: Can Section 36A of the Income Tax Assessment Act 1936 Apply If a Sole Trader Who Owns Trading Assets Transfers the Assets to Another Person as a Trustee of a Discretionary Trust?*, TD 96/1, 1996.

¹² See *Case 14* (1943) 10 CTBR 468, which discusses fair and reasonable valuation. See also *Pastoral and Development Pty Ltd v Commissioner of Taxation* (1971) 124 CLR 453; 2 ATR 401; *Case C12* (1971) 71 ATC 49; *Case R85* (1984) 84 ATC 569.

Under trading stock rules, deductions are calculated as the amount spent acquiring live stock during the year, plus any decrease or minus any increase in the value of the stock at the end of the year, compared to its opening value at the beginning of the year. In this calculation, two elements are easily ascertainable – namely, the purchase price and the opening value of the live stock (which is the same as its closing value in the previous year).¹³ The last element, the closing value, factors in non-transactional changes such as new offspring and other live stock acquired for free, which increases the closing value. Loss of animals due to wandering off, natural deaths and slaughter for domestic consumption decrease the closing value.

For deduction purposes, live stock slaughtered for domestic consumption (referred to as “killed for rations”) is the same as live stock that died during the year, although both are not counted in the end of year stocktake. There are two ways of approaching this problem. The first is to reverse the deduction by adding the purchase price of the animal to the taxpayer’s assessable income, or to the value allocated to offspring subsequently killed for rations. If it is not possible to determine the original cost of an animal (eg because it joined the herd or flock in a previous year and purchase information is no longer available), an average opening value may be used as a fair measure. This is based on the view that live stock killed for rations does not represent an expense or loss incurred in carrying on a business and should not be eligible for a deduction. Tables A1 and A2 in the Appendix contain examples of how live stock killed for rations are taken into account to calculate a trading profit. The second way to correct the inconsistency created when stock killed for rations are treated as a tax deductible loss is to assess the stock’s market value. This is based on the view that the transaction is a sale of live stock and recognises the animals’ appreciation in value as a trading profit when the imputed costs cannot be determined on a reasonable basis.

Overall, of the different valuation methods, the one most suited to live stock is market valuation, because it can incorporate the operational costs of farming into the sale price of the stock at any given point in time.¹⁴ Similarly, the next best method is the one used for manufacturing stock, which accounts for the various expenses and losses involved in the production process. It is also possible, though arbitrary, to assign a specific value to natural increases in live stock to moderate the potential for excessive accumulation of unassessed assets through breeding.

III. TAX REVIEWS AND LEGISLATIVE REFORM: A HISTORY

While the word “livestock” refers to farm animals generally, the term “live stock” (two words) is defined in the tax legislation, which states that it “does *not* include animals used as beasts of burden or working beasts in a business other than a primary production business”.¹⁵ Primary production is also defined in the legislation – and broadly.¹⁶ In a primary production context, the term “live stock” refers to living

¹³ In *Baillie v Commissioner of Taxation (Cth)* (1927) 40 CLR 156, an administrative error resulted in an inconsistency between the closing value and the opening value in the subsequent year. The unintended increase in value had to be ignored. The closing value was deemed to be the opening value in the subsequent year based on the *Income Tax Assessment Act 1936* (Cth) s 29. In *Cribb v Commissioner of Taxation* [1963] Qd R 541, the opening value of live stock was at the market value, not the closing value last used by the taxpayer, due to changes in the taxpayer’s bankruptcy status.

¹⁴ See, eg, ATO, *Income Tax: Value of Trading Stock on Hand at End of Year: Cost Price: Absorption Cost*, TR IT 2350, 1986; ATO, *Income Tax: Valuing Shares Acquired as Revenue Assets*, TR 96/4, 1996; ATO, *Income Tax: Valuation of Trading Stock – Average Cost or Actual Cost*, TR IT 2289 (1986); ATO, *Using an Average Cost Method in Determining Cost Price of Newsprint for Closing Stock Valuation*, TD 92/155 (1992); ATO, *Income Tax Administration Penalty Tax and General Interest Charge*, TR IT 2012, 1983 (particularly [42]); ATO, *Income Tax: Value of Trading Stock on Hand at End of Year: Cost Price: Absorption Cost*, TR IT 2350, 1986; *Australasian Jam Co Pty Ltd v Commissioner of Taxation (Cth)* (1953) 88 CLR 23.

¹⁵ *Income Tax Assessment Act 1997* (Cth) s 995-1(1) (emphasis in original).

¹⁶ A “primary production business” is defined in *Income Tax Assessment Act 1997* (Cth) s 995-1(1). It includes maintaining animals for the purpose of selling them or their bodily produce (including natural increase); manufacturing dairy products from raw materials that you produce; conducting operations relating directly to taking or catching fish, turtles, dugong, bêche-de-mer, crustaceans or aquatic molluscs; and conducting operations relating directly to taking or culturing pearls or pearl shell. See JBL Heading, “Primary Production – Workshop Session” (Convention Paper, Taxation Institute of Australia, Queensland Division, 19–21 April 1985); J Rawson, “Primary Production Investments” (Convention Paper, Taxation Institute of Australia, South Australian Division, April/May 1998).

animals such as those used in traditional agriculture as well as in fishing and pearling operations. Live stock also includes bees in honey-making businesses¹⁷ and dogs in puppy breeding.¹⁸

The tax legislation also includes live stock in the definition of “trading stock”, which is “anything produced, manufactured or acquired that is held for purpose of manufacture, sale or exchange in the ordinary course of a business”.¹⁹ Adding live stock to this category broadens the definition of trading stock significantly because the way live stock is used does not always fit within the ordinary use of trading stock, which is primarily for sale. Live stock can be used like plant and equipment to produce something – for example, honey, milk, pearls, wool or animal offspring. Although the statutory definition of trading stock deems live stock to be a revenue asset,²⁰ live stock as defined in the legislation is uniquely multipurpose and can function as both trading stock and a capital asset. It is also noted that trading stock rules are appropriate for treating live stock by reason of the mechanism they employ.

A review of the history of Australia’s tax laws confirms that live stock was once considered a statutory exception to the general definition of trading stock. History also shows that the pre-1997 rules operated with no apparent problems, or at least none that would justify any significant legislative change. Further, the old rules were endorsed by several different tax review committees and by the primary production industry. The current rules were introduced without thorough analysis on tax policy or apparent industrial need.

A. 1915–1922: The Original Legislation

When federal income tax was introduced in Australia in 1915, little attention was paid to the way live stock was characterised in the legislation. It was mentioned alongside produce, goods and merchandise, the value of which was taken into account at the beginning and end of the financial year for calculating profits.²¹ Live stock, if characterised as plant, was not subject to tax, while a narrow definition of depreciable assets limited it to machinery, implements, utensils, rolling stock and articles.²² For the purpose of calculating profits, the value of live stock was its purchase price if it was purchased during that financial year, or a “fair average value” determined by the Commissioner of Taxation.²³ A fair average value was equivalent to what is commonly known as a “standard value”: a set value to be used in all subsequent tax assessments for offspring and other live stock acquired by means other than purchase. A profit arose from sale and a loss from disposal, based on the difference between the sale or disposal price received and the purchase price or a fair average value paid.²⁴

However, setting a standard value meant there would eventually be significant deviation from market value over time, as actual profits changed with the market. To correct this, the standard value was replaced by an “average value” in 1917.²⁵ Average value was calculated as the total value of live stock, including the purchase price paid and values assigned to offspring during the year, divided by the total number of animals held at the end of the year (including those purchased and born that year). The total number of animals was used to determine the closing value of live stock. This was, in effect, a means of cost recovery for the animals that had died, been sold or been killed for rations during the year. The closing value of live stock was then used as its opening value the following year. The value assigned to natural increase was set by the Commissioner of Taxation because it was conceded that self-assessed values were

¹⁷ ATO, *Income Tax: Are Bees Kept for Use in a Honey Production Business Trading Stock as Defined in Section 70-10 of the Income Tax Assessment Act 1997?*, TD 2008/26, 2008.

¹⁸ A dog breeding business was considered in *Case N86* (1981) 81 ATC 459.

¹⁹ Currently *Income Tax Assessment Act 1997* (Cth) s 70-10.

²⁰ Currently *Income Tax Assessment Act 1997* (Cth) s 70-25.

²¹ *Income Tax Assessment Act 1915* (Cth) s 14(a).

²² *Income Tax Assessment Act 1915* (Cth) s 18(d).

²³ *Income Tax Assessment Act 1915* (Cth) s 14(a), supplemented by *Income Tax Regulations 1915* (Cth) reg 29A, as inserted by the *Statutory Rules 1915, No 245* (Cth).

²⁴ *Income Tax Regulations 1915* (Cth) reg 29A.

²⁵ *Income Tax Regulations 1917* (Cth) reg 46, as applied in *Rowntree v Commissioner of Taxation* (Cth) (1934) 3 ATD 32.

inconsistent, unreliable and would likely lead to reduced tax revenue.²⁶ It was also conceded that using a standardised valuation based on location would be inaccurate because variables such as weather and disease could affect live stock values differently, even within the same local area.²⁷ However, there were ongoing concerns that the Commissioner too could make inconsistent determinations when assigning values to natural increase ad hoc. Consequently, a new set of prescribed values was introduced in 1918.²⁸ Bearing in mind the varied market conditions in different parts of Australia, the government prescribed different base values for sheep, cattle, horses and pigs in different States, and for sheep and cattle in different districts within Western Australia.²⁹

This first experiment in prescribing values soon proved unsuccessful. In one high-profile case, a Tasmanian farmer argued that prescribing different values for live stock in different States was discriminatory and contravened the *Constitution*.³⁰ The High Court of Australia decided in favour of the farmer in 1923. In a subsequent case, the same farmer submitted that the live stock schedule in the *Income Tax Assessment Act 1915* (Cth) was invalid.³¹ Once again, the High Court decided in favour of the farmer, finding that the live stock schedule was not properly authorised by the Act. In response, the government enacted the *Income Tax Assessment Act (Live Stock) 1924* (Cth), which, for a limited time, gave taxpayers the opportunity to redo their tax assessment calculations without regard to the live stock schedule. Ultimately, the defect in the schedule was corrected by the *Income Tax Assessment Act 1922* (Cth), which properly authorised a new live stock schedule.³² It made the prescribed values the same for all taxpayers in Australia. It also introduced two valuation methods – the market value method and the cost-based method. The prescribed values in the live stock schedule applied to the cost-based method.

B. 1922–1936: The Kerr Royal Commission and New Rules

In 1920, the government established a Royal Commission on Taxation, chaired by W Warren Kerr, to review the income tax laws (Kerr Royal Commission). Its report, released in 1922, noted the way in which beasts of burden like horses, mules, bullocks, camels and other draught animals could be used like plant and equipment in some settings.³³ It also noted that dairy stock was used like plant, even though breeders and dealers applied the special live stock rules to dairy stock in a manner similar to trading stock. Acknowledging that the manner in which live stock is characterised affects how it is taxed, the Kerr Royal Commission recommended that taxpayers be allowed to nominate, irrevocably, the character of their live stock in their first year of tax reporting.³⁴ It also considered alternative valuation methods under the special live stock rules, rejecting cash accounting and the possibility of reverting back to standardised values, despite the practical simplicity of these options.³⁵ Cash accounting was rejected on the ground that it would enable taxpayers to accumulate large amounts of unrealised profits that would be taxed in bulk, but only once realised through a transaction, and likely at higher marginal tax rates. Equally problematic, using a standard value would likely misrepresent yearly income – because

²⁶ See Commonwealth, *Parliamentary Debates*, Senate, 29 May 1918, 5147 (Hon John Earle in response to John Grant, arguing against the prescribed value).

²⁷ See Commonwealth, *Parliamentary Debates*, Senate, 29 May 1918, 5142 (Hattil Spencer Foll).

²⁸ The definition of “value” was added to *Income Tax Assessment Act 1918* (Cth) s 3 and referred to in reg 46 and the amended reg 46A in the *Income Tax Regulation 1917* (Cth).

²⁹ Three years later, a new base value was added for calves at one thirds of the base value of cattle: see *Statutory Rules 1922, No 150* (Cth), which amended *Income Tax Regulations 1917* (Cth) reg 46.

³⁰ *Cameron v Deputy Commissioner of Taxation (Cth)* (1923) 32 CLR 68, which dealt with *Commonwealth of Australia Constitution Act* s 51(ii).

³¹ *Cameron v Deputy Commissioner of Taxation (Cth)* (1924) 34 CLR 68.

³² *Income Tax Assessment Act 1922* (Cth) s 2, Sch; *Income Tax Regulations 1922* (Cth) reg 50, Table III.

³³ Commonwealth, Royal Commission on Taxation, *Report and Appendices – Second Report* (1922) 117–123, in particular [433]–[434] (Kerr Royal Commission Report).

³⁴ Kerr Royal Commission Report, n 33, 117–123, in particular [435].

³⁵ Kerr Royal Commission Report, n 33, 117–123, particularly [418]–[422], which discuss a variety of live stock used by both breeders and dealers in ways other than as plant.

of the likely discrepancies between the standard value and actual purchase or sale prices, particularly if deductions were claimed based on the standard value. In effect, this would result in profits being misallocated from year to year. Overall, the Kerr Royal Commission recommended using either purchase price or market value, whichever was lower, to calculate live stock value.³⁶ It considered the market value method theoretically superior but noted that the cost-based method appeared to be necessary in practice, to account for variables like transportation costs, for example, which might vary widely depending on local conditions.

Around the time the Kerr Royal Commission released its report, the High Court of Australia handed down two decisions dealing with the *Land and Income Tax Assessment Act 1907* (WA) and the *War-Time Profits Tax Assessment Act 1917–1918* (Cth). In both cases, the Court decided that income derived from disposing of live stock as part of the sale of a business was not assessable for tax purposes within the tax framework at the time, due to a narrow judicial interpretation of “income”.³⁷ After this, it became apparent that some taxpayers were deliberately selling their businesses at the end of the financial year to avoid tax liability.³⁸ In 1922, the government introduced a new set of rules for assessing taxable income generated from selling live stock. The rules used market value or, if a market price was not available, a price determined by the Commissioner of Taxation.³⁹ These rules were designed to apply to live stock that would have been recorded on a revenue account if sold in the ordinary course of business, and did not apply to the live stock used as beasts of burden, working animals or breeding stock.⁴⁰ Under the depreciation provision distinct from these rules, beasts of burden and working animals, but not breeding stock, were added to the list of depreciable assets.⁴¹ There was no reason given for not including breeding stock in the depreciation provision but it is possible that, as the Kerr Royal Commission recommended, the government chose to accept taxpayers’ characterisation of their stock. In practice, farmers generally recorded breeding stock on a working account, not a capital assets account, and it was unusual for breeding stock to be treated as capital when a business was sold.⁴²

The government adopted the Kerr Royal Commission’s recommendations on valuation methods only in part. While agreeing that an accrual approach to assessing income was necessary,⁴³ the government modified the live stock rules to allow taxpayers to make an irrevocable choice to use either the cost-based method, which used prescribed values for natural increase, or the market value method.⁴⁴ The government also introduced the option to omit natural increase from a live stock valuation entirely.⁴⁵ This omission option went against the Kerr Royal Commission’s recommendations, which emphasised the need to recognise the true picture of the wealth accumulated in live stock and avoid underestimating annual trading profits.⁴⁶

³⁶ Kerr Royal Commission Report, n 33, [436].

³⁷ *Commissioner of Taxation (WA) v Newman* (1921) 29 CLR 484; *Hickman v Commissioner of Taxation (Cth)* (1922) 31 CLR 232.

³⁸ Explanatory Memorandum, *Income Tax Bill 1922* (Cth) 17–18. Later, in *Commissioner of Taxation (Cth) v Murphy* (1961) 106 CLR 146, a leasing arrangement was unsuccessfully attempted to recharacterise live stock to avoid a tax liability.

³⁹ *Income Tax Assessment Act 1922* (Cth) s 17. Similar exemptions were available in the income tax law of New South Wales, Tasmania and South Australia at the time: see Commonwealth, Royal Commission on Taxation, *Third Report* (1934) [797] (Ferguson Royal Commission Report).

⁴⁰ For example, breeding stock was recorded on a capital assets account in *Commissioner of Taxation (Cth) v Ryan* (1926) 38 CLR 472; *Commissioner of Taxation (Cth) v Weatherly* (1927) 39 CLR 190.

⁴¹ The *Income Tax Assessment Act 1922* (Cth) ss 16(a), 23(e) stated that beasts of burden and working animals that were not characterised as trading stock should be included in the depreciation rule: see Commonwealth, *Parliamentary Debates*, House of Representatives, 10 October 1922, 3483 (George Bell).

⁴² As highlighted by Isaacs J (in dissent) in *Commissioner of Taxation (Cth) v Weatherly* (1927) 39 CLR 190.

⁴³ Commonwealth, *Parliamentary Debates*, Senate, 24 August 1923, 3528–3529 (Rt Hon George F Pearce).

⁴⁴ *Income Tax Assessment Act 1923* (Cth), which amended *Income Tax Assessment Act 1922* (Cth) s 16(a)(ii), as applied in *Jones v Commissioner of Taxation (Cth)* (1939) 61 CLR 557.

⁴⁵ *Income Tax Assessment Act 1922* (Cth) s 16(aa), as inserted by *Income Tax Assessment Act 1923* (Cth).

⁴⁶ Kerr Royal Commission Report, n 33, [425]–[429].

More rules were added to the regime in response to judicial decisions. In 1926, the High Court decided that as an asset wool was not distinct from sheep before shearing.⁴⁷ However, the government considered it unacceptable to allocate no separate value to the wool for tax purposes when unshorn sheep could easily be purchased, shorn immediately and their wool sold. Consequently, a new rule was introduced to recognise the value of wool before it was shorn, separate from the purchase price of the sheep, in the amount stipulated under the sales agreement or, if not expressed, at market value or as determined by the Commissioner of Taxation.⁴⁸ On the vendor's side, the value of any wool sold was included in their assessable income. The sheep remained part of the vendor's business, which could be sold separately from the wool.⁴⁹ Interestingly, these rules for wool did not apply to lambs. No separate cost or value was allocated to unborn lambs in the sale of pregnant sheep. The purchaser was likely to account for the costs and added value of the lambs under the special live stock rules, unless they decided to characterise the sheep as working animals and claim depreciation on them. The vendor was assessed on the profits from selling the pregnant sheep in the ordinary course of their business, but the sheep would not be counted towards profits when selling the whole or part of the business.

C. 1936–1950: A New Act and the Ferguson Royal Commission

The *Income Tax Assessment Act 1922* (Cth) was rewritten in 1936, after a second Royal Commission on Taxation was established in 1932, chaired by the Hon David Ferguson (Ferguson Royal Commission). It was undertaken in response to findings that the tax rules for live stock were creating confusion and a heavy administrative burden. Farmers often felt the need to prepare at least three sets of accounts: one for the Commonwealth; a second for the State; and a third for personal bookkeeping.⁵⁰ The Royal Commission was tasked with simplifying and harmonising State and federal tax laws.

In its report, the Ferguson Royal Commission noted the dual economic character of breeding stock, as both a type of trading stock and a capital asset.⁵¹ It recommended assigning revenue character to all breeding stock.⁵² The Royal Commission also reviewed stock valuation methods and rejected the use of the “replacement cost” method,⁵³ one of three valuation methods available for ordinary trading stock at that time.⁵⁴ While it was known that the market value of live stock could fluctuate significantly at different times of the year and in different locations, using replacement cost in valuations was considered even more unreliable because, in effect, it would allow taxpayers to choose whatever value they saw fit as the replacement cost. The Commissioner of Taxation could police inappropriate self-assessments, but that was an expensive and burdensome process. The more practical solution was to abolish the replacement value option.

Overall, the Ferguson Royal Commission concluded, like the Kerr Royal Commission, that the existing methods for valuing live stock – the cost-based method and the market value method – were mostly sound.⁵⁵

⁴⁷ *Webster v Deputy Commissioner of Taxation (Cth)* (1926) 39 CLR 130. This case is contrasted with *Case L49* (1960) 11 TBRD 279, in which sheep was disposed “off shears” during the shearing season.

⁴⁸ *Income Tax Assessment Act 1927* (Cth), which inserted s 17 into the *Income Tax Assessment Act 1922* (Cth). See also Commonwealth, *Parliamentary Debates*, House of Representatives, 28 November 1927, 2079–2080 (John Prowse).

⁴⁹ The *Income Tax Assessment Act 1927* (Cth) repealed *Income Tax Assessment Act 1922* (Cth) s 17 and inserted s 16(h).

⁵⁰ Ferguson Royal Commission Report, n 39, [769]. See also Commonwealth, *Conference of Treasurers* (Summary of Proceedings, Melbourne, 17–19 July 1918) 30, comparing Victorian and federal income tax rules.

⁵¹ Ferguson Royal Commission Report, n 39, s XLII, particularly [799]–[804].

⁵² For example, the vast majority of animals were characterised as breeding stock in *Austin Pastoral Co of Bringagee Ltd v Commissioner of Taxation (Cth)* (1928) 41 CLR 75. In effect, without electing to omit the natural increase, the taxpayer could characterise offspring as future breeding stock to eliminate the recognition of the natural increase and later recharacterise it as trading stock immediately prior to sale.

⁵³ Ferguson Royal Commission Report, n 39, [787].

⁵⁴ Under *Income Tax Assessment Act 1922* (Cth) s 16(a)(ii), taxpayers were allowed to use the actual purchase price, market value or a replacement price in their valuation calculations. This provision was incorporated into *Income Tax Assessment Act 1936* (Cth) s 31.

⁵⁵ Ferguson Royal Commission Report, n 39, [782]–[786].

It was impractical to rely on the market value method alone because of the varied market conditions across Australia. Similarly, the cost-based method did not account for all actual costs. However, these two methods were found to be working together well and taxpayers were not being taxed on unrealised profits in full. The ongoing difficulty was in determining how to factor in natural increase appropriately and fairly for all taxpayers.⁵⁶ There was disagreement among primary producers about whether the prescribed values for natural increase should be higher or lower. The Ferguson Royal Commission recommended against removing the prescribed values from the regime because the benefits of using them outweighed the inconsistencies they might cause. As an alternative, the Royal Commission's report suggested that the rules include an option to adopt a different valuation in special cases, if the Commissioner of Taxation considered it appropriate. In addition, the report recommended that the option to omit the value added to live stock by natural increase be abolished.⁵⁷ The omission option disadvantaged new graziers while benefiting established graziers as, for the same level of stock, new graziers would require outgoings that established graziers did not. Also, in practice, taxpayers hardly ever exercised the omission option.⁵⁸ Similarly, the Royal Commission recommended that the rule requiring the value of wool to be calculated separately from the value of unshorn sheep be abolished because it was impractical and underutilised. The report also considered it impractical to introduce separate valuations for unborn lambs and pregnant sheep.⁵⁹

The *Income Tax Assessment Act 1936* (Cth) incorporated the Ferguson Royal Commission's recommendations on characterising and valuing live stock. All live stock used in primary production, including draught animals and herding dogs, were recognised as having revenue character.⁶⁰ This did not preclude an animal from being a revenue asset if it was not used for primary production purposes.⁶¹ Primary production was defined broadly: unless otherwise stated, it meant "production resulting directly from the cultivation of land or the maintenance of animals or poultry for the purpose of selling them or their bodily produce, including natural increase".⁶² Beasts of burden and working animals used in non-primary production activities remained depreciable assets.⁶³ Interestingly, as machinery increasingly replaced animal labour in non-primary production industries, the depreciation deductions available for these kinds of animals would become less and less relevant in coming years. However, breeding stock continued to be treated as a capital asset for the purpose of compulsory acquisition of land by State or federal governments.⁶⁴

New features were added for valuation methods. The Commissioner of Taxation was authorised to allow taxpayers to alter the valuation method from one to another or use an alternative method as appropriate.⁶⁵

⁵⁶ Ferguson Royal Commission Report, n 39, [788]–[790].

⁵⁷ Ferguson Royal Commission Report, n 39, [774]–[777].

⁵⁸ Ferguson Royal Commission Report, n 39, [776].

⁵⁹ Ferguson Royal Commission Report, n 39, [805]–[807].

⁶⁰ *Income Tax Assessment Act 1936* (Cth) s 36; Explanatory Memorandum, *Income Tax Assessment Bill 1935* (Cth) 9 n(e), 46–47 nn(a)–(b).

⁶¹ See, eg, *Case C106* (1953) 3 TBRD 626 – a stallion used in primary production; *Case H69* (1957) 8 TBRD 324 – a horse owned by the primary producer for their employee; *Case C20* (1971) 71 ATC 91 – stud bulls used in primary production. In contrast, in *Case M59* (1980) 80 ATC 409 a horse separately maintained by the cattle farmer for non-business purposes was not live stock subject to tax.

⁶² "Primary production" defined in *Income Tax Assessment Act 1936* (Cth) s 6; Explanatory Memorandum, *Income Tax Assessment Bill 1935* (Cth) 11 n(c). This new broad definition was based on wording from previous State and federal tax legislation relating to land and agriculture: see *Income Tax Assessment Act 1922* (Cth) ss 5A, 23(1)(q).

⁶³ The Commissioner issued Income Tax Order No 1217 to provide general guidance on the deductions allowed for depreciation under *Income Tax Assessment Act 1936* (Cth) ss 54–63 and its Schedule of Rates of Depreciation. The annual depreciation rates for horses used for refrigerating works or shipping and general carriers were 12.5% and for other animals 10%. From 1957, the rates were increased to 18.75% and 15% respectively for applying the declining balance depreciation (otherwise known as the diminishing value method).

⁶⁴ *Income Tax Assessment Act 1936* (Cth) s 36.

⁶⁵ *Income Tax Assessment Act 1936* (Cth) ss 32–33, which was applied in *Case E7* (1954) 5 TBRD 41. Previously (1917–1922), the Regulations authorised an alternative valuation method of animals exclusively kept apart from others in a herd or a flock. See

The Commissioner could also apply the cost-based method when taxpayers did not make an election to apply market values.⁶⁶ To achieve harmony between State and federal tax laws, the Commonwealth adopted the Ferguson Royal Commission's suggestion that the opening value of live stock be deemed equal to the figure last used under the applicable State law, on the condition that the same valuation would be used for applying that State law in subsequent years.⁶⁷ Any difference arising from adjusting this value would be assessed as income or deductible as an expense. However, as the States withdrew their income taxation during World War II, this measure became obsolete and was eventually repealed.⁶⁸

D. 1950s–1970s: The Spooner Committee and Economic Change

In 1950, another Commonwealth Committee on Taxation was established, chaired by ES Spooner (Spooner Committee). In its 1952 report, it recommended that breeding stock be treated as a revenue asset, instead of as a capital asset, to be consistent with the way purchasers used it.⁶⁹ A second important development occurred when fishing operations were added to the definition of “primary production” in 1958.⁷⁰ Around this time, Australia was experiencing economic difficulties. State and federal governments wished to support and encourage primary production. When the South Australian government planned to commercialise tuna fishing off the coast of Port Lincoln, it prompted changes to the way primary production was defined at the federal level.⁷¹ Traditionally, fishing had been categorised as a form of hunting, which was not considered primary production.⁷² At first, it was uncertain whether the federal live stock rules could be applied to fish, due to the short time period between fish being caught and sold. However, the rules were put into practice for fisheries, and later for other marine live stock such as turtles, dugong, crustacea, oysters, other shellfish and pearling operations.⁷³ This was necessary to facilitate a consistent approach to taxing similar animals in a similar manner.

E. 1975–1997: The Asprey and Mathews Committees

In 1975, a Taxation Review Committee chaired by the Hon KW Asprey (Asprey Committee) reviewed the live stock and trading stock rules. Its report concluded that the existing regime, which kept the

MC Maughan, “Primary Production – A Current Review” (Convention Paper, Taxation Institute of Australia, Queensland Division, 23 June 1978) 28.

⁶⁶ *Income Tax Assessment Act 1936* (Cth) s 32, which was applied in *Case C106* (1953) 3 TBRD 626; *Case G33* (1956) 7 TBRD 188; *Case C64* (1952) 3 TBRD 337; *Case E7* (1954) 5 TBRD 41; *Case U42* (1987) 87 ATC 311; *Case A42* (1969) 69 ATC 235.

⁶⁷ *Income Tax Assessment Act 1936* (Cth) s 30, as recommended in the Ferguson Royal Commission Report, n 39, [792]–[796].

⁶⁸ *Income Tax and Social Services Contribution Assessment Act 1951* (Cth), which repealed *Income Tax Assessment Act 1936* (Cth) s 30.

⁶⁹ Commonwealth Committee on Taxation (Chair ES Spooner), *Trading Stock (Provisions Other Than Those Relating to Live-stock); Together with Supplementary Report*, Report No 141 (1952) (Spooner Committee Report); Rt Hon Sir Arthur Fadden, *Reference No 20: Trading Stock (Provisions Other Than Those Relating to Live-stock): The Committee's Report to Treasurer* (1951) 7 (Spooner Committee Supplementary Report). Subsequently, the *Income Tax and Social Services Contribution Assessment Act (No 3) 1952* (Cth) deleted non-assessable breeding stock in *Income Tax Assessment Act 1936* (Cth) s 36(2).

⁷⁰ The *Income Tax and Social Services Contribution Assessment Act 1958* (Cth) amended the definitions of “fishing operations” and “primary production” in *Income Tax Assessment Act 1936* (Cth) s 6(1). See further *Case U185* (1987) 87 ATC 1063; *Case M67* (1980) 80 ATC 479; Harry Rigney, “Primary Production Transactions” (Convention Paper, Taxation Institute of Australia, Queensland Division, 19 May 2006) 10–12.

⁷¹ Presented by Senator Laught and supported by Mr Playford (the then Premier of South Australia) in Commonwealth, *Parliamentary Debates*, Senate, 8 May 1956, 570; 15 May 1956, 712–716; 25 September 1958, 682–683.

⁷² For example, in *Burnside and Marrakai Ltd v Commissioner of Taxation (Cth)* (1957) 11 ATD 181 the taxpayer contended that wild buffalos captured in the Northern Territory were maintained as live stock before their hides were sold. The argument failed and the taxpayer was denied tax concessions applicable to primary production.

⁷³ See Explanatory Memorandum, *Income Tax and Social Services Contribution Assessment Bill 1958* (Cth) Notes on cl 3; *Case 32/95* (1995) 95 ATC 306 (pearl oysters); ATO, *Trading Stock: Freshwater Crayfish*, TD 2017/7, 2017; ATO, *Trading Stock Valuation of Freshwater Crayfish*, TR IT 2667, 1992; ATO, *Fringe Benefits Tax: What Are the Indexation Factors for Valuing Non-remote Housing for the Fringe Benefits Tax (FBT) Year Commencing on 1 April 2003?*, ID 2003/4, 2003; ATO, *Law Administration Practice Statement*, PS LA 2006/3 (GA) (2006); ATO, *Pearl Oysters Determination*, TD 93/70, 1993, which has been superseded but dealt with freshwater crayfish and abalone bred on farms or in hatcheries for sale, characterised as live stock.

live stock rules separate, was appropriate, and recommended periodic review of the prescribed values used for assessing natural increase.⁷⁴ The report also made three main recommendations concerning the trading stock rules. First, it acknowledged the diversity that existed among businesses, and on that basis recommended against setting a statutory limit on costs attributable to trading stock. Secondly, it recommended that a “net realisable value” be used instead of market value for valuing stock, consistent with common accounting practice. Whereas market value was based on ideal market conditions, net realisable value took into account obsolescence and slumps in the market, which write-offs would be allowed for in determination of the market value. Therefore, it recommended moving to a self-assessment model based on net realisable value. Thirdly, it concluded that for ordinary trading stock, “replacement price” (ie “the amount the taxpayer would have to pay in his normal buying market on the last day of the year of income”)⁷⁵ was a satisfactory base and, in terms of tax policy, an acceptable representation of the wealth held in the stock.

At the time, ordinary trading stock could be valued using its purchase price, market value or replacement price. However, the Asprey Committee found that these valuation methods were unsuitable for live stock because live stock differed so much from ordinary trading stock.⁷⁶ Like the other tax review committees before it, the Asprey Committee supported using a combination of the cost-based and market value methods for assessing the value of live stock. Although the cost-based method should ideally absorb all the expenses involved in growing, maintaining and breeding live stock recorded on a work-in-progress account, the Asprey Committee accepted that it was necessary to exclude such costs from the value of live stock to avoid unnecessary complications in administering taxes. Instead, using the existing trading stock rules for valuations would provide taxpayers with the flexibility to allocate profits across different tax periods. It was accepted that the value of live stock could fluctuate significantly from year to year.⁷⁷

Also in 1975, another committee led by RL Mathews (Mathews Committee) submitted its recommendation to introduce inflation adjustment into the tax system.⁷⁸ The government accepted this recommendation. In the 1970s, in an attempt to help businesses maintain liquidity in the face of rising inflation, new tax rules were introduced to adjust trading stock valuations to reflect increases in the Consumer Price Index.⁷⁹ However, the initiative was short lived. It was considered biased in favour of certain kinds of businesses,⁸⁰ placed a significant burden on the government’s budget, and was abolished by 1979.⁸¹ Adjusting for inflation was a logical step for assessing the value of long-term taxable assets like live stock, which are held for a number of years. However, attempts to introduce this measure in Australia have not been successful due to the complexity involved in designing and implementing a workable

⁷⁴ Commonwealth, *Full Report*, Parl Paper No 136 (1975) [8.123]–[8.139] (Asprey Committee Report).

⁷⁵ ATO, *Taxpayer Election to Use Replacement Value for Valuation of Trading Stock Under ITAA 1997 s 70-45*, TD 92/198, 1992, [2].

⁷⁶ Asprey Committee Report, n 74, [18.16]–[18.17].

⁷⁷ Asprey Committee Report, n 74, [18.9]–[18.18].

⁷⁸ Commonwealth, *Inflation and Taxation: Report of Committee of Inquiry into Inflation and Taxation*, Parl Paper No 78 (1975). The economic modelling used in the report was heavily criticised in PL Swan, “The Mathews Report on Business Taxation” (1978) 54(1) *Economic Record* 2; PL Swan, “The Mathews Report on Business Taxation: Rejoinder” (1980) 56(154) *Economic Record* 270.

⁷⁹ The *Income Tax Assessment Amendment Act 1977* (Cth) inserted ss 82B, 82C, 92D into the *Income Tax Assessment Act 1936* (Cth); see also CCH Australia Ltd, *Understanding New Tax Rules on Trading Stock* (1977).

⁸⁰ J Howard, “Treasurer” (Press Release No 74, 25 July 1979); Commonwealth, *Parliamentary Debates*, House of Representatives, 24 May 1979, 2394 (Treasurer John Howard); Commonwealth, *Parliamentary Debates*, Senate, 24 May 1979, 2120 (John Carrick); Malcolm Fraser, “Prime Minister” (For Media: Statement to the Parliament No 93, 29 May 1979). See also NA Sinclair and GP Whittred, “The Trading Stock Valuation Adjustment and Economic Rents to Shareholders” (1982) 7(2) *Australian Journal of Management* 125; MJ Aitken and TS Walter, “The Trading Stock Valuation Adjustment: Some Extensions and Modifications” (1985) 10(1) *Australian Journal of Management* 77; RW Gibson, “Episodes in the Australian Tax Accounting Saga” (1984) 11(2) *Accounting Historians Journal* 77.

⁸¹ The *Income Tax (Rates and Assessment) Amendment Act 1979* (Cth) amended *Income Tax Assessment Act 1936* (Cth) s 82C. The redundant provision was repealed by *Taxation Laws Amendment Act (No 3) 1989* (Cth).

system for it. Another scheme for adjusting for inflation was attempted under the capital gains rules in 1985, but was replaced by a partial exemption relating to capital gains for individuals and trusts in 1999.⁸²

The Asprey Committee's recommendation to review the prescribed values for natural increase was finally implemented in 1988. An amendment was passed giving taxpayers the option to use actual costs instead of a prescribed value for offspring, provided that the actual costs were lower than the applicable prescribed value.⁸³ For trading stock, actual costs meant all production expenses incurred in the process of manufacturing.⁸⁴ For live stock, actual costs meant full absorption costing.⁸⁵ However, the feasibility of applying full absorption costing when assessing live stock value was contentious. It would need to include direct operational costs related to farming, like feed, vet fees and labour, as well as indirect costs associated with depreciable plant and equipment. As the Ferguson Royal Commission had noted in the 1930s, the process of calculating these costs would be inherently complex. Accordingly, the actual costs approach seemed impractical and too discretionary.

It was easier to put a price on natural increase in horse stock. Horses were often bred using insemination services. Accordingly, the costs involved in producing offspring were clearer. There was concern that the prescribed values for horse offspring might be too low and, in 1986, the government decided to price foals based on the insemination fee attributable to individual foals.⁸⁶ The Commissioner of Taxation also issued a circular letter in 1991 to ensure that average costing was not used for valuing thoroughbred horses.⁸⁷

In parallel with these changes to the trading stock and live stock rules, the depreciation regime for plant and articles transitioned to a self-assessment system in 1992. Live stock used as plant in non-primary production was depreciable at one of six prescribed rates based on an effective life period determined by the taxpayer.⁸⁸ Taxpayers could immediately deduct the value of live stock worth up to \$300 (deduction for low value), or a self-assessed value if the stock's effective life was less than three years (deduction for short life).

The issue of using actual, full absorption costing for valuing natural increase was raised again in 1995. Prior to this, industry practice was to refer to the last price used, which often remained the same for many years, effectively deferring taxes.⁸⁹ However, new rules were introduced that required actual costs be used to assign value to the offspring of animals not listed in the live stock schedule.⁹⁰ Overwhelmingly, the nature and extent of actual costs were never specifically defined and there was insufficient guidance on how to give effect to the new rules requiring the use of actual costs.

F. 1997–2001: The Tax Improvement Project and 1997 Act

In the 1990s, the financial reporting industry became increasingly interested in recognising the unique self-generating, self-renewing character of live stock. Australia was one of the pioneers in this area, developing a new accounting standard for live stock in 1998, two years before the International

⁸² See *Income Tax Assessment Act 1997* (Cth) Div 115 (especially s 115-15) ("discount capital gains").

⁸³ *Taxation Laws Amendment Act (No 4) 1988* (Cth), amending *Income Tax Assessment Act 1936* (Cth) s 34.

⁸⁴ ATO, *Income Tax: Value of Trading Stock on Hand at End of Year: Cost Price: Absorption Cost*, TR IT 2350, 1986.

⁸⁵ Explanatory Memorandum, *Taxation Laws Amendment Bill (No 4) 1988* (Cth) Notes on cl 16.

⁸⁶ *Income Tax Assessment Act 1936* (Cth) s 34(3)–(5): the insemination fee was apportioned if a single service was for more than one mare or resulted in more than one birth.

⁸⁷ CCH Australia, *Valuation of Eligible Horses – Former Sec 32* (2019) [17-840].

⁸⁸ See *Income Tax Assessment Act 1936* (Cth) ss 55–56.

⁸⁹ Department of the Parliamentary Library, Parliament of Australia, *Bills Digest*, No 24 of 1995, 31 January 1995, 4; G Gear, "Assistant Treasurer – Taxation Laws Amendment Bill (No 5) 1994" (Press Release, 7 December 1994).

⁹⁰ The relevant parts of the *Taxation Laws Amendment Bill (No 5) 1994* (Cth) were brought into effect by the *Taxation Law Amendment Act (No 1) 1995* (Cth), which amended *Income Tax Assessment Act 1936* (Cth) s 34. Smith considered that more discussion was needed in regard to the cost-based method: see DM Smith, "A Critical Review of the Debate (1961–1989) on the Use of Direct Cost or Absorption Cost for the Valuation of Trading Stock under s 31 of the Income Tax Assessment Act, 1936" (Occasional Paper No 118, Deakin University, 1991).

Accounting Standard for biological assets was released.⁹¹ Despite the connection between tax and accounting, the government was reluctant to embrace accounting standards. That reluctance may have influenced the team that drafted the *ITAA 1997* as part of the government's Tax Law Improvement Project. They reviewed the live stock rules and concluded that, for tax purposes, there was no compelling reason why live stock should be treated differently from ordinary trading stock and that the existing live stock rules created unnecessary complexity.⁹² This was misguided. Even though live stock can function as trading stock that can be bought and sold, unlike ordinary trading stock it is also a self-generating, self-renewing asset capable of natural increase.

Without regard to the tax reviews and legislative developments that had occurred in the preceding 82 years, the government accepted the Tax Law Improvement Project team's view about the redundancy of the live stock rules and decided to merge the live stock rules with the trading stock regime. Under these consolidated rules, each individual item of live stock was to be valued at the end of each financial year using either its purchase price, market value or replacement price. Taxpayers were permitted to change valuation methods from year to year without needing special consent from the Commissioner of Taxation.⁹³ A separate rule permitted write-offs for permanent losses such as obsolescence.⁹⁴ The revised provisions stipulated that the value of animals killed for rations was to be assessed as equal to their purchase price, regardless of any value that may have been added to that price while the animals were being raised.⁹⁵ In contrast, live stock disposed of outside the ordinary course of business, or that had ceased to be trading stock, was assessable at market value.⁹⁶ Lastly, the prescribed values for natural increase, which had been an ongoing source of difficulty, were not revised in the new Act.

In contrast to the manner in which the original live stock rules were undermined, the depreciation rules for capital assets were relatively neutral in the *ITAA 1997*. The depreciation rules allowed deductions for eligible depreciating assets based on the effective life period for taxpayers who were not in a primary production business, with an immediate write-off available for low value stock and stock with a short effective life.⁹⁷ Live stock could be pooled for declining balance depreciation purposes.⁹⁸

⁹¹ The landmark publication for accounting research in Australia was DL Roberts, JJ Staunton and LL Hagan, "Accounting for Self-generating and Regenerating Assets" (Discussion Paper No 23, Australian Accounting Research Foundation, 1995). After three years, a new standard was published, with delayed commencement, to allow for an adjustment period: Australian Accounting Standard, *Self-generating and Regenerating Assets* (AASB 1037, 1998, in effect from the financial year ending 30 June 2000). After the International Accounting Standard IAS 41 (Agriculture) was released in 2000 (with a proposed commencement date of 1 January 2003), Australia adopted the international standards in the Australian Accounting Standard AASB 141. It priced natural increase in live stock at "fair value".

⁹² Tax Law Improvement Project Team (Director B Nolan), *Assessable Income – Trading Stock* (Exposure Draft No 5, released by the authority of the Assistant Treasurer, Hon George Gear, 1995) 10; commented on by DM Smith and W Obst, "A Critical Analysis of ED 5 – The Proposed Simplification of Trading Stock Provisions" (Paper presented at the Australasian Tax Teachers Association, 1996). Similarly, Douglas suggested using the three valuation methods and, for reduction of compliance costs, an arbitrary cost assignment: RA Douglas, "Improving the Efficiency of Taxation of Livestock in Australia" (1995) 63(1) *Review of Marketing and Agricultural Economics* 164.

⁹³ *Income Tax Assessment Act 1997* (Cth) s 70-45. See also M McClaren, "Agribusiness – Planning to Succeed: Trading Stock – Don't Get Caught" (Convention Paper, Taxation Institute of Australia, South Australian Division, 19 March 2013).

⁹⁴ *Income Tax Assessment Act 1997* (Cth) s 70-55.

⁹⁵ *Income Tax Assessment Act 1997* (Cth) s 70-110.

⁹⁶ *Income Tax Assessment Act 1997* (Cth) Subdiv 70-D: there are special rules about disposals due to, for example, notifiable disease, loss of pastures to fire, flood or drought, resumption of land by the government and contamination of land. See also *Income Tax Assessment Act 1997* (Cth) Subdiv 385-E.

⁹⁷ See *Tax Laws Improvement Act 1997* (Cth). When enacted, the *Income Tax Assessment Act 1997* (Cth) provided depreciation of plant under Div 42, with an immediate write-off available for plant that had an effective life of fewer than three years (s 42-125) or a low cost of \$300 or less (s 42-130).

⁹⁸ *Income Tax Assessment Act 1997* (Cth) Subdiv 42-L.

G. 2001 Onwards: The Ralph Review and Concessions for Small Business

Special concessions for small business were introduced in 2001, following a 1999 tax review focused on the business aspects of income tax (Ralph Review). The Ralph Review only examined the live stock rules briefly and affirmed the live stock valuation methods adopted in the *ITAA 1997*.⁹⁹ Importantly, it recommended simplifying the trading stock rules and the depreciation rules for small businesses and various other tax concessions to benefit business more broadly, which the government adopted.¹⁰⁰ Although the old valuation methods for live stock had an inherent margin of error, it appears they were more sound than the new simplified trading stock rules. The new rules were questionable because they provided a form of tax deferral in addition to, particularly, failing to factor in operational costs in live stock valuations.

Under this new regime, primary producers classified as small businesses were allowed to estimate the closing value of their trading stock without undertaking an accurate stocktake.¹⁰¹ If the difference between the opening value and the closing value was estimated at \$5,000 or less, the closing value was deemed to be equal to the opening value. All trading stock, including live stock, was taken into account in this estimation, to avoid splitting the stock into different categories attributable to different business activities. The closing value was used as the trading stock's opening value the following year, unless the taxpayer no longer qualified as a small business or the \$5,000 threshold was reached. In effect, for the purpose of assessing annual income, taxpayers were allowed to disregard live stock expenses up to \$5,000.

The Ralph Review also led to the restructure of depreciation rules,¹⁰² with immediate write-offs available for low price live stock paid by individual taxpayers.¹⁰³ Taxpayers who carried on a business other than primary production could pool low value animals and depreciate them on a declining balance basis.¹⁰⁴ Under the small business rules, taxpayers could deduct animals worth up to \$1,000 immediately¹⁰⁵ or pool them if they cost more than \$1,000.¹⁰⁶

Over the past decade, the government has regularly changed the thresholds for qualifying as a small business.¹⁰⁷ The government has also changed the small business thresholds for instant write-offs.¹⁰⁸ A new class of taxpayer – the “medium business” – was introduced to allow temporary instant write-offs

⁹⁹ Review of Business Taxation (Chair JT Ralph), *A Tax System Redesigned: More Certain, Equitable and Durable* (AGPS, 1999) 200, particularly Recommendation 4.20 (Ralph Review Report).

¹⁰⁰ Ralph Review Report, n 99, 584–586, particularly Recommendations 17.3, 17.4.

¹⁰¹ A “small business” was defined as one with an average annual turnover of \$1 million or less and depreciating assets of \$3 million or less at the end of an income financial year: *New Business Tax System (Simplified Tax System) Act 2001* (Cth). It inserted Subdiv 328-E (simplified trading stock rules) and Subdiv F (eligible small business) and amended *Income Tax Assessment Act 1997* (Cth) s 70-5.

¹⁰² See *Income Tax Assessment Act 1997* (Cth) Div 40. The depreciation rate is calculated as 100% divided by the asset's effective life, using straight line depreciation. The rate for declining balancing depreciation is the straight line depreciation rate multiplied by 150% or, for assets acquired after 9 May 2006, 200%.

¹⁰³ *Income Tax Assessment Act 1997* (Cth) s 40-80(2).

¹⁰⁴ A pool is available for animals purchased for less than \$1,000 or depreciated to a value below \$1,000. Depreciation on pooled animals can be claimed on a declining balance basis at the annual rate of 37.5%, or 18.75% of the cost in the first year that live stock was added to the pool: *Income Tax Assessment Act 1997* (Cth) Subdiv 40-E.

¹⁰⁵ *Income Tax Assessment Act 1997* (Cth) s 328-180.

¹⁰⁶ Pooled animals are depreciable at the annual rate of 30%, or 15% of the cost in the first year that live stock was added to the pool: *Income Tax Assessment Act 1997* (Cth) s 328-190.

¹⁰⁷ The income threshold for qualifying as a small business increased to an average annual turnover of \$10 million in 2017: *Tax Laws Amendment (Small Business) Act 2007* (Cth); *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017* (Cth), which amended *Income Tax Assessment Act 1997* (Cth) s 328-110.

¹⁰⁸ In the past, the government temporarily increased the threshold to \$6,500, \$20,000, \$25,000, \$30,000 and \$150,000, due to expire on 30 June 2020: see *Income Tax Assessment Act 1997* (Cth) s 328-180.

for assets worth up to \$30,000 (or \$150,000 from 12 March 2020).¹⁰⁹ These temporary write-off thresholds are due to expire on 30 June 2020. Accelerated depreciation is available to businesses with an aggregate turnover less than \$500 million during the pandemic crisis of COVID-19.¹¹⁰

IV. REASSESSING THE SYSTEM

There is no evidence of strong support by the primary production industry of the changes to the live stock rules made in 1997 nor did they serve any particular policy purpose. Prior to 1997, the unique economic character of live stock had been acknowledged for many years and the use of either the cost-based method or the market value method for valuing live stock was settled practice. The logic behind the 1997 changes was flawed. Administrative practice and compliance activities may have shifted and adapted since then, but the 1997 changes still deserve to be examined. Doing so raises important questions about tax policy and what it takes to design and operate an efficient tax system.

This part further discusses tax expenditures involving live stock in Australia. These areas have not been subject to sound analysis for justification of continuing government assistance. The prescribed value of natural increase to recognise accrued wealth has not been updated for several decades, while purchased live stock may be reducing in value as it dies, is sold or is killed. The special treatment of bred horses is worth noting – as for other live stock, trading stock treatment may be more appropriate than the depreciation treatment currently available. The special treatment of live stock disposed outside the ordinary course of business also requires policy analysis to see if a tax system is the best means of providing assistance to primary producers in exceptional circumstances.

A. Live Stock Valuation Methods

Assessing income is not always straightforward. In particular, the value produced by live stock's natural increase is difficult to measure, as are the costs involved in raising live stock, both purchased and bred. While the cost of purchased stock is comparable to the cost of bred stock plus the suppliers' profit margin, the value assigned to natural increase is arbitrary because it is impractical to attribute clear direct and indirect operating costs to offspring. Full taxation – tax on market value of newly born animals and their subsequent increase in the value as they grow – is unlikely in a tax system that is conservative about assessing unrealised gains. This may mean that for some taxpayers the size of their live stock holding can continue to increase along with the wealth accrued in it, while for tax purposes the value of their live stock appears to be decreasing. It has been acknowledged that live stock can function as a capital asset and that its turnover may be slower than ordinary trading stock. In some contexts, this may make it appear desirable to allocate profits from live stock flexibly, by adjusting the profits reported year to year (considered further below). However, choosing an appropriate live stock valuation method at the beginning of the process may be the most important step of all.

When the market value method of valuation fails, it is difficult to point to one best alternative method. That said, the cost-based method, which uses purchase price as its base, functioned well as an alternative for many decades prior to 1997 and it offered a clear benefit: objectivity. Any departure from an accepted benchmark like the cost-based method should come with benefits that outweigh the shortcomings of the benchmark, unless the departure arises from embracing ordinary industry practice. This is important for the tax system to recognise. Unfortunately, it appears that none of this was a factor in the 1997 changes to the live stock rules. It seems the changes arose by asking “why not?”, instead of questioning why things should be changed if they were working well.

It is possible that the revised rules have not changed industry practice, even though they allow flexible allocation of profits across different tax periods. For that reason, some may not see the need to amend the current laws. As was argued in respect of the 1997 changes, any further change would require a particular

¹⁰⁹ *Income Tax Assessment Act 1997* (Cth) s 40-82, as amended by *Coronavirus Economic Response Package Omnibus Act 2020* (Cth) Sch 1 s 1.

¹¹⁰ See *Coronavirus Economic Response Package Omnibus Act 2020* (Cth) s 7, which is available from 12 March 2020 until 30 June 2021.

policy or industry advocacy. The market value method is to remain as a means of accurate measurement of net accretion, and any deviation to help practical administration of tax would need to be permitted to the extent that it is clearly justifiable. In any respect, the previous rules, which functioned well for so many years, should not be forgotten. It is important to understand and appreciate the history upon which the current system has been built before finding ways to improve it.

B. Key Tax Concessions for Live Stock

Tax concessions are an important feature of the Australian system. Aside from the simplified trading stock rules and depreciation rules, there are also three key tax concessions that affect live stock: first, the low prescribed values for natural increase; secondly, an accelerated write-off process for horse-breeding stock, achieved through discounted valuations; and thirdly, tax deferral on profits from the forced disposal of live stock or on compensation received for live stock deaths. The government has not reviewed the appropriateness of these concessions, although they have been acknowledged in tax expenditure statements since the 1980s.

1. Prescribed Values for Natural Increase

Since 1922, the live stock schedule in the tax legislation has contained prescribed values for live stock acquired through natural increase (ie offspring). The schedule has been used for the cost-based method to function with the industry practice of counting heads for a year-end stocktake. These prices, which covered the main classes of live stock bred in Australia, were used when applying the cost-based valuation method. Originally, minimum and maximum prices were provided for sheep, cattle, horses and pigs, and taxpayers were required to choose a price within that range, except for animals exclusively designated as stud stock. The schedule was updated to include stud stock in the *Income Tax Assessment Act 1936* (Cth), which raised the minimum prices. However, the updated prices remained relatively low, to accommodate the different market conditions in different parts of Australia.¹¹¹ The maximum prices were removed in 1951, after the Spooner Committee found them to be of little use.¹¹² In practice, the low prices in the schedule were biased, favouring bred stock over purchased stock by providing a form of tax deferral on unrealised profits. The Asprey Committee recommended the government undertake periodic reviews of the prescribed values in the live stock schedule to prevent this. The prices were finally reviewed in 1984, about a decade after the recommendation was made and 49 years after the original prescribed values were introduced.¹¹³ However, after the review, the revised prices still did not come close to actual market cost. The new prescribed values for sheep and pigs were only approximately 4% of their market value and the prescribed values for cattle and horses only 2% of their market value.¹¹⁴

The prescribed values were increased by three to four times in 1988,¹¹⁵ but again they did not reflect the market value of the relevant animals.¹¹⁶ Two new classes of live stock were added to the schedule – goats and deer. Poultry and emus were added in 1994 and 1996 respectively.¹¹⁷ Table 1, below, shows the changes

¹¹¹ *Income Tax Regulations 1936* (Cth) reg 5; *Income Tax Assessment Regulation 1997* (Cth) reg 80-55.01 (presently in force).

¹¹² Regulations under the *Income Tax and Social Services Contribution Assessment Act 1936–1951* (Cth), amending *Income Tax Regulations 1936* (Cth) reg 5. See Spooner Committee Report, n 69.

¹¹³ *Income Tax Regulations (Amendment); Statutory Rules 1984 No 28 1984* (Cth) amending *Income Tax Regulations 1936* (Cth) reg 5(3). The amendment was found to contain a technical defect that allowed taxpayers to use the pre-1 July 1984 values if they had done so in the past. This issue was remedied by requiring taxpayers to account for natural increase using either their last-used price or the minimum value prescribed, whichever was greater: see *Income Tax Assessment Act 1936* (Cth) s 34, as amended by the *Taxation Laws Amendment Act (No 3) 1986* (Cth).

¹¹⁴ J Kerin, “Minister for Primary Industry: Supplementary Information for the 1984–85 Budget” (Press Release, 21 August 1984) Decision 16.

¹¹⁵ *Income Tax Regulations (Amendment); Statutory Rules 1988 No 384* (Cth), amending *Income Tax Regulations 1936* (Cth) reg 5(3).

¹¹⁶ Commonwealth, *Parliamentary Debates*, House of Representatives, 31 August 1988, 734 (Peter Morris).

¹¹⁷ *Income Tax Regulations (Amendment); Statutory Rules 1995 No 153* (Cth), amending *Income Tax Regulations 1936* (Cth) reg 10(3); *Income Tax Regulations (Amendment); Statutory Rules 1996 No 114* (Cth) reg 10(3).

made to the live stock schedule over time, including the prescribed values and the addition of new live stock classes. These new classes reflected changing consumer demand and increasing commercialisation and mass production in industries that used to be dominated by small-scale farming. For the four original classes of live stock (sheep, cattle, horses and pigs) and for the additional classes added in the 1980s or 1990s, the prescribed values have not changed for over 30 years. While the *Constitution* prohibits different prices from being prescribed for different regions of Australia, the low prescribed values in the schedule are too low to reflect market value or to reduce the bias in favour of bred stock.

TABLE 1. Minimum Prescribed Values for Natural Increase

Financial Year	1921/1922–1934/1935	1935/1936–1983/1984	1984/1985–1986/1987	1987/1988–1993/1994	1994/1995–1995/1996	1996/1997–2018/2019*
Sheep	A£0 2s 6d	\$0.40	\$1.00	\$4.00	\$4.00	\$4.00
Cattle	A£0 10s	\$2.00	\$5.00	\$20.00	\$20.00	\$20.00
Horses	A£0 15s	\$2.00	\$5.00	\$20.00	\$20.00	\$20.00
Pigs	A£0 5s	\$0.50	\$4.00	\$12.00	\$12.00	\$12.00
Goats	–	–	–	\$4.00	\$4.00	\$4.00
Deer	–	–	–	\$20.00	\$20.00	\$20.00
Poultry	–	–	–	–	\$0.35	\$0.35
Emus	–	–	–	–	–	\$8.00

* The latest prices are prescribed in *Income Tax Assessment Regulations 1997* (Cth) reg 70-55.10.

There are at least two alternative approaches to valuing natural increase. The first is to use the *average price* of stock purchased during the financial year to calculate the current value of the animals. This would reflect market conditions for that year to allow taxpayers to account for the natural increase at a high value if operating in the high-price market or a low value if operating in the low-price market. The average purchase price could be applied to animals of any age, not just new offspring, which gives effect to recognise to some extent the accrued gain by way of growth of animals in the taxpayer's possession. If one year is not an adequate base due, for example, to abnormally high or low purchase prices in some years or a small number of purchases, a multiyear average may be used. In the second alternative, the prescribed value assigned to offspring could be based on the *accumulated value* of all the live stock held – that is, the opening stock value plus acquisition costs during the year, divided by the total number of animals held, including animals purchased that year. This option is, however, discriminatory for taxpayers participating in the same market as they bought animals at different prices at different times while the current value of animals applies to them all equally.

Table A3 in the Appendix compares three different valuation methods for valuing natural increase: the prescribed value method (used under the current law); the cost-based method (using an average purchase price); and the accumulated value method. These produce significantly different results, which highlights the importance of choosing the right method. More analysis and further industry consultation is required to determine the best way to value natural increase.

2. Discounted Valuations for Breeding Horses

Over the years, various methods have been used to assess the value of live stock (including natural increase) in primary production. Valuing breeding stock appropriately has also proved challenging. Animals used in businesses other than primary production were already being treated as depreciable assets, but to help Australia's horseracing industry, special depreciation deductions (or special closing stock valuation) for horses were introduced in 1985, mirroring similar steps taken in New Zealand.¹¹⁸

¹¹⁸ *Taxation Laws Amendment Act (No 3) 1985* (Cth), substituting *Income Tax Assessment Act 1936* (Cth) s 32; Explanatory Memorandum Part B, *Taxation Laws Amendment Bill (No 3) 1985* (Cth) Notes on cl 23.

When assessing taxable income, the first question is whether the taxpayer's activities qualify as a business.¹¹⁹ The next question is whether the business is a primary production business and, if so, whether any animals involved in it should be dealt with under the live stock provisions. For horses used in primary production, the answer to this question turns on whether they are breeding stock falling under the live stock provisions, or capital assets. In practice, this dichotomy is not clear cut. In Australia, primary production of horses is limited to breeding because horses are not sold for meat. Racehorses are categorised as capital assets and horseracing is a non-primary production business.¹²⁰ However, breeding stock horses are often raced to enhance the value of their foals. Successful racehorses are also bred when they retire from racing, which can generate large profits. Thus, racehorses can also be characterised as breeding stock in primary production.¹²¹

Given these complexities, the Commissioner of Taxation considered it necessary to provide an alternative means of tax deduction for horses used in primary production businesses.¹²² This practice was legislated in the 1980s. The new rule applied to horses in primary production in addition to the valuation methods available at the time for assessing live stock including natural increase (the cost-based method, market value method or a method approved by the Commissioner of Taxation).¹²³ It provided for two types of depreciation deduction – a “general reduction” and a “special reduction” – for horses acquired under contracts entered into after 20 August 1985. Different depreciation rates applied to male horses and female horses, and straight line depreciation was allowable for female horses based on their age.¹²⁴ However, it became apparent that some taxpayers were claiming depreciation deductions on young mares, below breeding age. Accordingly, the rule was modified the following year to limit depreciation to mares at least three years old.¹²⁵ In 1992, the depreciation rules that applied to plant and articles were standardised, slightly increasing the depreciation that could be claimed on animals used as

¹¹⁹ There is an extensive list of cases examining the essential characteristics of a business including, but not limited to, profit-making intent, the nature, type and scale of activities, systems and organisations and any other activities undertaken by the taxpayer. See, eg, *Ferguson v Commissioner of Taxation (Cth)* (1979) 37 FLR 310; 9 ATR 873 (five cows maintained for breeding purposes); *Commissioner of Taxation (Cth) v Walker* (1985) 79 FLR 161; 16 ATR 331 (one female Angora goat purchased for breeding). In the context of horses, the existence of a business can be established despite the small scale of the activities: *Case J60* (1977) 77 ATC 525; *Case Q116* (1983) 83 ATC 602; *Case R83* (1984) 84 ATC 557; *Case T61* (1986) 86 ATC 447. It can also be established despite trading losses: *Case Q63* (1983) 83 ATC 331; *Case Q113* (1983) 83 ATC 580; *Case Q116* (1983) 83 ATC 602; *Case R19* (1984) 84 ATC 194; *Case S5* (1985) 85 ATC 113; *Case V86* (1988) 88 ATC 597; *Case W16* (1989) 89 ATC 213; *Case X28* (1990) 90 ATC 273. However, it was always necessary for the activities to have a commercial flavour and not merely to be preparatory in nature: *Tweddle v Federal Commissioner of Taxation* (1942) 180 CLR 1; 7 ATD 186; *Case 133* (1942) 10 CTBR 685; *Case J49* (1977) 77 ATC 427; *Case J62* (1977) 77 ATC 532; *Case U72* (1982) 82 ATC 446; *Case Q26* (1983) 83 ATC 122; *Case Q73* (1983) 83 ATC 368; *Case T14* (1986) 86 ATC 194; *Case V8* (1988) 88 ATC 146; *AAT Case 12,860*; *Daff v Commissioner of Taxation (Cth)* (1998) 39 ATR 1042; 98 ATC 2129. See also AR Gotterson, “Back to the Farm” (Convention Paper, Taxation Institute of Australia, New South Wales Division, 6–8 April 1984); Heading, n 16; G Winter, “Licensing in Agribusiness: The Hidden Traps” (Convention Paper, Taxation Institute of Australia, South Australian Division, 6 May 2005) 15.

¹²⁰ Racehorses are capital assets: *Riddle v Commissioner of Taxation (Cth)* (1952) 9 ATD 391. Horses may also be held under a leasing agreement, as discussed in Winter, n 119, 15.

¹²¹ The overlap between racing and breeding and between primary production and non-primary production for horse businesses was considered in *Case M72* (1980) 80 ATC 497, in which depreciation deductions were rejected because the taxpayer company had been established to maintain an interest in horses rather than racing.

¹²² In general, name sires (or stallions) were deductible up to 20% per annum on the purchase price, unless a purchase offer or official valuation was available to prove that market value had been maintained or increased. This treatment was extended to stud rams and stud bulls later. See JT Finn, *Taxation of Primary Producers in Australia* (CCH Australia Ltd, 1981) 32; Ligertwood Committee Report, n 6, [502]–[505].

¹²³ One consistent method was to be applied across all live stock in the same class, unless the Commissioner of Taxation approved an alternative method for the whole or part of the live stock: see *Case C106* (1953) 3 TBRD 626.

¹²⁴ The general reduction allowed the closing value of male horses at no more than 50% of their opening value and female horses at 33⅓% of their opening value to give effect to depreciation of 50% and 33⅓% per annum on declining balance; the special reduction depreciated female horses on a straight line basis to result in a cost base of \$1 by the age of 12.

¹²⁵ *Taxation Laws Amendment Act (No 3) 1986* (Cth), adding s 32(1A) to the *Income Tax Assessment Act 1936* (Cth).

plant in non-primary production.¹²⁶ The same year, the deduction rules for horses were also simplified to standardise depreciation on a straight line basis only.¹²⁷

In 1993, the government attempted to solve the problem of characterising horse businesses. The Commissioner of Taxation issued a ruling stating that horses only qualify as live stock if the “sole or main purpose” of maintaining them is to sell them or their bodily produce, including any progeny.¹²⁸ The ruling also stated that, by itself, horseracing would not be considered a business, and that a horse business should involve breeding or training activities. The Ralph Review attempted to tackle the issue further by recommending restrictions on the deductions that could be claimed for losses against income received from certain activities, in addition to existing tests that prevented deductions for non-commercial activities.¹²⁹ The government did not implement the Ralph Review’s recommendation, but it acknowledged that the “sole and main purpose” test lacked legislative and judicial support. The Commissioner issued a revised ruling in 2008 stating that breeding and training must be an “integral part” of an eligible horse business, while maintaining that horseracing alone did not constitute a business.¹³⁰ This view has not been tested in the courts and it is unclear how it has been applied in practice in the horse industry.

The new depreciation deduction rules for horses were problematic because at least part of the value of horse-breeding stock was attributable to the offspring they produced. Also, horses sent to the slaughterhouse did not generate profits. A horse could have a successful racing career followed by a highly profitable breeding career, or could fail at both and be sent to slaughter. In effect, the timing of the depreciation deductions allowed expenses to be claimed for horses earlier than for other live stock, which was not justified. However, the special rules for horses were retained in the *ITAA 1997*,¹³¹ instead of being merged with the ordinary trading stock rules. The special tax concessions available for horses, and the preferential cost recognition they provide, are still being used and have not been examined, even in recent years. Without proper evaluation, these concessions are unjustifiable.

3. Disposals Outside the Ordinary Course of Business

Since 1922, live stock sold as part of the sale of a business has been included in the vendor’s assessable income, for the same amount deductible by the purchaser.¹³² However, income received from forced disposal of live stock outside the ordinary course of business was treated differently. For tax purposes, such income could be spread over five years. It began in the post-World War II years, when all levels of government in Australia were resuming land to use for resettling war veterans. Pastoralists whose land was subject to compulsory acquisition were obliged to dispose of their live stock by selling their animals or disposing of them in some other way, before surrendering their land.¹³³ The Commonwealth considered it necessary to provide temporary tax relief to these pastoralists to lessen the tax burden associated with disposing of their live stock. Legislation was introduced in 1945 to provide an “income spreading” option that allowed the profits from the disposing of live stock to be spread over five years.¹³⁴ It was considered unlikely that taxpayers with low assessable incomes, unclaimed tax losses or whose future income was expected to be high would use this option. The Commissioner of Taxation was also

¹²⁶ See *Income Tax Assessment Act 1936* (Cth) ss 55–56. For example, an animal with a taxpayer-assessed effective life of at least six years but less than 10 years depreciated at an annual rate of 20% on a straight line, or 30% on a declining balance basis.

¹²⁷ Male horses were depreciated up to a maximum of 25% of the cost per annum; female horses were depreciated at a maximum of 33⅓% or the cost per annum to result in no less than \$1 by the age of 12. See *Income Tax Assessment Act 1936* (Cth) ss 32, 32A.

¹²⁸ ATO, *Horse Industry Issues*, TR 93/26, 1993.

¹²⁹ Ralph Review Report, n 99, [204]–[205], Recommendation 7.5 [295]–[298].

¹³⁰ ATO, *Income Tax: Various Income Tax Issues Relating to the Horse Industry; Including Whether Racing, Training and Breeding Activities (Carried Out as Stand-alone Activities or in Combination) Amount to the Carrying on of a Business*, TR 2008/2, 2008.

¹³¹ *Income Tax Assessment Act 1997* (Cth) ss 70-55, 70-60, 70-65.

¹³² See also *Income Tax Assessment Act 1922* (Cth) s 16A, as inserted by the *Income Tax Assessment Act 1927* (Cth) and applied in *Case 2/99* (1999) 99 ATC 108, which dealt with the transfer value of live stock for tax purposes, in the hands of the purchaser.

¹³³ Explanatory Memorandum, *Income Tax Assessment Bill 1945* (Cth) Notes on cl 5.

¹³⁴ The *Income Tax Assessment Act 1945* (Cth) amended *Income Tax Assessment Act 1936* (Cth) s 36.

given power to assess any unused profits immediately when a taxpayer was about to leave Australia, became or applied to become bankrupt, commenced to be wound up, or died.

Six years after this tax relief was introduced, two key cases were decided in the High Court. In one, the taxpayer's income was assessed based on compensation money they had received for slaughtering diseased cattle as required by the law.¹³⁵ In the other, there was no tax consequence when live stock owned by an individual became the interest of a newly formed partnership.¹³⁶ The Spooner Committee reviewed these cases from a tax policy perspective.¹³⁷ The government concurred with the Committee's findings, resulting in a statutory amendment to offset disposals when live stock was disposed of by way of a gift, or by way of any change of ownership or interest in a partnership. The Spooner Committee also considered providing tax relief for forced sales arising from flood, drought and fire, but it concluded that tax was not the best way to offer financial assistance in such situations.¹³⁸ However, contrary to the Committee's recommendation, in 1952 the government expanded the income spreading rule to help farmers restock their live stock after loss or destruction of pastures or fodder caused by natural disasters.¹³⁹ The logic behind this was that, although a primary producer might suffer a disaster in one financial year, they may not come across a favourable opportunity to buy replacement stock until a later financial year.¹⁴⁰ In other words, five-year income spreading, which provided a form of tax deferral, was justified based on the assumption that the producer would have the same level of pre-tax profit, irrespective of when the replacement stock was acquired, whether in the first year after the disaster or in any of the next four years.

In 1960, the income spreading rule was expanded to include lessees of Crown land whose leases were taken over by a State government for the purpose of eradicating cattle tick.¹⁴¹ In 1961, it was extended again to cover compensation received for stock deaths or compulsory destruction of live stock for the purpose of controlling or eradicating a disease.¹⁴² The primary production industry submitted that the government should also allow a deemed sale price to be used when calculating assessable income in these situations, a price lower than the actual compensation received. Unsurprisingly, this idea was not adopted.¹⁴³ Over time though, the income spreading rule came to be used differently from the policy objective it was originally intended to achieve, which was to help primary producers purchase replacement stock after unexpected emergencies.

Another option was introduced in 1967 to replace income spreading – namely, the “cost reduction” rule.¹⁴⁴ In the event of fire, drought or flood, taxpayers could adjust their assessable income calculations by reducing the cost of replacement animals to either the purchase price or an average price per head, whichever was less, as long as it did not exceed the total compensation received. The reduced cost assigned to replacement animals could then be used when they were sold or disposed of in the future.

¹³⁵ *Federal Commissioner of Taxation v Wade* (1951) 84 CLR 105.

¹³⁶ *Rose v Commissioner of Taxation* (1951) 84 CLR 118. See also *Case 40* (1948) 14 CTBR 20, where no devolution arose out of the death of a partner in a partnership; *Peterson v Commissioner of Taxation* (1960) 106 CLR 395, where there was no dissolution of a partnership after the death of a partner.

¹³⁷ Spooner Committee Report, n 69; Spooner Committee Supplementary Report, n 69.

¹³⁸ Spooner Committee Report, n 69, 7, in particular [48]–[49].

¹³⁹ *Income Tax and Social Services Contribution Assessment Act (No 3) 1952* (Cth), amending *Income Tax Assessment Act 1936* (Cth) s 36, applied in *Case P25* (1963) 14 TBRD 127 (income spreading applied to ewes sold due to drought); *Case S47* (1966) 17 TBRD 260 (income spreading denied because the taxpayer failed to demonstrate the proceeds would be used for replacement stock).

¹⁴⁰ Commonwealth, *Parliamentary Debates*, Senate, 4 June 1952, 1332–1333 (Reginald Wright). It was also stated that so much tax was absorbed that insufficient funds would be available for restocking: see Explanatory Memorandum, *Income Tax and Social Services Contribution Assessment Bill (No 3) 1952* (Cth) Notes on cl 7.

¹⁴¹ *Income Tax and Social Services Contribution Assessment Act 1960* (Cth), amending *Income Tax Assessment Act 1936* (Cth) s 36.

¹⁴² *Income Tax and Social Services Contribution Assessment Act (No 3) 1961* (Cth), inserting s 36AA into the *Income Tax Assessment Act 1936* (Cth).

¹⁴³ This was not supported in the Ligertwood Committee Report, n 6, [515]–[518].

¹⁴⁴ *Income Tax Assessment Act (No 3) 1967* (Cth), inserting s 36AAA into the *Income Tax Assessment Act 1936* (Cth).

Taxpayers were also allowed to inflate their profits by a nominated amount to reduce the overall cost of replacing animals, instead of accounting for the value of offspring born during the five-year concession period. Any unused profit created by this reduction was assessable at the end of the concession period.

In the 1970s, the Asprey Committee supported using tax relief as a way to manage “bunched income” for primary producers, but recommended that it be made available to non-primary producers too.¹⁴⁵ Bunched income is income that, but for the forced disposal of live stock, would have been earned over a number of years, presumably when the live stock reached a particular age. The Committee noted that there would be less bunching if a market valuation was used for assessing live stock instead of the cost-based method, which deferred tax on unrealised gains.

The cost reduction rule was expanded again in 1980 to include live stock that had died or was legally required to be destroyed due to disease.¹⁴⁶ In 1986, an even more generous cost reduction method was introduced, which allowed tax deferral for up to 10 years when live stock died or was destroyed as part of the government’s Bovine Brucellosis and Tuberculosis Eradication Campaign.¹⁴⁷ In 1990, yet another expansion of the rule occurred, which applied to live stock that the law was required to destroy due to land contamination. This final change modified both the income spreading rule and the cost reduction rule.¹⁴⁸ Both rules, in their modified forms, were incorporated into the *ITAA 1997*.¹⁴⁹ This meant taxpayers could choose between either income spreading or cost reduction when reporting profits or compensation they received after the death or forced sale of live stock due to the compulsory acquisition of their land, cattle tick eradication laws, natural disaster or contamination of their land. The choice was also available when live stock died or was destroyed to control certain diseases.

These tax concessions mean that some primary producers are legislatively excused from accurately measuring their net income. Despite the Spooner Committee’s warnings against using the tax system to offer financial assistance to primary producers, and its recommendation that the income averaging measures offered to primary producers be made available to all taxpayers, these special concessions for live stock remain in place. The government has never reviewed them. It is true that unlike other industries, primary production is particularly sensitive to natural disasters and disease and, on that ground, it is often perceived as a higher risk business than others.¹⁵⁰ However, business risk should not be the main concern when designing tax rules for live stock. All businesses face risk and can be threatened by unexpected changes. Primary producers must speculate and innovate just like other entrepreneurs. Special rules for primary producers must be based on sound tax principles and policy, not on false perceptions. While income-averaging remains in place, the effectiveness of these concessions is difficult to justify.

V. CONCLUSION

In the past, live stock was assessed for tax purposes using two valuation methods – namely, the market value method and cost-based method. The market value method was theoretically superior but could not be relied on as the sole method due to the diversity among live stock operators and fluctuating market prices. The alternative, the cost-based method, provided objectivity and greater certainty for tax administration. However, in 1997 the government took what was, in retrospect, hasty action to remove the special tax rules for live stock and treat live stock the same way as ordinary trading stock, in an

¹⁴⁵ Asprey Committee Report, n 74, [14.83]–[14.85], [18.19]. For more information about income averaging for primary production, see RL Bowra, “Tax Planning for Primary Producers” (Convention Paper, Taxation Institute of Australia, Victorian Division, 4–6 August 1972); DG Neilson, “Income Tax and The Farmer” (Convention Paper, Taxation Institute of Australia, Victorian Division, 3–5 May 1974); CR Beavis, “Selected Taxation Aspects Relating to Primary Producers” (Convention Paper, Taxation Institute of Australia, West Australian Division, 30 September–2 October 1977).

¹⁴⁶ *Income Tax Assessment Amendment Act (No 4) 1980* (Cth), inserting s 36AAA(1A) into the *Income Tax Assessment Act 1936* (Cth).

¹⁴⁷ *Taxation Laws Amendment Act (No 3) 1986* (Cth), inserting s 36AAA(2A) into the *Income Tax Assessment Act 1936* (Cth).

¹⁴⁸ *Tax Laws Amendment Act (No 2) 1990* (Cth), inserting s 36AAA(1AA) into the *Income Tax Assessment Act 1936* (Cth).

¹⁴⁹ *Income Tax Assessment Act 1997* (Cth) Subdiv 385-E.

¹⁵⁰ A venture that fails or suffers a temporary downturn can still be considered a business: see *Case D3* (1972) 72 ATC 13, where a venture growing crops and grazing cattle failed due to drought.

attempt to simplify and standardise the tax laws. There was no proper examination of the benchmarking and valuation methods involved nor any industry consultation. The government adopted the view that live stock was not substantially different from trading stock, abandoning the previous policy, which had been based on several decades of tax reviews and legislative reform. Any departure from established tax policy and principles should come with clear benefits, but these changes to the live stock rules have produced no discernible policy. In practice, the changes gave taxpayers the flexibility to allocate profits across different financial years by using a replacement value or switching between valuation methods year by year. While this may have benefited some taxpayers, it has not necessarily benefited the tax system overall. Without particular policy concerns at present, however, it may be unnecessary to undo the changes that are already in place.

This article examined tax rules governing live stock with a view to achieve neutrality, including: the small and medium business concession that allows deferral of trading stock (including live stock) up to a total value of \$5,000; simplified depreciation rules for immediate write-offs and accelerated depreciation; prescribed values of natural increase; depreciation on horses classified as live stock; and tax deferral for profits from forced disposal of live stock in certain circumstances. The small and medium business concessions and simplified depreciation rules are unlikely to be sound in the live stock context, but they require analysis of a broader group of assets for any further change. Others are specific to live stock. From a policy perspective, it is necessary to ensure that the benefits of providing these concessions are clearly defined and that the tax system is the best means of providing those benefits. Accordingly, first, immediate action is required in regard to the prescribed values for natural increase, which have not been reviewed for several decades and no longer reflect the market value of live stock. Although the *Constitution* prohibits the government from prescribing different prices for different regions of the country, tax assessment calculations can be adjusted based on the purchase prices paid by individual taxpayers in their local markets. Secondly, the special stock valuation of breeding horses is unjustifiable and inequitable between ordinary primary producers and horse breeders, which needs urgent government attention. Lastly, the rules governing involuntary disposals present uncertain benefits while primary producers are allowed to average bunched income. Review is necessary to evaluate the effectiveness of these rules.

It is unlikely that the current rules will remain in place forever. Tax law is, after all, an instrument used to achieve the government's overarching policy goals. In the case of the live stock rules, the government's goal of simplifying the tax system appears to have taken precedence over other important policies and principles. In the future, there may or may not be a change to the current live stock rules, depending on the government's priorities. However, irrespective of how the government responds now or in the future, the tax community should be aware of how the present system for taxing live stock came about and, in particular, why the current valuation methods were avoided for so many years. When the current system fails, a better one will be needed based on sound logic and analysis.

APPENDIX: EXAMPLE CALCULATIONS

Averaging is one of the most common valuation methods used to account for live stock and to calculate trading profits. To calculate average value, the opening value of existing stock is added to the cost of purchased stock and natural increase. That total value is divided by the total number of animals to arrive at an average price per animal. Table A1 illustrates an example of this process, where the average value is \$63.91 per animal.¹⁵¹

¹⁵¹ Tables A1 and A2 are adapted from J Finn, *Taxation of Primary Producers in Australia* (CCH Australia Ltd, 3rd ed, 1990) 82–83. Different examples are given in Department of Primary Industry, *Income Tax for Farmers and Graziers* (AGPS, 7th ed, 1967) 6–9.

TABLE A1. Example: Calculating Average Value

	Number of Animals	Price per Animal	Total Value
Opening value	150	\$50.00	\$7,500.00
Purchases	20	\$300.00 (on average)	\$6,000.00
Natural increase	60	\$20.00 (prescribed)	\$1,200.00
<i>Total</i>	<i>230</i>	<i>Total</i>	<i>\$14,700.00</i>
Average value			
Total value ÷ total number of animals			\$63.91

In Table A1, an average value is \$63.91. This value is applied to the number of closing stock to calculate the closing value of live stock in Table A2. Trading profits is calculated by subtracting expenses from income. Income includes animals killed for rations at their cost; expenses include reduction in the value of live stock. As demonstrated, a net increase in the number of live stock by 10 animals reduces expenses by \$2,725.60. Alternatively, this amount can be taken as income.

TABLE A2. Example: Calculating Trading Profits

	Number of Animals	Price per Animal*	Total Value
Stocktake			
Opening stock	150		
Acquisitions			
from purchases	20		
from natural increase	60		
Disposals			
from sales	-60		
from deaths	-7		
from killed for rations	-3		
Closing stock	<i>160</i>	\$63.91 (average)**	\$10,225.60
TRADING PROFIT (LOSS)			
INCOME			
Sales	60	\$400.00	\$24,000.00
Killed for rations			
from opening stock	1	\$50.00	\$50.00
from purchases	1	\$200.00	\$200.00
from natural increase	1	\$20.00 (prescribed)	\$20.00
<i>Total</i>	<i>63</i>		<i>\$24,270.00</i>
EXPENSES			
Opening value	-150	-\$50.00	-\$7,500.00
Purchases	-20	-\$300.00	-\$6,000.00
Closing stock	160	\$63.91	\$10,225.60
<i>Total</i>	<i>-10</i>		<i>-\$3,274.40</i>
Trading Profit			\$20,995.60

* Unless otherwise stated, this example uses actual purchase prices instead of market values.

** This average value comes from Table A1. In effect, the average value can be applied to all animals removed from the group, whether due to death, being lost, sold or killed for rations. In this example, the average value has been used for stock sold, lost to death and killed for rations.

In Table A2, natural increase is assigned a prescribed value of \$20. This is Option 1 in Table A3, which compares alternative valuation methods. Option 2 uses the average purchase price of live stock acquired during the year. It presumes that bred stock (ie natural increase) has the same value as purchased stock, which is higher than the prescribed value and comes close to current market value. Option 3 uses an accumulated value equal to the opening value plus the price of stock purchased during the year, divided by the total number of animals. It is also higher than the prescribed value, but falls below current market value due to inflation.

TABLE A3. Alternative Valuation Methods

	Number of Animals	Price per Animal	Total Value
Opening value	150	\$50.00	\$7,500.00
Purchases	20	\$300.00 (average)	\$6,000.00
Natural increase	60		
Option 1 – Prescribed value		\$20.00	\$1,200.00
Option 2 – Purchase price		\$300.00 (average)	\$18,000.00
Option 3 – Accumulated value		\$79.41*	\$4,764.60
<i>Total number of animals</i>	230		
<i>Average value</i>			
<i>[opening value + purchased value + natural increase value] ÷ total number of animals (230)</i>			
Option 1 – Prescribed value			\$63.91
Option 2 – Purchase price			\$136.96
Option 3 – Accumulated value			\$79.41

* The accumulated value is the total opening value plus the price of purchases, divided by the total number of animals: $(\$7,500 + \$6,000) \div (150 + 20) = \79.41 .