Date of issue: 23 May 2018

Inland Revenue
Te Tari Taake

QUESTION WE'VE BEEN ASKED

QB 18/09
Income tax – can sharemilkers and contract milkers deduct farmhouse expenditure using the approach in IS 17/02?

The Commissioner's view on the appropriate treatment of farmhouse expenses in different circumstances is set out in the interpretation statement "IS 17/02: Income tax – deductibility of farmhouse expenses", Tax Information Bulletin Vol 29, No 4 (May 2017): 82. This Question We've Been Asked (QWBA) clarifies the approach for sharemilkers and contract milkers.

Key references

"IS 17/02: Income tax – deductibility of farmhouse expenses" *Tax Information Bulletin* Vol 29, No 4 (May 2017) called "IS 17/02" in this QWBA.

Key terms

Type 1 farm: a farm where the cost or value of the farmhouse is less than 20% of the cost or value of the farm. IS 17/02 allows sole traders and partnerships on type 1 farms to claim an automatic 20% of certain farmhouse expenditure. All other farms are type 2 farms and have to do a home office calculation.

Sharemilker: a person working on a dairy farm under a sharemilking agreement who is entitled to receive a share of the profits from the dairy farming operations.

Contract milker: a person carrying on a business like a "sharemilker" except they operate under a contract milking agreement and are paid on the basis of production instead of a profit share.

Question

Can sharemilkers and contract milkers use the approach in IS 17/02 and claim a 20% deduction for farmhouse expenditure?

Answer

Yes – sharemilkers and contract milkers may use the approach in IS 17/02 to claim a 20% deduction for farmhouse expenditure (for example, power and insurance bills) without calculating actual business use of the farmhouse, if:

- **they carry on a sharemilking or contract-milking business as sole traders or a partnership independent from the farm owner's business;**
- **the business is of sufficient scale to require its own home office and centre of operations in the sharemilker's or contract milker's farmhouse; and**
- **the sharemilker or contract milker's farmhouse is used in a similar manner to and to a similar extent as other farmhouses on type 1 farms.**

Explanation

1. IS 17/02 concerns deductions for farmhouse expenditure where that expenditure has both private and business elements. A deduction is available only to the extent that the expense is incurred in carrying on the farming business. IS 17/02 draws a distinction between how type 1 and type 2 farms calculate business use. The Commissioner allows sole traders and partnerships on type 1 farms to claim automatic deductions for farmhouse expenditure at fixed rates (although they can do a calculation if they wish). Type 2 farms must do a home office calculation, or use the formula in s DB 18AA of the Income Tax Act 2007, to calculate actual business use.

2. Sharemilkers and contract milkers who live on the farm are likely to incur farmhouse expenditure that has some nexus with their business. The Commissioner has been asked to clarify whether sharemilkers and contract milkers can claim a 20% deduction of farmhouse expenditure following the type 1 approach.

Scope of this QWBA

3. "Sharemilking" is the arrangement where a farm owner supplies the dairy farm and the sharemilker provides the labour and resources to run the farm. The sharemilker runs the milking shed, oversees milk production, is responsible for herd management and manages some aspects of the farm (this will vary depending on the terms of the sharemilking agreement). Herd owning sharemilkers usually provide the herd and commonly receive around a 50% share of the dairy company pay-out. Variable order sharemilkers usually work with a herd belonging to the farm owner (although they may also own cows) and receive 20-29% of the pay-out. Contract milking is very similar to sharemilking in terms of the contractual obligations, but they are primarily paid based on a set number of cents per kilo of milk solids, instead of a share of the profits. For both sharemilkers and contract milkers a direct correlation exists between the level of milk production achieved and their income.

4. A sharemilker undertakes to perform the work of a dairy farmer under a sharemilking agreement and is entitled under the agreement to receive a share of the returns or profits from the dairy farming operation. This definition of "sharemilker" is consistent with s 2 of the Sharemilking Agreements Act 1937 and the similar definition in the schedule of the Sharemilking Agreements Order 2011.

5. In this QWBA, a "contract milker" carries out the same role on a dairy farm and performs the same tasks as a sharemilker. The difference is that they operate under a contract milking agreement (rather than a sharemilking agreement) and are paid based on production rather than receiving a share of the profits.

6. This QWBA applies only to sharemilkers and contract milkers who are operating as sole traders or as partners in a partnership and are provided with a farmhouse on the farm. Where a sharemilker or contract milker is operating through a company or trust they should refer to the principles in IS 17/02 to determine deductibility.

7. This QWBA applies only to sharemilking and contract milking where the scale of the business requires the sharemilker's or contract milker's farmhouse to be used as an integral part of their business. As well as carrying out administrative tasks and business planning from the farmhouse, the business will often have employees and employee meetings will be held there. The farmhouse is often used to store farm equipment owned by the sharemilker or contract milker as part of their business.

8. This QWBA does not apply to employees or other farm contractors. For guidance in determining whether a person is an employee, see the interpretation guideline IG 16/01: "Determining employment status for tax purposes (employee or independent contractor?)", *Tax Information Bulletin* Vol 28, No 3 (April 2016): 97.

Deductibility of farmhouse expenses

9. For an expense to be deductible under s DA 1 of the Income Tax Act 2007, a sufficient relationship (nexus) must exist between the expense incurred by the taxpayer and the deriving of assessable income or the carrying on of a business for the purpose of deriving assessable income. Also, a deduction is not available under s DA 1 to the extent the general limitations in s DA 2 apply, including in this context, a limitation on private expenses.

10. Whether an expense is deductible will depend on the particular facts of each case. In the context of farmhouse expenses, it will be necessary to determine who has incurred the expense and in what capacity. The farmhouse expenditure incurred by sharemilkers and contract milkers is likely to be relatively modest and include gas, power and insurance. Where sharemilkers and contract milkers incur this type of expenditure, s DA 1 will usually be satisfied. However, s DA 1 is only satisfied to the extent that the farmhouse is used for business purposes. To the extent that the farmhouse is used for private purposes, s DA 1 is unlikely to be satisfied, and s DA 2 will prohibit the deduction for private expenditure.

Whether sharemilkers and contract milkers may be treated as farmers on a type 1 farm and claim a 20% deduction for farmhouse expenditure

11. Usually, taxpayers would do a home office calculation to ascertain business use of a private residence. However, using IS 17/02 some farmers operating as sole traders or partnerships can adopt a practical approach. This approach balances the strict application of the law with the associated compliance cost of doing so, while maintaining equity between taxpayers and protecting the integrity of the tax system. Farmers on a type 1 farm are allowed an automatic 20% deduction for farmhouse expenses and 100% deductions for rates and interest (rates and interest will be incurred by the farm owner rather than the sharemilker or contract milker).

12. Type 1 farms are those where the value of the farmhouse is less than 20% of the total value of the farm. The Commissioner accepts that sharemilkers and contract milkers will operate only on type 1 farms, because of the scale of operations carried out on dairy farms. Because of the amount of land required, the milking shed and plant, barns, stand-off and run-off pads and other assets, the farm's value is usually quite significant, so the type 1 farm definition is met.

13. In terms of business use, the 20% deduction is intended to be a reasonable approximation of business use of the farmhouses on all type 1 farms across the country. It will not be correct in every instance (and farmers may still do their own calculation if they wish). For sharemilkers and contract milkers, actual business use of the farmhouse will depend on their particular circumstances. This is no different to other type 1 farms where the use of the farmhouse varies from farm to farm.

14. Although use of the farmhouse will vary from dairy farm to dairy farm the Commissioner accepts that sharemilkers and contract milkers (as described in this QWBA) will generally use the farmhouse for staff meetings, preparing food, feeding staff and farm visitors, business meetings, administration, record keeping, storing equipment, business planning and office work, completing regulatory requirements and so on. On this basis, the use of the farmhouse occupied by the sharemilker or contract milker is equivalent to that on other type 1 farms.

15. As sharemilkers and contract milkers are on type 1 farms and using the farmhouse they occupy in an equivalent way to other type 1 farmers they are permitted to use the approach in IS 17/02 to claim a 20% deduction for farmhouse expenditure.

16. The following examples are included to assist in explaining the application of the law.

Examples

Example 1 – Sharemilkers

Luke and Betty are herd owning sharemilkers in Taranaki operating as a partnership. They have just signed a sharemilking agreement and will take their herd of 300 cows to Justin's farm. The agreement provides for a 50:50 split of proceeds from the dairy company.

Under the sharemilking agreement, Luke and Betty are provided with land on the farm for their cows and a farmhouse for their family. They are responsible for providing equipment, working dogs and farm labour. In terms of farmhouse expenditure Luke and Betty pay for gas, power and contents insurance. Justin pays the rates, interest on loans and buildings insurance.

As sharemilkers on a type 1 farm Luke and Betty can use the approach for farmers on type 1 farms in IS 17/02. They may claim a deduction of 20% for their gas, electricity and insurance expenses without having to calculate actual business use.

Example 2 – Contract milkers

Marion and Barry are contract milkers in the Wairarapa operating as a partnership. They have a year-to-year contract milking agreement with the farm owner Ted. Ted has spent the last few years building up a beef and lamb farm with his son in another district. Ted lives on the beef and lamb farm but intends to return to his own farm in a couple of years. Ted owns the herd of 440 cows, and Marion and Barry milk and manage the herd. Ted is "hands off" but he deals with the dairy company and visits regularly to check on things such as the amount of feed on hand and the health of the cows.

Day-to-day running of the farm is left to Marion and Barry. They have Alan working for them full time. Alan stays in a separate cottage on the farm. During busy periods, they also employ other farm workers to work in the milking sheds or on the farm.

Marion and Barry were previously variable order sharemilkers but changed to contract milking because of the volatility in dairy prices. Their day-to-day work remains the same but they are now paid a set amount per kilo of milk solids. As part of the contract milking agreement they live in the main farmhouse on the farm. Marion and Barry run their contracting milking business and manage the farm from their farmhouse. They use their farmhouse for meetings with their staff and for other business meetings and planning. The farmhouse kitchen is used to prepare food for the staff and Alan often eats his meals at the kitchen table. The farmhouse has a home office where Marion and Barry complete the many administrative and regulatory requirements. The farmhouse is also used to store farm equipment.

Marion and Barry are contract milkers and can use the approach for farmers on type 1 farms in IS 17/02 to claim 20% of relevant farmhouse expenditure without having to do a home office calculation. Alan may not use this approach because he is not a "contract milker" for the purposes of the QWBA.

References

Subject references

contract milker
deductions
farmhouse
sharemilker

Legislative references

Income Tax 2007: ss DA 1, DA 2, DB 18AA
Sharemilking Agreements Act 1937: s 2 ("sharemilker", "sharemilking agreement")
Sharemilking Agreements Order 2011: Schedule ("sharemilker")

Other references

IG 16/01: Determining employment status for tax purposes (employee or independent contractor?), Tax Information Bulletin, Vol 28, No 3 (April 2016): 97

IS 17/02*:* Income tax – deductibility of farmhouse expenses, *Tax Information Bulletin*, Vol 29, No 4 (May 2017)