TIGHTENING THE NON COMMERCIAL LOAN RULES: PUBLIC CONSULTATION

NFF SUBMISSION

June 2009

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The National Farmers' Federation

The National Farmers' Federation (NFF) was established in 1979 and is the peak national body representing farmers, and more broadly agriculture across Australia.

The NFF's membership comprises of all Australia's major agricultural commodities. Operating under a federated structure, individual farmers join their respective state farm organisation and/or national commodity council. These organisations collectively form the NFF.

Each of these state farm organisations and commodity council's deal with state-based 'grass roots' issues or commodity specific issues, respectively, while the NFF represents the agreed imperatives of all organisations at the national and international level.

Introduction

The NFF welcomes the opportunity to provide comments to the Public Consultation on "*Improving fairness and integrity in the Tax System - Tightening the non-commercial loan rules in Division 7A of the Income Tax Assessment Act 1936*".

The NFF notes that on 12 May 2009, as part of the 2009-10 Budget, the Treasurer and the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs announced that the Government would tighten the non-commercial loan rules in Division 7A of the Income Tax Assessment Act 1936 (Division 7A) to prevent shareholders and their associates avoiding tax on distributions and benefits they receive from private companies. The NFF notes that the measure is intended to remove the scope for private companies to allow company assets – such as holiday homes, luxury cars and boats – to be used for free, or at a discounted rate, without triggering a tax liability. The NFF notes that by contrast, the same use of the asset by an employee – rather than a shareholder – would attract fringe benefits tax.

The NFF understands the Government's rationale to tighten the non-commercial loan provisions under Division 7A. However, the NFF encourages the Government to ensure that farmers are not unintentionally affected by the new legislation through their legitimate use of company assets owned exclusively for business use - in particular farm land. Should the Government fail to allow for this anomaly, the financial implications and resulting red tape would be an extremely significant impost to many farm businesses who currently hold their farm land within a private company structure.

Therefore, the NFF recommends that the Government, in designing the legislative changes to Division 7A, ensures that it does not apply to business assets owned by a private company that are used exclusively in a business operated by a shareholder in the private company or an associate of such a shareholder.

Background

For many farm operations there is a distinct difference between the legal entity that owns the farm land and the trading entity that operates the farming business on a daily basis. Australian Bureau of Agriculture and Resource Economics (ABARE) data indicates that approximately 10% of Australian farms use a company structure as their trading entity. Other trading structures include trusts, partnerships or sole traders. It is the NFF's belief that a significant number of farm businesses hold their land within a separate entity, a private company. It is not uncommon for the trading entity to comprise the same family members as the private company shareholders. These arrangements have often functioned with no formal lease agreement or payment between the asset owning company and the trading entity. Implicit in this arrangement, however, is a "license" to use the land asset.

Why would a farmer hold their land in a company structure?

There are a number of historical and current reasons why farm land would be held within a company structure. These include:

- death duties,
- intergenerational transfer of assets/succession planning, and
- asset protection.

Since 1985 however, there has been a tax penalty for farmers purchasing their business real estate in a company, because of the difficult interaction between the capital gains tax provisions and the way companies operate. In effect it means that capital gains on an asset owned by a family company when sold will be taxed at up to twice the rate it would be if the asset was owned by an individual or a family trust.

It therefore logically follows that the vast majority of farms, factories and offices owned by companies are the result of things done pre-1985 and often by the current operator's parents or grandparents.

There are significant red tape (accounting and legal fees) in dissolving the farm company and moving to a different farm business structure.

Source: JMA Legal (June 2009)

On 12 May 2009, the Federal Treasurer, the Hon Wayne Swan MP, issued a media release outlining initiatives aimed at 'improving fairness and integrity in the tax system'. One initiative announced is an extension to the non-commercial loan rules in Division 7A, whereby shareholders (or their associates) will no longer be permitted to use a company asset such as land or a car for free or at a discounted rate.

The NFF understands that granting a lease to a shareholder to use company property has always been incorporated by Division 7A while licenses have not. The proposed changes to the legislation will extend the Division 7A provisions to cover licenses. As such, licenses to use company assets will be considered leases and charged at a deemed market rate. Licenses in the hands of the company will, therefore, be treated as taxable income.

Policy intent

The NFF questions whether it is the policy intent of the Government to cover bona-fide primary production business assets within these legislative changes. In this regard, the NFF notes that the 2009 Budget papers indicate that the measure will ensure that "*shareholders in private companies and their associates are taxed when they use company assets for private purposes*". Clearly, the use of company assets for business use is not incorporated within this language suggesting that that it should not apply to business assets owned by a private company that are used exclusively in a business operated by a shareholder in the private company or an associate of such a shareholder.

The NFF also notes that within the Federal Budget Papers the forward revenue projections from this measure are estimated at $10 million per year. The NFF believes that the revenue figures would be significantly higher if the intention was to capture business assets owned by a private company that are used exclusively in a business operated by a shareholder in the private company or an associate of such a shareholder.

The NFF notes that the Government's Public Consultation paper has sought stakeholder comments on:

"*what account, if any, should be taken if the use of the private company asset by the shareholder or their associate is for a business related purpose and would otherwise be deductible to the shareholder or their associate.*"

The NFF is strongly of the view that no account should be taken for this situation within the legislation.

Implications for farmers

The NFF is extremely concerned that the proposed legislation will inadvertently capture bona-fide primary production business assets, when the policy intent clearly appears to be aimed at closing a loophole that enables shareholders or their associates to utilise luxury company assets tax-free.

The NFF highlights the following example of the problem that will be faced by many Australian farms:

An example of the potential problem for farmers

Assumptions
1. farm land is held within a private company structure
2. farm trading business is conducted in a separate entity
3. farm land is valued at $2.5 million
4. average rental market rate is 5% of sale value i.e. $125,000 p.a.

The farm trading entity will have to pay $125,000 rent per year to the company. This payment will be a tax deduction in the books of the trading entity and assessable income in the hands of the company.

The farm company will pay $37,500 in tax (at the 30% company tax rate) regardless of trading entity's profits or losses. The remaining $87,500 ($125,000 - $37,500) is then locked up in the company, raising significant cash flow issues for the trading entity.

Few farming businesses can lock up cash in the company so most will have to draw the money back out of the company.

This will cause significant problems, particularly if those in the farm trading entity are not shareholders of the company, as is the case with many historical landowning companies (e.g. the parents are the company shareholders yet the children own the farm trading entity). In this scenario, the payment of dividends is not possible (because the farm trading entity operators are not shareholders), and the farm trading entity will be required to borrow the money back from the company.

If the farm trading entity does not pay the benchmark rate of interest on the loan of the cash back from the company to the trading entity, and make the required minimum yearly loan repayments, it will be taxed as a dividend under the existing provisions of Division 7A. If they do pay the interest, the company will be taxed again. And so it goes...

Source: Derived from JMA Legal (June 2009)

Changing the farm business structure to avoid the above scenario is an extremely complex, costly and time consuming solution for farm businesses inadvertently caught by the proposed legislative changes.

For example, transferring the trading entity into the farm owning company raises significant issues including the loss of personal marginal tax rates under 30%, potential tax issues involved in transferring trading stock, loosing access to income averaging, Farm Management Deposits, risk management tools and the significant red tape costs (legal and accounting costs) incurred through making the transfer.

Alternatively transferring the farm assets out of the company may trigger a capital gains tax liability and stamp duty obligations, removing the protection of assets afforded under a company structure and exposing the farm to additional business risk, and adding a significant red tape impost (legal and accounting costs) incurred through making the transfer.

Therefore, the NFF encourages the Government to ensure that the proposed changes to Division 7A do not apply to business assets owned by a private company that are used exclusively in a business operated by a shareholder in the private company or an associate of such a shareholder.

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