National Farmers' Federation

NON COMMERCIAL LOSSES

NFF SUBMISSION

November 2009

Table of Contents

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 Senate's inquiry into the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009. The NFF focuses it comments on proposed changes announced in the 2009-10 Budget to tighten the non commercial losses rules for individuals with an adjusted taxable income in excess of $250,000.

The NFF is concerned that ill-thought through policies aimed at closing a perceived loophole surrounding hobby farm investors, could inadvertently encapsulate and disadvantage genuine farming operations. The NFF believes that the proposed changes could lead to significant unintended consequences including the potential to:

- Provide a disincentive for farmers to maximise off-farm income
- Negatively impact environmental outcomes
- Negatively impact regional communities
- Lead to repercussions on existing loans
- Negatively impact farm values
- Provide a disincentive to start up ventures

Furthermore, the NFF questions why further measures are necessary to determine whether an entity is legitimately carrying on a business. The NFF notes that existing thresholds are already in place to ensure that hobby farms cannot be entered into purely as a loss making entity to offset gains from other businesses. In essence, this suggests that the proposed changes to the non-commercial loss provisions would be double regulation and excessive red tape.

The NFF cannot see any justification in creating a distinction in the treatment of an investment in a small farm to the treatment of an investor in metropolitan housing who can access taxation benefits through negative gearing. With this in mind, the NFF believes that the proposed measure would dampen consumer demand in regional Australia at a time that more, not less, stimulus is desperately needed.

Background

In the 2009/10 Commonwealth Budget, the Government proposed to change the Non-Commercial Loss Rules of the Income Tax Legislation and deny an "individual", who derives more than $250,000 of income from other sources, an income tax deduction for any losses incurred in "carrying on a business", either individually or as a partner in a partnership.

Under the proposed changes, the Commissioner of Taxation will have the discretion to allow a deduction for the loss if there are exceptional circumstances or because the nature of the activities means that an individual is temporarily carrying on an uncommercial business. Application needs to be made to the Commissioner to have his discretion applied. The full set of parameters of the 'Commissioner's discretion' thresholds remains unclear.

The losses, if disallowed, are not lost, but are quarantined to the business activity. This means they will only be deductible against profits from that type of business activity and not from other sources of income the individual may have.

The existing non-commercial loss rules will apply to anyone deriving less than $250,000 of other income and the losses incurred by those individuals from carrying on their business will be deductible against their other income.

Existing non-commercial loss thresholds

There are already thresholds to determine whether an entity is legitimately carrying on a business. These provisions are intended to ensure that hobby farms cannot be entered into purely as a loss making entity to offset gains made in other businesses.

The existing non-commercial loss rules were designed to try and stop "individuals" (not companies and trusts) claiming losses from the carrying on of a business that was not commercial in nature. The rules attempt to do this by applying thresholds.

As long as an individual achieves at least one of the four thresholds then they are considered to be carrying on a business and any loss incurred was allowed to be offset against other income. The thresholds are as follows:

1. The particular activity from which the loss arose had assessable income of at least $20,000.
2. The individual must have real property, or an interest in real property, with a value of at least $500,000, used on a continuing basis in a business activity.

3. The value of certain other assets (excluding real property, cars, motor cycles and similar vehicles) used on a continuing basis in carrying on the activity is at least $100,000.
4. The particular activity results in a profit for tax purposes in 3 out of the past 5 years;

A general discretion exists for the Commissioner of Taxation to allow losses to be claimed against other income, even if an individual does not achieve any of the thresholds. This discretion may be granted if the business is affected by special circumstances or the business has started and there is an objective expectation that the business will achieve one of the thresholds or profitability within a reasonable period.

If an individual is carrying on a primary production business and their income from other sources was less than $40,000 p.a. then the non-commercial loss rules do not apply. In this instance none of the thresholds need to be achieved.

However, if your income from other sources was greater than $40,000 then the non-commercial loss rules do apply to the primary production business and at least one of the thresholds must be met.

The NFF believes that the non-commercial loss rules have been implemented to ensure that an entity is legitimately carrying on a business and provide the framework for the Australian Taxation Office to do this effectively. The NFF believes that these rules are appropriate to ensuring that investors do no purely engage in agriculture in order to make a loss that they can offset against other income sources.

In essence, the NFF therefore believes that to include another income based threshold to the non-commercial loss provisions as is being proposed, is unnecessary and would constitute excessive red tape.

The measure will reduce economic stimulus

The Australian Government has been open about the economic challenges facing the global and Australian economies as a result of the global financial crisis. On the 3rd February 2009, in a joint statement with Prime Minister Rudd, the Treasurer, Wayne Swann stated:

The global financial crisis has driven almost all major advanced economies into recession...... The global commodity boom which has provided significant stimulus to the Australian economy over recent years has come to an end. No country will escape the impacts of the global recession, which is causing falls in growth, job losses and budget deficits right across *the world. The weight of the global recession is now bearing down on the Australian economy. Economic growth is slowing and employment will weaken.*[1]

The ability to offset losses from investment and expenditure encourages individuals to invest. For this reason the NFF believes that the proposal to impose an income threshold to the non-commercial loss rules will act to reduce expenditure by high income individuals in regional Australia. Where these individuals may have previously been less cautious about investing in additional on farm expenditure that enhances the long term productive capacity of that enterprise, these changes are likely to see this attitude change.

The NFF therefore questions why, at a time when the Australian Government is trying to attract increasing expenditure and stimulus within the economy, that they would be entertaining the proposed changes that will inhibit spending in the economy.

The suggested budget savings are over-estimates

The 2009/10 Budget Papers suggest that the tightening of the non commercial losses rules for individuals measure will generate ongoing revenue of $700 million over the forward estimates period. The NFF believes that the measure will have a much smaller revenue impact.

Instead, the NFF is of the view that the changes are likely to induce high income individuals to shift their investments to alternative tax effective mechanisms - most likely negative gearing of residential property (outlined below), usually in metropolitan areas. Therefore, the revenue gains are likely to last only until investors are able to move their investment. The result will therefore only be a short term revenue gain for the Commonwealth Government.

It should also be recognised that should this investment be shifted towards the residential property market as anticipated, this will add pressure on the cost of home ownership. This effect would contradict existing efforts by the Commonwealth and State Governments to reduce the cost of home ownership.

Negative gearing versus non-commercial losses

Current taxation rules allow for negative gearing of investment properties. Negative gearing allows the cost of investing to be claimed against personal income regardless of income level. For example, a property investor can offset their income when the annual net income of the rental is less than the loan interest and the deductible expenses associated with the maintenance of the property.

[1] Swann W, 3 Feb 2009, *Macroeconomic and Fiscal Outlook*, Joint Media Release with The Prime Minister

The NFF believes that running a small farm is not vastly different from owning an investment property within a metropolitan area to rent to tenant. Both are small businesses, both require regular maintenance, both have the potential to make losses. On this basis, The NFF cannot see any justification in creating a distinction in the treatment of an investment in a small farm to the treatment of an investor in metropolitan housing who can access taxation benefits through negative gearing.

Therefore, the NFF believes that the proposed changes to the non commercial losses rules for individuals would break this link with existing negative gearing rules, leading to a redistribution of investor income away from regional areas and towards the metropolitan housing market.

Potential negative impacts

Disincentive to maximise off-farm income

Including an income threshold to determine the eligibility of individuals to non-commercial loss provisions will have significant potential ramifications for genuine farmers who make a positive contribution to Australia's productive farming base. The concept is particularly concerning due to the significant increase in the importance of off-farm income to Australian farm businesses and the resulting complexities in differentiating genuine farming businesses from hobby farms.

As the Australian Bureau of Statistics notes:

"Over the last two decades Australian farming families have become increasingly dependent on off-farm income to maintain their standard of living. During times of financial hardship, off-farm income can moderate the effect of a reduction or variability in farm income. In 2000-01 average off-farm income from all sources was valued at $29,300 for broadacre farms and $35,700 for dairy farms (just under half of the average total family income)."

More recent data from the 2007-08 financial year supports this trend, showing the share of off-farm to total farm family income was around 51% for the broadacre and dairy industries.

Clearly in today's climate, off-farm income plays a very significant part within modern farming operations and has provided invaluable assistance in helping farmers to cope with seasonal risk. Such a practice should be endorsed and promoted.

While it may appear that imposing a $250,000 threshold will avoid any impact on genuine farming operations, the NFF is aware of a number of instances where this is not the case. The NFF therefore questions why these farmers, who have been more successful than most at generating off-farm income (even for a temporary period) should be penalised.

Impact on environmental outcomes

As discussed previously, including an income threshold to determine the eligibility of individuals to non-commercial loss rules may create a disincentive for high income individuals to invest in their 'hobby farms'. The NFF is concerned that the first expenses to be sacrificed may be those investments in activities that lead to positive environmental outcomes. These may include:

- Investments in fencing riparian vegetation along creeks;
- Spraying weeds;
- Pest control measures;
- Investments in planting vegetation to enhance on-farm biodiversity;
- Erosion control measures; and
- Water conservation, including dams, troughs and reticulation works.

As the law currently stands, the NFF believes that many of the farms being targeted by the proposed changes to the non-commercial loss rules have a solid track record in environmental management and sustainability. The NFF argues that it would be a poor outcome if these individuals failed to invest in delivering positive environmental outcomes on their properties due to taxation concerns.

Impact on regional communities

The NFF argues that the indirect impacts on rural communities and businesses, particularly those on the periphery on major business centres, as a result of changes to the non-commercial loss rules, will be significant.

In many cases, the losses being incurred by high income earners are providing a vital injection of funds to rural and regional communities through:

- The wages being paid to farm managers;
- The equipment purchased from the local rural trading shops; and
- The contract pay going to shearers, fencers, mechanics and welders.

While it is extremely difficult to identify hobby farm numbers across the country and the Australian Bureau of Agriculture and Resource Economics (ABARE) does not collect a figure, in Western Australia alone, it is estimated that there are more than 50,000 'hobby' farmers. Collectively, their financial and social input into rural areas is enormous.

On this point the NFF also reinforces the point that the ability to offset losses from investment and expenditure encourages individuals to invest. For this reason the NFF believes that the proposal to impose an income threshold to the non-commercial loss rules will act to reduce expenditure by high income individuals in regional Australia.

Impact on start up ventures

The NFF is also concerned about the potential for the changes to the non-commercial loss rules to stifle investment in agricultural ventures where the investor may need to maintain off-farm work as a transitional means to support the early years of the venture.

For example, in horticulture, it may be 3-6 years after planting before the crop enters into a productive phase. Alternatively there are cases where a farm business is being 'scaled-up' over time (i.e. a lack of capital or availability results in the property's livestock stocking rate being increased over a period of time).

The NFF would like clarity on whether such cases would be a consideration for the ATO Commissioner to give discretion. If this is not the case, the proposed changes will increase uncertainty in investment decisions in regional Australia.

Impact on existing loans

The NFF believes that care must be taken when changing the non-commercial loss provisions when investors have entered into commercial arrangements with the bank on the basis that any losses would be tax deductible.

This sovereign risk will have serious implications for many people’s ability to service the debt and repay the loan.

Impact on farm values

The NFF is concerned that imposing a threshold on the non-commercial loss provisions could risk negatively affecting farm values. This would be dangerous in the current economic environment in which banks are extremely sensitive about their debt to equity ratios.

Indexation of tax related thresholds

The NFF believes that at a minimum, any proposed regulatory income threshold must be indexed to account for inflation. This is an often neglected element of taxation related policy and has led to significant problems over time as static thresholds encapsulate an increasing portion of the population due entirely to the fact that they have not been indexed to inflation.

The NFF notes that a $250,000 income may be deemed to be a high income earner today, however there are no guarantees that it will continue to be the case in 10-15 years.

NFF Contact

Charles McElhone
Manager – Economics & Trade
Ph: 02 6273 3855
Fax: 02 6273 2331
Email: cmcelhone@nff.org.au