National Farmers'
Federation

Second Submission to the Review of Business Taxation

April 1999

Prepared by
Robert Douglas
Director, Rural Policy
National Farmers Federation

And

Beverley Jordan
Senior Economist
New South Wales Farmers
Association

Contents

Executive Summary

The National Farmers' Federation (NFF) believes that the Review's *A Platform for Consultation* offers few benefits to Australia's farmers, but that many of the options discussed could impose significant costs on them. This is because it is based on a comprehensive income tax benchmark which is inappropriate for business. Further, the Review has adopted a 'one size fits all' approach which has failed to recognise the special needs of small business.

NFF supports the retention of the existing accelerated depreciation provisions and the balancing charge rollover relief. These provisions are essential to facilitate new investment to increase the productivity and competitiveness of agriculture. Modeling conducted for NFF shows that proposed changes could cost typical farm businesses in excess of $5,000 per year. The proposals would substantially reduce the benefits of the indirect tax reform package. NFF believes that, in some cases, farmers would be worse off after tax reform if the options canvassed in *A Platform for Consultation* were implemented.

NFF believes that the Review has not demonstrated why there should be changes to the existing tax provisions for trading stock. Proposals to include consumables in trading stock would lead to a significant one-off tax grab. Taxing consumables as trading stock will significantly increase compliance costs, perhaps by more than the additional revenue raised, therefore giving the economy no net benefit.

NFF is strongly opposed to options to capitalise and depreciate the maintenance costs of standing crops. NFF believes that the proposals have no substantive basis, and would act as a major impediment to new investment in horticulture, viticulture and forestry.

It is essential that crown leases of land continue to be taxed as they are now, and that the existing CGT rollover relief on extension of leases is retained. It is also essential that the existing tax treatment of transferable water entitlement be retained.

NFF believes that the retention of indexation for capital gains tax is essential, unless a true speculative gains tax is introduced. The options put forward by the Review are likely to favor speculation over long-term productive investment, and are likely to adversely affect investment in agriculture.

NFF supports the principle that rollover reliefs should exist where an asset is involuntarily disposed of. The underlying principle should be that the taxpayer is entitled to place themselves in a similar position to where they were before the disposal took place.

The National Farmers' Federation strongly opposes proposals to tax partnerships in the same way as companies. While the stated strategy of balancing the objectives of greater integrity and reduced compliance costs through greater consistency is laudable, NFF believes it will not be achieved. The case for reform is not convincing and the proposed options would introduce greater complexity and more anomalies than they set out to remove. The option that is not canvassed in the Review – the status quo - should prevail.

NFF believes that the entities taxation proposals contained in the Review would impose large compliance and financial costs on small business. They would lead to the double taxation of tax preferred income, and impose substantial additional tax burdens on members of cooperatives.

The National Farmers' Federation suggests that a possible method of relieving small business of the financial and compliance costs of entities taxation would be to allow a ‘small business’ trust election. ‘Small business’ trusts could then choose to remain outside the entities taxation system and under the current regime for the taxation of trusts. To qualify as a ‘small business’ trust, all distributions from the trust would have to be made to beneficiaries identified by a tax file number.

If the entities taxation proposals are implemented, NFF believes that it is only equitable that a ‘window of opportunity’ be allowed for existing trusts to divest themselves of their assets to their ultimate owners, free of CGT, and with all stamp duties and legal costs paid for by the Commonwealth.

1. Introduction

The National Farmers' Federation (NFF) welcomes the opportunity to make a further submission to the Review of Business Taxation. NFF has long championed the cause of tax reform in Australia, and has advocated the introduction of a broad-based consumption tax since 1988.

NFF believes that the Review's *A Platform for Consultation* offers few benefits to Australia's farmers, but that many of the options discussed could impose significant costs on them. There are two main reasons why the Review is likely to fail Australia's farmers.

The first reason is that the wrong starting place has been chosen. In its first submission to the Review, NFF argued that the wrong benchmark had been chosen as the appropriate tax base. A comprehensive income tax base is inappropriate as a tax base for business. The comprehensive income tax base was designed in the US primarily as a means of redistributing income at a time when income tax collections were less than 5 per cent of total tax collections. Even at the relatively low tax rates applying at that time, Henry Simons warned that implementation of his ideas would have a deleterious impact on economic growth[1].

As Australia approaches the new millenium, it is essential that it has a tax system that will promote economic growth and international competitiveness. A century of tinkering with the income tax has shown that it is not appropriate for business. NFF again urges the Review to examine an expenditure tax base.

The second reason is that the Review has not adequately considered the needs of small business, instead choosing a 'one size fits all' approach. The only reference to small business in the index of *A Platform for Consultation* refers to capital gains tax. The Small Business Consultative Committee is referred to in the overview. Otherwise, the Review appears to be silent on the special needs of small business.

Small business has special needs because in many cases family members undertake all management. Small business cannot afford to employ specialist advice for every transaction. There will be enormous difficulties in small business managers changing their business practices to conform to many of the options proposed.

ABARE[2] has estimated that the average manager of a farm business is 52 years old, and has less than 4 years of high school education (less than 15 per cent of farm mangers have completed technical or tertiary qualifications). They work about 55 hours a week. They are typically forced to only use accountants to prepare tax returns after the year has ended, and after all transactions have been completed. This is because they live in rural and remote Australia, with below average access to communication and education. In the next 12 months, they have to introduce systems to deal with GST, the Australian Business Number, and other indirect tax changes.

---

[1] Simons, H C (1938) *Personal Income Tax*

[2] ABARE (1998) *People in Farming*

This group will be affected by many of the options proposed by the Review (such as options relating to accelerated depreciation, CGT, trading stock, etc). Many of the options proposed are not simple; they are very complex. They test the minds of the highly educated Secretariat staff who developed them; and the professional staff of industry organisations who comment on them. The average small business operator will have enormous difficulties in attempting to understand the changes. There is likely to be a serious failure to comply with the new laws – not because of tax avoidance, but because of the complexity of the law. The problems of non-compliance will cascade through the system. (For example, a small business operator who is unaware of the new definition of ‘distribution’ will also fail to frank a distribution that they do not know they are making). NFF believes that these problems are likely to be endemic through the small business sector. Inevitably, the proposals will increase the probability of a taxpayer revolt.

NFF believes that the farming sector requires special tax provisions because of its unique position in the economy. The gross value of farm production is about $27 billion, or 3.5 per cent of GDP. Rural exports total about $25 billion, or about 22 per cent of total exports. The industry has suffered a decade of low commodity prices and adverse climatic events. ABARE has estimated farm net cash income at $5.3 billion for 1998-99, even lower than the $5.6 billion during the disastrous drought of 1994-95. The index of farmer’s terms of trade is estimated to reach a record low of 76.5 during 1998-99, a drop of 8 per cent from the previous year.

Table 1 shows ABARE’s estimates of average farm financial performance for the 3 years 1995-96 to 1997-98. It can be seen that farmers, on average, have low cash incomes, but are asset rich.

Table 1
Broadacre Industries Financial Performance

	1995-96 $	**1996-97 $**	**1997-98 $**
Farm business profit	9,979	4,840	2,000
Equity at 30 June	972,109	989,550	Not calculated

Another important structural issue in agriculture is the intergenerational transfer of family farms. The need to facilitate intergenerational farm transfer was recognised by Government when it introduced the Retirement Assistance Scheme for Farmers. In many instance, tax, and in particular CGT, acts as a major impediment to intergenerational transfer. NFF believes that the tax laws should be designed to assist in encouraging the intergenerational transfer of family farms.

NFF has long supported tax reform because of the need to reduce taxes on agriculture, especially inefficient indirect taxes. If the benefits of indirect tax reform are offset by increased income taxes, many farmers will believe that the trade-off was not worthwhile.

In the balance of this submission, NFF provides comments on areas of the Review of particular interest to Australia’s farmers. Comment is not provided on areas where NFF has no policy position (eg, life assurance).

2. Accelerated depreciation and balancing charge rollover relief

NFF believes that retention of the existing accelerated depreciation provisions are essential if Australian businesses are to increase productivity and competitiveness by investing in new technology.

Australian agriculture is capital intensive, investing over $4 Billion a year in new capital. Depreciation was estimated to cost farmers about $3.4 Billion in 1997-98, more than half farm net cash income of $6.2 Billion, or 13 per cent of gross farm cash income[3].

It is important to remember that successive years of low commodity prices and adverse climatic events have resulted in many farmers postponing investment decisions. As a result, the stock of plant of many farm businesses is aged, and in urgent need of replacement. Accelerated deprecation provisions will be essential to support this overdue replacement.

Australian farmers have to invest in new technology in order to boost productivity, and overcome the impact of low commodity prices. Frequently, the use of better technology also has benefits for the environment. For example, many farmers are replacing water extensive methods of irrigation (such as flood or spray irrigation), with water intensive drip irrigation. In state-of-the-art systems, fertilisers are also delivered through the irrigation system. The result is not only increased productivity and better quality farm produce. There are also significant environmental benefits because of lower water use. These benefits include increased environmental flows of water, reduced accessions to the water table, and resultant lower soil salinity.

Much of the recent productivity improvement on Australian farms can be attributed to farmers investing in new plant and equipment that includes the latest world class technologies. Tractors, combine harvesters, sprayers and seeding and tillage equipment all include sophisticated computer-based programs which allow access to global positioning systems and other precision technology.

This allows farmers to adopt the Precision Agricultural (PA) practices that result in the productivity improvements they require to remain competitive in the global market.

It was observed recently by John Harvey, Grains Research and Development Corporation program manager, that while PA technology was still in its infancy at farm level, those who had used it were surprised at the large yield variations within a paddock. Four or five fold variations in crop yields over short distances had been detected using PA technology. With tractors equipped with yield monitors, farmers can do a range of experiments without interrupting harvest. Similarly, the use of variable rate seeders can also be used to make experimentation easier.

[3] ABARE (1998) *Australian Commodities, December*

Similarly, many farmers are changing from conventional tillage to minimum tillage practises – practises that require different machinery. Minimum tillage practises increase yields and reduce costs. They also provide significant environmental benefits in retaining soil carbon, and improving soil structures.

Spraying is a major cost for vineyard operators. It is common for vines to be sprayed up to 11 times in any one season. With vines, timeliness of spraying is critical. When mildew occurs, spraying has to be done immediately, with severe consequences for delays. It has been estimated that using a new technology sprayer such as the Green Tech model can deliver cost savings of $102,000 per annum for a 200 ha vineyard. The main cost savings occur in chemical reduction, minimising production loss and labour productivity.

It is important that the tax systems provides incentives to invest in such technologies, and does not act as an impediment to productive investment.

ABARE statistics show that sole traders and partnerships operate over 95 per cent of farm businesses. These businesses cannot benefit from the proposed reductions in the company tax rate, but will certainly suffer from reductions in depreciation rates.

NFF requested the Centre for Agricultural and Regional Economics (CARE) to investigate the impact of removing accelerated depreciation and the balancing charge rollover relief on typical farm businesses (copy attached). A summary of the results is presented at Table 2.

Table 2
Impact of depreciation changes on typical farm businesses (average over 11 years)

Item	**Cropping and grazing $**	**Irrigated cropping and grazing $**
Increases in taxable income		
Effective life depreciation	5,138	5,067
Balancing charge rollover relief	11,787	8,321
Taxable income	16,925	13,388
Increase tax payable		
Increase in tax payable	5,708	5,486

It can be seen from Table 2 that the proposed changes would have a significant impact on these farm businesses. These changes would significantly erode the benefits to be received from the Government's indirect tax reforms.

The Prime Minister's has undertaken that no Australian will be worse off because of tax reform**.** NFF believes that certain combination of options discussed in *A Platform for Consultation* could negate the advantages that some farm businesses could receive from the introduction of a GST, and reductions in fuel excises and personal income tax rates.

Removal of accelerated depreciation will also affect low-income farmers' entitlements to access social welfare benefits because tax depreciation is taken into account for determining eligibility to welfare benefits. As many farmers make losses, they clearly will not benefit from the income tax cuts associated with the package. The increased social welfare payments are designed to compensate for the introduction of a GST on the assumption that income remains constant. As a result, tax reform could make many of these farmers worse off.

The Review raised a number of specific options in *A Platform for Consultation*. NFF believes that depreciation deductions should be claimed by the taxpayer incurring the expenditure, rather than based on accounting principles. Depreciation deductions should be based based on actual cost to the taxpayer, and available from the time the plant is first used, or held in reserve for use.

We disagree that the cost base should be reduced by the expected disposal receipts, as there is no guarantee that these amounts will be realised. Depreciation should continue to be calculated on the assumption that there will be no residual value. Deductions for depreciation should commence once an item of plant is installed and held ready for use. Small items of plant should continue to be eligible for immediate write-off.

NFF believes that the cost base of wasting assets should be reduced by the amount of any subsidies received, so reducing the amount of depreciation deductions received. This would result in a more equitable result than the current treatment of assessing the subsidy when received.

NFF strongly opposes proposals to remove the balancing charge rollover relief on disposal of assets. This option is revenue neutral over time. Having to pay tax on the balancing charge would impose a significant impediment to replacing plant.

NFF understands that the balancing charge rollover relief is being used inappropriately by some taxpayers. If that is the case, anti-avoidance legislation should be introduced to deal with that mischief, rather than the removal of a valuable instrument assisting in the upgrading of capital stock.

NFF believes that if the incorrect choice were made to remove accelerated depreciation provisions, it would be essential that the new provisions do not apply to existing assets. The assets were acquired under the existing rules, and it would be inequitable to change those rules after an investment decision had been made.

NFF also believes that is essential that any changes take place on 1 July 2000, to allow investment decisions that are currently being planned to take place under the existing rules.

3. Trading stock

NFF disagrees that the current arrangements for trading stock allow excessive flexibility. The existing provisions sensibly ensure that taxpayers are not required to pay tax on unrealised gains. Following discussions with Secretariat officials at focus group meetings, the proposed changes appear to be driven exclusively by revenue considerations, and have no policy basis.

Prices of agricultural commodities fluctuate widely, and farmers need flexibility in valuation. A good example of the extent of commodity price fluctuation occurred 10 years ago, with sale yard price of sheep in 1989 being $150 per head, but a year later farmers were being paid to shoot sheep. Other examples include beef, which averaged 235 cents a kg in 1993-94, 152 cents a kg in 1996-97, and is expected to average 197 cents a kg in 1998-89. Wool prices have fluctuated from 547 cents a kg to 705 cent a kg and back to 520 cents a kg over the same period[4].

NFF believes that it is essential that farmers have at least the choices of cost or market for trading stock valuation. Different choices should be available for different types of trading stock, eg, the farmer may choose to value sheep at market value and cattle at cost. It is essential that these choices be available annually. Livestock prices fluctuate constantly. Perhaps the best example was the changes in sheep prices in the late 1980's, when prices rose dramatically, and then fell even more dramatically. If farmers had used market values at that time, they would have been assessed on large gains when the market rose. They then would have incurred even larger losses as the market reversed, and sheep had a negative value. However, they would not have been able to offset the losses against the previous gains, or claim refunds of the taxes paid on those gains. There is a clear need for flexibility in the valuation of livestock to ensure that tax is only paid on realised gains.

Compliance costs will be minimised if flexibility can be used to value trading stock. If trading stock comprises a large number of virtually identical items, average cost, rather than the actual cost per item, may produce an appropriate result for low compliance costs. Similarly, accurate standard costs systems are another useful method of reducing compliance costs.

NFF rejects the option that the value of consumable stores and spare parts be included in trading stock. From a policy perspective, there are extensive legal precedents that clearly show that these items are not trading stock. The option proposes taxing what decades of legal precedent have said should not be taxed.

There are also 2 pragmatic reasons why this option should not be accepted. The first is that there could be a significant one-off revenue grab in the year of transition. The value of consumables would be included in closing stock, with no offsetting deduction available for the value of consumables on hand at the beginning of the year.

4 ABARE (1998) *Australian Commodities, December*, Table 21

The second pragmatic reason would be that the compliance costs of this option could easily exceed the revenue raised. NFF believes that it is ludicrous to ask farmers to value a half a container of drench, a quarter of a drum of grease, and a handful of woolpacks. Not only would the compliance costs be excessive, but also the option could reinforce incentives not to comply with other provisions of the law.

NFF is strongly opposed to the Review's proposals for standing crops. Again, there are a long series of legal precedents that growing crops are not trading stock. Existing law requires that the capital costs of planting horticultural crops be depreciated following the first commercial harvest. The degree of acceleration for such depreciation is the same as the general acceleration available to other wasting assets. Similar, but more generous provisions apply to viticulture.

The expenses proposed to be capitalised are recurrent maintenance expenses and are properly deductible in determining taxable income. There is no policy justification for capitalising such expenses, and this option is another revenue raising option.

If implemented, these proposals would act as a substantial impediment to new investment in horticulture and viticulture. Such an impediment would be contrary to the Government's policy of increasing agricultural production, particularly horticultural production through initiatives such as *Supermarket to Asia.*

Australian horticulture is characterised by the ability to produce a wider variety of fruit and vegetables than most other counties. Australia produces about 3 per cent of world horticultural production. The gross value of production is over $4,000 million, of which about $600 million is exported. In 1996-97, the value of production increased by about 7 per cent, and there was a 3 per cent increase in exports despite the Asian crisis.

For many individual fruits and vegetables, there has been spectacular growth. For example, there have been about 1 million cherry trees panted in Australia over the last 5 years. Of these, 25 per cent are for export, and 5 per cent are import-replacing. It is expected that 1.2 million trees will be planted of the next 5 years, of which 50 per cent will be for export, and 10 per cent will be import-replacing. The new plantings are expected to generate $25 million of exports annually, and provide seasonal work for up to 5,000 people. It costs about $18,000 a hectare to establish a cherry orchard, and maintenance costs in the first 5 years are about $44,000. Implementation of the option discussed in *A Platform for Consultation* would act as a serious impediment to new plantings.

Similarly, in the mango industry, both the volume produced and the value of production have more than doubled since 1991-92, with a significant amount of the extra production being exported. It is anticipated that production will continue to grow by about 5 per cent a year, and again a significant amount of the new production will be exported.

The proposed changes to the taxation of standing crops would act as a serious impediment to new investment. In New Zealand, similar changes to the taxation of forestry stopped new investment, and it was necessary to reverse the change to restart investment.

4. Leases and rights

Crown Leases

Crown leases are the most common types of tenure in the pastoral zone of Australia, which is over half of Australia's geographic area. While these leases may legally be granted for short time periods, in practise, they are leases in perpetuity as they are normally rolled over upon expiry.

NFF believes that the existing tax treatment of these leases should be retained. Rental payments to the crown should be immediately deductible in the year incurred. If a lease is bought or sold, the transactions should take place on capital account (unless the taxpayer is a land trader).

Transferable water entitlements

Transferable water entitlements (TWEs) are used as an instrument of micro-economic reform to assist in allocating water to its highest value use within a basin. Until the introduction of TWEs, rights to water were tied to particular parcels of land. Land with a water entitlement traded at higher prices than similar land without a water entitlement.

NFF believes that the correct tax treatment of TWEs should be:

- where the entitlement was purchased, it should be treated on capital account with the gain or loss being assessed on realisation;
- where the original entitlement was acquired with a parcel of land and acquired pre-CGT, the TWE should be treated as a pre-CGT asset; and
- where the original entitlement was acquired with a parcel of land and acquired post-CGT, the TWE should be treated as a post-CGT asset with the farmer entitled to allocate the cost base between land and TWE on any reasonable basis.

NFF strongly believes that TWEs should be taxed on a realisation basis only. This is because the value of TWEs varies with climatic conditions, becoming more valuable in droughts, and less valuable in good seasons. Taxing TWEs in a 'mark to market' basis could result in the taxation of unrealised gains, which would disappear when climatic conditions returned to normal.

5. Capital gains tax

As discussed above, agriculture is a capital-intensive industry, and therefore laws relating to the taxation of capital gains are of particular interest to Australia's farmers. NFF policy calls for the replacement of CGT with a speculative gains tax, where the portion of a gain subject to tax becomes less over time, and eventually none of the gain is taxable.

Investments in agriculture are typically long term investments, and it is not unusual for a farm business to be held by the same family for up to 100 years.

NFF is particularly concerned that any changes to CGT do not favor speculation at the expense of long-term productive investment. We believe that all the options discussed in *A Platform for Consultation* would adversely affect long-term investments, in particular the agricultural sector, in their current form.

In order to gain a better understanding of the impact of the different options, NFF calculated what differences the main options discussed would make to tax liabilities for a variety of time periods, and increases in value. Two options are analysed: the 30 per capped rate option, and the taper relief option for business assets with the taper increasing by 7.5 per cent a year. The differences are shown in Table 3. It is assumed that an asset cost $100,000 in Year 0. It is further assumed that the rate of inflation is a uniform 3 per cent. If the asset were sold in (say) Year 10, and its price had kept pace with inflation, its price would be $134,392. It is also assumed that tax is payable at the highest marginal rate (48.5 per cent including Medicare Levy). Medicare Levy is also included when analysing the 30 per cent capped rate option, making the effective rate 31.5 per cent.

Under current law no tax would be paid as the asset had merely kept pace with inflation. If indexation was removed and a 31.5 per cent tax rate imposed, $10,833 would be payable. Under the taper relief option, only 25 per cent of the gain would be taxable, ($8,598) but this would be subject to a 48.5 per cent rate resulting in a $4,170 liability.

The position becomes more complex when an asset increases in value faster than inflation. Assume the same asset was sold in year 10 after appreciating at a rate of twice inflation. It would be sold for $179,085. Under the current system, $21,676 tax would be paid. (The taxable gain would be $44,693 ($179,085 - $134,392) taxed at a 48.5 per cent marginal tax rate.) Removal of indexation and a 31.5 per cent tax rate would result in $24,912 tax being payable, $3,236 more tax than the current system. The taper relief option would result in $9,589 tax being payable ($79,085 gain * 25% * 48.5%), or $12,087 **less** than the current system.

Clearly, the current system is better where assets increase in value at the rate of inflation, or less. Where assets increase in value at higher rates, the taper relief may result in less tax being payable.

Table 3 shows differences in taxes payable compared with the current system for different asset appreciation rates and periods. Positive figures show more tax being payable, negative figures show less tax being payable.

Table 3
Differences in tax payable under different CGT regimes

Years asset owned	Difference in tax between indexation and 48.5% rate (existing system), and no indexation and a 31.5% rate		Difference in tax between indexation and taper relief option, both 48.5% rate	
	Increase in asset price		Increase in asset price	
	Inflation $	Twice inflation $	Inflation $	Twice inflation $
1	945	435	1,346	1,237
2	1,918	852	2,511	2,054
3	2,921	1,250	3,485	2,413
4	3,954	1,625	4,261	2,268
5	5,017	1,975	4,828	1,573
10	10,833	3,326	4,170	-12,087
15	17,576	3,320	6,765	-23,738
20	25,393	1,575	9,774	-41,188
25	34,454	-2,914	13,262	-66,694
40	71,254	-48,148	27,427	-228,059

Because the inflation calculations are compounding, the effects of achieving a gain at twice the inflation rate are very large. For example, the values of the asset at the end of Year 10 would be $134,392 and $179,085 respectively. At the end of Year 25, the respective values would be $209,378 and $429,187. At the end of Year 40, the values would be $326,204 and $1,028,572 respectively.

It is clear that any changes to the CGT provisions will benefit some, and harm others. As stated earlier, NFF believes the options discussed in *A Platform for Growth* would leave the agricultural sector worse off.

NFF supports the simplification of the CGT rules and would support removal of indexation provided the taper relief option is available to all taxpayers, and that the amount of gain taxed reduces to zero. NFF believes that the rate of taper should be 10 per cent a year, and that none of the gain should be taxed once an asset has been held for more than 10 years.

CGT small business reliefs

At present, small business is entitled to a CGT rollover relief where an active asset is sold and replaced, or on retirement from business. NFF would not support replacement of the current $500,000 limit in exchange for a limit of 50 per cent of the gain. This would leave taxpayers with gains of less than $1 million worse off. Given the net asset requirement of $5 million in accessing the reliefs, gains in excess of $1 million are likely to be uncommon.

6. Involuntary receipts

NFF supports the principle that taxpayers in receipt of compensation for an involuntary disposal of an asset should not be adversely affected by the tax system. Affected taxpayers should be given the opportunity to acquire replacement assets and be left on the same tax basis as they were before the involuntary disposals. The practical effect of this principle is that if the affected asset was a pre-CGT asset, the replacement asset should also be considered to be pre-CGT. If the affected asset was post-CGT, the notional 'gain' received from the compensation should be able to be used to reduce the cost base of the replacement asset, so deferring CGT until realisation of the replacement asset.

The two main types of involuntary disposal that should be included are compulsory acquisitions, and disposals because of an 'Act of God'.

In designing provisions dealing with compulsory acquisition by Government, it is important that the Review ensures that the provisions allow for modern acquisition practises. In many cases, Governments will give a private firm the right to acquire an asset. The legislation will give the private firm a right to negotiate with affected taxpayers, and ask Government to exercise compulsory acquisition powers where negotiations fail. It is essential that acquisitions negotiated with private firms under the threat of compulsory government acquisition qualify as an involuntary disposal.

In designing provisions for disposals because of 'Acts of God', it is important that the provisions not only apply to events such as fire, flood and earthquakes, but also to natural events such as drought.

NFF believes that it is essential that farmers who destock in times of drought, or to prevent environmental damage to land, be allowed to set any profits from such disposals aside to purchase replacement livestock, with tax liabilities being determined following sale of the replacement livestock.

NFF supports the principle that it should not matter what the replacement asset is. For example, if $200,000 compensation is received for the disposal of a pre-CGT asset, and a new asset is purchased for $500,000, 2/5th of a replacement asset could be treated as pre-CGT and 3/5th as post-CGT.

7. Partnerships

The National Farmers' Federation strongly opposes proposals to tax partnerships in the same way as companies.

While the stated strategy ("balance the objectives of greater integrity and reduced cost of compliance through greater consistency", p335) is laudable, NFF argues that it will not be achieved. The case for reform (Chapter 14, *A Platform for Consultation)* is not convincing and the proposed options would introduce greater complexity and more anomalies than they set out to remove. The option that is not canvassed in the Review's paper – ie the status quo - should prevail.

As 82 per cent of farm businesses are operated as partnerships, these proposed changes would potentially affect a significant proportion of the agricultural sector.

The case put forward by the Review for reforming the way in which the disposal of partnership assets and interests are taxed appears to be twofold: reducing a perceived compliance burden and closing opportunities for tax minimisation.

The essence of the policy argument is contained in paragraph 14.19. It seems to rest on a perceived need to remove anomalies and opportunities for tax minimisation introduced by measures that prevent the taxation of unrealised income. No case is made in support of the principle of taxing unrealised income. Yet, it appears that the option of taxing partnerships as entities will do precisely that in certain circumstances that are commonly encountered in Australian agriculture. It is worth noting that justification for the very measures the Review proposed removing – an action by one partner should not trigger a tax liability for other partners - is acknowledged in the discussion document.

The opportunities for tax avoidance and/or minimisation raised in the discussion paper appear to be over-played as justification for the proposed changes. As acknowledged in the focus group meeting, the main opportunity for reducing tax liabilities - transferring unrealised balancing charges to tax preferred entities – is available to a minority of taxpayers. This should be solved by appropriate use of anti-avoidance provisions rather than via measures likely to penalise all tax payers (through increased cashflow and compliance cost burdens) for the sake of blocking the potential actions of a few.

The proposals to remove balancing charge rollovers, currently available when a partnership restructures, are of particular concern to NFF. In cases where the partnership is extended to include the next generation of the farming family, the value of the underlying assets is not realised. They are merely transferred to the next generation. It seems clear that calculating liability at the entity level will ensure that the original partners are subject to taxation of unrealised gains. This, along with other anomalies surrounding treatment on death of the taxpayer will act against the Government's stated policy aim, which NFF endorses, of assisting the transfer of the family farm business to the next generation.

The main justification for these reform options is to remove a perceived compliance burden associated with the register of interest in partnership assets currently required for CGT purposes and the (lack of understanding) of the fractional interest approach. This seems fallacious since one of the options proposed by the Review relies on extending the fractional interest approach.

Both proposed options will increase compliance costs for taxpayers. As such they are inconsistent with the Review's goal, supported by NFF, of simplifying the tax system.

The Review's Option 1 – extending the fractional interest approach to depreciation – will require partners to maintain individual depreciation schedules. Although based on a set of records already required for CGT purposes, this introduces an unnecessary set of complex calculations – which must be completed annually. It could also shift the focus of decision making from being primarily on depreciation as a means of facilitating capital replacement and technological advance within the partnership with individual tax management an incidental issue to one where the latter is the main focus (as it is for tax policy makers!)

The Review's Option 2 – applying an entity approach – will have the effect of trading the current set of compliance issues for another that is likely to be a significantly greater burden. Although maintaining a register of interests in the partnership assets is an onerous task – increasing with the passage of time for farmers who hold assets for significant time periods – taxpayers and their advisers are now familiar with the requirements and have in place a process to ensure compliance.

In the time available, the NFF has not been able to determine the size of this compliance burden. However, an informal poll of several farmers' and their rural accountants'/advisors' opinions suggest that the burden associated with the Review's preferred option will be greater. Currently, farm partnerships are relatively stable with partnership interests changing infrequently. However, farm businesses are asset rich with a relatively high turnover of wasting assets. Under current arrangements changes to asset registers are made on disposal or acquisition with relatively straightforward data requirements. Under the Review's preferred option each partner's cost base would need to be recalculated each year. Although on the evidence of discussions at the focus groups, the methods for calculating this cost base are not well developed, it seems reasonable to assume that they will be complex and require a relatively high level of expertise.

In addition, the mere fact of a change in requirements brings with it a set of costs that are difficult to quantify. These include the costs of acquiring knowledge of the change and its requirements, the psychic costs and the opportunity costs of implementing the change (time spent in administration that would otherwise be spent in core business activities). In the case of farmers – as with most small business – these costs are high because they are directly borne by key decision-makers in the business and cannot easily be shifted.

At a time of significant change in the tax system, these costs should be a matter of concern and arguably alternatives should be sought that minimise the quantum of this burden. Change for change sake should definitely be avoided.

8. Entities taxation

NFF believes there is no justification for the entities taxation proposals contained in *A New Tax System*. NFF agrees with the Review's policy design principles:

- *entities should be considered as extensions of their ultimate owners;*
- *business income should not bear more than one layer of Australian taxation;* and
- *the investment neutrality principle.*

NFF believes that the best method of achieving these objectives is for entities to receive a similar tax treatment to that currently accorded to trusts, partnerships and sole traders.

NFF believes that it is essential that tax preferences provided to entities be allowed to flow-through to their ultimate owners. Failure to allow tax-preference flow-through is inconsistent with the Review's first design principle. It appears that proposals to remove tax preference flow-through are a ploy to claw-back legitimate tax preferences given by Parliament. To paraphrase the words of a senior member of the Review Secretariat during a focus group meeting- 'Governments have given more tax preferences than the country can afford'. NFF believes that if it is considered that there are too many tax preferences, they should be individually examined, and removed only after a full cost-benefit analysis and extensive public consultation.

ABARE statistics show that only 1 per cent of farm businesses are operated by trusts[5]. However, trusts are extensively used in agriculture to hold land for intergenerational transfer purposes. Removal of tax preference flow-through, in particular the benefits of indexation of capital gains, would make use of trusts inappropriate for these purposes.

The National Farmers' Federation suggests that a possible method of relieving small business of the financial and compliance costs of entities taxation would be to allow a 'small business' trust election. 'Small business' trusts could then choose to remain outside the entities taxation system and under the current regime for the taxation of trusts. To qualify as a 'small business' trust, all distributions from the trust would have to be made to beneficiaries identified by a tax file number.

If the entities taxation proposals are implemented, NFF believes that it is only equitable that a 'window of opportunity' be allowed for existing trusts to divest themselves of their assets to their ultimate owners, free of CGT, and with all stamp duties and legal costs paid for by the Commonwealth.

---

[5] ABARE (1998) *People in Farming*

Imputation systems

The Review canvases 3 options for a redesigned imputation system; deferred company tax (DCT), resident withholding tax (RWT), or taxing unfranked inter-entity distributions. NFF believes that taxing unfranked inter-entity distributions should be the preferred option, as the other options will impose large cash-flow burdens of many small companies and trusts. The cash-flow problems will occur because under both the DCT and RWT proposals, tax will be deducted at entity level at a rate of 30 per cent, but many beneficiaries will not have a marginal tax rate of 30 per cent, much less an average tax rate of 30 per cent.

NFF has modeled the cash flow implications of entities taxation on a beef-sheep property. Entities taxation would mean that the farm overdraft would have to be increased by $8,000 in the first year (without allowing for increased compliance costs). To put this in context, NFF had previously estimated that the non-business changes of ANTS – GST, reductions in fuel excises and income tax rates, and increases in welfare payments – would leave the farm family $1,800 a year better off. The $1,800 would become less because of increased tax and lower welfare payments if accelerated depreciation is removed**.**

Double taxation of tax preferred income

As noted in *A Platform for Consultation*, many tax preferences are of a temporary nature (eg, accelerated depreciation). A major flaw in both the DCT and RWT proposals is the possibility of double taxation when temporarily tax preferred income is distributed.

NFF considers that it is essential that double taxation does not occur. The problem of double taxation is yet another example of the problems with entities taxation. If entities were taxed as trusts, the problem would not occur. NFF notes that the double taxation problem occurs only with the DCT or RWT options. This strengthens the case for choosing the option of taxing unfranked distributions between entities.

Refund of excess imputation credits.

As noted above, entities taxation can result in substantially more tax being collected at entity level than will ultimately be paid by shareholders or beneficiaries. Should a DCT or RWT be introduced, NFF considers it essential that immediate refunds of excess imputation credits be allowed to shareholders or beneficiaries.

Definition of distribution

All the options for defining ‘distribution’ proposed by the Review are unacceptable to NFF. The proposed definitions are much wider than the existing concepts of dividends and deemed dividends, and include imputed benefits.

The following examples illustrate some of the anomalies that would arise if the proposed definitions were used.

Example 1. Many co-operatives provide agronomic services free of charge to their members. Under the options discussed, farmers using these services would be taxed on their market value. The Review Secretariat has confirmed that that there will be no allowance made if the services would have been normally deductible for income tax purposes. This will result in double taxation! It was disingenuous of the Review not to state this effect explicitly in *A Platform for Consultation*. Failure to openly discuss these impacts adds to the perception that the Review is merely another Treasury revenue grab.

Example 2. Many fertilizer companies provide agronomic advice, including farm visits, to all users. It is not uncommon for farmers to own shares in such companies. The proposals require those farmers who were members of the company to pay tax on such advice, while their non-member neighbors would receive the advice tax-free.

Example 3. A farm business has shearer's quarters for which tax deductions are claimed. If family members, or friends, were accommodated in the quarters at Christmas, they would be liable for tax on the value of the accommodation received.

Example 4. In many farm businesses, the land-owning entity may be a company or trust in order to facilitate intergenerational transfer of the family farm. The business is typically operated by a partnership. The distribution rules will force the land–owning entity to charge a market rent for the land, which will be tax-deductible to the operating partnership. Any profits in the land-owning entity would be frankable. If the operating partnership was making a loss (not uncommon in farming), all the tax paid by the land-owning entity would eventually be refunded, but there could be a significant cash flow impact. Failure to charge market rent would result in the partners being fully assessed on the value of the market rent. Ignorance will be extremely costly!

Example 5. For many years, a trust has loaned funds interest-free to beneficiaries. The trust does not claim interest deductions. The beneficiaries would be assessed on the notional interest forgone, even though tax deductions were not claimed by the trust.

These examples clearly show the practical problems that the proposed definitions of distributions will cause. The impact will be exacerbated in the small business sector, as many managers will not know that they are providing a distribution, and therefore will not pay DCT or RWT (if applicable). The result will be massive non-compliance with the law caused by the complexity of the law itself, rather than a overt decision not to comply. Non-compliance in this area could flow to other areas, threatening the integrity of the revenue base.

The compliance costs imposed on small business by these proposals will be large, and could threaten the viability of many small businesses.

Defining the contributed capital of a trust

Should the entities taxation proposals proceed, NFF broadly supports the proposed rules for determining the contributed capital of trusts.

NFF believes that the existing assets of existing trusts should not be adversely affected by these proposals. This will be achieved if existing post-CGT assets continue to receive the benefits of indexation until such time as they are sold.

The proposals will become more equitable if the contributed capital rules relating to trading stock and depreciated assets allowed taxpayers the choice of market or cost values.

Defining the contributed capital of companies

NFF believes that existing companies should be able to define their contributed capital in the same way as proposed for trusts, with the modifications proposed by NFF.

Profits first rule

As no clear policy reason has been enunciated for the profits-first rule (other than that someone, somehow, some time may not pay tax), NFF believes that there is no justification for this rule. This is another example of unnecessary complexity being proposed to satisfy no known mischief.

Taxation of co-operatives

Extending entities taxation to co-operatives would impose additional compliance and financing costs on cooperatives and their members for no additional revenue. Secretariat officials at focus group meetings admitted that the only reason for this proposal was for consistency.

Three main problems can be identified with taxing cooperatives as entities. As mentioned earlier, the proposed definition of 'distribution' will mean that most members' services received from cooperatives will be taxable, even though the services are used in the members business. If the service would have been tax deductible to members if purchased at arms-length, there is no justification for including the amount in member's income unless an offsetting deduction is allowed.

The proposals are likely to lead to a large increase in compliance costs because of the need to maintain franking accounts. The proposals will certainly increase the financing burden on cooperatives due to the need to fund either DCT or RWT.

There will be practical difficulties in determining what is a distribution based on the business done with the cooperative in the year in which the goods and services are transacted with the member. Most cooperatives return their surplus based on the business done in the year in which it is transacted and the funds are taxed in the hands of its members.

However, many cooperatives also distribute their funds based on business conducted over a longer period, say five to ten years. It appears that under the entities taxation proposals that some part of such payments would be considered a ‘distribution’ requiring franking, rather than a payment accrued on the basis of business done to be taxed in the hands of the member. Again, this will give rise to no additional revenue, but will considerable increase compliance costs both for the cooperative and its members.

9. Fringe Benefits Tax

NFF strongly supports the proposal to make employees, rather than employers, liable for tax on fringe benefits. It is clearly inequitable that the employer should be taxed on benefits provided to employees. This is particularly the case where, as in agriculture, the employer must provide benefits under the conditions of an industrial award. NFF urges the Review to include this option in its final report.

NFF also supports the proposal to include only specific benefits in the FBT tax base, rather than the current system where all benefits are included unless there is a specific inclusion. We believe that benefits that must be provided under the terms of an industrial award should always be excluded from FBT.

Similarly, NFF supports the proposal for a *de minimus* FBT exclusion of $1,000 per employee. The potential revenue loss has to be balanced against the reduction in compliance costs that could be achieved. There is little doubt that compliance costs exceed revenue raised for many small benefits provided. NFF believes that, as a matter of principle, all taxes should have a threshold that will ensure that revenue raised will always be greater than the compliance costs of collecting the tax.

NFF urges the Review to re-examine the Government's decision to impose FBT on shareholders of companies and beneficiaries of trusts. If the entities taxation proposals proceed with the proposed definition of 'distribution', any benefit provided to a shareholder or beneficiary would be taxed as a distribution in any case. The gains to the revenue from attempting to tax as a fringe benefit anything that escapes the entities net appear small when compared to the compliance costs imposed on small business in trying to work out which system the benefit should be taxed.