

TAX LAWS AMENDMENT (FARM MANAGEMENT DEPOSIT REFORMS)  
BILL 2016

EXPOSURE DRAFT EXPLANATORY MATERIAL



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## ***Glossary***

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The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
FMD	farm management deposit
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
Commissioner	Commissioner of Taxation



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# Chapter 1

## Farm management deposit reforms

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### Outline of chapter

1.1 Schedule 1 reforms the income tax treatment of farm management deposits (FMDs) by:

- increasing the maximum amount that can be held in FMDs to \$800,000;
- allowing primary producers experiencing severe drought conditions to withdraw an amount held in an FMD within 12 months of its deposit in the income year following deposit without affecting the income tax treatment of the FMD in the earlier income year; and
- allowing amounts held in an FMD to offset (ie. reduce the interest charged on) a loan or other debt relating to the FMD holder's primary production business.

1.2 All legislative references in this Chapter are to the *Income Tax Assessment Act 1997* (ITAA 1997), unless otherwise stated.

### Context of amendments

1.3 The Government released the *Agricultural Competitiveness White Paper* on 4 July 2015. The paper contains a number of policies to strengthen the agricultural sector including:

- improving the tax system for the agricultural sector; and
- strengthening the Government's approach to drought and risk management to facilitate more effective risk management by primary producers.

1.4 FMDs assist primary producers that carry on a primary production business in Australia to manage risks from fluctuating primary production income levels that are common in the agricultural sector. FMDs allow primary producers, in effect, to carry over income from years

of good cash flow and to draw on that income in years of reduced cash flow in response to adverse economic events and seasonal fluctuations that affect their primary production business.

1.5 Division 393 achieves this outcome by enabling primary producers (with a limited amount of non-primary production income) to claim a deduction in an income year generally for the amount deposited into FMDs in that income year.

1.6 When an FMD is withdrawn, the amount previously deducted is included in the primary producer's assessable income in the income year of withdrawal. This, in effect allows eligible primary producers to defer the payment of the income tax on these amounts until withdrawn.

## **Summary of new law**

1.7 Schedule 1 makes changes to the FMD framework in the income tax law to make FMDs more flexible by increasing the amount that may be held in FMDs, allowing early withdrawal of FMDs in severe drought conditions and enabling FMDs to be used in loan offset arrangements.

1.8 The reforms:

- increase the maximum amount that can be held in FMDs to \$800,000;
- allow primary producers experiencing severe drought conditions to withdraw an amount held in an FMD within 12 months of deposit in the income year following deposit without affecting the income tax treatment of the FMD in the earlier income year; and
- allow amounts held in an FMD to offset (ie. reduce the interest charged on) a loan or other debt relating to the FMD owner's primary production business.

## **Comparison of key features of new law and current law**

<i>New law</i>	<i>Current law</i>
<b>Increase in FMD cap</b>	
The maximum amount that can be held by an individual in an FMD at any time is \$800,000.	The maximum amount that can be held by an individual in an FMD at any time is \$400,000.



<i>New law</i>	<i>Current law</i>
<b>Consequences of early withdrawal of FMDs because of severe drought</b>	
<p>An amount withdrawn from an FMD within a year of its deposit does not lose its taxation treatment as an FMD if prescribed rainfall conditions are met for a prescribed period.</p> <p>Accordingly, if an amount of an FMD is withdrawn within twelve months of its deposit and it meets the conditions set out below then:</p> <ul style="list-style-type: none"> <li>• entitlement to the deduction claimed remains; and</li> <li>• the amount must generally be included in the assessable income of the FMD holder in the income year the withdrawal occurs.</li> </ul>	<p>An amount withdrawn from an FMD is generally treated as never having been an FMD if the amount held in the FMD is withdrawn within twelve months of its deposit.</p> <p>Accordingly, the FMD holder is required to amend their previous year's income tax assessment to remove the deduction claimed for the amount of the deposit.</p>
<b>Rainfall conditions for early withdrawal</b>	
<p>The rainfall conditions and period for withdrawal unless prescribed by regulation are as follows.</p> <p>The qualifying primary production business must demonstrate that any part of the land of the business has experienced a rainfall deficiency for at least six consecutive months. The deficiency must be equivalent to or worse (ie lower) than five per cent of average rainfall (one in twenty year event) for that six month period based on the most recently available publicly released data from the Bureau of Meteorology at the time of the withdrawal.</p>	<p>Not applicable.</p>
<b>Use of FMDs with qualifying primary production loan offset accounts</b>	
<p>The agreement for the making of an FMD can allow the linking of an FMD to a loan or other debt of the FMD owner or their partnership to reduce the interest charged on that loan or other debt if:</p> <ul style="list-style-type: none"> <li>• they are carrying on a primary production business; and</li> <li>• the loan is used wholly for the purpose of that business.</li> </ul> <p>To the extent that an FMD loan offset</p>	<p>The agreement for the making of an FMD must not allow the FMD to be used for loan offset purposes.</p> <p>The use of an FMD for loan offset purposes results in the deposit being treated as if it was never an FMD.</p>

<i>New law</i>	<i>Current law</i>
<p>arrangement results in a lower amount of interest payable on a loan or other debt other than for the purposes of a primary production business of the FMD owner or a partnership in which they are a partner, then an administrative penalty is payable. The administrative penalty equals 200 percent of the amount by which interest has been reduced on the portion of the loan subject to the non-qualifying purpose.</p>	
<b>Effect of FMD offset arrangement on interest income and deductions</b>	
<p>For the avoidance of doubt, these amendments clarify that if an amount would otherwise be included in the assessable income of the FMD owner as a result of entering into a qualifying loan offset arrangement, then such income is neither assessable income nor exempt income. The amendments also clarify that any corresponding deduction is limited to the actual amount charged.</p> <p>To the extent that an FMD offset arrangement is non-qualifying, the treatment of interest income and deductions depends on the application of the general income tax law to the arrangement.</p>	<p>The treatment of interest income and deductions depends on the application of the general income tax law to the arrangement.</p>

## **Detailed explanation of new law**

1.9 Schedule 1 makes a number of reforms to the income tax treatment of FMDs.

### **Increase in FMD cap**

1.10 Schedule 1 increases the maximum amount that an individual can hold in FMDs at any time from \$400,000 to \$800,000. This enhances the capacity of the FMD framework to assist primary producers to manage seasonal fluctuations in cash flow, including extended periods of positive or negative cash flow. [*Schedule 1, item 8, table item 10, section 393-35*]

### **Example 1.1: Higher contribution to FMDs**

Sebastien holds \$400,000 in an FMD on 30 June 2016 and continues to meet all eligibility requirements concerning the FMD. He experiences strong growth in his primary production business, with sale prices for his produce increasing.

Sebastien deposits \$200,000 in an FMD in both the 2016-17 income year and also the 2017-18 income year. Following the second deposit, Sebastien has reached the \$800,000 cap on amounts he can deposit to an FMD. Any further amount contributed will not be an FMD under subsection 393-30(3) and will not qualify for a deduction under section 393-5.

### **Consequences of early withdrawal of FMDs because of severe drought**

1.11 Schedule 1 allows a primary producer to gain early access to an amount held in an FMD if they carry on a qualifying primary production business on land that satisfies a rainfall deficiency test for the period prescribed by regulations. If no period is prescribed then the test must be met for a consecutive period of six months. Early access to an FMD enables an amount held in an FMD to be withdrawn within 12 months of its deposit without affecting the deduction for the amount deposited to the FMD in the previous income year.

1.12 Schedule 1 is designed to assist primary producers to support themselves in times of severe drought by providing them with early access in these circumstances. Early access in times of severe drought has not been available since the repeal of the exceptional circumstances provisions in Commonwealth legislation (eg, the former subsection 393-40(3) repealed in 2014). The rainfall deficiency test restores the ability of primary producers subject to severe drought to access amounts recently deposited to FMDs with an objective test that can be applied using publicly available information.

1.13 The schedule is intended to allow primary producers to deposit amounts into FMDs with confidence, knowing that if they experience a severe drought and they need to access the funds in the next income year but within 12 months they will not lose access to a previously claimed tax deduction.

#### ***Qualifying primary production businesses for early withdrawal***

1.14 The owner of an FMD can carry on such businesses through a variety of entities. These entities include as a sole trader, as a partner or as a beneficiary that is presently entitled to income of the trust or a unit holder in a fixed trust under section 393-25.

1.15 However, early access to FMD withdrawals is only available for some categories of primary production businesses as defined in section 995-1. *[Schedule 1, item 11, paragraphs 393-40(3)(a) and (b)]*

1.16 These qualifying classes of primary production businesses are businesses that:

- cultivate or propagate plants, fungi or their products or parts (eg. vegetable cropping, plant propagation, mushroom farming);
- maintain animals for sale or the sale of their bodily products or offspring (eg. cattle farming, sheep farming including wool production, farming of aquatic animals such as fish, crustaceans and molluscs);
- produce dairy products from raw material produced by the primary producer (eg. dairy farmers); and
- plant or tend trees in a plantation or forest for logging (eg tree cultivation for logging).

*[Schedule 1, item 11, paragraphs 393-40(3)(a) and (b)]*

1.17 The above types of primary production businesses are those that would be likely to be directly affected by severe drought.

1.18 In contrast, early access to FMDs does not extend to an FMD owner that only carries on one or more of the following primary production businesses:

- commercial fishing, pearling and related activities (other than farming of aquatic animals);
- felling of trees; or
- transporting trees that the transporter logged for milling or processing or to a place for transport to a mill or processing plant.

1.19 Early access does not extend to the above types of primary production businesses because drought conditions do not directly impact on these activities and therefore FMD owners not involved in drought affected activities are unlikely to need early access in times of severe drought.

1.20 If an FMD owner carries on both qualifying and non-qualifying primary production businesses, they can access the early withdrawal concession for severe drought if they meet the relevant rainfall conditions for their qualifying primary production business.

### ***Rainfall deficiency***

#### ***Rainfall in period prior to withdrawal***

1.21 The rainfall deficiency test that must be met to benefit from the early access concession requires that rainfall has not exceeded a prescribed level in the prescribed period leading up to the FMD withdrawal. That is, it imposes a prescribed maximum threshold on rainfall that has been experienced for a prescribed minimum period prior to withdrawal. [*Schedule 1, item 11, subparagraph 393-40(3)(b)(i) and paragraph 393-40(3AA)(a)*]

1.22 If no time period or rainfall threshold is prescribed by regulations then the amendments provide that the rainfall deficiency condition will be satisfied for a withdrawal if the Bureau of Meteorology rainfall data for the most recent six consecutive months for which records are publicly available preceding withdrawal is within the lowest five per cent of recorded rainfall for that period. [*Schedule 1, item 11, subparagraph 393-40(3)(b)(ii) and paragraph 393-40(3AA)(b)*]

1.23 This test considers the most recent six months of rainfall information which is publicly available from the Bureau of Meteorology at the time of withdrawal of the FMD amount to avoid restricting the time withdrawals can be made due to the availability of data. This Bureau of Meteorology data is collected monthly and published by the Australian Bureau of Agricultural and Resource Economics and Sciences on its rainfall monitor tool.

#### ***Land subject to withdrawal and deposit rainfall tests***

1.24 The final requirement is that the rainfall test for withdrawal must be satisfied in relation to the land on which the qualifying primary production business is being carried on by the FMD owner. The rainfall test only needs to be satisfied in relation to a part of the land. It can be just one part of a number of parcels of land from which the business is carried on. Alternatively if there is more than one qualifying primary production business, then any part of the land of one of those businesses can satisfy the rainfall test.

1.25 The land must have been held (owned, leased or held in any other form of interest) for at least six months (or such other period as prescribed) and still be held at the time of withdrawal for the concession to be available. This reflects that the rainfall test must be met for a

minimum of six months (or such other prescribed period) that is publicly available immediately preceding the withdrawal of the FMD amount.

*[Schedule 1, items 2, 9 to 12, paragraph 393-15(2)(ca), note 1 to subsection 393-40(1), note 1 to subsection 393-40(2), subsection 393-40(3), subsection 393-40(4)]*

1.26 If an amount is deposited in an income year and withdrawn within 12 months because of severe drought in the following income year then:

- entitlement to any deduction remains;
- an amount must generally be included in the assessable income of the FMD holder in the income year when the withdrawal occurs; and
- any subsequent deposit in the income year of the withdrawal cannot be treated as an FMD.

1.27 The only circumstance in which a withdrawal of an FMD amount in a later income year would not result in the amount of the withdrawn FMD being included in assessable income is the extent to which the FMD did not qualify as a deduction in the earlier income year. This can occur under the existing operation of subsection 393-5(2) to the extent the amount of the deposit to an FMD exceeds the primary production business income of the taxpayer in the year of the deposit.

1.28 The concession provided by these amendments is only relevant to the extent that the deposit and withdrawal occur in different income years. To the extent the deposit and withdrawal occur in the same income year, it does not matter whether the amount is deductible and then included in assessable income. This is because the rules for making and withdrawing FMDs give the same net outcome where they occur in the same income year as a deposit being treated as never having been an FMD.

**Example 1.2: FMD deduction retained for prior year deposit when withdrawn due to severe drought**

Jerome owns a 50 hectare cattle farm that he has operated for a number of years as a sole trader. He also owns and runs a sheep farm with his brother across the border in another state. He deposited \$200,000 to an FMD on 20 June 2017 and was entitled to a deduction for this amount.

Jerome must demonstrate that some part of either of the properties from which he carries on the cattle and sheep farms has been subject to severe drought conditions according to the most recently available 6-monthly rainfall data. If he can demonstrate this it will allow him to withdraw the amount after 30 June 2017 without affecting the FMD

deduction claimed for the 2016-17 income year. However, the withdrawal must be made prior to 20 June 2018 for the early access concession to be available to Jerome.

Jerome obtains evidence from the Australian Bureau of Agricultural and Resource Economics and Sciences rainfall monitoring tool in late April 2018 that shows the 6-monthly rainfall received on his sheep farm was in the 0-5 percent range for the most recently available period of six months. This is the period of October 2017 to March 2018 inclusive. New monthly data is released in the middle of the following month for the previous month.

As rainfall for the most recently publicly available data period of six months is five per cent or less of average rainfall for this period, Jerome can access the early FMD withdrawal concession.

As a result, there is no change in entitlement for the \$200,000 deduction claimed in the 2016-17 income year. Jerome must include an amount of \$200,000 in his assessable income in the 2017-18 income year as he normally would for the withdrawal of the FMD amount in that income year.

### **Example 1.3: Early withdrawal of FMD in the same income year**

Eloise carries on a primary production business of cereal cropping in a marginal rainfall area in Australia. On 21 July 2017, she makes a \$200,000 deposit to an FMD as a result of a record farm crop that has been harvested in the last season. Her primary production income exceeds \$200,000 and she therefore obtains a deduction for the full amount of the deposit. However, from November 2017 rainfall conditions changed significantly and she only plants a small cereal crop. Due to the severe drought none of the crop can be harvested.

As a result of the severe drought, Eloise is forced in May 2018 to withdraw all of the FMD deposit that was made in July 2017 to provide her with cash flow for her business. Even if Eloise can demonstrate that she meets the rainfall conditions to qualify for the early withdrawal concession for severe drought, there is no benefit from qualifying for the early access concession. This is because the withdrawn amount included in assessable income offsets any FMD deduction for which entitlement is retained for the same income year. Accordingly, Eloise does not seek to obtain rainfall data in these circumstances.

### **FMD offset against loans or other debts**

1.29 Schedule 1 allows an FMD owner to link their FMD to a loan or other debt account of the FMD owner (or a partnership in which the FMD owner is a partner) under a loan offset arrangement. Under such an arrangement, generally interest payable on the loan or other debt is

reduced and interest is not charged on the FMD. *[Schedule 1, item 7, section 393-37]*

However, to be eligible for an offset arrangement, the loan or other debt being offset must relate wholly to a primary production business carried on by the FMD owner directly or through a partnership. *[Schedule 1, item 7, paragraph 393-37(b)]*

1.30 The concession does not extend to loans held by companies, trusts or a person who is not the FMD owner. If FMDs are allowed to offset loans to such entities it would be expensive and complex to administer for financial institutions and could pose taxation integrity risks.

1.31 The amendments enable financial institutions to offer financial products that allow their primary producer clients to enter into such qualifying loan offset arrangements. This allows capital held in FMDs to be used with more flexibility so that it can also assist primary producers reduce their funding costs.

#### ***Administrative penalty***

1.32 To ensure that the FMD tax concession is appropriately targeted, an administrative penalty is imposed if an FMD is applied for non-qualifying loan purposes, including non-primary production business or private loans of the FMD owner or their partnership. *[Schedule 1, item 13, section 288-115]*

1.33 An amount is generally treated as never having been an FMD where it does not meet the requirements to be an FMD. However, under Schedule 1 an administrative penalty applies instead to simplify compliance where a loan offset by an FMD is partly non-qualifying. Treating the whole amount as never having been an FMD would be overly punitive, while keeping track of the amounts in an account that qualified as FMDs and the amounts that did not would be overly complex. The administrative penalty balances the need for appropriate deterrence whilst ensuring minor breaches are not disproportionately penalised. *[Schedule 1, items 4 and 6, subsection 393-30(2), section 393-35 (table item 8)]*

1.34 An administrative penalty applies equal to 200 per cent of the amount by which interest has been reduced on the portion of the loan used for the non-qualifying purposes. The effect of the penalty is to remove any benefit from using an FMD loan offset for a non-qualifying purpose and to also impose an additional cost to act as a deterrent to taxpayers to enter into such arrangements and to recover the time value of the benefit the taxpayer may have obtained through non-compliance. *[Schedule 1, item 13, section 288-115]*



1.35 The administrative penalty is subject to the provisions in Subdivision 298-B in Schedule 1 to the *Taxation Administration Act 1953* that apply to existing administrative penalties. As a result, among other things:

- the Commissioner must give written notice of the penalty and the due date for payment;
- the Commissioner may remit the penalty in whole or part (and the taxpayer may appeal this decision); and
- the general interest charge applies to the penalty.

1.36 The Commissioner would be expected to take into account all relevant factors in deciding to remit the administrative penalty in whole or part which would include factors such as:

- if the taxpayer has acted deliberately or recklessly;
- how quickly the taxpayer addressed the non-compliance once they became aware of it;
- if the breach was minor in nature and unintended; and
- if the taxpayer had otherwise been fully compliant with the tax law.

#### **Example 1.4: Breach of FMD offset arrangement**

Lydia is a sole trader that carries on a primary production business. Lydia borrows \$100,000 for her primary production business. While the loan is otherwise used for the purposes of her primary production business operated as a sole trader, she also increased the loan in September 2017 by \$50,000 to buy shares in a mining company (interest is deductible as the shares are held to derive dividends).

Lydia has \$150,000 held in an FMD as at 31 January 2018. On 31 January 2018, she enters into a loan offset product offered by her bank. The product allows the linking of the FMD to the loan, such that the balance in the FMD notionally reduces the balance of her loan, with interest being charged on the reduced loan amount.

Accordingly, on 31 January 2018, the balance of the loan of \$150,000 is offset against the \$150,000 FMD under the FMD offset arrangement.

The full amount of the loan is repaid on 30 June 2018 by Lydia from the proceeds of the sale of a property. Lydia does not disclose the breach to the Commissioner under which the FMD is offset against a loan used only partly for her primary production business.

Without the FMD offset occurring, interest of \$9,000 would have otherwise been charged on the \$150,000 loan. Given that a portion of the loan was used for a non-qualifying purpose, interest of \$3,000 will be subject to the administrative penalty provisions ( $\$50,000 / \$150,000 \times \$9,000$ ).

Accordingly, the Commissioner provides a written notice to Lydia that she is subject to an administrative penalty of \$6,000 (200 per cent of the \$3,000 of interest not required to be paid for applying the FMD offset for a non-qualifying purpose). This penalty is calculated in relation to the period from 31 January 2018 when the breach first occurred until the loan was repaid on 30 June 2018. As the Commissioner considers that the breach was intentional, the Commissioner does not remit any of the penalty.

Lydia can object to the Commissioner's decision not to remit any of the administrative penalty.

#### ***Clarification of tax outcomes***

1.37 To avoid any doubt about the outcomes for these products, the amendments provide that the FMD holder or partnership of which the FMD owner is a partner is treated as not deriving income that might otherwise be derived as a direct consequence of the operation of a qualifying loan offset arrangement. The amendments also clarify for the avoidance of any doubt that any corresponding deduction is limited to the actual amount charged. [*Schedule 1, item 7, section 393-37*]

1.38 The amendments do not affect the potential application by the Commissioner of the general anti-avoidance rules under Part IVA of the *Income Tax Assessment Act 1936*.

1.39 The general income tax law continues to apply to non-qualifying loan offset arrangements, such as a loan offset arrangement where an FMD is offset against a loan held by a trust. Depending on the circumstances of such arrangements, they may not be effective for income tax purposes.

**Table 1.1: Summary of implication of use of FMD for offsets**

<i>Entities types for offsets</i>	<i>Offset of loans against FMD owner (whether solely or in partnership)</i>		<i>Offset of loans of other entities (trust, company or *third party) – non-qualifying loan offsets</i>	
	<i>Administrative penalty</i>	<i>Tax outcome</i>	<i>Administrative penalty</i>	<i>Tax outcome</i>
<i>FMD deduction and interest treatment</i>				
<i>Solely primary production business use of loan related to FMD owner</i>	No penalty applies.	Amendments apply if required to clarify that the FMD loan offset arrangement is effective for income tax purposes.	Administrative penalty applies equal to 200 per cent of total FMD interest offset	General income tax law applies.
<i>Private or non-primary production business use related to FMD owner</i>	Administrative penalty applies equal to 200 per cent of interest that has been reduced on the portion of the loan used for private or non-primary production purposes.	General income tax law applies.	Administrative penalty applies equal to 200 per cent of total FMD interest offset.	General income tax law applies.

\* Third party does not include a partnership in which the FMD owner is treated as carrying on a primary production business.

## Consequential amendments

1.40 Schedule 1 also makes a number of consequential amendments to the income tax law, including guide material to reflect the changes made to the tax treatment of FMDs. [Schedule 1, items 1, 2, 9, 10 and 12, section 393-1, paragraph 393-15(2)(ca), note at the end of section 393-30, note 1 at the end of subsections 393-40(1) and (2) and subsection 393-40(4)]

## Application and transitional provisions

1.41 The amendments in Schedule 1 apply to the 2016-17 income year and later income years. [item 14]



