REGULATION IMPACT STATEMENT

Background

1.1 The Government announced changes to Farm Management Deposits (FMDs) in the *Agricultural Competitiveness White Paper* (White Paper) released on 4 July 2015.

1.2 FMDs are a risk management tool to help primary producers deal with uneven income between years, particularly during times of downturn and uneven and unpredictable changes in income. Uncertainty frequently occurs as a result of weather variations, natural disasters and changing market conditions.

1.3 FMDs increase the self-reliance of Australian primary producers by helping them manage their financial risk and meet their business costs in lower income years through cash reserves set aside in higher income years. FMDs provide a benefit to primary producers because they allow untaxed business income to be set aside for a future year. Income deposited is tax deductible in the year the deposit is made, and included in assessable income in the year it is withdrawn.

1.4 Prior to release of the White Paper, and in the context of an approvals process managed by a taskforce within the Department of Prime Minister and Cabinet, a short form regulation impact statement was prepared and regulatory costs were agreed with the Office of Best Practice Regulation.

1.5 This RIS is being prepared for and assessed by the Office of Best Practice Regulation prior to introduction of the legislation to Parliament (the final decision point).

1.6 The changes to FMDs aim to improve their value to farmers and make them more flexible. The changes, which include doubling the amount that can be held in FMDs, re-introducing early access provisions for farmers in severe drought and allowing FMDs to offset primary production business loans will apply from 1 July 2016.

1. The problem

1.7 The objective of the FMD scheme is to encourage primary producers to improve their resilience by building up cash reserves that can be drawn on in times of downturn or difficulty.

1.8 Around 35,000 primary producers own around 45,000 FMD accounts holding approximately $4 billion[1]. There are an estimated 330,000 primary producers in Australia, so approximately 10 per cent of primary producers in Australia currently hold FMDs.

1.9 While primary producers derive a number of benefits from FMDs, feedback from stakeholders as part of the White Paper consultation process identified a number of restrictions currently imposed on the use of FMDs that impair the effectiveness of FMDs in assisting primary producers to build up sufficient cash reserves to deal with uneven and unpredictable changes in income. In particular, concerns were raised about restrictions on how soon an FMD can be withdrawn, restrictions on using FMDs as a loan offset and restrictions on the total amount that may be deposited.

1.10 The current cap of $400,000 has not been updated since 2006-07 and has not been indexed to reflect changes in the consumer price index. Feedback from stakeholders

[1] Department of Agriculture- Farm Management Deposit Statistics - December 2015 quarter.

in consultation found that since the time of the last update, the costs and scale of farming businesses have all increased substantially. This means $400,000 may no longer serve as an adequate reserve during low income years, compromising the resilience of primary producers. Enabling primary producers to put more in FMDs would better meet the objective of encouraging primary producers to improve their resilience by building up additional cash reserves.

1.11 Since the cessation of exceptional circumstances in 2014, farmers who withdraw their FMDs before 12 months have passed because of severe drought will lose their tax concession. There was some concern that this may discourage those farmers susceptible to drought to put aside deposits, if they fear they may need to withdraw them within 12 months. This would reduce the cash reserves set aside by primary producers, having a negative impact on their self-reliance. The 12 month holding rule in this instance may also act as a disincentive for farmers in drought to access their FMDs in times of difficulty, contrary to the objective of the FMD scheme, as they will lose the tax concession on a deposit withdrawn within 12 months of being made.

1.12 Stakeholders questioned the rationale for provisions that currently prevent FMDs being used as loan offsets. Allowing FMDs to be used as an interest loan offset could help primary producers reduce overall debt and improve cash flow. This means the provisions currently preventing FMDs being used as loan offsets may work against the overarching objectives of the FMD scheme.

1.13 Given the size of the agricultural sector (the value of farm production was $51 billion in 2013-14)[2] and its contribution to the Australian economy and export market (currently making up 2 to 3 per cent of GDP[3] and 15 per cent of the export market), the broader public have an interest in ensuring the sector remains sustainable and steps are taken to manage rising levels of rural debt (in the decade to 2013-14, the RBA estimates rural debt rose to $64 billion)[4].

2. Case for government action/Objection of reform

1.14 Agriculture is a significant employer, particularly in regional areas. Around 270,000 people are employed in the sector with a further 223,000 in food, beverage and tobacco manufacturing[5]. The numbers employed in agriculture and its production levels demonstrate that broader use of FMDs and greater contributions could further support the sector's sustainability with benefits for the broader economy. A case for Government action therefore exists, to encourage primary producers to improve their resilience by building up cash reserves that can be drawn on in times of downturn or difficulty, particularly as drought and ongoing changes in weather patterns will be continuing challenges.

1.15 FMDs were introduced in 1999 replacing the former income equalization scheme which applied to enable primary producers to even out the effect of fluctuating incomes.

1.16 The rules and regulations concerning FMDs are contained in the *Income Tax Assessment Act 1997*.

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[2] *ABARES 2015a Agricultural commodities: June quarter,* Australian Bureau of Agricultural and Resource Economics and Sciences, Canberra.

[3] 2014, *Agricultural commodity statistics 2014*, Australian Bureau of Agricultural and Resource Economics and Sciences, Canberra, December.

[4] RBA 2014, *Rural debt by lender, statistics table D9*, Reserve Bank of Australia, Sydney, December.

[5] Commonwealth of Australia 2015a, Agriculture portfolio: deregulation annual report 2014, Department of Agriculture, Canberra.

1.17 Government action is required to amend the law and re-introduce early access, allow FMDs to be used as loan offsets and increase the maximum deposit limit. While there is a case for Government action and the changes will go toward the objective of encouraging primary producers to build up cash reserves to be drawn upon in difficult times, there are likely to be some limits to the effectiveness of Government action. Re-introducing early access, while consistent with the Government's objective of ensuring FMDs are available to be drawn upon in low income years, is likely to be beneficial to a small number of primary producers, who are affected by drought and have made a deposit in the last twelve months. Government action in removing the restriction on FMDs being used as loan offsets will have practical effect for primary producers if financial institutions assess they are commercially viable products to offer to primary producers. The effectiveness of the increase in the cap will be constrained by the number of primary producers that have the financial capacity to put aside amounts over $400,000.

3. Policy options

Option One: Early access provisions

1.18 One option would be to provide primary producers with greater flexibility to access deposits within 12 months without losing the tax concession. This option would allow primary producers who are affected by severe drought to access FMDs within the 12 month period where a deposit has been made in one income year and the amount is withdrawn in the following income year, without losing the concessional tax treatment in the year of deposit.

1.19 This would mirror the previous exceptional circumstances which allowed primary producers to gain early access to FMDs. Up until 1 July 2014 primary producers could gain early access to their FMDs without losing the concessional tax treatment where the Minister for Agriculture, advised by the National Rural Advisory Council, made a declaration of exceptional circumstances. Early access was also allowed where natural disaster relief and recover arrangements applied. As a result of wider changes to income support for farmers, exceptional circumstances declarations are no longer made. This proposal aims to restore concessional treatment for primary producers experiencing severe drought.

Option Two: Allow FMDs to be used as Loan Offset Accounts

1.20 This option would allow FMDs to be used as loan offset accounts to maximise the benefit farmers can receive from their account. If banks offer this product, primary producers would have more flexibility in how they obtain the return on their FMDs. This may improve the value primary producers receive from these accounts and improve their cash flow. Allowing FMDs to be used as loan offset accounts may also encourage competition in the products offered by FMD providers. Primary producers would only be able to use FMDs as a loan offset for business loans, otherwise the proposal could lead to a disproportionate tax advantage for primary producers.

Option Three: Increase the cap to $800,000

1.21 This option would increase the cap on FMD holdings from $400,000 to $800,000 to enable primary producers to better manage uneven income and become more self-reliant. The option would allow farmers who have the capacity to make larger deposits, providing them with more funds to draw upon in low income years.

Option Four: Status Quo

1.22 This option makes no changes to the current system. Department of Agriculture statistics show FMD holdings are generally highest in good years and lower in bad years, suggesting farmers are able to successfully use the accounts as an income smoothing tool to increase self-reliance and prepare for downturns.

4. Cost benefit analysis of each option/Impact analysis

Option One: Early access provisions

1.23 Early access provisions in times of drought were raised by a small number of individual stakeholders during consultation on the Agricultural Competitiveness Green Paper.

1.24 A small proportion of primary producers, around 70 per year, are likely to benefit from re-introduction of the exceptional circumstances early access provisions, as it would allow them to withdraw their deposit early without losing the concessional tax treatment. Such early access may assist a primary producer to recover from financial hardship stemming from drought and would allow them to rely on their own money, rather than relying on grants or loans. However, the proposal does not overcome any disadvantage a primary producer accessing their funds early may face from their financial institution, because all FMDs are currently offered as 12 month deposits.

1.25 The option would also reduce compliance costs for eligible primary producers who have already submitted their tax returns. Usually, a primary producer who withdraws an FMD earlier than 12 months after its deposit no longer receives a deduction in the year the deposit is made, which requires them to amend their assessment if they have already lodged their tax return. Primary producers eligible for early access would not need to amend an assessment as the deduction claimed in the year of deposit would still stand.

1.26 The option would have a limited impact on the budget as only a small number of primary producers would be affected and could only defer the tax liability by one income year. The proposal is estimated to have a negligible cost to revenue over the forward estimates period.

1.27 Primary producers would readily be able to determine whether they are eligible for early access using the Australian Bureau of Agricultural and Resources Economics and Sciences (ABARES) monitor tool. This was determined in consultation with stakeholders. Feedback from targeted consultations indicated primary producers preferred the guidelines to be clear and objective. Clear and objective guidelines increase certainty and minimise the risk of an Australian Taxation Office (ATO) audit for primary producers that want to comply with the law because no subjective criteria would apply. The rainfall monitor is consistent with the eligibility criteria used for other drought assistance measures administered by the Department of Agriculture. Using the one tool should minimise compliance costs for primary producers, although it is possible state governments will use different tools and eligibility criteria to measure drought which may increase the regulatory burden on farmers.

1.28 There may be some initial education costs for primary producers following introduction of the provisions. Interested primary producers would also need to determine whether they are eligible for the exception through the rainfall deficiency test. The test considers the rainfall recorded in the most recent six months publicly available at time of withdrawal. Where rainfall is within the lowest five per cent of recorded rainfall for those six consecutive months, the primary producer would be eligible for early access.

1.29 The option has estimated average annual compliance costs of $109. This reflects the education costs for primary producers and the regulatory saving to primary producers who no longer need to amend their assessments.

Table 1.1: Regulatory burden and cost offset estimate table

Average annual regulatory costs (from business as usual)				
Change in costs ($)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$109	-	-	$109
Cost offset ($)	Business	Community organisations	Individuals	Total, by source
Agency	–$109	-	-	–$109
Are all new costs offset? ☑ **Yes, costs are offset** ☐ **No, costs are not offset** ☐ **Deregulatory—no offsets required**				
Total (Change in costs – Cost offset) ($) = $0				

Note: Offsets will be found for 2016 from the Treasury portfolio.

Option Two: Allow FMDs to be used as Loan Offset Accounts

1.30 During consultation, which followed release of the Agricultural Green paper, stakeholders argued lifting the restriction on using FMDs as loan offset accounts would mean primary producers could also use their FMDs to reduce interest paid on debt and improve cash flow. If financial institutions offer the product, this proposal may result in better outcomes for farmers.

1.31 The option is estimated to have a gain to revenue of $10 million over the forward estimates period. The proposal is expected to reduce the amount of interest primary producers pay on business debt, which would reduce the tax deductions they can claim.

1.32 Farmers may incur compliance costs in setting up loan offset arrangements against their FMDs. Further, many farmers have loans that relate to both their farm business and personal assets. These farmers may wish to use FMDs to offset their loans and would need to separate these mixed loan accounts, incurring some costs in doing so.

1.33 Financial institutions that offer the product would face costs in developing systems to allow FMDs to be used as loan offsets.

1.34 Based on the costs to banks in developing systems and the costs incurred by primary producers in switching FMDs from interest bearing to loan offset accounts, this proposal is estimated to have average annual compliance costs of $853,723.

Table 1.2 Regulatory burden and cost offset estimate table

Average annual regulatory costs (from business as usual)				
Change in costs ($)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	$853,723	-	-	$853,723
Cost offset ($)	Business	Community organisations	Individuals	Total, by source
Agency	–$853,723	-	-	–$853,723
Are all new costs offset? ☑ **Yes, costs are offset** □ **No, costs are not offset** □ **Deregulatory—no offsets required**				
Total (Change in costs – Cost offset) ($) = $0				

Note: Offsets will be found for 2016 from the Treasury portfolio.

Option Three: Increase the cap to $800,000

1.35 The option would assist primary producers who are able to set aside amounts in excess of $400,000 in FMDs to better manage fluctuations in cash flows.

1.36 This option may have a small effect on banks which may receive additional FMDs as a result of the proposal.

1.37 The option is estimated to have a cost to revenue of $20 million over the forward estimates period.

1.38 The option is not anticipated to have any further regulatory impact than what is already in place. We understand there are only some primary producers who would need to learn of the change to the limit as not many have holdings approaching $400,000. Further, we expect primary producers would spend an insignificant amount of time learning of the changes as they would be communicated with existing ATO materials.

Option Four: Status Quo

1.39 An advantage of maintaining the status quo would be that no additional compliance costs would be imposed on primary producers.

1.40 A disadvantage is that it would not reduce requests for government assistance for primary producers in times of drought.

5. Consultation

1.41 Consultation was undertaken on the various options as part of the development of the White Paper which included the release of an Issues Paper on 6 February 2014 and a Green Paper on 20 October 2014. More than 1,000 submissions were received from stakeholders across rural, regional and metropolitan areas, encompassing farmers, industry associations, researchers, finance sector representatives, supply chain participants, and State and Territory governments.

1.42 Further consultation occurred in November/December 2015 on the exposure draft and explanatory materials. Targeted consultation on the early access and loan offset options were also conducted in September 2015.

Early Access

1.43 All stakeholders were supportive of including an option to allow early access in times of drought. The targeted consultations sought to ascertain what circumstances could be relied on to effectively identify primary producers suffering severe drought while imposing low compliance costs on primary producers and minimising administrative complexity. Stakeholders supported a tool that would provide certainty to primary producers in determining whether they were eligible for early access. Based on these consultations and discussions with the Department of Agriculture and the ATO the method for determining eligibility would be based on whether a primary producer had experienced rainfall within the lowest 5 per cent of rainfall for that land in the 6 months prior to withdrawal based on information available on the ABARE’s website.

1.44 During consultation on the exposure draft and explanatory materials some organisations indicated they would have preferred a mechanism that provided greater flexibility for access, particularly to allow for early access within 6 months of deposit. Providing greater flexibility of access would have reduced certainty as to eligibility. Six months is an appropriate test period for establishing circumstances of drought. The drought period should not cover the period when the deposit was made because early access is intended to support a primary producer that is subject to circumstances they could not have anticipated at the time of deposit. It is not intended to provide a tax deferral mechanism for primary producers that decided to deposit funds into an FMD when they knew they would require early access.

Loan offset

1.45 Many submissions supported allowing FMDs to be used as loan offset accounts. However, financial institutions were concerned with the policy and highlighted complexities and compliance costs that would be imposed on them from making the change. Financial institutions were not clear on whether they would offer FMDs as a loan offset. There was also some confusion with how the provisions would operate.

1.46 Financial institutions indicated there would be significant complexities and costs for them if they were to allow an FMD owner to offset a loan held by another entity. On that basis the legislation only allows FMDs to offset loans held by individuals and partnerships, and not trusts and companies.

1.47 Financial institutions will not need to offer FMDs as loan offset accounts and so the change allows financial institutions and primary producers to determine what arrangements are most suitable for them. The legislation will not require financial institutions to undertake any additional monitoring if they offer the product. Changes have been made to the draft legislation and explanatory materials to provide greater certainty as to how the loan offset provisions will operate.

Increase the cap

1.48 All submissions received were supportive of the option to increase the cap.

6. Option Selection

1.49 Options one, two and three are all likely to deliver a net benefit by increasing primary producers’ resilience because they are all likely to increase the amount primary producers set aside and can draw on in downturns. This is supported by the feedback received during consultations on the White Paper.

1.50 Changes to FMDs will result in some increased compliance costs for primary producers and financial institutions and increased administration costs for the ATO, whereas option four (status quo) will not. However, these compliance costs will only be incurred by those that choose to utilise the additional flexibility of FMDs.

1.51 The early access change is likely to increase amounts deposited into FMDs, because primary producers will know when they decide to deposit funds they will not face adverse tax consequences if they need to withdraw the funds early as a result of drought.

1.52 It is appropriate that financial institutions and primary producers be given the option to use FMDs as a loan offset account as these arrangements may be more beneficial for primary producers than current arrangements allow. Where financial institutions offer to use FMDs as a loan offset account for primary production business debt, primary producers will be more likely to put aside amounts into FMDs rather than using income to pay off debt. This will increase primary producers' resilience in the event of a downturn. To the extent the change results in a net reduction in interest repayments, the change will mean primary producers will have more money to support themselves in the event of a downturn. The changes are also expected to have a small positive impact on the Budget.

1.53 Increasing the cap from $400,000 to $800,000 takes into account rising farm business costs and inflation. While the proposal to increase the cap would have some cost to the Budget, it would increase amounts put aside in FMDs for use in a downturn, and would thereby increase the resilience of primary producers. The change is overwhelmingly supported by stakeholders.

1.54 The fourth option (the status quo) would not increase the resilience of primary producers and was not supported.

7. Implementation/Evaluation

1.55 The Treasury has been engaging with industry stakeholders affected by the policy change, as well as the Department of Agriculture and the ATO throughout the process, in order to work out implementation details and ensure that the three proposals are effectively implemented. The proposals will come into effect on 1 July 2016.

1.56 Doubling the deposit limit to $800,000 is straightforward and has broad based stakeholder support.

1.57 Early access in times of drought will be relatively simple for the primary producers to determine eligibility and for the ATO to enforce compliance. The rainfall monitor is similar to tools used for determining eligibility to other drought concessions reducing implementation risks.

1.58 Financial institutions have indicated it may take some time for them to develop the systems required to offer FMD loan offsets. This means primary producers are unlikely to benefit from the changes immediately. Earlier introduction of legislation may have allowed financial institutions to offer FMD loan offsets sooner. However, earlier introduction would not have allowed for more considered development and consultation on the proposal.

1.59 Treasury, the Department of Agriculture and the ATO will continue to engage to examine whether the changes are meeting their objectives and the FMD provisions remain appropriate and up to date.