Finance

How farmers can use limited company status to reduce land deal repayments

Analysis
Martin O'Sullivan

It's a deal: "I have encountered many such situations where company formation came to the rescue of what might have been a lost opportunity for farmers," says Martin O'Sullivan

Limited company formation can come to the rescue of farmers struggling to balance the books on land deals, and also provide an escape route from heavy debt and tax burdens

It is probably fair to say that most people contemplating borrowing for land purchase are high-rate tax-payers, because otherwise they are unlikely to be able to afford the repayment.

Unfortunately, the cost of land is not a tax-allowable expense and it is only the interest on the borrowed money that is allowable. This presents an even greater obstacle in that the loan principal has to be repaid out of after-taxed income.

So, the reality is that where you are borrowing to fund land purchase it can end up costing you as much again as the cost of the land.

I will illustrate this by way of the following two examples.

CASE STUDY 1

Tom Farmer earns a taxable profit of €70,000 per annum and operates as a sole trader. He pays approximately €20,000 in tax, PRSI and USC.

His wife is working off-farm and earns a salary of €34,000 and takes home €25,000 per annum.

The family's annual personal, family and household drawings amount to €45,000, of which the farm contributes €20,000.

Tom makes an annual personal pension contribution of €5,000.

He has a bank loan of €70,000 costing €7,000 in annual repayments and his average annual capital expenditure is €10,000 on machinery and motor vehicle replacement.

So, in a typical year Tom has an after-tax retained surplus of approximately €8,000.

Forty acres of adjoining land has come up for sale at a price of €380,000 and Tom hopes to buy it.

He will need to borrow €300,000, which over a 15-year term will cost him €27,000pa in repayments.

A quick calculation tells us that Tom will need to find an additional €19,000pa to meet the full repayment.

The interest on the loan will be fully tax allowable and this will save him approximately €5,000 in tax in the early years of the loan, but he still has to find a further €14,000 in after-tax profit.

Tom in his innocence had thought that an extra 14 cows would get him over the line, but he forgot that the taxman would have to get his share of the additional profit in the form of tax, PRSI and USC.

So, Tom will need to make an additional profit of €28,500 in order to service the land loan and meet the annual tax.

In a nutshell, Tom is going to have to make €600,000 over the next 15 years to repay the €300,000 before we ever mention interest.

The proposition as things stand will not be a runner for Tom as the cost of 30 additional cows and the associated additional infrastructure will be beyond his reach.

So is there a solution?

It is clear that a greater part of the problem lies with the taxman's take. If that could be lessened sufficiently this project could be a runner.

The current tax structure is based on Tom as a sole trader so perhaps a partnership with his wife and son could be considered or failing that a limited company.

PARTNERSHIP

The principal tax objective in creating a partnership is to make optimum use of the 20pc tax band, which could create a maximum saving of €7,060 per partner.

Tom has used up all of his low band, as has his wife, so there is no saving in them forming a partnership.

There may be an opportunity to create a partnership involving his son but if the son is already being paid a wage and using up his personal tax and employee credits, the maximum tax saving here is €3,760.

This leads us on the considering the option of creating a limited company..

LIMITED COMPANY

The obvious advantage of creating a company is the 12.5pc tax rate and the fact that it can release equity such as stock or machinery in the form of a director's loan.

The benefit of the 12.5pc rate can be seen in a second example, also based on Tom's attempt to buy that neighbouring land.

CASE STUDY 2

Tom has been advised by his accountant that the formation of a limited company may make the land purchase a viable proposition based on his original plan to increase his cow numbers by 14, thereby increasing his taxable profit to €84,000.

To fund his drawings requirement of €20,000, Tom will be paid a gross salary of €22,000 from the company. His pension contribution of €5,000 will also be paid by the company. So the farm profit of €84,000 is reduced to €57,000, which will be liable to Corporation Tax of €7,125.

So, in this scenario Tom's total tax bill, both personal and corporate, is now €9,125 even with his extra 14 cows.

In summary his new-found position is as follows.

Company profit (after Tom's salary & pension contribution): €57,000
Less Corporation tax: €7,125
Existing loan repayment: €7,000
Capital expenditure provision: €10,000
Surplus available for additional debt servicing: €32,875

By forming the company, Tom can show his bank that servicing the new land loan is clearly within his capabilities.

The primary reason is that Tom has been able to increase his cow number by 14 while also reducing his tax bill by €10,875.

And the additional good news is that he still has €13,300 of his low tax band intact in the event that he needs to increase his personal drawings.

The case studies are not at all far-fetched. I have encountered many such situations where company formation came to the rescue of what might have been a lost opportunity.

Company formation may also provide an escape route to those farmers carrying both a heavy repayment and tax burden, particularly those over 55 years of age who may have the option of selling a part of their farm to their company, thereby creating a fund of up to €750,000 free of tax.

The company may now own some of the land, but the farmer owns the company, so no big deal.

Apart from land purchase or debt rescheduling, this manoeuvre can be a very tax-effective method of providing for other family members.

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