DEFERRED FARM INCOME – THE SLEEPING GIANT?

Farm businesses can often accumulate "deferred income" and over time, these amounts can become substantial with the potential for significant future income tax implications.

"Deferred income" is income that would usually be accounted for as taxable income in the year that it is earned or generated but is deferred or delayed to a future year through one of a number of deferral mechanisms available to primary producers. These deferrals can be either deliberate, as for example depositing funds into a Farm Management Deposit, or unintentional such as when market values for livestock rise.

Some of the main ways that deferred income can be generated are as follows:

Farm Management Deposits ("FMD's"). Using this scheme, primary producers are able to reduce their taxable incomes in "good" years by depositing cash in special types of bank deposits. These deposits can be redeemed in "bad" years and are included with taxable income in those years but usually offset by additional expenditure such as fodder. In this way, FMD's can be a very effective tool as part of a drought management strategy. However, they can also become a risk if they build up to a level in excess of reasonable requirements. The maximum amount that can be held in FMD's is now $800,000 per person so it is possible for farming families to accumulate very significant amounts in these facilities.

Drought Deferred Sales meaning deferral of livestock profits arising as a result of loss or destruction of pastures. This is a popular technique used in drought periods or dry spells where livestock sales occur as a result of poor pasture conditions and that would otherwise have not occurred. It is very effective at reducing taxable income in this situation and does not involve the outlay of any cash. One of the risks of this strategy is that the deferrals can only be made for a maximum of up to 5 years and sometimes the cash from the proceeds of the "forced sales" are used for other purposes and a build-up of deferred sales can create an issue if there is a run of "good" years following dry spells. This is often exacerbated when the cash from the forced sales is used to acquire replacement stock (often at higher prices) as conditions improve. The investment in additional livestock is not immediately deductible for income tax purposes but the return of the profit on the forced sales (within the maximum five year period) is taxable.

Unrealised profit in livestock inventory. Many farmers will use the "average cost" method for valuing year-end livestock inventories for taxation purposes. This means, particularly for those who run breeding operations (as opposed to trading), that the taxation value of inventories over time can be considerably lower than market value. In the event of the sale of the farm or some other forced sale event, that difference between average cost and market value is realised and can significantly increase taxable income.

Excess depreciation claims. The depreciation provisions are generally fairly generous, enabling large proportions of plant & equipment capital expenses to be claimed against taxable income. An example of these provisions is the 100% write off option for assets costing less than $20,000. Over time, the total "written down value" of farm plant can be much lower than the value that would be realised at, say, a clearing sale. Unlike the sale of the farm property which is a capital gain event but often exempt from any tax due to the operations of the Small Business Tax Concessions, any excess received on the sale of plant (over taxation written down value) will be taxable income and not subject to the CGT exemptions.

The examples listed above are not exhaustive and there are other provisions that can give rise to deferred farm income.

The "sleeping giant" here can be the unexpected tax consequences that could arise from an unplanned event. For example, upon death any FMD's or drought deferred sales related to the deceased person automatically becomes taxable income in the year of death and depending on the circumstances, this can create a very significant taxable income with a consequential significant tax bill.

The same is true if the taxpayer ceases to be a primary producer – for example if they retire or exit the family business to allow another family member to take over. In the event of sale of the farm, there can be a further realisation of deferred income from livestock dispersal (at market value) and the sale of plant & equipment at the farm clearing sale.

The key here is to;

a) to be constantly aware of the accumulated amount of "deferred income" that you are currently carrying forward and
b) ensure that you include this aspect in your succession and retirement planning.

Even with good planning, it is possible that "deferred income" can build up significantly over time and reducing it could be expensive due to tax paid at higher rates.

One way to "chip away" at deferred income might be to consider using a superannuation contribution strategy to effectively move the deferred income into a retirement savings vehicle using the applicable tax concessions to improve the overall result.

For example, let's say a farming family of 2 parents and a son and daughter has over a period accumulated $1M in "deferred income", mainly in FMD's. They have had a run of "good" years and now feel the amounts in FMD's are excessive to their needs and they also have some drought deferred sales that need to be returned as income over the next couple of years.

This family could use a strategy of making concessional superannuation contributions up to the allowable cap of $25,000 per person (i.e. a total of $100,000 p.a.) funded either in part or in full by redemptions from the FMD's. The end result would be that each year they could reduce deferred income by $100,000 at an effective tax rate cost of 15% (that is the rate the superannuation fund must pay on the contributions received).

Depending on their other incomes, this rate may be considerably less than they would pay if the income was simply returned with no offset and tax paid at that personal marginal rates. Over time, these savings could add up to the tens of thousands, particularly in the case of an unplanned event or death situation.

Another advantage of this strategy is that the family starts to accumulate a significant off-farm asset in a tax effective environment which can be a future source of tax-free retirement income. Should they wish to maintain “control” over their investment assets, they could utilise a Self-Managed Superannuation Fund structure.

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