Australian Government
Department of Agriculture, Fisheries and Forestry

2006 Review of the Farm Management Deposits Scheme

Executive Summary

November 2006

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Acronyms

AAA	Agriculture Advancing Australia
ABA	Australian Bankers' Association
ABARE	Australian Bureau of Agriculture and Resource Economics
ABS	Australian Bureau of Statistics
ADI	Approved Deposit-taking Institution
ANAO	Australian National Audit Office
ANZSIC	Australia and New Zealand Standard Industrial Classification
APRA	Australian Prudential Regulation Authority
ATO	Australian Taxation Office
CIE	Centre for International Economics
CPA	Certified Public Accountants (Australia)
.csv	Comma Separated Value
DAFF	Department of Agriculture, Fisheries and Forestry
EC	Exceptional Circumstances
ECIRS	Exceptional Circumstances Interest Rate Subsidy
ECRP	Exceptional Circumstances Relief Payment
FMB	Farm Management Bond
FMD	Farm Management Deposit
IED	Income Equalisation Deposit
IRS	Interest Rate Subsidy
ITAA	Income Tax Assessment Act 1936
JCC	Joint Consultative Committee
KPI	Key Performance Indicator
MOU	Memorandum of Understanding

Appendices

- Report of FMD AAA Survey
- ABARE Economic Modelling Report
- Maps of FMD holdings and EC regions
- Consultation Report
- Extract from 2005 ABARE Farm Survey Report
- CIE Issues and Options Report
- State and industry graphs

Executive Summary

1.1 Overview of FMD Scheme

The Farm Management Deposits (FMD) Scheme was established in April 1999 as a tax-linked, financial risk management tool for primary producers. The primary objective of the FMD Scheme is to assist primary producers deal more effectively with fluctuations in their cash flow resulting from climate variations and changes in market prices.

At 30 June 2006 more than 42,000 primary producers held a total of $2.797 billion in the FMD Scheme. Although there was growth in the value of holdings by $4.3 million (0.2 per cent) in 2005-06, there has been a net decline in holdings in all states, with the exception of Queensland and a net decline in the number of holders by 1,197 (2.7 per cent). This coincides with persistent poor seasonal conditions across Australia. FMD holdings represent a significant reserve of liquid assets which are able to be drawn upon in low income years, such as drought.

The FMD Scheme is an element of the *Agriculture Advancing Australia* (AAA) package, an integrated policy package developed to encourage farmers to adopt a more self-reliant approach to risk management. The Scheme allows eligible primary producers to set aside pre-tax primary production income in profitable years to establish cash reserves to help meet costs in low-income years, facilitating increased financial self-reliance.

FMDs are only available to individual primary producers. To be eligible to invest in an FMD, individual primary producers must not earn more than $50,000 off farm income in the year of deposit. In addition, only primary production income can be invested in FMDs, up to a maximum holding of $300,000 at any given time. Deposits are tax deductible in the year they are made, and included as taxable income in the year they are withdrawn. To qualify for the tax deduction, deposits must remain in the account for at least 12 months, unless the withdrawal is made in Exceptional Circumstances (EC), and the deposit was made prior to the area being EC declared.

An initial review of the FMD Scheme was undertaken in 2002. Broadly, the review found that the Scheme was meeting its objectives as an effective way in which primary producers could set aside income to address future adverse financial circumstances. As the Scheme was still in a build-up phase, it was thought to be too early to ascertain the full economic impact of FMDs. The review considered that the effectiveness of the Scheme could be better assessed when there is a rural downturn, after the Scheme had attained a greater level of maturity.

This is the second evaluation of the FMD Scheme to be undertaken since the commencement of the Scheme, and was undertaken concurrently with a wider evaluation of the AAA suite of programmes which are due to conclude in 2008. The review reports on the effectiveness and efficiency of:

- the FMD Scheme in meeting its policy objectives as a tax-linked, financial risk management tool for primary producers; and
- the Scheme's administration and legislative framework.

1.2 Key Findings & Recommendations

Policy Effectiveness

The 2006 review did not examine the policy appropriateness of the FMDs as a policy instrument. The first triennial review of the Scheme in 2002 considered the policy rationale appropriate and consistent with the government's aim of encouraging primary producers to become more innovative and financially self-reliant. Furthermore, the extent to which the Scheme is currently operating effectively and efficiently provides evidence on the validity of the rationale of the programme.

Research and data drawn upon in the review, provide indicators of potential effectiveness and efficiency. Key findings of the 2006 FMD Review indicate the Scheme is, *prima facia*, meeting its objectives as a tax-linked, financial risk management tool for primary producers. With more than 42,000 primary producers holding a total of $2.797 billion in FMDs at 30 June 2006, farmers perceive they receive considerable benefits through participation in the Scheme.

The majority of farmers view FMDs as an important aspect of their overall risk management strategies, and most farmers holding FMDs have made withdrawals from their accounts since the Scheme's inception. A high proportion of actual withdrawals have been used for working capital and there is evidence some deposits and withdrawals may reflect the industry and regional incidence of drought severity throughout Australia. Moreover, the total value of FMD holdings represents a significant reserve of liquid assets which are able to be drawn upon in low income years in the future to manage climatic variations and/or market fluctuations.

Given the unfavourable seasonal conditions in recent years, many farmers have accumulated debt and may be approaching equity levels which will limit their ability to borrow further. If they have invested in FMD's these will be available to sustain liquidity.

The 2006 FMD Review has identified six main reasons why farmers invest in FMDs:

- obtain a commercial option to make better timed expenditure decisions.
- earn interest on otherwise taxed income;
- pay a lower eventual tax rate in situations where there is an expectation that tax rates will be lowered in the future;
- can leverage up the effects of EC interest rate subsidies;
- obtain flexibility in superannuation planning; and/or
- may mistakenly overestimate the benefits of the Scheme in relation to available alternative investment options, due to the complex nature of incentives they create.

The review found that FMD holders who are using tax averaging are likely to receive low or negative nominal returns from investing in the FMD Scheme in response to five of the motivations listed above. However, investing in response to the first motivation could deliver important benefits to farmers and the wider economy with associated risk management benefits. By placing funds in an FMD, farmers take out an option to later find a tax deduction to offset quarantined income.

Evidence to support the suggestion that farmers are using FMDs to buy a commercial option, is based on the finding that tax management triggers the majority of FMD deposits, and most withdrawals are used for working capital which would most likely cover deductible expenses. In addition, there is a distinct annual pattern of large net FMD deposits in June, and net withdrawals in July, which may suggest that farmers are using FMDs primarily as tax planning instruments. However, use of FMDs to obtain a

commercial option for better and more timely resource allocation decisions, is likely to result in economic gains to farmers and to the economy and is consistent with good risk management practice.

Rather than a driver of Scheme use, the pattern of FMD deposit and withdrawal transactions may be a consequence of the tax-based nature of the Scheme, with deposits made in late June when the taxation and financial position of the farmer is known, and funds withdrawn at the first available opportunity, being 12 months later in June or July. By providing a tax based instrument that increases farmers' commercial options through income smoothing and liquidity management, the FMD Scheme has been used for risk management purposes. Used in this way, FMDs promote better and timelier resource allocation decisions. For instance fertiliser is more likely to be applied when best needed rather than simply in the year high income is earned. Better farm management decisions are entirely consistent with better risk management decisions. Timely investments make the farm more financially viable and sustainable to cope with downturns due to climate variations or market fluctuations when they occur. Simply put, there is less risk that a farm will fail financially if poorly timed expenditure can be avoided. Without FMDs, poorly timed expenditure may be forced on farmers as they hurriedly seek to obtain off-setting tax deductions before the end of a high-income financial year. Poorly timed expenditure leads to sub-optimal productivity and leaves farmers more financially vulnerable than they need be.

In financial markets options are important risk management instruments. They increase choice and flexibility and so help spread and reduce financial risk. Similarly, an instrument such as FMDs that increases farmers' financial options, potentially gives them more choices and so helps reduce risk. FMDs form part of a portfolio of risk management instruments in a farmer's risk management strategy. The greater the number of instruments, the more robust the risk strategy is likely to be.

Widespread drought conditions have been experienced throughout Australia since 2002-03. During this period, FMD holdings have continued to rise, with deposits broadly matching withdrawals. The aggregate trend of increasing/steady deposits through ongoing drought conditions may be masking the industry and regional incidence of drought severity. While the current review has been conducted following a prolonged period of drought conditions, many areas of Australia continue to experience below average rainfall conditions and have therefore not entered the recovery phase of the drought cycle. It is possible that farmers have made FMD deposits during the drought from the proceeds of the forced sale of livestock, and these deposits may not be withdrawn until the drought has

broken and restocking can begin. As a result, further analysis of the Scheme's operation after climatic conditions improve would assist in evaluating the role of FMDs in facilitating the return to profitability of farm businesses through the drawing down of available FMD reserves to replant and/or restock and to determine the effectiveness of the Scheme as a risk management tool for drought preparedness. This analysis would be used to inform the next full review of the Scheme in the 2009-10 financial year.

Recommendation: The FMD Scheme be retained with its primary objective as a tax-linked, financial risk management tool for primary producers.

Further analysis of the Scheme's operation should be undertaken after climatic conditions improve.

Evidence gathered during the current review indicates that farmers are using FMDs for a variety of reasons including flexibility in retirement planning. While positive economic gains may arise from such a use, farmers are likely to require both risk management reserves and retirement savings. In consultations, stakeholders proposed that FMDs be permitted to be rolled over into superannuation without a tax impost, however to do so would greatly extend the purpose and use of the Scheme from that of risk management of primary production. In addition, changes announced in the 2006-07 Budget to superannuation laws are likely to reduce the taxation costs of transferring FMDs to superannuation in the near future, providing an increased incentive for farmers to transfer assets currently held in the farm business to superannuation accounts.

Recommendation: FMDs should not be allowed to be rolled over into superannuation.

Policy Efficiency

Treasury has estimated the cost of the Scheme to the Commonwealth revenue at a total of $905 million for the years 2000-01 to 2004-05, with a projected cost of $110 million for the 2005-06 year. Scheme efficiency in relation to these costs may be calculated based on the economic gains that arise from farmers' investment in FMDs that lead to better and more timely resource allocation decisions.

While no comprehensive economic evaluation of the benefits and costs of the FMD Scheme was available at the time of the current review, positive economic gains and associated risk management benefits are likely to arise when FMDs are used to obtain an option, for flexibility in retirement

planning and by paying a lower eventual tax rate for those not using income averaging. Other uses of FMDs run the risk of creating economic losses if they represent inferior investment decisions and the high opportunity costs of investing in assets providing low after tax returns. The high proportion of actual withdrawals that have been used for working capital and the high proportion of future withdrawals expected to be used for retirement or superannuation, suggests that FMDs are predominantly used for reasons that could result in economic gains and a positive overall efficiency outcome.

Target Market

That over 40,000 primary producers currently hold, on average, some $60,000 of FMDs suggests that the Scheme is very popular among farmers. ABARE survey findings indicate higher income, higher valued farms have a greater tendency to use the Scheme. This may suggest the Scheme does not tightly reach its defined target market of middle income farmers. However, the Scheme is being used by a substantial number of farmers in all areas of agriculture and by a variety of farmers. Of those using it, over 50 per cent appear to be middle-income farmers. But there is no identifiable single group or even set of groups that can logically or economically be identified as the main users. This suggests that the Scheme is not unduly favouring one group or discriminating against another.

Use of the Scheme during recent drought

The current drought, which began in 2002–03, was preceded by two years of generally favourable seasonal conditions for the Australian farm sector. Correspondingly, there was strong growth in the number and value of holdings in the FMD Scheme from its inception until June 2002. By far the most significant uptake in the Scheme occurred in the June 2002 quarter, when holdings nationwide rose 92 per cent from $1.1 billion to $2.1 billion, and the number of holders increased 80 per cent from 24,200 to 43,400.

Drought has been a widespread feature of much of Australia's landscape during the last three or four years, and may explain much of the increased churning of both deposits and withdrawals of FMDs that has occurred since 2003-04. Since the onset of drought in 2002, FMD holdings have continued to increase steadily on an annual basis to a total of $2.797 billion at 30 June 2006. Over the same period, the number of primary producers with FMDs has declined slightly to 42,365.

The aggregate trend of increasing/steady deposits through ongoing drought conditions may be masking the industry and regional incidence of

drought severity, and its impact on FMD withdrawal and deposit behaviour. 66 per cent of farmers who have held FMDs have now made withdrawals from their accounts. Industries in which the proportion of farmers who have made a withdrawal is larger than the national average are cropping, cotton, sheep and mixed crops and livestock. New South Wales had by far the largest withdrawal rate of all the states, reflecting drought conditions. Although the total value of deposits had continued to rise between 2002 and 2005, total holdings in NSW have actually declined. In Western Australia where drought conditions have varied and have been less severe by comparison, deposits have grown strongly over the same period. However persistent poor seasonal conditions across Australia have resulted in all states, with the exception of Queensland, experiencing a net decline in holdings during 2005-06.

Use of the FMD Scheme in recent years might also have been affected by the operation of Exceptional Circumstances (EC) declarations designed to assist farmers in a region or industry experiencing a severe downturn due to a rare and severe climatic or other event. When a declaration is made, assistance is available to eligible primary producers in the form of interest rate subsidies and income support in the form of the EC Relief Payment.

The Terms of Reference for the 2006 FMD Review requires the review to examine the interaction of the FMD Scheme with other Australian Government policy measures.

ABARE modelling results suggest that interest rate subsidies under the EC programme may make it advantageous for farms in EC declared areas to borrow money to put into FMDs. Interest rate costs of borrowing could be more than halved under the EC programme while the interest premium on an FMD could be nearly 50 per cent, allowing an opportunity to leverage up on subsidised borrowed funds. However, there is some empirical evidence that use of the Scheme for leveraging-up the benefits of EC interest rate subsidies is not significant.

Eligibility to receive an EC interest rate subsidy, EC Relief Payment, and income support under the Farm Help programme is subject to an off-farm assets test. Proceeds from the forced sale of livestock are not taken into account in the assessment of eligibility for these payments when they are placed in a term deposit of at least 3 months, including an FMD. However, FMDs are generally not considered off-farm assets for this purpose.

Given the intention of FMDs as a tool to facilitate the accumulation of liquid reserves to be used during a downturn in income, it has been suggested that FMDs be removed as an “exempt farm asset” in the

application of the assets test for EC business support (2006 Corish; 2006 CIE).

While the treatment of FMDs under related programmes potentially impacts on the effectiveness of the FMD Scheme in encouraging primary producer self-reliance, the issue of programme interaction needs to be addressed through the administration of related DAFF programmes, rather than the FMD Scheme.

Recommendation: The issue of FMDs being treated as "exempt assets" in determining eligibility for related DAFF programmes should be reconsidered.

Scheme Terms and Conditions

Restrictions on eligibility and use of the Scheme make it simple to operate, audit and enforce. However, restrictions may also inhibit the Scheme's effectiveness and diminish the commercial option values that FMDs embody in the facilitation of improved risk management, farm business growth, inter-generational success, ownership structures and overall efficiency of resource use. Notwithstanding this, Scheme criteria and thresholds are important integrity measures to encourage the risk management objectives of the Scheme.

The FMD holding limit of $300,000 per individual has not been altered since the inception of the scheme in 1999. However, the distribution of FMD holdings has changed over time, with funds accumulating in smaller numbers of larger deposits. At June 2000, 8.6 per cent of total FMD funds were held in deposits between $250,000 and $300,000 in size, compared with more than double that amount (20.8%) at June 2006. Different industries and regions have different risk management needs that FMDs serve, and the Scheme is likely to be self-limiting when the benefits from implementing commercial options funded from FMD withdrawals exceed the interest payment and tax deferral benefits from retaining those FMDs.

The review acknowledges the increasing scale of farm businesses and thus the increased cost of production. To remain effective into the future, thresholds should take account of farm sector trends and the parallel need for larger risk management reserves to operate larger scale farm businesses.

Recommendation : Consideration be given to raising the $300,000 deposit threshold to $365,000 to restore its real value, however given that different industries and regions have different risk management needs

that FMDs serve and considering the increasing scale of farm businesses there may be scope to further increase the threshold.

Off-farm income can be a strategic component of a risk management portfolio for farmers, particularly during downturns such as drought where a farm business may rely on off-farm income from wages to meet household living expenses and family educational needs. In some cases off-farm income from wages in certain professional occupations may exceed $50,000; 46% of farm businesses who hold FMDs rely on off-farm income to manage risk. There is evidence to suggest that in the small and medium to large sized farms and income groups, spousal income from off-farm wages exceeds the $50,000 off-farm income limit. This effectively rules out one member of a farm business partnership from holding FMDs.

The $50,000 off-farm limit has not been increased since the Scheme's inception. The potential abuse of the Scheme by those who earn large off-farm incomes would be addressed by retention of the limit of tax deductibility to primary production income.

Recommendation: Consideration be given to increasing the off-farm limit per individual taxpayer to $65,000 to restore its real value, however the review acknowledges the importance of off farm income to manage risk, particularly in downturns such as drought and there may be scope to increase the limit further.

In the case of couples, the review recommends consideration be given to a $130,000 combined off-farm income limit per spousal couple.

Extending FMDs to companies could improve their management of risks and improve the efficiency of their resource use generally. The inability of companies to acquire FMDs also excludes any businesses that incorporate to benefit from the Commonwealth corporations powers from using the Scheme in their risk management strategies.

Although company profits are taxed at a fixed rate and extending FMDs to them would not result in any tax equity benefits, to extend access of FMDs to companies would promote their option value use among larger business operations and remove some distortions in the use of FMDs by individual primary producers as they approach retirement age. However, further investigation of allowing companies to access the Scheme would need to be undertaken to consider the complexity of tax law amendment this access would require and the subsequent cost to revenue.

Unlike companies, a trust is not a business structure for managing how resources are used to generate profits but rather a device for protecting

assets and distributing income to its members for tax management purposes. Extending access of FMDs to trusts is unlikely to improve the operational effectiveness of FMDs, and could lead to abuse of the Scheme. As a company can be a beneficiary of a trust, to allow companies to own FMDs while preventing trusts from owning them could create an incentive to use a company as a beneficiary of a trust so that tax could be deferred. However, limiting the maximum holding threshold would contain the potential for trusts using a company as a beneficiary to indefinitely defer tax. Maximum deposits within a year are also limited to primary production income.

Recommendation: Consideration be given to the extension of access of FMDs to companies, however further investigation on the feasibility and cost of extending access of FMDs to companies will need to be undertaken.

Recommendation: Access to the Scheme should not be extended to trusts.

Sources of farm risks, especially those arising from drought and market downturn, have consequences in rural areas that extend well beyond farmers. While a case can be made to extend FMDs to other rural businesses, to do so would require a large number of arbitrary boundaries that would greatly complicate the administrative simplicity of the existing Scheme and add to its compliance and enforcement costs. To extend the Scheme to producers of non-primary production activities is not likely to improve the effectiveness of the Scheme in achieving its objectives.

Recommendation: FMDs should not be extended to non-primary production rural businesses.

Currently FMDs must be repaid upon the death of a holder or him/her becoming bankrupt or ceasing to be a primary producer for at least 120 days. These requirements exist to encourage use of the Scheme for longer term risk management, rather than tax management alone, consistent with the Scheme's objectives.

Recommendation: The mandatory repayment requirements upon the death of a holder, becoming bankrupt or ceasing to be a primary producer for at least 120 days be maintained.

Administration, Reporting and Communication

Participation in and awareness of the Scheme are high, however research and data examined during the review indicates there is a complex mix of

incentives to hold FMDs. This may lead to some misunderstandings over the costs and benefits of FMDs and the Scheme's intent as a longer term risk management instrument.

Recommendation: Consideration be given to a targeted information and communication campaign with key influencers of the Scheme.

Enhancements following the 2002 FMD Review and 2003 ANAO performance audit have strengthened the administrative effectiveness and monitoring and evaluation of the Scheme, however, further strengthening of key performance indicators would assist in determining whether the Scheme is being used as intended and is meeting its risk management objectives.

Recommendation: Key performance indicators for the Scheme should be reviewed and strengthened.

New reporting requirements for Approved Deposit-Taking Institutions (ADIs) were implemented in 2005-06 to improve the accuracy and timeliness of reporting and enable a more effective evaluation of Scheme use. While these were agreed and implemented with the ADIs, it may be necessary to amend current legislation for FMDs to reflect the changed requirements.

Recommendation: Consideration be given to whether current legislation for FMDs requires amendment to reflect the new reporting requirements for ADIs.

While the requirement to hold FMDs with one ADI is administratively efficient and allows easier tracking of individual holdings, it may place a restriction on competition that in any National Competition Policy review would need to be removed unless it was demonstrated that its benefits exceeded its costs.

Recommendation: The requirement that all FMDs of an individual must be held with one financial institution should be reviewed.