# NRAC

National Rural Advisory Council

# Report on the effectiveness of the Farm Management Deposits Scheme

October 2012

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# Abbreviations

| | |
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| **ABARES** | Australian Bureau of Agricultural and Resource Economics and Sciences |
| **ABS** | Australian Bureau of Statistics |
| **ATO** | Australian Taxation Office |
| **DAFF** | Department of Agriculture, Fisheries and Forestry |
| **FMD** | Farm Management Deposit |
| **NRAC** | National Rural Advisory Council |

# Terms of reference

## Scope of the assessment

The National Rural Advisory Council (NRAC) will conduct an assessment of the effectiveness of the Farm Management Deposits (FMD) Scheme evaluating whether the scheme is meeting its policy objectives and is supporting primary producers' abilities to manage their financial risk in preparing for future challenges such as climate variability and market fluctuations.

In conducting the assessment, NRAC will:

- consider the appropriateness of the $400 000 FMD cap
- consider the appropriateness of the FMD Scheme's $65 000 off-farm income test
- consider the appropriateness of including off-farm income generated from renewable energy as eligible deposits
- consider the appropriateness of allowing farming business structures currently *not* eligible to have access to the FMD Scheme
- investigate the agricultural sector's level of understanding and awareness of the FMD Scheme and reasons for non-participation
- identify possible enhancements or incentives to the FMD Scheme which may increase participation
- consider the appropriateness of Exceptional Circumstances and natural disaster exemptions to the normal rules which apply to the operation of the FMD Scheme.

## Timeframe and reporting

- Assessment to be conducted from July 2012 to October 2012.
- Assessment completed and written report submitted to the Minister for Agriculture, Fisheries and Forestry by 31 October 2012.

## Supporting structures

Supporting research, data and secretariat functions will be provided by the Department of Agriculture, Fisheries and Forestry (DAFF).

# National Rural Advisory Council

NRAC was established under the Australian Government's *Rural Adjustment Act 1992* (Cwlth) to provide independent expert advice and information as requested to the Australian Government Minister for Agriculture, Fisheries and Forestry on matters that include:

- rural adjustment
- regional issues
- training issues
- Exceptional Circumstances declarations
- any other matter the minister requests advice or information about.

NRAC comprises eight members—a chairperson, a state representative, an Australian Government representative, a National Farmers' Federation representative and four others appointed to provide expertise in areas relevant to NRAC operations, such as banking, economics, farm management or training, financial administration, regional adjustment, regional development or sustainable agriculture.

# Executive summary

In July 2012, Senator the Hon. Joe Ludwig, Minister for Agriculture, Fisheries and Forestry, asked NRAC to assess the effectiveness of Australia's FMD Scheme (the scheme). This assessment was conducted from July to October 2012.

The scheme, implemented in 1999, is designed to increase the self-reliance of Australian farmers by helping them manage financial risk associated with climate variability and market fluctuations. It allows farmers to smooth their income over the longer term by making tax-effective deposits in higher-income years, which can be withdrawn as pre-tax farm income in later years.

The scheme aligns with the Australian Government's drought reform objectives of promoting a transition from crisis management to risk management and preparedness. With climatic conditions in Australia predicted to become increasingly variable, the government decided it was an appropriate time to assess the effectiveness of the scheme in its current form. On 26 October 2012, Australian primary industries ministers acknowledged the importance of the scheme in the drought reform context. Ministers agreed to the scheme being promoted as part of the new national drought reform package, details of which will be known after government budget processes. In this context NRAC's assessment of the effectiveness of the scheme can feed into the Australian Government's consideration of drought policy reform.

In conducting this assessment, NRAC considered a range of elements and issues; including the appropriateness of the $400 000 FMD cap and the $65 000 non-primary production income threshold. NRAC also considered ways to increase participation in the scheme, including whether to expand it to include farm business structures currently not eligible to participate.



NRAC consulted with a wide range of stakeholders, including accountants, the agribusiness sector, the banking sector, industry representatives, national and state farming organisations and peak industry bodies. Australian Government officials, as well as state and territory government officials, were also consulted. Through these consultations NRAC found that farmers have high levels of awareness of the scheme. Indeed, more recent favourable climate conditions may have contributed to the highest level of aggregate holdings in the scheme's history—$3.53 billion at 30 June 2012.

During its consultations, NRAC heard about factors that may influence a farmer's use of FMDs, such as the availability of sufficient cash to make a deposit, the tax incentive associated with the scheme and the ability to use FMDs as a tax-effective way to make contributions to superannuation funds. NRAC recommends that action be taken to improve understanding of the scheme as a risk management tool, especially with accounting peak bodies, financial institutions and farm organisations.

Throughout consultations, stakeholders identified the importance of farmers diversifying their income streams to increase their capacity to prepare for and manage their businesses through downturns. In this context, NRAC questions whether the threshold on non-primary production income is an unnecessary impediment to diversification and recommends that the Australian Government increase the threshold from $65 000 to $100 000 and then phase it out by 2020.

NRAC also assessed the limits on individual farmer FMD accounts, noting that the rationale for the current $400 000 cap was partly to avoid possible abuse of the scheme. Many stakeholders put forth views on the cap during consultations, including on whether to raise, remove or maintain it.

Considering the cap in the context of the scheme as a whole, and against broader trends in primary production in Australia, NRAC recommends that at this time the cap remain at $400 000 and be reviewed every three years.

Stakeholders presented mixed views about the merits of expanding the scheme to allow direct participation by trusts and companies, with no consistent view emerging. Overall, NRAC considers that broadening the scheme to trusts and companies would be of marginal benefit to the objectives of the scheme and does not recommend that the Australian Government do so.

The scheme has a natural disaster exemption for early withdrawal of a deposit without losing tax benefits, which NRAC concludes is beneficial to farmers. An FMD account, for example, can provide a primary producer with immediate access to cash to help with recovery and rebuilding. For this reason, NRAC recommends that this important exemption be retained.

The scheme also has an exemption for farmers operating in areas declared to be experiencing 'Exceptional Circumstances'. NRAC understands that under future drought policies, such declarations would no longer be made. Despite this, NRAC believes an equivalent exemption should remain, and recommends that the Australian Government examine ways to retain this utility for farmers in the development of a new package of drought-related programs.

A major incentive to use the scheme is that farmers can reduce tax payable in a high-income year by making a deposit in an FMD account and withdrawing funds in a subsequent year when their income, and therefore tax liability, is lower. The scheme requires funds to be deposited for at least 12 months and a farmer can hold multiple FMD accounts, limited only by the $400 000 cap. The administrative burden that financial institutions, advisors and administrators face in having to deal with multiple accounts held by individual farmers was raised during consultations. NRAC recommends that the Australian Government amend FMD legislation to allow matured funds to be consolidated into a single account, under conditions that would not conflict with scheme objectives.

NRAC notes the limited availability of sufficient comparable data to support robust analysis and review of the scheme in some areas. To inform future assessments, NRAC believes improved collection, analysis and reporting of scheme data is required. NRAC recommends that DAFF continue to work with the Australian Taxation Office (ATO), as the holder of taxation-related data, and the Australian Government Treasury, with its responsibility for tax-related policy, on improved data collection and analysis.

There is no doubt that the scheme is an important tool for farmers across Australia. NRAC's recommendations are designed to enhance the scheme to further support farmers as they manage income variability and risk.

# Introduction

The Australian Government's FMD Scheme was implemented in 1999 and is designed to increase the financial self-reliance of Australian farmers by helping them manage financial risk associated with climate variability and market fluctuations by holding a cash reserve. The scheme replaced previous government measures designed to address tax equity, income-smoothing and savings objectives.

The scheme assists farmers deal more effectively with fluctuations in cash flow. It is designed to increase the self-reliance of Australian farmers by helping them manage their financial risk, meet their business costs in low-income years and facilitate increased financial self-reliance.[1] The scheme allows eligible farmers to set aside pre-tax income from primary production in years of high income, which they can draw on in years of low income. Income deposited in an FMD account is tax deductible in the year in which the deposit is made. It becomes taxable income in the year in which it is withdrawn. As farmers face progressive marginal tax rates, the scheme provides an opportunity to reduce their tax burden.

To be classified as an FMD, the deposit must be held (for at least 12 months) with a deposit-taking institution (for example a bank, credit union or building society) authorised under the *Banking Act 1959* (Cwlth).

In July 2012, Senator the Hon. Joe Ludwig, Minister for Agriculture, Fisheries and Forestry, asked NRAC to assess the effectiveness of the scheme to evaluate if it was meeting its policy objectives. The assessment's terms of reference are at page vi.

NRAC's assessment was informed by consultation with a wide range of stakeholders. During July and August 2012, NRAC consulted with, and received written submissions from accountants, the agribusiness sector, the banking sector, industry representatives, national and state farming organisations and peak industry bodies. Consultations were also held with Australian Government officials, as well as state and territory government officials. A list of those consulted is in Appendix 3.

This report considers how farmers use the scheme to manage business risks. It assesses a number of scheme aspects and examines the relative merits of each and includes:

- the history of the scheme, including findings from previous reviews and analysis of available data relating to the scheme (Chapter 1)
- consideration of changes to the scheme's eligibility criteria, particularly the cap on the amount a farmer can hold in FMDs and the upper threshold applied to non-primary production income, including earnings from renewable energy (Chapter 2)
- the eligibility of different business structures to hold deposits under the scheme, including the feasibility of extending the scheme to companies and trusts (Chapter 3)
- NRAC's conclusions and recommendations, which include findings on awareness levels among farmers and their advisors of the scheme and possible ways to enhance that awareness (Chapter 4).

## 1.1 The Farm Management Deposits Scheme—background and purpose

The Australian Government has been providing farmers with financial, risk management and income-smoothing tools for several decades. The FMD Scheme succeeded the Income Equalisation Deposits Scheme and Farm Management Bond Scheme (summarised in Box 1). A 2002 evaluation of the FMD Scheme found that its policy

1 Department of Agriculture, Fisheries and Forestry 2007, '2006 Review of the Farm Management Deposits Scheme'.

rationale—providing farmers with a risk management tool—should reduce calls for assistance during 'rural downturns' and encourage farmers to establish risk management reserves.[2]

**Box 1: Predecessors of the Farm Management Deposits Scheme**

Before the FMD Scheme was introduced in 1999, two other government schemes—Income Equalisation Deposits Scheme and Farm Management Bond Scheme—were used to address tax equity, income-smoothing and savings objectives.

**Income Equalisation Deposits Scheme**

This scheme, which began in 1976, was designed to help farmers reduce fluctuations in their income by enabling them to put money aside in good years for use in bad years. The scheme could only be used by individual farmers, including individual members of partnerships and beneficiaries of trusts.

At the start of the Income Equalisation Deposits Scheme the maximum holding for a depositor was $100 000. This increased to $300 000 by the end of the scheme in 1999. The deduction a farmer could make in any one year could not exceed their taxable primary production income for that year.

The tax on the deposit was deferred until the year it was withdrawn and paid at the marginal rate of the depositor at that time. Voluntary withdrawals could not be made in the first 12 months, however, withdrawal was required in the event of death, bankruptcy, or if the taxpayer ceased to be a farmer. The farmer paid a 20 per cent withholding tax on the withdrawal.

Deposits had an investment and non-investment component. Interest was only payable on the investment component at a rate equivalent to the Australian Government's short-term bond rate, which was adjusted quarterly. In 1997, for example, the investment component was 61 per cent of the deposit. The non-investment component, often labelled the 'tax component', represented the proportion that may have been paid in tax if the income equalisation deposit had not been made.

**Farm Management Bond Scheme**

This scheme, which began in 1992, ran parallel to the Income Equalisation Deposit Scheme. The bonds operated in a similar way to the Income Equalisation Deposit Scheme, but with the following differences:

- interest was payable on 100 per cent of the deposit
- only farmers with non-farm taxable income of less than $50 000 could deposit
- the maximum deposit was $150 000, with a combined limit for both schemes of $300 000
- no withholding tax applied to withdrawals from the Farm Management Bond Scheme
- withdrawals could only be made in times of hardship arising from circumstances such as drought, fire, flood or low commodity prices
- withdrawals made at other times, including on retirement from farming, were treated in the same way as ordinary income equalisation deposits.

**Source:** Adapted from J McColl, R Donald and C Shearer, Department of Primary Industries and Energy, 1997.

## Characteristics of the Farm Management Deposits Scheme

The FMD Scheme, established in 1999, provides farmers with a risk management tool to assist them to be more self-reliant and prepared for climate variability and market fluctuations by encouraging them to hold cash reserves. The scheme has remained largely unchanged with only increases to both its cap and non-primary production income threshold. To participate in the scheme a farmer must meet the eligibility criteria listed in Box 2.

2 R Douglas, M Oliver and N Hall 2002, 'Farm Management Deposits Scheme Evaluation'.

**Box 2: Criteria to participate in the Farm Management Deposits Scheme**

To be eligible for the FMD Scheme, farmers must:

- be an individual receiving primary production income with no more than $65 000 in non-primary production taxable income in the year a deposit is made
- deposit $1000 or more each time
- hold no more than $400 000 in an FMD at any time
- hold their deposit for at least 12 months to access the taxation benefits (holders in areas declared to be experiencing Exceptional Circumstances or affected by a natural disaster may be exempt from this)
- only deposit primary production income in an FMD account.

Farmers include those in the farming, fishing and forestry sectors. For the purposes of the scheme, this is a farmer who:

- has a primary production business in Australia, but is not a trustee of a trust estate
- is a partner (not a company) in a partnership that has a primary production business in Australia
- is a beneficiary (not a company) entitled to a share of the income of a trust estate where the trustee has a primary production business in Australia.

When the scheme began in 1999, a $300 000 cap was in place limiting the maximum amount a farmer could hold as an FMD. This cap was carried over from the Income Equalisation Deposits Scheme, based on the rationale that it would restrict possible abuse of the FMD Scheme.[3]

Only primary production income can be deposited in an FMD. Non-primary production income—assessable income arising from activities outside of primary production—cannot be used to make a deposit. This restricts possible abuse of the scheme that might arise if other forms of income could also be used for an FMD. The ATO definition of primary production is in Box 3.

**Box 3: Definition of primary production activities**

Primary production activities are defined in the Income *Tax Assessment Act 1997* (Cwlth), section 995-1(1) as:

**a)** cultivating or propagating plants, fungi or their products or parts (including seeds, spores, bulbs and similar things), in any physical environment; or
**b)** maintaining animals for the purpose of selling them or their bodily produce (including natural increase); or
**c)** manufacturing dairy produce from raw material that you produced; or
**d)** conducting operations relating directly to taking or catching fish, turtles, dugong, beche de mer, crustaceans or aquatic molluscs; or
**e)** conducting operations relating directly to taking or cultivating pearls or pearl shell; or
**f)** planting or tending trees in a plantation or forest that are intended to be felled; or
**g)** felling trees in a plantation or forest; or
**h)** transporting trees, or parts of trees that you felled in a plantation or forest to the place:
 **i** where they are first to be milled or processed; or
 **ii** from which they are to be transported to the place where they are first to be milled or processed.

The scheme provides farmers with two early access provisions. If farmers have been affected by a natural disaster or are located in areas declared to be experiencing Exceptional Circumstances, they may access their FMD, while retaining its tax benefits before its 12-month anniversary. These provisions ensure an FMD can be accessed without losing associated taxation benefits and help farmers recover from lower production or profitability.

3 Taxation Laws Amendment (Farm Management Deposits) Bill 1998, Explanatory Memorandum, p. 7.

Additionally, if a primary producer holding an FMD ceases to operate a primary production business and does not begin a primary production business again within 120 days, the FMD must be withdrawn and recognised as taxable income.

With Australian climatic conditions predicted to become increasingly variable, the scheme aligns with the Australian Government's drought reform objectives, which are to promote a transition from crisis management to risk management and preparedness. According to the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES), Australian farmers experience a higher degree of production risk than other sectors of the economy, and this is expected to rise with an increasingly variable climate in important agricultural regions.[4]

## 1.2 Taxation elements of the Farm Management Deposits Scheme and related measures

In addition to the FMD Scheme, the Australian Government provides farmers with a range of tax concessions designed to help them manage fluctuations in their income caused by market and climate conditions. Appendix 1 lists current taxation concessions available to farmers. During consultations, NRAC heard that the most commonly used concessions were income averaging and deferral of profit from forced disposal or death of livestock. These are briefly described below.

- The income averaging system is designed to ensure that farmers with fluctuating incomes pay no more tax over a number of years than do individuals on comparable, but steady, incomes. This is achieved by making an 'average adjustment' each year in which averaging applies. ATO data shows that, at 30 June 2011, approximately 97 per cent[5] of individuals who identified as earning income from primary production activities were accessing this system.
- The deferral of profit from the forced disposal or death of livestock, due to fire, drought or flood, can take place over a period of five years. A farmer can elect to defer profits and use the funds to pay for re-stocking in the disposal year or any of the next five income years. Any unused profit is included in assessable income in the fifth income year.

During consultations, NRAC heard that other taxation arrangements can impact on a farmer. This includes amendments made to non-commercial loss rules[6] which can impact on an individual offsetting a business loss with income from another source. Some stakeholders indicated that these rules may impact on the tax effectiveness of a farmer's FMD. NRAC notes that non-commercial loss rules apply to all industries and are to avoid individuals running a business at a loss to reduce their taxable income.

Legislation giving effect to the FMD Scheme is contained in the *Income Tax Assessment Act 1997* (Cwlth), the *Taxation Administration Act 1953* (Cwlth) and the Income Tax (Farm Management Deposits) Regulations 1998. These instruments have been amended a number of times. The most recent amendments came into effect in late 2011, increasing the scheme's flexibility for farmers. The most significant amendments mean farmers can now:

- simultaneously hold FMD accounts with multiple financial institutions
- access their FMD within 12 months of their deposit without losing the tax benefit if they have been affected by a natural disaster.

Farmers wishing to deposit additional funds are unable to consolidate their accounts until their existing FMD's 12 month anniversary is due. This is due to the rules surrounding what is classified as a deposit and as a withdrawal. Because farmers have limited ability to predict their income for a financial year, this leads some farmers to hold multiple FMD accounts.

4 A Lock, M Hatt, E Mamum, J Xu, S Bruce, E Heyhoe, M Nicholson and K Ritman 2012, *Farm risk management in a changing climate*, ABARES conference paper 12.5, Canberra, March. CC BY 3.0.
5 ATO statistical information, unpublished.
6 *Tax Laws Amendment (2009 Budget Measures No. 2) Act 2009* (Cwlth), schedule 2, p. 57.

During consultations, NRAC also heard that recent amendments to Australia's superannuation laws impact on how farmers view and use the scheme. Amendments reducing the amount of additional concessional contributions a farmer can make to superannuation from $50 000 to $25 000 a year may increase the scheme's attractiveness, as funds that would have previously been contributed to a superannuation fund may in future be deposited in an FMD account.

NRAC notes that while no funding is directly provided for operating the scheme, the cost to government is estimated in money the government foregoes in tax revenue to provide the scheme. NRAC does not have access to the details of how the estimates are derived, however NRAC notes that the Treasury estimates the cost of foregone revenue for providing the scheme from 2001-02 to 2010-11 was $1.43 billion.[7]

## 1.3 Reviews of the Farm Management Deposits Scheme

The FMD Scheme was reviewed in 2002 by DAFF. The review recommended that the scheme continue in its present form for at least another three years.[8] No other notable recommendations were made.

The scheme was reviewed a second time by DAFF in 2006.[9] Among this review's recommendations was that the cap on deposits held by a farmer be raised from $300 000 to $365 000 and that the non-primary production income threshold be raised from $50 000 to $65 000. These recommendations aimed to restore the real value of the cap and threshold when compared to the change in value of money over time. The review also recommended providing scope to make further increases to the cap and threshold; given that agriculture sub-sectors and regions face different risk management needs and that the size and scale of farm businesses are increasing. Following the review, the government raised the cap on deposits to $400 000, and increased the non-primary production income threshold to the recommended $65 000.

The 2009 Productivity Commission inquiry into the Australian Government's drought policy concluded that the scheme plays a positive role in encouraging farmer self-reliance and preparedness. The inquiry did not recommend amendments to the scheme.

In 2011, the review of the Western Australian Drought Pilot concluded that FMDs are an effective risk management tool for farmers.[10] The pilot review panel suggested that future evaluations should consider the potential benefits of raising the deposit cap and enabling companies to hold FMDs, rather than restricting eligibility to individuals.

## 1.4 Farm Management Deposits Scheme data

NRAC notes the limited availability of reliable time series and cross-sectoral data on the use of scheme and acknowledges the limitations this placed on any analysis of the scheme.

At 30 June 2012, the scheme had total holdings of $3.53 billion, the highest figure in its history. At 30 September 2012, holdings had fallen to $3.16 billion[11], however this fall is consistent with the pattern of deposits and withdrawals associated with September quarters. Deposits traditionally increase and peak in the June quarter, before the end of the financial year, and then steadily decrease across all industries during September, December and March quarters.

Table 1 shows holdings by state and territory over 13 years as at 30 June each year. As illustrated, the highest levels of holdings in 2012 were in New South Wales, Victoria and Queensland.

7 Tax Expenditure Statement 2011, January 2012, p. 84.
8 R Douglas, M Oliver and N Hall, op. cit.
9 Department of Agriculture, Fisheries and Forestry, op. cit.
10 M Keogh, R Granger and S Middleton 2011, 'Drought Pilot Review Panel: a review of the pilot of drought reform measures in Western Australia', Canberra, p. 109.
11 Department of Agriculture, Fisheries and Forestry 2012, *Farm Management Deposits Statistics*, www.daff.gov.au/agriculture-food/drought/assistance/fmd/statistics, viewed in September 2012.

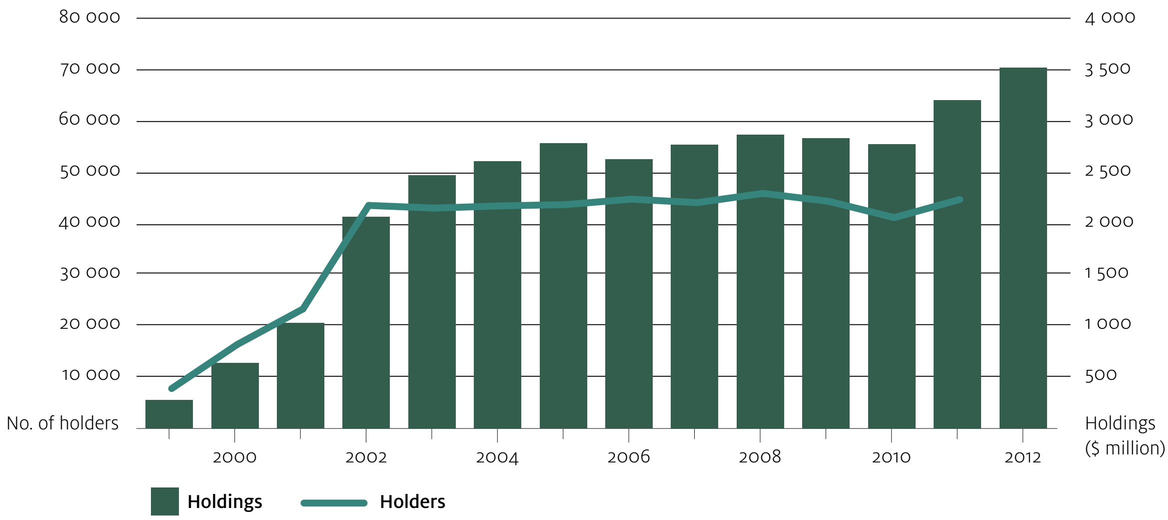
**Table 1:** Farm Management Deposit holdings at 30 June each year from 1999 to 2012 ($millions)

| | NSW | Vic. | Qld | SA | WA | Tas. | NT and ACT* | Total |
|---|---|---|---|---|---|---|---|---|
| **1999** | 64 | 46 | 78 | 55 | 32 | 4 | 1 | 279 |
| **2000** | 157 | 114 | 200 | 96 | 69 | 7 | 3 | 645 |
| **2001** | 262 | 204 | 297 | 134 | 113 | 12 | 10 | 1 033 |
| **2002** | 548 | 499 | 432 | 338 | 212 | 25 | 20 | 2 074 |
| **2003** | 598 | 559 | 461 | 473 | 327 | 34 | 28 | 2 480 |
| **2004** | 584 | 601 | 502 | 503 | 361 | 40 | 28 | 2 619 |
| **2005** | 613 | 651 | 560 | 500 | 411 | 46 | 12 | 2 792 |
| **2006** | 569 | 604 | 593 | 429 | 383 | 46 | 10 | 2 635 |
| **2007** | 609 | 624 | 684 | 418 | 395 | 46 | 6 | 2 781 |
| **2008** | 594 | 709 | 715 | 401 | 406 | 49 | 5 | 2 879 |
| **2009** | 584 | 689 | 686 | 399 | 429 | 51 | 4 | 2 843 |
| **2010** | 571 | 629 | 688 | 406 | 437 | 51 | 2 | 2 784 |
| **2011** | 708 | 720 | 704 | 570 | 456 | 55 | 3 | 3 216 |
| **2012** | 805 | 799 | 750 | 649 | 463 | 64 | 3 | 3 532 |

* NT and ACT have been grouped together for privacy reasons.
**Source:** Adapted from Department of Agriculture, Fisheries and Forestry, 2012.

Figure 1 illustrates the amount of deposits and the number of holders from 1999 to 2012. The number of holders has generally held steady since 2002. The marked increase in the level of holdings in 2011 may be a consequence of more favourable seasons over recent years. ABARES analysis shows that the gross value of Australian farm production increased by 20 per cent in 2010–11, from approximately $39 billion in 2009–10 to approximately $48 billion in 2010–11, on the back of a 6 per cent increase in the volume of agricultural production combined with higher prices for grains, cotton, fruit, beef cattle, sheep, lambs and wool.[12] The figure also demonstrates that at aggregate level FMDs were not heavily drawn on during the 2003–09 drought that took place in eastern Australia.

**Figure 1:** Value of Farm Management Deposit holdings and number of holders from June 1999 to 2012

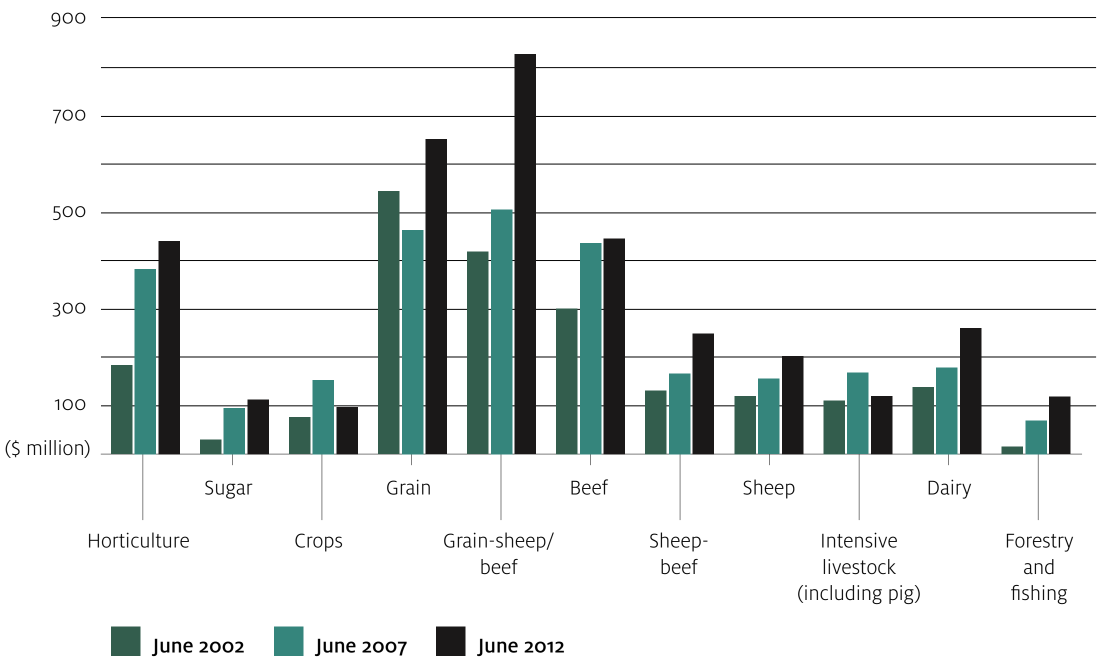



**Source:** Adapted from Department of Agriculture, Fisheries and Forestry, 2012.

12 ABARES 2012, *Agricultural Commodities,* September quarter 2012, vol. 2 no. 3, www.daff.gov.au/abares/publications, viewed in October 2012.

Figure 2 illustrates value of FMD holdings by industry over the 10 years from 2002, as at 30 June each year. These figures are based on farmers' characterisation of their industry at the time they deposited money into an FMD account.

**Figure 2:** Aggregate Farm Management Deposit holdings by industry as at 30 June each year




**Source:** Adapted from Department of Agriculture, Fisheries and Forestry, 2012.

Generally, aggregate funds in the scheme held steady or continued to increase from 2002 to 2011; however, in 2010 the number of farmers holding FMDs and aggregate FMD holdings decreased. This may reflect a positive change in seasonal conditions and farmers drawing on FMDs to reinvest in their farm businesses for restocking or increased cropping activities; however information on how farmers use the funds they withdraw from FMDs is not collected.

In assessing the scheme, NRAC asked ABARES to conduct analysis of its survey data on the characteristics of farms with FMDs in Australia's broadacre and dairy industries.

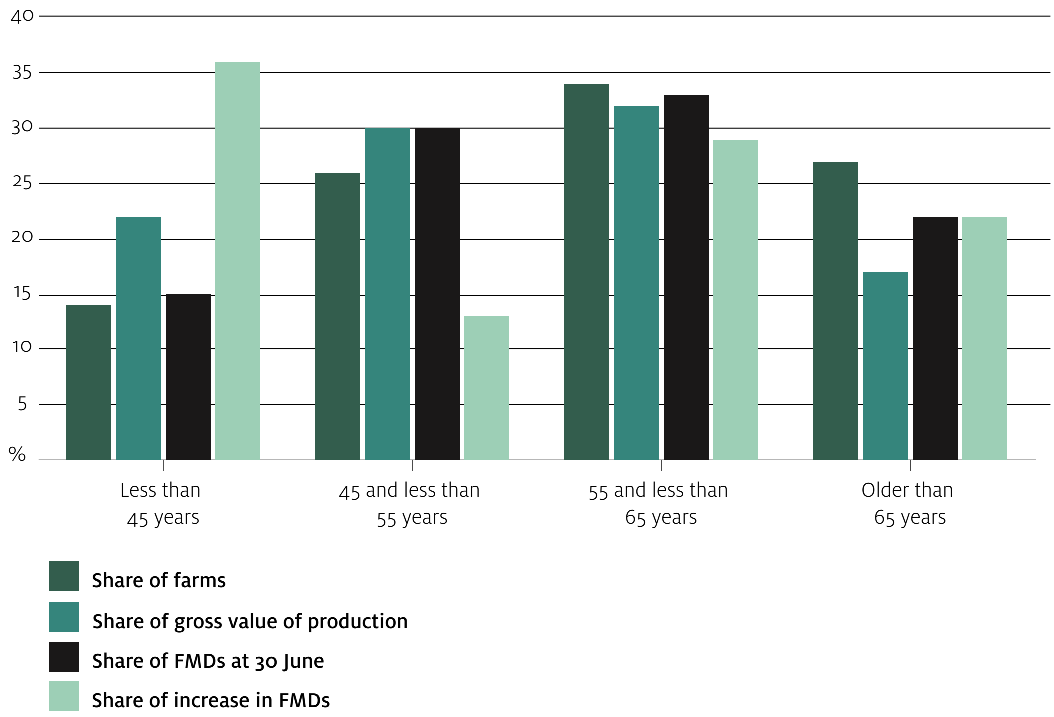
ABARES' analysis of the pattern of FMD withdrawals by farmers of different ages suggests that in years of reduced income, farmers over 65 years of age were less likely to withdraw their FMDs than were younger farmers. The analysis suggests that on average, the use of FMD withdrawals for capital additions, such as upgrading or buying new machinery, was more than twice as common on farms with owner–managers less than 45 years of age.[13] Relatively lower FMD holdings for younger farmers may reflect cash being returned to the farm business for capital additions or debt reduction, which is more likely during the early stages of a farming career. NRAC's stakeholder consultations confirmed this observation.

13 Australian Agricultural and Grazing Industries Survey and Australian Dairy Industry Survey.

ABARES advised NRAC that for several years after the start of the scheme, holdings for younger farmers were relatively small. FMDs increased for younger and middle-aged farmers from 2002–03 with the onset of widespread drought across eastern Australia. This may be partly because farmers used FMDs to hold funds from drought sales of livestock. More recently, in the four financial years ending 2010–11 and following the return to better seasonal conditions, farmers under 45 years of age accounted for the largest share of the overall increase in FMDs (around 35 per cent). This is illustrated in Figure 3.

Anecdotally NRAC heard that changes in FMDs can sometimes lag drought conditions by a year or so. For example, livestock farmers going into a drought are likely to sell stock and deposit some proceeds into an FMD during the drought. They then withdraw after the drought, once feed is again available and restocking occurs.

**Figure 3:** Share of aggregate Farm Management Deposits for family-operated broadacre and dairy farms, 2007–08 to 2010–11, by age of farm owner or manager




**Source:** Australian Agricultural and Grazing Industries Survey and Australian Dairy Industry Survey

A farm business must be profitable to have sufficient cash flow to hold an FMD. The higher the level of profit generated by a farm business in a financial year, the more likely the farmer will be able to set aside income for years of reduced income and the more motivated the farmer will be to decrease tax liability.

According to the Australian Bureau of Statistics (ABS) there were around 75 600 farm businesses with an agricultural output of more than $50 000 in 2010–11.[14] ABARES considers that the approximately 45 000 farm businesses generating less than $50 000 in agricultural output in 2010–11 are generally small lifestyle farms that are unlikely to generate significant taxable primary production income and therefore hold FMDs. ABARES estimates that the number of individual primary producers eligible to hold FMDs could be around 158 000. This estimate is based on the assumption (drawn from ABARES farm survey data) that agricultural businesses generating at least $50 000 in output have an average of 2.2 partners and that around 5 per cent of these businesses are corporate. NRAC notes that if a higher figure of $100 000 in agricultural output is

14 Australian Bureau of Statistics 2012, *Agricultural Commodities Australia 2010–11*, cat. no. 7121.0, www.abs.gov.au/agcensus2011, viewed in September 2012.

considered a threshold for sufficient income (rather than $50 000), this would reduce the number of individual primary producers eligible to hold FMDs to 120 000 (based on ABS and ABARES data). At 30 June 2011, DAFF data indicated that 39 813 primary producers were participating in the FMD Scheme. Depending on the threshold used, this would suggest that somewhere between 25 and 33 per cent of eligible primary producers are participating in the FMD Scheme.

ABARES estimates that in the four financial years ending 30 June 2011, farmers holding FMDs derived an average of 23 per cent of their disposable income from non-primary production sources. Farmers who did not hold FMDs derived an average of 55 per cent of their disposable income from non-primary production sources. During the same period, ABARES estimates that only 10 per cent of the farmers who did not participate in the scheme were likely to be ineligible because they earned more than $65 000 in non-primary production income.[15]

ABARES' survey data indicates that around 5 per cent of broadacre farm businesses are operated in an incorporated business structure such as a company. Published ATO statistics are consistent with this, reporting that 5 per cent of entities in the agriculture, forestry and fishing industries in 2009–10 were companies. For non-corporate primary production, unpublished ATO data indicates that 57 per cent of farmers reported primary production income from partnerships in 2010–11. A further 28 per cent reported primary production income as a sole trader and 11 per cent through a trust. The remainder, less than 4 per cent, reported primary production income through some combination of partnerships, trusts and sole-trading arrangements. These proportions have not changed significantly since 2007.[16] During NRAC consultations, stakeholders noted that farm business arrangements can be complex and comprise a number of entities.





15 Australian Agricultural and Grazing Industries Survey and Australian Dairy Industry Survey.
16 ATO statistical information, unpublished.

# Consideration of changes to eligibility criteria

NRAC considered proposed changes to the FMD cap on deposits and non-primary production income threshold together since these eligibility criteria share much in common.

As noted in Chapter 1, both eligibility criteria were last adjusted after a 2006 review of the scheme—the cap increased from $300 000 to $400 000 and the threshold from $50 000 to $65 000.

During consultations, NRAC heard considerable support for amending both criteria. Many stakeholders suggested that one or both limits may be restricting participation in the scheme, with the threshold a barrier to eligibility and the cap a limit on a farmer's total FMD holdings. Most stakeholders considered that the decline in the real value of the cap and the threshold since 2007 needed to be addressed and provided suggestions on how this could be achieved.

## 2.1 Current cap on Farm Management Deposit holdings

NRAC understands that the policy rationale for the cap[17] was to avoid possible abuse of the scheme and thereby limit the government's exposure to foregone taxation revenue.

In its 2009 report on drought reform, the Productivity Commission (the Commission) reported that the average holding for each individual was $70 000.[18] The Commission pointed out that 'the FMD cap does not limit the amount of reserves a farming business can put aside in other accounts. Rather it limits the extent of the favourable tax treatment'. In addition, it reflected that, given the:

> *... tax expenditure cost [for] the provision of FMDs which is likely to increase with enhanced use of FMDs and would increase further with any increase in the cap ... there is no argument for increasing the FMD cap.*[19]



The Commission recommended that the scheme be retained with its cap of $400 000.[20]

NRAC heard anecdotally that many farmers with FMD accounts are close to the FMD cap and on this basis should be raised. Some stakeholders suggested that, due to the increase in scale of Australian farm businesses, farmers want to deposit larger sums of money into the scheme to prepare for periods of reduced income.

To take account of increasing farm sizes and types of farming operations, other stakeholders suggested basing the cap on an amount equivalent to two years' input costs. Based on similar rationale, some stakeholders also suggested linking the cap to an appropriate farm cost index to ensure levels remain relevant to the costs and needs of farmers.[21]

In considering options to amend the cap, NRAC examined the available information, including data, on holdings and the structure of farming businesses.

While NRAC heard anecdotally that many farmers considered the cap to be a limit to participation in the scheme, DAFF figures show that, at 30 June 2011, less than 1 per cent of all FMD holders had balances between $350 000 and $400 000. Of this 1 per cent of holders, approximately 24 per cent were in the horticulture industry, 19 per cent in mixed grain-sheep/beef, 14 per cent in beef and 10 per cent in grain. NRAC also notes that DAFF

17 Taxation Laws Amendment (Farm Management Deposits) Bill 1998, Explanatory Memorandum, p. 7.
18 Department of Agriculture, Fisheries and Forestry, Farm Management Deposits Statistics.
19 Productivity Commission 2009, *Government Drought Support*, report no. 46, final inquiry report, Melbourne, p. 200.
20 ibid., p. 201.
21 National Farmers' Federation submission, 5 September 2012.

data for 2011–12 shows that the average holding per farmer was approximately $77 000 and that most held balances of $100 000 or less.[22]

NRAC notes that ABARES' survey data from 1999–2000 to 2010–11 shows that primary production partnerships average 2.2 individuals per farm for broadacre businesses and 2.14 individuals per farm for dairy businesses.[23] As a result, although the FMD is held individually, a farm business could notionally have holdings of more than $800 000 to help operate the farm.

Most stakeholders agreed that if the cap is to be retained it should be reviewed regularly to ensure its real value is not eroded and to maintain its importance as a risk management tool.

## 2.2 Current non-primary production income threshold

NRAC was not able to ascertain the policy rationale for the non-primary production income threshold of the scheme by examining the legislation governing the scheme. Through its reading of scheme reviews and related material, NRAC concludes that the threshold most likely reflects the government's desire to target the scheme to farmers who earn most of their income from primary production and, in doing so, limit the government's liability to foregone taxation revenue.

NRAC's stakeholder consultations revealed that a range of avenues are open to farmers to diversify income. These include contract harvesting, returns from non-primary production investments (such as property or shares), employment in other sectors (for example, education or health), and hosting renewable energy or gas production infrastructure on their farms. Some stakeholders expressed the view that becoming ineligible to participate in the scheme because of diversified income was counter-intuitive. Indeed, most suggested increasing the non-primary production income threshold.

Rather than simply increasing the threshold, other stakeholders proposed that the definition of primary production income be broadened to capture some activities not currently considered as primary production by the ATO.[24] Some stakeholders suggested expanding the definition to include income earned from renewable energy projects, such as wind farms, while others drew attention to the fact that while farmer participation in coal seam gas projects may be involuntary, income from such projects could render a farmer ineligible to participate in the scheme.[25]

Some stakeholders also asked whether the threshold should remain, given that only income derived from primary production could be deposited in an FMD account, thereby limiting the potential for abuse of the scheme through the deposit of non-primary production income.

While stakeholders had divergent opinions on how the non-primary production income threshold should be changed, with varying levels of complexity in implementation and administration, all sought to address the same issue—how to ensure farmers diversifying their income were not precluded from opening or making an FMD in a financial year.

In assessing options for the threshold, NRAC considered ABARES data, including details of farm income, and available ATO data. Since the threshold was raised to $65 000 in 2007, the national average weekly earnings has increased from approximately $55 000 to approximately $70 000 a year (as at May 2012).[26]

In the four years ending 2010–11, recognising the variable seasonal conditions and the impacts this may have had on production during this period, ABARES' survey of broadacre and dairy farms shows that farmers without FMDs had generated an estimated average of 55 per cent of their income from non-primary production activities.[27]

22 Department of Agriculture, Fisheries and Forestry, *Farm Management Deposits Statistics.*
23 Australian Agricultural and Grazing Industries Survey and Australian Dairy Industry Survey.
24 GE Energy submission, 7 September 2012.
25 National Farmers' Federation submission, 5 September 2012.
26 Australian Bureau of Statistics 2012, Average Weekly Earnings Australia, May, cat. no. 6302.0, www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/6302.0May%202012?OpenDocument, viewed in October 2012.
27 Australian Agricultural and Grazing Industries Survey and Australian Dairy Industry Survey.

ABARES' analysis indicates that farm businesses without FMDs at least partly rely on off-farm income to support their farms.

NRAC notes that ABARES' survey data indicates that 8 per cent of family-operated broadacre and dairy farms in 2010–11 had the owner–manager or spouse with off-farm income of more than $65 000.[28]

Regarding potential income from hosting renewable energy projects, NRAC heard from the Clean Energy Council that the average payment to farmers per wind turbine was approximately $10 000 a year, depending on the commercial terms of the agreement.[29] NRAC recognises, however, that renewable energy projects may not be an option for all farmers as they are limited to those who live in locations suited to those types of projects.

As with the FMD cap, stakeholders proposed that if retained, the income threshold should be reviewed regularly.

## 2.3 Balancing options for changes to the Farm Management Deposits cap and non-primary production income threshold

In assessing the options to change the cap and non-primary production income threshold, NRAC notes that raising the cap on deposits would increase the amount an individual farmer could hold in an FMD and raising the non-primary production income threshold would allow a greater number of farmers to participate in the scheme.

NRAC considered the suggestion by some stakeholders to link the cap and threshold to appropriate indices to maintain their relevance to farm businesses.[30] While attractive at face value, NRAC believes linking to an index raises practical and administrative difficulties and would therefore not be a trivial task. NRAC considered a range of options but could not identify an appropriate index for either the cap or threshold, noting that indices such as the Consumer Price Index do not capture primary producer-specific circumstances such as off-farm investments.

Increasing the cap on deposits and the non-primary production income threshold by linking both to an index may also increase the compliance burden on those using (farmers), advising (accountants and other professionals) and delivering (authorised deposit-taking institutions) the scheme. These groups may not be immediately aware of the precise value of the FMD cap at a point in time, should it change frequently. This may result in some primary producers being unexpectedly ruled ineligible to participate, or vice versa. It may also make it more difficult to use an FMD account in business planning. NRAC also considers it undesirable to use a formula (such as a two-year average of farm input costs) to derive each farmer's cap on deposits.

In assessing stakeholder suggestions to amend the FMD cap, NRAC recognises, in light of available data, that increasing the limit would only benefit a small proportion of farm businesses (less than 1 per cent). Those most likely to benefit would be larger farm businesses, which could improve their risk management by putting aside more cash for lower-income years.

Increasing the non-primary production income threshold will raise the effective maximum amount a farm business can hold in FMDs if additional business members, previously precluded from the scheme, are ruled eligible and deposit funds. A change to the threshold could therefore reduce any need to increase the FMD cap at this time. An increase in the threshold may also help more farmers with drought-preparedness strategies. For the scheme to remain relevant, NRAC notes that the threshold cannot be counter-intuitive to farmer efforts to diversify income streams to manage risk.

NRAC understands the rationale of stakeholders suggesting exemptions for some sources of non-primary production income from the income threshold criterion or amendments to the definition of primary production income to include additional activities. In relation to the former, NRAC considers it would be difficult to differentiate between potential exemptions in an objective way, given the wide range of circumstances and interests of individual farm businesses. In relation to the latter, the definition of primary production income

28 Australian Agricultural and Grazing Industries Survey and Australian Dairy Industry Survey.
29 Clean Energy Council submission, 10 September 2012.
30 National Farmers' Federation submission, 5 September 2012.

is contained in taxation legislation and NRAC recognises that any amendment would have wide-ranging impacts beyond the FMD Scheme, such as income averaging provisions and other primary producer-specific taxation concessions.

Removing the non-primary production income threshold would be prima facie consistent with the scheme's objectives to enable farmers to better manage variable incomes. It would enable more farmers to participate but still only apply to income earned from farming. Removing the threshold would also make redundant claims for certain activities to be exempt or for the threshold to be indexed. NRAC also recognises that the non-commercial loss provisions limit the ability of individuals to offset farm losses against income from other sources. These rules, while not affecting the FMD Scheme directly, ensure that in certain circumstances, withdrawals of FMDs cannot be used to offset losses from other business ventures.

# Chapter 3

# Eligibility of business structures under the Farm Management Deposits Scheme

## 3.1 Current Farm Management Deposits Scheme eligibility

To be eligible to participate in the scheme, a farmer must derive primary production income as a sole trader, a member of a partnership or as a beneficiary of a primary production trust. FMDs must be taken out by individual farmers.

During NRAC's consultations, representatives of farming organisations, and some from the accountancy and banking sectors, requested that access to the scheme be extended to trusts and, to a lesser extent, companies. This chapter examines the relative merits of these suggestions.

As discussed in Chapter 1, farms operate within various business structures for a range of reasons. Deciding which business structure to adopt requires taking into account the advantages and disadvantages of each within the operating environment. During consultations, NRAC heard that many farm business structures have existed for more than a generation and were founded on considerations relevant decades ago but not necessarily relevant today. These structures are challenging to assess and restructuring could be costly and have taxation and asset ownership implications, such as stamp duty and capital gains tax.

The reasons for structuring a farm business as a company generally include providing farmers with personal, legal and financial protection, and access to a flat tax rate of 30 per cent on profits. By comparison, a trust generally offers asset protection, assists with succession planning and enables flexible management of income distribution to beneficiaries (individuals, partnerships or companies). Trusts are not intended to retain business income, and trust profits not distributed to beneficiaries in a financial year are taxed at a penalty rate (the top marginal rate of 45 per cent). This serves as a disincentive to the practice.



## 3.2 Extending the Farm Management Deposits Scheme eligibility to companies

During NRAC's consultations, some stakeholders supported extending the scheme to companies. It was suggested that while a company incurs a flat marginal tax rate of 30 per cent, using FMDs would allow a company to better manage its cash flow by determining when a tax liability would be incurred.[31] Stakeholders advised NRAC that cash flow was a risk for companies to the same extent it is a risk to other business structures (trusts, partnerships and sole traders).

In considering amending the scheme to allow FMDs to be held by companies, NRAC notes the Australian Government's announced intention to introduce a company loss carry-back measure.[32] This measure, if passed through the Parliament, will be retrospective from 1 July 2012 and apply to losses arising from 2012-13. It will allow companies in a tax-loss position to claim a refund of some previously paid tax. It will also allow companies to carry-back up to $1 million of losses a year, providing a cash benefit of up to $300 000 a year on the basis of a 30 per cent corporate tax rate. NRAC understands that the cash benefit to companies would only become available once relevant tax returns are completed. Further, as the measure is phased-in, a one year carry-back period will apply for 2012–13, followed by a two year carry-back period from 2013–14. NRAC notes that a company would not have to decide to participate throughout the financial year; unlike the FMD Scheme, the company can decide when completing its company tax return.

31 National Farmers' Federation submission, 5 September 2012.

32 Assistant Treasurer, the Hon. David Bradbury MP, 6 May 2012, *Tax relief for businesses in our patchwork economy*, media release, accessed 29 October 2012.

NRAC considers that, even though the loss carry-back is a new measure, it aims to achieve a similar outcome for farm businesses as access to the FMD Scheme does—greater flexibility with cash flow. Some stakeholders indicated during consultations that access to the FMD Scheme provides farmers with greater flexibility than would the loss carry-back measure, mainly because a company holding FMDs could withdraw funds at any time and not have to wait until settling its annual taxation affairs. Under the scheme, the company could also hold funds for more than two years, whereas the loss carry-back measure only allows losses to be offset against tax paid in the previous two years. NRAC recognises, however, that neither FMDs nor the loss carry-back would provide benefits to farmers at earlier stages of their careers, during which time the farm may not yet have made a profit.

In addition to the loss carry-back measure for companies, NRAC notes that the Business Tax Working Group released its final draft report on a potential cut to the company tax rate on 24 October 2012, ahead of its finalisation and submission to government.

On balance, companies pay a flat rate of tax, and receive other benefits associated with incorporation, including the introduction of loss carry-back for up to $1 million in losses. This weakens the argument that companies should also be given access to FMDs. In addition, only a small proportion of farm businesses are incorporated, which means the benefits of expanding the scheme to companies may be marginal.

## 3.3 Extending the Farm Management Deposits Scheme eligibility to trusts

During consultations, some stakeholders advocated for the scheme to be expanded to allow trusts to hold FMDs. A basic overview of trusts is provided in Box 4.

**Box 4: Trusts—a basic overview**

Trusts are used for various purposes, including protecting assets and allowing flexibility in distributing income to beneficiaries.

Trustees may hold assets and earn income each year; however, the fundamental rules underpinning them generally require that all income generated be distributed to beneficiaries at the end of each financial year. Income not distributed is generally taxed at the highest marginal tax rate in the hands of the trustee.

Another feature of a trust is that the losses it generates cannot be transferred to its beneficiaries. Unlike income, losses are retained by the trust, carried forward and can be offset against income generated in future (subject to the trust loss rules).

**Source:** Adapted from Marks B, 2009.

FMDs cannot be held by trusts, although individual beneficiaries of farm trusts can hold FMDs in their own name. Trusts can have up to 12 beneficiaries. Hypothetically this allows each beneficiary in a farming business operating under a trust structure to hold the maximum amount of FMD holdings—a total of $4.8 million in FMD funds if all beneficiaries held the maximum $400 000 in FMDs.

During consultations, NRAC heard that some farm businesses are structured to include a trust for asset-holding purposes and to assist with succession planning, while integrating the flexibility of partnerships to distribute income and losses to individuals.[33,34] The apportionment of profits and losses within the partnership could be set such that they are not retained within the trust (they are apportioned to individuals in the partnership). In this case the trust could hold the assets, providing protection and assisting with succession planning. This circumstance could be expanded to apply to farm businesses with more than two individual farmers. This is just one example of many types of structures operating in primary production businesses.

33 Statham Cheesman submission, 31 August 2012.
34 Institute of Chartered Accountants Australia submission, 21 September 2012.

A key challenge stakeholders raised during consultations was that trust beneficiaries holding FMDs cannot offset FMD withdrawals against losses held within the trust. As stated earlier in this report, Australian trust law does not allow losses to flow out of the trading entity to individual beneficiaries. NRAC heard that this has resulted in individual beneficiaries (farmers) paying a higher marginal tax rate than they would have had they been able to access losses within the trust to offset their FMD withdrawal.

Some stakeholders expressed a view to NRAC that extending the scheme to trusts, rather than beneficiaries, would ensure that a cash reserve to draw on in times of reduced income was held within the business rather than being distributed to beneficiaries.

NRAC recognises that while beneficiaries cannot offset FMD withdrawals against losses held within their trusts, which impacts on their individual taxation outcomes, trusts can still carry losses forward and offset these losses against future earnings. NRAC cannot envisage an arrangement whereby FMDs could be held by the trust while remaining consistent with existing trust law and enhancing the overall effectiveness of the scheme at the same time. Allowing trusts to hold FMDs would permit trusts to carry profits forward and defer, or in some instances avoid, the obligation to distribute profits to beneficiaries.

Allowing trusts to hold FMDs may impact on a beneficiary's ability to hold deposits in their own right. Additionally a trust cap would be needed to maintain consistency across the scheme. This may reduce the amount of funds available to help farmers prepare for future challenges (because the trust would be limited to $400 000 in FMDs, whereas each single beneficiary—of which there are usually more than two—could currently hold FMDs of up to $400 000 each). Finally, if the trust holds the FMD, the timing of withdrawal and the purpose for which the deposit is used would have to be at the discretion of the trustee, and not individual trust beneficiaries.

NRAC notes that the Treasury is reviewing the trust income tax provisions of the *Income Tax Assessment Act 1936* (Cwlth), Division 6, Part III, and rewriting them into the *Income Tax Assessment Act 1997* (Cwlth), with new arrangements to take effect from 1 July 2014.

# Conclusions and recommendations

NRAC was asked to assess the effectiveness of the FMD Scheme, to evaluate whether it is meeting its policy objectives and supporting farmers to manage the financial risk associated with climate variability and market fluctuations. This chapter presents NRAC's conclusions and recommendations. These are based on the wide range of stakeholder views presented during consultations and NRAC's own analysis and other available information.

## 4.1 Understanding and awareness of the Farm Management Deposits Scheme

NRAC found that farmers and their financial advisors have high levels of awareness of the scheme, which is not surprising given that it has been in place since 1999. Levels of awareness may have recently been enhanced by more active promotion of the scheme by financial institutions, arising from the Australian Government's November 2011 legislative amendment allowing farmers to hold FMD accounts with multiple financial institutions. This has resulted in greater competition between financial institutions to attract deposits, and hence increased promotion of FMDs. At this early stage, financial institutions have already reported that this legislative amendment has resulted in an increase in their FMD business.

Beyond awareness, it is challenging for NRAC to comment on whether farmers and their financial advisors widely understand the objectives and potential uses of the scheme. While time-series data is available on total FMD holdings by industry sector, only anecdotal or inferred information is available on why farmers put money into FMDs or withdraw funds from them.

During its consultations, NRAC was presented with examples of farmers using FMDs to fund operational and capital expenditures. Other considerations that may influence a farmer's use of FMDs are the tax incentives associated with the scheme or the ability to use deposits as a means to make contributions to superannuation funds in a tax-effective way. Notwithstanding why FMD funds are withdrawn, farmers who deposit money into FMDs have cash available—despite poor seasons and prices—and are therefore in a better position to manage risk.

Given that around 89 per cent of farmers use the services of accountants[35], a farmer's use of the scheme is likely to be heavily influenced by professional advice. Consultations showed that accountants place varying degrees of emphasis on the scheme's tax minimisation benefits and its potential to help farmers by encouraging them to hold cash reserves for use in times of low income. NRAC concludes that while professionals provide advice based on their client's circumstances, a broader awareness and greater understanding of the scheme among professionals may increase the uptake of FMDs as a risk management tool.

NRAC anticipates that, given the government's intention to reform drought policy to increase farmers' focus on risk management and preparedness, which includes building financial reserves for times of low income, there is a need to improve advisors' understanding of the scheme as a risk management tool.

**Recommendation: NRAC encourages DAFF to continue to work with accounting peak bodies, financial institutions and farm organisations to increase the farm sector's understanding of the FMD Scheme, particularly its role as a risk management tool.**

35 Australian Agricultural and Grazing Industries Survey.

## 4.2 Limits on individual farmer holdings in the Farm Management Deposits Scheme

When considering the limit on the total funds an individual farmer can hold in FMD accounts, NRAC notes that the cap was revised to its current level of $400 000 in 2007 following a review of the scheme. NRAC also notes that while the objective of the cap is to place 'some restriction on possible abuse of the provisions'[36], changes to other tax laws over time—such as superannuation regulations and non-commercial loss rules—have also impacted on how the scheme is used.

Stakeholders provided a range of views on the cap, including whether to raise it, link it to the size of individual farm businesses, remove it, or maintain it at the current level. In response, NRAC examined available statistics on FMD account holdings to assess the extent to which the cap might be impeding farmers from taking full advantage of the scheme. The available statistics show that FMD holdings of more than $350 000 represented less than 1 per cent of all account holders as at 30 June 2011. This suggests that raising the cap may allow only a very small number of FMD holders to increase their level of cash reserves. It would not have an immediate benefit for the vast majority of farmers.

While current information does not make a pressing case for changing (or removing) the cap, NRAC assessed the cap in the context of broader trends in farming in Australia, including an increase in farm size and input costs, as well as the likelihood of increasing climatic variability. NRAC considers that these factors would inevitably put more pressure on the cap and, in turn, may reduce the scheme's capacity to help farmers have cash available to ride out or recover from downturns, such as drought. On this basis, NRAC believes that the cap should be retained at its current level and be regularly reviewed.

**Recommendation: NRAC recommends that the current $400 000 FMD cap on deposits be retained, as it is not considered to be a barrier to farmers participating in the scheme in the current operating environment.**

**NRAC recommends that the Australian Government review the cap every three years. Regular review will ensure the FMD Scheme reflects the evolving nature of farm businesses and maintains its value in real terms over time.**

## 4.3 Amending the non-primary production income threshold

In considering the non-primary production income threshold, NRAC notes that this was last reviewed in 2006, at which time it was increased from $50 000 to its current level of $65 000. NRAC recognises the wide range of avenues for farmers to earn off-farm income, including using farm assets in contract work such as harvesting and off-farm employment. NRAC heard examples of farmers diversifying into hosting renewable energy projects, such as wind or solar farms, as well as issues relating to payments from mining projects undertaken on farm property.

From its consultations and knowledge of farming industries, NRAC believes that enabling farmers to diversify income streams is important in increasing their capacity to prepare for and successfully manage their businesses through periods of downturn, such as drought. In this context, NRAC believes the threshold on non-primary production income is an unnecessary impediment to income diversification.

NRAC examined the rationale for retaining the threshold. On the one hand, NRAC acknowledges that the threshold targets the scheme to farmers who earn most of their income from farming, rather than through supplementing their income with, or being secondary to, non-primary production activities. On the other hand, NRAC feels strongly that making farmers ineligible to participate in the scheme because they have diversified their income is out of step with the scheme's objectives and is a barrier to enhancing participation. NRAC also acknowledges that only income from primary production activities can be deposited in FMD accounts, limiting the scope to distort the scheme's objectives.

36 Taxation Laws Amendment (Farm Management Deposits) Bill 1998, Explanatory Memorandum, p. 7.

On balance, NRAC considers that enhancing participation in the scheme would be best served by removing the non-primary production income threshold. NRAC recognises that doing so would be a significant change to the scheme and agrees it would be prudent to phase the threshold out, rather than suddenly removing it. This would enable any unintended consequences to be monitored and addressed. In the meantime, NRAC believes that, based on changes to average earnings over time and the ability of farmers to generate non-primary production income from on-farm activities, the threshold should be increased from $65 000 to $100 000 and a phase-out scheduled over the next eight years (by 2020). NRAC accepts that amending the threshold will have implications for foregone revenue and that this is a matter for the government to consider.

NRAC recognises that an increase in the non-primary production income threshold would almost certainly result in a greater number of farmers being eligible to participate in the scheme and that this would have flow-on benefits to farm businesses where currently only one partner may be eligible to hold an FMD account.

Recommendation: **NRAC recommends that the Australian Government increase the non-primary production threshold to $100 000 as soon as possible and phase it out by 2020.**

**NRAC does not recommend that the threshold be maintained as it limits the ability of farmers to manage the risks associated with volatility in primary-production income.**

## 4.4 Extending Farm Management Deposits Scheme eligibility to companies

Companies, regardless of industry, are afforded a flat rate of tax and other benefits of incorporation, such as providing equity holders personal, legal and financial protection. During consultations, NRAC heard that extending the scheme to companies may assist in the management of cash flow by allowing equity holders to determine when a tax liability may be incurred.

NRAC notes the Australian Government's announced intention to introduce a company loss carry-back measure. NRAC considers that the new measure might achieve a similar outcome for some farming companies to what would be gained through access to the FMD Scheme. Some of the common benefits are flexibility with cash flow and shifting tax liability between financial years. However, NRAC recognises the limitations to the loss carry-back measure when compared to potential company access to FMDs. In particular, the loss carry-back measure is limited to two consecutive years of losses and the timing of cash flow benefits may be delayed in times of lower income.

NRAC also notes that companies do not separately report primary production and non-primary production income, so extending access to FMDs to companies would necessitate a fundamental change in taxation arrangements, to differentiate between primary production and non-primary production income.

NRAC is not convinced that extending the scheme to companies is justifiable given the tools already available to companies to manage financial risk and the very low levels of incorporation among farming businesses.

Recommendation: **NRAC does not recommend that the Australian Government extend the FMD Scheme to companies as it has not been provided with strong evidence to indicate there would be benefits to the FMD Scheme's objectives.**

## 4.5 Extending Farm Management Deposits Scheme eligibility to trusts

In its consultations NRAC heard mixed views about the merits of expanding the scheme to allow direct participation by trusts, with no consistent view emerging from any stakeholder group.

Some stakeholders expressed views that extending the scheme to trusts would ensure that a cash reserve was held within the business rather than being distributed to beneficiaries. Others felt little need to expand the scheme to include trusts and noted that this could add administrative complexities to already complex business structures.

NRAC acknowledges that many farming businesses use trusts and understands the business rationale for allowing trusts to participate in the scheme. The rationale is primarily so farm profits can be held within the trust (that is, in FMD accounts) which would, in turn, allow the trust to retain funds for capital investment or to offset future losses. NRAC recognises that allowing a trust to hold an FMD would require a fundamental change.

Overall, NRAC considers that broadening the scheme to allow participation by trusts would be of marginal benefit to the scheme's objectives, mainly because eligible farmers, whether beneficiaries of a trust or not, can already participate as individuals. NRAC also recognises that allowing a trust to hold an FMD would be inconsistent with the intention of Australia's trust law and would create considerable administrative complexities and equity issues between primary producers and non-primary producers.

With respect to these broader issues, NRAC notes the review of trust income tax provisions under the *Income Tax Assessment Act 1936* (Cwlth) that is underway, led by the Treasury, with any new arrangements to take effect from 1 July 2014.

**Recommendation: NRAC does not recommend that the Australian Government extend the FMD Scheme to trusts as it has not been provided with strong evidence to indicate there would be benefits to the FMD Scheme's objectives.**

## 4.6 Exemptions for early withdrawal

Eligible farmers affected by natural disasters can withdraw their FMDs within 12 months of deposit without losing taxation benefits if they are accessing, or have accessed, primary production Category C[37] recovery assistance under the Australian Government's Natural Disaster Relief and Recovery Arrangements.

NRAC accepts the benefits of the natural disaster exemption. Natural disasters are acute events with the potential to cause considerable damage to properties and infrastructure. An FMD account can provide a farmer with immediate access to cash to help with recovery and rebuilding. The exemption means a farmer does not need to amend an already-completed tax return if withdrawing funds within 12 months of deposit.

With respect to the current exemption for areas declared to be experiencing Exceptional Circumstances, NRAC considers that the ongoing utility of this exemption for farmers should be examined as part of any new drought measures introduced by the Australian Government.

**Recommendation: NRAC recommends that the Australian Government retain the exemption that provides access to a primary producer's FMD in times of a natural disaster as it is an important aspect of recovery.**

**NRAC recommends that the existing exemption for the early withdrawal of FMDs should remain for Exceptional Circumstances declarations made, until the system is replaced. NRAC recommends that equivalent arrangements should be made, in the absence of Exceptional Circumstances declarations.**

**NRAC recommends that the Australian Government consider including an exemption mechanism in developing and implementing its package of drought-related programs.**

37 Natural Disaster Relief and Recovery Arrangements, Determination of Terms and Conditions, 2011, version 1.

## 4.7 Other possible enhancements to the Farm Management Deposits Scheme

### Consolidation of individual farmer accounts

As noted in this report, one main benefit of the scheme is that farmers can reduce the tax payable in a high-income year by making a deposit into an FMD account and withdrawing funds in a subsequent year when their income, and therefore tax liability, is lower. This system relies on funds remaining deposited for more than 12 months.

The current legislative definition of what constitutes a withdrawal and a deposit creates an incentive for farmers to hold multiple accounts. This is because consolidating matured accounts without triggering taxable income is difficult. Also, depositing funds into an existing FMD account resets the 12 month clock for the entire deposit.

NRAC's consultations revealed that multiple FMD accounts present an administrative burden, with financial institutions noting the challenges they and their clients face in managing them. Indeed, one financial institution claimed that a client had as many as 40 FMD accounts. NRAC sees merit in exploring options to reduce the administrative burden on farmers by making it easier to consolidate FMD accounts once the initial 12 month period elapses. NRAC concludes that options for this need to be considered alongside relevant monitoring and compliance arrangements between the financial institutions, DAFF and the ATO. NRAC recognises that this would require legislative amendment.

There are also possible financial benefits for individual holders in consolidating FMD accounts. This is because financial institutions, in a competitive environment, will most likely offer a higher interest rate for higher-denomination deposits. For example a $200 000 FMD is likely to attract a higher interest rate than would a $10 000 FMD for the same term.

**Recommendation: NRAC recommends that the Australian Government make provision in the legislation governing the FMD Scheme to allow funds held in multiple FMD accounts, which have been held for the minimum 12 months, to be consolidated into a single account in the name of the same FMD holder.**

**NRAC recommends that this be implemented in a way that is consistent with relevant monitoring and compliance mechanisms.**

### Availability of data to support analysis and review

Through its consultations NRAC notes the limited availability of sufficient comparable data to support robust analysis and review of the scheme. NRAC notes the important role the scheme plays in preparing farmers to manage risk and prepare for periods of reduced income. NRAC believes that to support future reviews of the scheme's effectiveness, including the FMD cap and non-primary production income threshold, improved collection, analysis and reporting of data is required.

**Recommendation: NRAC recommends that DAFF continue to work with other Australian Government departments, particularly the ATO and the Treasury, to improve the collection and reporting of data to analyse the FMD Scheme.**

## Appendix 1: Taxation measures for primary producers

| Tax provision | Description |
|---|---|
| Income averaging | Ensures that primary producers with fluctuating incomes pay no more tax over a number of years than individuals on comparable, but steady, incomes. This is achieved by making an ‘average adjustment’ each year in which averaging applies. |
| FMD Scheme | Allows primary producers to smooth their income over the longer term by making tax-effective deposits in higher income years, which can be withdrawn as pre-tax farm income in later years. |
| Water facilities—also applies to irrigation water providers | Provides a deduction for the capital expenditure on water facilities (includes plant or a structural improvement) over three income years. |
| A Landcare operation—also available to other users of rural land | Provides a deduction for capital expenditure on Landcare operations in the year it is incurred. |
| Profit from forced disposal or death of livestock | Allows the deferral of profit from the forced disposal or death of livestock, due to fire, drought or flood, to take place over a period of five years or the deferral the profit and use it to reduce the cost of replacement livestock in the disposal year or any of the next five years. |
| Tax relief for people affected by drought | Provides assistance to farmers and other taxpayers whose income is derived from drought affected areas. Farmers finding it difficult to pay their tax debts can apply for more time to pay or arrange to make payments by instalment without interest being charged. |
| Depreciating assets—applies to all taxpayers | Provides a deduction for the decline in value of depreciating assets each year. |
| Carbon sink forests | Provides a deduction for capital expenditure in the year it is incurred for an initial five year period (starting 1 July 2007) or a concessional capital write-off from 1 July 2012 onward. |
| Double wool clips | Allows the deferral of the profit on the sale of the second wool clip to the next year. |
| Insurance recoveries | Allows a primary producer who has an assessable insurance recovery for loss of livestock or for loss by fire of trees that were assets of a primary production business carried on in Australia, to elect to include the amount in assessable income in equal instalments over five years. |
| Fuel tax credits | Provides businesses with a ‘credit’ for the fuel tax (excise or customs duty) included in the price of fuel used in business activities, machinery, plants, equipment and heavy vehicles. |
| Horticultural plants | Provides a deduction for the decline in value of horticultural plants at a rate of 7% to 40% per year. |

| Tax provision | Description |
|---|---|
| Luxury car tax | Provides, in certain circumstances, primary producers and tourism operators can claim a refund of 8% of the cost of the car (to a maximum of $3 000). |
| Small business entity concessions —applies to all small business entities | Provides small businesses with access to one or more of the following tax concessions:<br><br>• small business tax break<br>• simplified trading stock rules<br>• simplified depreciation rules<br>• immediate deductions for prepaid expenses. |
| Zone tax offset—applies to all people living in what are designated as remote areas | Provides people who have lived or worked in a remote or isolated area of Australia with a tax offset in the form of a fixed amount and a percentage of a base amount. |
| Electricity connections and telephone lines for small businesses | Provides small businesses with a deduction in equal instalments over 10 years for capital expenditure incurred in connecting:<br>• mains electricity to land on which a business is carried on or in upgrading an existing connection to such land, or<br>• a telephone line brought on or extending to land being used to carry on a primary production business. |

**Source:** Compiled by Department of Agriculture, Fisheries and Forestry, October 2012

# Appendix 2: Farm Management Deposits Scheme statistics—September 2012

| Industry description | NSW | | Vic. | | QLD | | SA | | WA | | Tas. | | ACT and NT | | Industry Total | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | No. of FMD accounts | Value of deposits ($'000) | No. of FMD accounts | Value of deposits ($'000) | No. of FMD accounts | Value of deposits ($'000) | No. of FMD accounts | Value of deposits ($'000) | No. of FMD accounts | Value of deposits ($'000) | No. of FMD accounts | Value of deposits ($'000) | No. of FMD accounts | Value of deposits ($'000) | No. of FMD accounts | Value of deposits ($'000) |
| Horticulture | 975 | 77 078 | 1 072 | 96 273 | 1 043 | 100 689 | 854 | 71 485 | 274 | 32 173 | 159 | 13 231 | 6 | 533 | 4 383 | 391 462 |
| Sugar | 94 | 4 498 | * | 115 | 1 389 | 102 221 | * | 30 | 0 | 0 | 0 | 0 | 0 | 0 | 1 483 | 106 864 |
| Crops | 424 | 28 339 | 253 | 12 340 | 328 | 26 658 | 208 | 9 677 | 65 | 4 756 | 48 | 2 924 | 0 | 0 | 1 326 | 84 694 |
| Grain | 1 357 | 99 132 | 1 443 | 88 684 | 659 | 55 607 | 2 346 | 199 645 | 866 | 103 709 | 24 | 1 257 | ** | 412 | 6 695 | 548 446 |
| Grain-sheep/beef | 2 963 | 182 790 | 2 441 | 149 250 | 749 | 52 833 | 1 952 | 150 195 | 1 124 | 141 411 | 42 | 4 625 | 7 | 1 555 | 9 278 | 682 659 |
| Beef | 1 567 | 82 988 | 1 142 | 59 339 | 2 587 | 222 171 | 252 | 15 566 | 257 | 20 725 | 172 | 10 916 | 15 | 1 133 | 5 992 | 412 838 |
| Sheep-beef | 1 409 | 79 867 | 911 | 48 049 | 447 | 34 492 | 522 | 37 164 | 166 | 12 947 | 135 | 7 435 | 5 | 195 | 3 595 | 220 149 |
| Sheep | 1 121 | 58 201 | 1 057 | 59 399 | 127 | 9 426 | 513 | 31 693 | 241 | 17 057 | 99 | 5 847 | ** | 86 | 3 158 | 181 709 |
| Pig | 39 | 2 511 | 21 | 2 047 | 58 | 5 612 | 37 | 3 235 | 10 | 525 | *** | 188 | 0 | 0 | 165 | 14 118 |
| Intensive livestock | 479 | 29 159 | 354 | 21 942 | 342 | 28 336 | 174 | 11 275 | 82 | 4 657 | 22 | 952 | ** | 83 | 1 453 | 96 404 |
| Dairy | 406 | 27 438 | 2 417 | 155 926 | 357 | 22 560 | 154 | 13 733 | 73 | 6 406 | 138 | 8 902 | 0 | 0 | 3 545 | 234 965 |
| Forestry & fishing | 414 | 21 994 | 339 | 21 643 | 419 | 28 585 | 203 | 13 861 | 163 | 14 032 | 49 | 2 710 | 0 | 0 | 1 587 | 102 825 |
| Other | **** | 50 | 6 | 150 | 14 | 262 | 7 | 375 | 0 | 0 | **** | **** | 0 | 0 | 27 | 837 |
| **State/territory total** | **11 248** | **694 045** | **11 456** | **715 157** | **8 519** | **689 452** | **7 222** | **557 934** | **3 321** | **358 398** | **888** | **58 987** | **33** | **3 997** | **42 687** | **3 077 970** |

* Victorian and South Australian sugar industry FMD accounts have been aggregated with the respective New South Wales FMD accounts for privacy reasons.

** Northern Territory and Australian Capital Territory grain, sheep and intensive livestock industry FMD accounts have been aggregated with the respective New South Wales FMD accounts for privacy reasons.

*** Tasmanian pig industry FMD accounts have been aggregated with the respective New South Wales FMD accounts for privacy reasons.

**** New South Wales other industry FMD accounts have been aggregated with the respective Queensland FMD accounts. Tasmanian other industry FMD holdings and accounts have been aggregated with the respective Queensland FMD holdings and accounts for privacy reasons.

**Source:** Adapted from Department of Agriculture, Fisheries and Forestry, Farm Management Deposits Statistics, 2012.

# Appendix 3: Stakeholder consultations

| Stakeholders | Located* | Meeting details | | |
|---|---|---|---|---|
| | | Date (2012) | Location | Face-to-face (F), teleconference (T) or written submission (W) |
| Statham Cheesman Pty Ltd | Roma | 3 August | Canberra | T |
| O'Regan & Partners | Mount Isa | 3 August | Canberra | T |
| WHK | Dalby, Inverell, Mildura | 3 and 28 August | Canberra | T |
| Fleming Partners | Deniliquin | 3 August | Canberra | T |
| RSM Bird Cameron | Perth | 3 and 28 August | Canberra | T |
| Agricultural Finance Forum (several members) | Australia-wide | 9 August | Sydney | F |
| Rabobank | Sydney | 14 August | Canberra | T |
| National Farmers' Federation Drought Working Group | Australia-wide | 14 August | Canberra | F |
| Queensland Farmers’ Federation | Brisbane | 14 August | Canberra | T |
| Pastoralists and Graziers Association of Western Australia | Belmont | 21 August | Perth | F |
| Pascoe Partners | Perth | 21 August | Perth | F |
| Nuffield Australia 2011 scholarship winner | Bruce Rock | 21 August | Perth | F |
| Farmanco Management Consultants | Mundaring | 21 August | Perth | F |
| Dairy Australia | Melbourne | 27 August | Melbourne | F |
| GE Energy | Brisbane | 27 August | Melbourne | F |
| Vestas Australia | Melbourne | 27 August | Melbourne | F |
| Clean Energy Council | Melbourne | 27 August | Melbourne | F |
| Australian Agribusiness Group | Melbourne | 27 August | Melbourne | F |
| Southern Quality Produce Co-operative Ltd | Ballarat | 27 August | Melbourne | F |
| Viterra | Adelaide | 27 August | Melbourne | F |
| Sheridan Partners | Kyabram | 28 August | — | T |
| Primary Industries Standing Committee High Level Group on Drought | Australia-wide | 31 August | Canberra | T |
| Australian Government Department of the Treasury | Canberra | 31 August | Canberra | F |
| Australian Taxation Office | Canberra | 31 August | Canberra | F |
| Statham Cheesman Pty Ltd | Roma | 31 August | — | W |
| National Farmers’ Federation | Canberra | 5 September | — | W |
| GE Energy | Brisbane | 7 September | — | W |
| Clean Energy Council | Melbourne | 10 September | — | W |
| Institute of Chartered Accountants Australia | Australia-wide | 21 September | — | W |

* Refers to head office location and/or office(s) where stakeholder representatives who consulted with NRAC are located.

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