

Tax Planning Strategies

Clever tax planning can save thousands

With an increasing volatility to payouts, tax planning is essential for the modern farming business. While you can't avoid tax altogether, with some clever tax planning, you can minimise your tax liability and to some extent influence when it's payable.

You also need to plan taxes around payout decreases. There is a cost in giving Inland Revenue more money than you need to, even if it is refunded in the future!

There are several strategies that can be used effectively to minimise tax by smoothing out fluctuating incomes between high and low years.



Why do we do tax planning?

There are several reasons why you should do tax planning with your accountant. These include:

- Controlling the level of tax you pay (see the strategies on the following pages)
- Avoiding Inland Revenue penalty or interest charges
- Planning your cashflows
- To receive social policy entitlements like Family Assistance and Student Loans

How do payout changes affect your profit?

When calculating income it's not quite as simple as multiplying last year's payout, or this year's predicted payout by your anticipated milk solid production. From a tax point of view there's a timing difference between what WMP announces and the tax year in which this income falls into, depending upon when they pay it and what your balance date is

E.g. Although Westland Milk Products announced a payout after retentions for the 2009/10 year of \$6.15. This is not the figure that appeared in the financial accounts of clients. For May balance dates the payout for tax purposes for the 2009/10 season was just \$4.60

The payout for 2010/11 based on the tax year was \$6.89 for May balance dates. The income therefore varied by \$2.29 per kg MS. Below is an example of the difference this made for a 100,000 kg MS farm.

	<u>2009/10</u>	<u>2010/11</u>	<u>Increase in Income</u>
Payout Tax Year	\$4.60	\$6.89	\$2.29
Milk Solids	100,000	100,000	
Dairy Income	\$460,000	\$689,000	\$229,000

Let's consider the above from a tax perspective assuming your profit was just \$40,000 in 2009/10 it would be \$269,000 in 2010/11, if there were no changes in costs.





Example:

	<u>Income</u>	<u>Tax</u>	<u>UOMI</u>	<u>Total</u>
2009/10	40,000	5,500	0	5,500
2010/11	269,000	79,700	7,700	87,400

Unless some tax planning was done in 2011, a large portion of the additional income could be lost to tax. Also by doing nothing there could be a hit with use of money interest (UOMI.) The amount in this example is \$7,700; a cost that could be avoided.

This example could be considered in reverse. If payout dropped back by \$2 and you produce 100,000 kgMS, you could be over paying tax on \$200,000 of income or approx \$66,000 of tax. This \$66,000 could be better used keeping the overdraft down, reducing debt, or maybe putting in a meal system to increase production

One of the biggest factors to consider when tax planning are the various tax brackets of those involved.



Tax Brackets

One of the reasons for looking at tax minimisation strategies is that as income rises you will pay more per dollar of your income in taxes. Sometimes these increases will only be temporary in nature and will fall again in the following year. An even spread of income often means lower taxes. The tables below show the current tax brackets.

Tax Brackets - Individuals

Up to \$14,000	10.5c
\$14,000 - \$48,000	17.5c
\$48,000 - \$70,000	30c
\$70,000 +	33c

Tax Brackets – Non Individuals

Companies	28c
Trusts (Trustee rate)	33c

Note that in many circumstances, both company and trust income can be distributed to shareholders or beneficiaries and tax can then be paid at their tax rate.

The following is an example of the tax saving that can be made by smoothing an individuals Income between years

	<u>Income</u>	<u>Tax</u>
Year 1	20,000	2,520
Year 2	100,000	23,920
	120,000	26,440

	<u>Income</u>	<u>Tax</u>
Year 1	60,000	11,020
Year 2	60,000	11,020
	120,000	22,040

Saving \$4,400



TAX MINIMISATION STRATEGIES

Strategy 1

Avoid use of money interest (UOMI)- Estimate and Pay Provisional Tax

Use of Money Interest is charged in several circumstances and can be quite substantial. (See example Mr & Mrs Jones in strategy two)

The current rate of use of money interest is currently 8.4% pa. Given that most farmers can currently borrow at rates below this, this is not something we want to be paying.



The two instances which we want to avoid are:-

- A company or Trust where the tax for the year was more than the provisional tax that was paid.
- Individuals where the total tax liability on their income is more than \$50,000. Roughly this equates to about \$180,000 worth of profit.

To minimise or avoid paying Use of Money Interest you may need to estimate your actual income and pay provisional tax to Inland Revenue based on these accurate estimates.

(Note many farmers now farm in a company or trust structure, so need to be particularly wary about use of money interest charges)

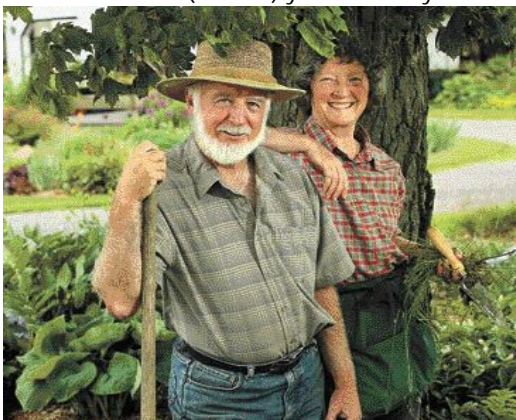
Strategy 2

Farm Income Equalisation Deposits

This scheme allows you to physically deposit money with Inland Revenue and reduce either the current or the previous year's taxable income by the amount of the deposit.

The maximum deposit amount is the taxpayer's net income from farming, or fishing, or forestry, for that income year. So you can't include income from investments or wages.

The money must be deposited for at least 12 months, although it can be withdrawn early in limited circumstances. It earns interest at 3% p.a. if deposited for 12 months or more. The interest accrues to the year of refund and is treated as taxable income in that (refund) year. In the year of withdrawal the amount of the deposit adds into your taxable income.



Income Equalisation Deposits can also be used to avoid use of money interest charges.

Example

Mr and Mrs Jones have been dairy farming for the last 4 years, producing around 100,000 in milk solids annually; their combined taxable income has remained consistently around \$100,000 each year.

This year the payout has increased from \$4.86 last year to \$7.69. Taxable income has now increased by \$2.83 per kgMS, assuming no increase in spending. This would increase taxable income by \$283,000 to \$383,000.

(note this was the actual increase in payout for the tax year for a client

between the 2010 and 2011 years)

Mr and Mrs Jones will pay Tax on \$191,500 each which is \$54,000. Use of money interest charges will apply ~ about \$5,000 each.

A deposit of \$13,000 each brings tax back below the threshold for use of money interest, and the interest charged can be avoided. Saving about \$5,000 each. The tax has also been reduced by \$4,000 each. This tax reduction of \$4,000 is not actually a saving, because the tax on the \$13,000 will be added back to your income the year you receive the deposit back.

Example

Before Income Equalisation Deposit

	<u>Income</u>	<u>Tax</u>	<u>UOMI</u>	<u>Total</u>
Mr Jones	191,500	54,000	5,000	59,000
Mrs Jones	191,500	54,000	5,000	59,000
	<u>383,000</u>	<u>108,000</u>	<u>10,000</u>	<u>118,000</u>

After Income Equalisation Deposit of \$26,000 (\$13,000 each)

	<u>Income</u>	<u>Tax</u>	<u>UOMI</u>	<u>Total</u>
Mr Jones	178,500	49,800	0.00	49,800
Mrs Jones	178,500	49,800	0.00	49,800
	<u>357,000</u>	<u>99,600</u>	<u>0.00</u>	<u>99,600</u>

The \$26,000 could normally be uplifted after six months to buy some more livestock, or for farm development.

The effective rate of return for a 12 month deposit in this example is over 100%.

Because deposits must be made in cash and only yield 3% interest, there is little point in using the Scheme unless income can be shifted from a higher tax bracket to a lower bracket, or save use of money interest charges as above.

In the examples used consideration must be given to the use the money could have been put to. Maybe it could have been used to clear debt reducing interest payments and financial commitments. Or perhaps it could have been used to increase production.

(NB we have not attempted to explain all the rules around income equalisation, but have merely given you some information as a discussion point with us.)

Strategy 3

Buy Up Consumables

Providing the unused consumables at year-end cost no more than \$58,000 and are in your possession at year-end date you can claim a deduction for these.

Examples are:



Fencing Materials
Drenches
Fertiliser
Fuel

Ear Tags
Detergents
Hay & Silage
AI (Semen cost)

Note: Care should be taken if the value is over \$58,000. The consumables must be on hand at your year end. (Home grown supplements can be excluded)

This strategy is less useful if income is predicted to remain high the following year, as by purchasing and claiming these expenses in advance there will be fewer expenses to claim the following year.

Strategy 4

Invest in 100% Deductible Farm Development Expenditure

The following items enjoy a 100% deduction even though they are capital in nature:



- 1) The destruction of weeds or plants detrimental to the land
- 2) The destruction of animal pests detrimental to the land
- 3) The clearing, destruction, and removal of scrub, stumps and undergrowth
- 4) The repair of flood or erosion damage
- 5) The planting and maintaining of trees for the purpose of preventing or combating erosion
- 6) The planting and maintaining of trees for the purpose of providing shelter
- 7) The construction on the land of fences for agricultural purposes

This should be an investment decision. If you are investing for example \$30,000, consider these three things:

- 1) The fact that you will spend \$30,000 cash, which may have had other uses, including lowering debt. Therefore lower annual interest charges.
- 2) The tax saving – at 33c this is \$9,900
- 3) Will the spending boost income by at least \$30,000 over the next 5 years or will it increase the farm value by at least \$20,100 (\$30,000 - \$9,900 or Amount of spending less the tax savings)

Strategy 5

Unexpired Expenditure

Get an invoice or legal agreement and pre-pay for rentals or services that you are yet to receive.



- E.g. 1 Rental for lease of land, buildings or livestock to a maximum of \$23,000 or 6 months rental, whichever is the lesser.
- E.g. 2 Other services e.g. Accounting, Farm Advisory, AI Servicing etc. to a maximum of \$12,000 or 6 months, whichever is the lesser.
- E.g. 3 Other periodic charges – Rates invoiced.

Once again not a good strategy to employ when income is predicted to remain high. There are a lot more examples in this area and you should contact us if you want to employ this strategy.

Strategy 6

Purchasing Assets

Many people mistakenly believe that by spending \$85,000 buying a Tractor or another piece of capital equipment for the farm, they will reduce their profit by the same amount. This is not true, while you will eventually get to claim this cost back, it can only be expensed over Inland Revenues assessment of the assets useful life, which in the case of a tractor is 15.5 years.

E.g. You purchase a new Tractor for \$85,000 purchased on the 1st Sept 2011 at your balance date you will have owned this 9 months. The deductible depreciation on this will be \$9,945. That's right, you have spent \$85,000 and only reduced your income by \$9,945.

Also consider what happens when you trade in your old tractor.



E.g. You sold your old tractor which had a written down book value of \$16,000 for \$20,000 making a profit of \$4,000. Because this tractor originally cost you \$40,000 and you had claimed the depreciation on this over the years, your \$4,000 profit is now depreciation recovered and becomes taxable income.

Therefore in this example changing your tractor has only reduced your income by \$5,945 (\$9,945 - \$4,000.) Not the best way to reduce tax!

When buying assets you need to ensure that your reasons for purchase are more about making life easier or focusing on efficiencies such as fewer breakdowns, more economic to run, getting the job done faster thus saving time, as opposed to the purchase price of the assets reducing your tax.

Strategy 7

Deferring Fertiliser Expenses

Another option available to farmers and used in years when income is lower, is to defer claiming the cost for fertiliser and lime (this includes the cost of purchase, spreading, freight).



These costs can be spread over the year incurred and any one or more of the four years following. The costs can be claimed in any year in any proportion.

E.g. You know that your 2011 taxable income was \$80,000 and you have expensed \$100,000 worth of fertiliser in that year. You are also aware that the 2012 taxable income is likely to be more like \$180,000.

You are in partnership with your spouse, and this income is split 50:50

By deferring the claim on \$60,000 of fertiliser expenses in 2011 you will pay \$17,000 more taxes for 2011. However if you then claim the \$60,000 fertiliser in 2012 you will reduce 2012 taxes by \$19,800. Between the two years you will have saved \$2,800 in tax.

Conclusion

Care should be taken to ensure you don't spend a dollar to save 33 cents. Any decisions made should be reviewed as an investment decision rather than simply assessing how much tax will be saved.

It could be that a combination of strategies is used, for example you may buy a block of land intending to develop it in the following year. An income equalisation deposit could be used to take income out of this year and transfer it to next year where it might be offset against the development expenditure.

If you wish to discuss any of these strategies further, please contact Peter Cuff on (03) 755 8866

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