Consider farming with your SMSF

This book excerpt is from *How to deal with financial distraction* by Dr Steven J Enticott.

One of life's greatest challenges comes from financial distraction. This is because money, finance, and financial security can represent the greatest distractions you or I will ever face. Harnessing the powers of tax effectiveness, combining a SMSF and primary-production farming is one of the most powerful ways to eliminate financial distraction from our lives.

Long-term rural investment is one great way to reduce your immediate financial distractions, with proven long-term rates of return on established practices, coupled with the capital growth of rural property, especially in productive areas with good rain and soil.

Farming with your SMSF, especially if you have a general interest in all things rural, can be one of the most powerful ways to invest.

Additionally, and often by its very nature, the investment can work well as a double-edged taxation strategy. By double-edged, I mean that it maximises the tax concessions in terms of both superannuation and in a lot of different types of farming, especially when we're considering long lead times before seeing a profit (and forestry falls into this category in particular). This means you can receive significant up-front tax deductions coupled with a delayed income, which will often be taxed at a lower rate when it does commence, ultimately meaning less tax overall.

By using your superannuation rather than personal, non-superannuation equity to buy land you intend to commercially farm, you can free up that equity for other investments or even to fund the farming business itself. Even better, by using instalment warrants, your SMSF can even borrow to buy the land, again freeing up your equity.

You have a lot of options.

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HOW THE ATO DEFINES A PRIMARY PRODUCER
You are a primary producer if you carry on a business of:

Plant and animal cultivation

- cultivating or propagating plants, fungi or their products or parts (including seeds, spores, bulbs and similar things) in any physical environment
- maintaining animals for the purpose of selling them or their bodily produce, including natural increase
- manufacturing dairy produce from raw material that you produced
- fishing and pearling
- conducting operations relating directly to taking or catching fish, turtles, dugong, beche-de-mer, crustaceans or aquatic molluscs
- conducting operations relating directly to taking or culturing pearls or pearl shell

Tree farming and felling

- planting or tending trees in a plantation or forest that are intended to be felled
- felling trees in a plantation or forest
- transporting trees or parts of trees that you felled in a plantation or forest to the place
- where they are first to be milled or processed
- from which they are to be transported to the place where they are first to be milled or processed*

*Australian Tax Office. Available http://www.ato.gov.au/businesses/PrintFriendly.aspx?ms=businesses&doc=/content/33519.htm. Viewed 10 August 2012

> *Tree farming is a well-established and profitable enterprise whose reputation has only suffered as a result of a few big companies that sold ultimately doomed prospectus-based products.*

Tree farming

Don't let yourself be put off by tree farming (I do it myself). It's a well-established and profitable enterprise whose reputation has only suffered as a result of a few big companies that sold ultimately doomed prospectus-based products.

In reality, the timber industry is both mature and well proven.

An example:

Your SMSF buys farm land for $400,000 and rents it back to you at an independently assessed commercial rate of $30,000 p.a. (plus outgoings). Let's also assume you're on the average marginal tax rate of 34%.

Immediately we have a tax arbitrage (which is the ability to take advantage of a difference in tax rates as the basis for profit) represented by a 34% deduction in your name (as the farmer) for the rent, and a tax rate of 15% on the income for the SMSF. This represents either a 19% tax saving or a real positive return of 19%, but no matter how you want to look at it, it's the same dollar outcome.

You now plant a tree plantation in your own name on your SMSF's land, with the planting spread over three financial years at a total cost of $200,000, using your own subcontracted forester to do the work. At a taxation rate of 34%, this enables you to claim personal tax refunds/deductions of $68,000. There are a series of commercial business tests you'll need to pass to be able to do so, which I'll talk about later.

Some other tax deductions that are possible over time involve ongoing annual expenses, including the rent you're now paying to your SMSF (which is also a great way to get more funds into your superannuation fund), insurance, interest on loans (if borrowed) and the ongoing costs from planting and maintaining the trees.

TAX TIP

And this is a terrific point to share a tax tip when it comes to income and deductions. If you're facing a year where you're anticipating a significant burst of income (from a large capital gain, for example) that will push you into the top tax bracket (46.5%), the total tax refund/deduction from our example rises to $93,000, so it's very important to get the timing of your investments just right.

Importantly, with this timing we're claiming tax deductions while the plantation grows, in financial years well before when we'll be expecting to receive income from the harvest. When we do harvest, ideally it will be later, during the usually more relaxed working years just prior to retirement, when we're still able to maximise superannuation contributions and minimise the plantation income.

Ideally, you don't harvest the whole plantation in one year, but spread it out (or at least the income from it) over two or more years while other income (and therefore your tax rate) is lower, again picking up once more on tax arbitrage.

Your own superannuation fund can also borrow if necessary (through a simple instalment warrant) to buy into the farming land.

Here are a couple of examples of how that works.

Your SMSF buys farm land and rents it back to you to farm beef cattle. There's no difference here from the previous examples, except the income commences a lot sooner from the sale of the cattle.

Your SMSF buys farm land and rents it back to you for broad-acre crop farming. You can even live on part of the farm while tending to your fields. Once again, there's no real difference with this example, other than the relative speed of the income from the crop.

Just don't forget that we have two very different entities here – you and your SMSF – with two totally different income streams – the SMSF's rental income and your income from the crop yield (for example) – and altogether different tax treatments – your SMSF attracts only 10% to 15%, while you attract the normal rate on income that all taxpayers face, which requires traditional tax planning to maximise your returns (such as contributions to super, wages to family members when working in the business, and normal capital asset depreciation and write-offs).

By now I hope you're getting a feel for how this works. As with all genuine, ATO-approved primary-production businesses where there is a need or it is normal practice to do so, you can also live on small parts of the farm land while tending its operation.

So why farmland?

It's my belief (backed by plenty of experience) that farm land is generally too cheap, and for the simple reason that it will be in significant demand in the future. Think about supply and demand and the effects of a growing population in Australia.

Sooner or later, our various carbon-emission-reduction schemes will start to drive demand for land, by forcing major corporations into buying up farmland for carbon offsets. The day is coming and it'll bring the established international carbon market along with it.

Food production will be an ongoing issue as the world's population grows and farm usage faces increasing competition from lifestyle demands as cities become more crowded and seek to expand. Additionally, banks are currently lending less on rural land after the global financial crisis.

Like all boom/bust cycles, however, this will eventually end, allowing people to be able to borrow again.

All of this will contribute to higher rural land prices in the future.

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Why superannuation?

Rural land is almost a perfect match for superannuation investment, simply because it is a long-term investment. With the recent poor performance from managed superannuation, there is a lot of general reluctance about putting funds into superannuation. The do-it-yourself superannuation options, however, have been booming (including rural land), as the available superannuation tax concessions simply can't be ignored, and for many of us, SMSFs provide a more acceptable way to access them.

Under our current laws, pretax contributions to superannuation provide the most tax-effective strategy we have. By simply investing in superannuation, you can make a 19% return on pretax money if you're in the 34% tax bracket (the equivalent at the time of writing of around four years' term deposit interest), or a 31.5% return if you're in the top tax bracket.

Let's look at another example of how this difference works.

*Assume you pay tax at the 34% tax rate and have surplus savings of around $200 per week after tax ($303 before tax). Ordinarily you'd lose $103 in tax each week. Alternatively, if you salary sacrifice directly into superannuation, you lose only $45 per week in tax. That's a savings difference of $58 each and every week, week after week.**

Don't forget, with superannuation the tax-effective savings don't stop at the contributions level, as superannuation earnings are only taxed at 10% to 15%, and after retiring it gets even better, as the earnings attract an unbelievable tax rate of 0%! Further, the tax paid on superannuation payouts after the age of 60 (and retired or semiretired) is again zero (in most cases, but remember, individual circumstances vary, so always get independent advice)!

*The catch is you can't get to this money until you retire at 55 or 60 (depending on your age now).

Borrowing with your super

Since September 2007, SMSFs have been able to borrow on their own behalf, through the prudent use of easily constructed instalment warrants.

An instalment warrant is a form of derivative and I'm very well placed to provide advice about the benefits of their use.

Let's consider a simple strategy using instalment warrants.

Let's say you put $200,000 into your own SMSF, which then borrows a further $200,000 through an instalment trust structure and buys a farm for forestry. You can rent the land back to either yourself or an investor, making the investment cashflow positive, which with your 9% superannuation payroll contributions and any additional salary sacrifices will help pay down the loan even faster.

There are numerous strategies you can pursue (well beyond the simple examples we're briefly covering here) that can substantially enhance your returns. For example, you can consider getting together with friends in a geared unit trust to buy a larger block, providing significantly enhanced economies of scale. Alternatively, you can finance the purchase of units in a unit trust yourself, to avoid gearing inside the trust.

Whatever you decide to do, you must always talk to your financial advisor, who will have plenty of other tax-effective ideas.

Tax laws & deductions

The ATO's main concern when it comes to primary production involves satisfying a series of noncommercial loss-deductibility tests, which is something you'll need to discuss with an accountant prior to embarking on any agri-investment.

While this may all appear quite daunting, relax. Accountants deal with them regularly, and as long as the primary-production activity is an independently verifiable venture, then there are usually no issues whatsoever.

The income requirement & business tests

The first noncommercial loss-deductibility test involves being able to offset a business loss (we are focusing on primary production, but the tests are the same for any other business loss) against other income, which means you need to satisfy the following tests.

The income requirement test

Your income must be less than $250,000. This $250,000 is not just your taxable income (per your tax assessment) but also includes:

- business losses
- total reportable fringe benefits amounts
- additional reportable superannuation contributions
- total net investment losses.

Even if you're 'lucky' enough to fail the $250,000 test (meaning you have income above $250,000), you can apply for a private ruling on the exercise of the Commissioner of Taxation's discretion to allow the loss offsets. The basis for the Commissioner's discretion includes:

- special circumstances outside your control (high income from an unusual event, like receipt of a large insurance payout from fire, flood, and even drought)
- the nature of the activity, for example when there are long lead times before a tax profit (tree farming for instance)
- an objective expectation based on independent evidence (via an independent report) that a profit will be made in a time that is normal for the industry.

Once the Commissioner's discretion has been granted, then the losses are fully claimable against your ordinary income.

The business tests

If you have an adjusted income below $250,000, then passing one of these next four business tests is essential to be able to offset the losses:

- **the assessable income test**, where the business activity has assessable income of at least $20,000
- **the profits test**, where the business had a profit for tax purposes in three out of the past five years (including the current year)
- **the real property test**, where the value of real property (or of an interest in real property) that you used in the business on a continuing basis was at least $500,000
- **the other assets test**, where the value of assets (excluding real property, cars, motorcycles and similar vehicles) you used on a continuing basis in carrying on the business was at least $100,000.

In-house assets restrictions

The final issue to address involves in-house assets restrictions, which generally prevent an SMSF's members from effectively investing in themselves (or associated entities).

This doesn't, however, apply to farms or business property.

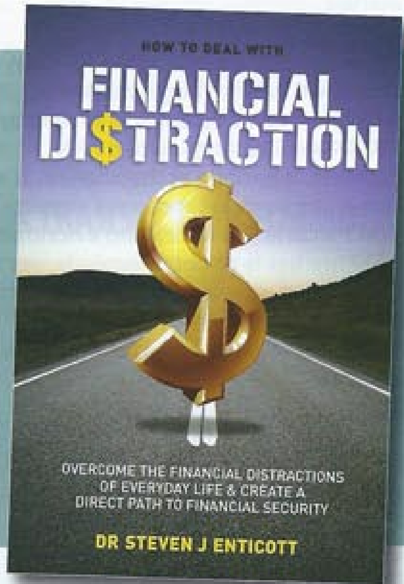
For example, our SMSF can own a farm that may also have a farmhouse on it that you're allowed to use, as long as it's for the daily management/ maintenance of the farm or tending the crops while you're leasing the farmland back to the SMSF member (yourself) or the farmer. As long as that part of the farmland is no larger than two hectares, then there are no regulatory issues. The catch is, though, that the property's purpose must be for farming, which means no part of it may be used by you for private or domestic purposes (for example by also taking the family there for holidays or other recreation).

When your super is involved, it's all work and no play.

- immediate tax-effective returns on your contributions
- concessional (low) tax rates on the earnings
- tax-free status at age 60 for most (and semi-retired/retired)
- the ability to borrow.

The primary-production rules are full of traps and superannuation rules often change from year to year, but this is nothing to be intimidated by, just understood and complied with.

You do need to speak with your accountant (and I cannot emphasise this enough), or do your own research prior to undertaking any tax-effective investment opportunities based on the primary production activities described in this chapter.



> *Our SMSF can own a farm that may also have a farmhouse on it that you're allowed to use, as long as it's for the daily management/maintenance of the farm or tending the crops.*

If our primary-production activity doesn't pass one of these four tests, then an application can be made for the Commissioner's discretion in the exact same way as for the income requirement test.

Remember, a viable venture only needs to qualify for the Commissioner's discretion once, and for the life of the project the discretion will usually apply.

Finally, there is one other exemption to note for primary production losses. Where other non-primary-production adjusted income is less than $40,000 and excludes capital gains from the calculation, you're able to offset the losses without question.

Summing it all up

The results from combining superannuation, agribusiness and farming land are well worth the effort, and simply too good to be ignored.

1. Get advice in the first instance and get it quickly. Speak to a farmer or forester and a SMSF expert.

2. Maximise the super power of superannuation. Why? Because it's yours, it's protected, it has so many tax advantages, and it will be instrumental in accelerating your wealth through farming opportunities. Why accelerate wealth? Because wealth gives you choices, which is always a good thing.
3. Superannuation offers fantastic opportunities:

Dr Steven Enticott is a finance professional, speaker, author of How to deal with Financial Distraction *www.financial distraction.com.au, a taxation specialist and senior partner of www.ciatax.com.au, accountants. He is a Chartered Tax Advisor, Registered Financial Advisor, Fellow of The Institute of Public Accountants, Fellow Member of the Taxation Institute Australia, and a passionate member of the International Positive Psychology Association.*