On-farm financial risk management project

Off-farm income

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Aggregate CONSULTING

Formerly known as Holmes Sackett

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National Farmers Federation

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Executive Summary 1.

Off-farm income

The objectives of this research works were to identify barriers for farmers seeking off-farm income sources or find incentives that could be created that would encourage farmers to use off-farm income as a risk management tool to lower dependency on government assistance when under exceptional circumstances such as drought.

This report used the outcomes of the National Farmers Federation (NFF) risk survey, a more detailed survey conducted by Holmes Sackett of 87 producers, benchmarking data from the Holmes Sackett benchmarking database, ABARES statistics, and published statistics from New Zealand, Canada, United States of America, and the United Kingdom.

All findings and recommendations were presented to a producer reference group comprised of producers from Queensland, New South Wales, Victoria, and Tasmania.

Exceptional circumstances have major impacts on farm profits. Within the Holmes Sackett benchmarking database, farms experiencing the drought from 2018 through to 2020 saw the Earnings before Interest, Lease and Tax (EBILT) fall on average 92% (the lowest was a fall of 270%) from pre-drought profits.

This volatility is well recognised. Less recognised is the fact that the average EBILT of that group of farms was still a profit over the course of the drought.

Benchmarking data shows that a farm business generating less than 3% return on assets under management (EBILT ÷ Total Assets under Management) with less than 30% liabilities (measured as total debt ÷ total assets under management in broadacre agriculture) is unlikely to need off-farm income as a risk management strategy.

A less profitable farm, a small-scale farm, or a farm that is expanding and therefore has significant amounts of debt (greater than 30% liabilities) will be far more dependent on off-farm income to manage risk in the absence of any better alternative.

Results from the survey data from this project show:

- That ~65% of farms generate some form of off-farm income.
- That the total off-farm income represents approximately 5% of total income and 14.5% of net farm profit.
- Salaries and wages (requiring time) makes up about 36% of this off-farm income and is particularly important to small scale businesses.
- Contracting and consulting (requiring time, farm expertise and capital tied up in plant and equipment) made up 24% of off-farm income.
- Investment returns from real estate or shares (requiring capital only) a further 39% of off-farm income.
- Current levels of off-farm income in Australia (5-8% of total income), provide useful buffers against exceptional circumstances, but are unlikely to cover most of the risk in those businesses that need it the most. This level of off-farm income represents ~15% of profits before exceptional circumstances, so the levels that are currently available provide a cushion.

International research showed the levels of off-farm income appear not to be significantly different to New Zealand but are significantly different to Canada, USA, and the UK, all of which have much higher levels of subsidisation in their agriculture. The increased percentage of off-farm income in these countries is a function of decreased average farm scale and profit leading to a dependence on off-farm income which predominantly comes from salaries.

Income from investments in shares or real estate made up 39.3% of total off-farm income in the Holmes Sackett survey and 90% of assets held off-farm.

Producers overwhelmingly stated that the reason they invested off-farm was for diversification of income, a risk management strategy.

The risk management benefits of off-farm income are widely understood but either because the benefits from reinvestment on-farm are deemed to be better, or because some producers (21%) thought they lacked expertise in off-farm investment, off-farm investment was not the first priority when making decisions about where to invest capital available to them.

Producers overwhelmingly stated that investing or reinvesting in the growth of the farming business was the main reason not to invest off-farm.

The recommendations in this report take into consideration that reinvestment on-farm to make the business more profitable, or increase scale, is itself a risk management option.

The issues the recommendations in this report address are:

- Tax legislation does a very good job at incentivising on-farm investment, but this same legislation means off-farm investment is at a disadvantage.
- The returns from debt reduction (another risk management tool that allows producers to manage volatility better) does not compete against the tax incentives for farm reinvestment and therefore producers may invest in low return farm improvements which due to permanent or temporary tax legislation look appealing against debt reduction.
- Even though off-farm income generation is a real and widely recognised risk management tool for farming businesses, it is not treated as a farm related activity when it comes to taxing salaries earned off-farm or using farm assets as collateral for investing off-farm.

The recommendations in this report address the issues raised. They include:

- Some temporary tax-deductible debt reduction to compete with tax effective reinvestment of profits on-farm
- Having the rules around access to debt the same for on-farm investment as they are for off-farm investment
- Allowing producers to seek out casual work without having to pay PAYG tax on casual wages earned.

As a general principal, if off-farm income is to be further incentivised as a farm risk management tool, the off-farm income, and all of the labour, plant and equipment, and capital required to support off-farm income, needs to be taxed and financed under the same legislation as any other farm operation or investment.

Objectives

2.

To determine:

- Barriers can be removed that inhibit farmers securing sources of off-farm income that will help to reduce income volatility and thereby make them less dependent on exceptional circumstance funding.
- Incentives can be created to encourage farmers to secure sources of off-farm income to reduce income volatility to make them less dependent on exceptional circumstances funding.

Definitions

3.

Off-farm income

Off-farm income has been defined as a source of income that comes from anything other than the primary production of produce from the farm.

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The definition is limited to primary production because it is primary production that is subject to exceptional circumstances caused by drought, flood, or fire.

Under this definition off-farm income may include:

- Value adding activities (i.e. supplying branded product to retail).
- Marketing activities (i.e. grain storage).
- Alterative employment off-farm.
- Alternative business using farm assets (i.e. contracting).
- Income generating asset acquisitions (i.e. share portfolio, residential housing etc).
- Farm management deposits.
- Lease or royalty incomes (i.e. windfarm leases, carbon credits, environmental offsets).

Types of off-farm income

4.

Uncorrelated versus correlated off-farm income

Uncorrelated off-farm income is that which will not likely be impacted by the same exceptional circumstance that effects on-farm income.

Correlated off-farm income is that which is likely to be impacted by the same exceptional circumstances that impact on-farm income.

An example of correlated off-farm income is a harvest contracting business as it is likely to be adversely impacted by drought at the same time the farm harvest is impacted, conversely dividend income from a share portfolio is unlikely to be impacted by drought and is therefore considered to be uncorrelated off-farm income.

Identifying uncorrelated sources of off-farm income have risk management benefits through a supply of income independent of the farm business.

Correlated incomes can still have risk management benefits for the farm business if they make the business more profitable and therefore resilient to variation in income caused by exceptional circumstances.

Examples of correlated farm incomes that may have risk management benefits are things like a contracting business that uses labour, plant and equipment or capital, that is surplus to primary production requirements of the farm business.

Passive versus active off-farm income

Income derived from assets that do not require active management are considered to generate passive off-farm income, whereas income derived from resources shared with the farm (i.e. family labour, management expertise, plant and equipment) are considered to be active sources of off-farm income.

Both passive and active sources of off-farm income can have risk management benefits however active income source can also lead to a loss of profitability if the management resource is insufficient to be able to adequately meet the requirements of both income streams.

This scenario is quite common in growing farm businesses where an active income source (i.e. a contracting business) is started that makes the business more profitable initially because it makes for more efficient use of labour resources in particular, but as the business grows and management becomes unable to keep on top of all requirements, it can lead to loss of production in the farming business.

Passive off-farm income sources are beneficial in that they do not compete for management resources, but they do often require significant amounts of capital to be invested and therefore compete for a limited pool of capital.

This requirement for capital can have negative impacts on the financial risk management of the business if that capital would be better employed on-farm to make the farm business more profitable.

Impacts of exceptional circumstances and resilience of farm businesses

5.

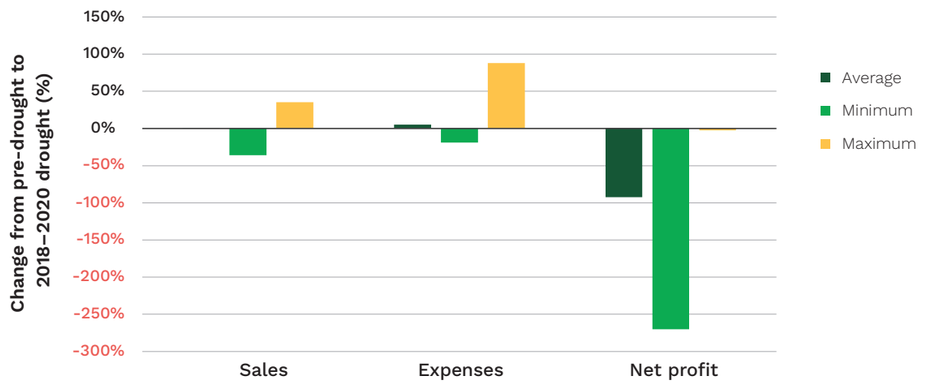
Holmes Sackett benchmarking data

Analysis of a sample of 24 farms from the recently severely drought affected regions of the New England, Central West and Monaro in NSW allows some insight into the impact of exceptional circumstance on farm businesses.

The data comes from the Holmes Sackett benchmarking database. The farms analysed have all benchmarked their farm businesses in the years proceeding and after the drought which ran from 2018 to 2020.

No two droughts (or other exceptional circumstances) are the same in terms of the severity of the impact on production and price, however this particular drought period, because it was extended and severe, does give a good example of the extent to which farm income and profits can be affected and also the range in effects within any sample of businesses.

Throughout this drought period the commodity prices for their production (principally wool, lamb, mutton, beef, wheat, and canola) were favourable in comparison to previous droughts. However, it was still a protracted and severe drought due to the size of the rainfall deficit.



Graph 1. Earnings before interest lease and tax fell 92% on average from pre-2018 drought to during the drought running from 2018 to 2020

From within the groups of farms analysed the average sales income was equal to the proceeding years and ranged from ~36% higher to 36% lower. Where sales income is higher it is quite often associated with selling down livestock inventory to reduce supplementary feeding costs. Even if livestock prices are lower, increased numbers of livestock sold can offset lower prices. Where there are lower sales relative to pre-drought sales, this was often associated with cropping enterprises having lower yields.

Expenses ranged from 88% higher to 19% lower. In drought, where expenses are higher it is quite often associated with strategies to feed livestock through the drought whilst trying to maintain livestock inventory. Lower expenses are most often associated with lower harvest expenses in crops.

The total impact of drought on a business is measured by what happens to the Earnings before Interest, Lease and Tax (EBILT) of the business. This is calculated as cash sales less cash expenses, less adjustments for any changes in livestock, fodder, or grains inventories, less a depreciation allowance on plant and equipment, less a wage equivalent for owner labour.

The average EBILT of these farms analysed fell by 92%, and for the worst affected farms it fell by 270%, whereas a few farms were nearly as profitable through the drought as they were prior to the drought.

Whilst these are big swings in percentage terms, the variation does not give an indication of the absolute profit that was made. The average EBILT pre drought of this group of farms was $253 per hectare whilst the average EBILT during the drought was $40 per hectare. Less than half (29%) made a loss per hectare over the entirety of the drought.

National Farmers Federation survey data

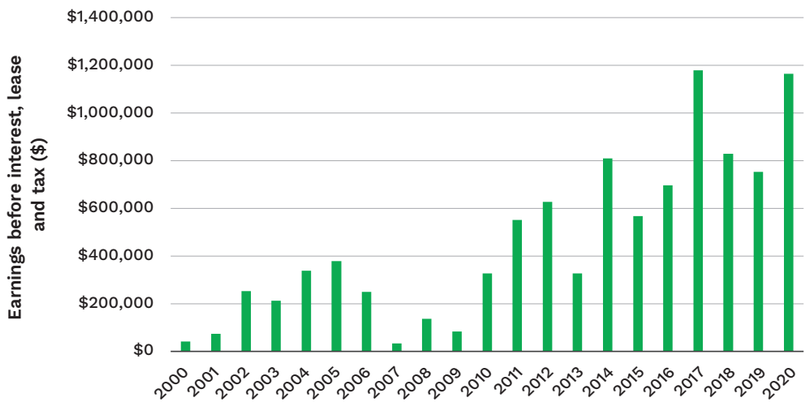
The responses from the National Farmers Federation survey on what the average farm income was in the worst 10% of years, compared with all other years, was that EBILT fell by 98% (similar to the benchmarked changes seen as a consequence of the 2018 to 2020 drought in the Holmes Sackett Benchmarking database).

On average EBILT per hectare was expected to fall from $587 to $148 meaning more than half of the producers expected to make a profit before interest lease and tax in those years. This result is again like the outcomes of the Holmes Sackett analysis.

Resilience of farm businesses to the variation in profits

Resilience of a farm business to the inherent variations that come with primary production are mostly a function of the profitability of the business and the equity in the business.

Graph 2 below is an example of a business that has high profitability, achieving an average return on assets under management of 5% over a ten-year period. Return on assets under management is calculated as EBILT divided by the total market value of assets being managed (whether owned or leased). The assets primarily include land, livestock, plant, and equipment.



Graph 2. Variation in profits does not necessarily mean there is substantial risk within a business

Source: Holmes Sackett Pty Ltd

Without any debt this business has no risk despite variations in price and seasons causing up to 87% reductions in farm profit from one year to the next.

Those same variations in seasons and commodity prices have also seen farm profits rise by up to 300% from one year to the next. If the sole purpose of risk management is to limit variation a farm can end up with lower average profit over a decade.

This same business however may well face substantial risk if the equity levels in the business are sufficiently low that EBILT cannot cover the business's current commitments (i.e. interest payments on loans, machinery lease costs).

From the years 2000 to 2010 interest repayments of $200,000 per annum would have had financial repercussions for this farm. Over that same period however this business maintained an equity level of 85% and averaged $45,000 per annum in interest repayments. Farm profits therefore averaged greater than four times the required interest payments.

In that same period from 2000 to 2010 the business grew by 50% in area under management through the acquisition of more property and net assets grew by more than four times.

This is an example of a business that has thrived amidst the variation in farm profits due to relatively high profitability and a strong balance sheet.

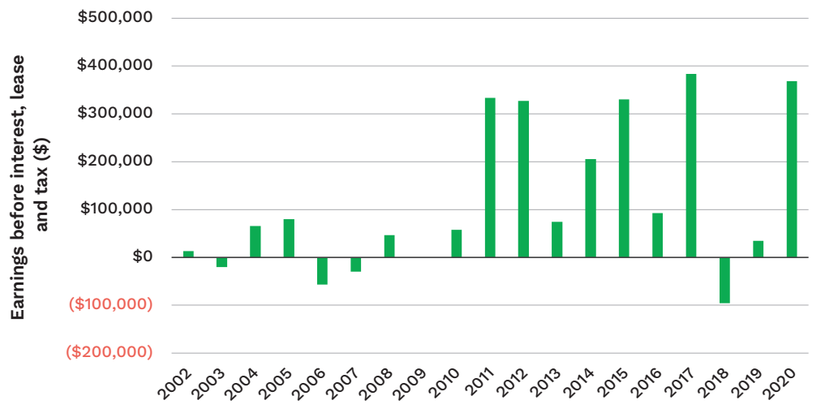
The EBILT from a second farm, near the first and with a similar enterprise mix and therefore facing the same seasonal conditions and commodity price risks, are shown in Graph 3. This farm has averaged 2.3% return on assets under management over the last two decades.

In percentage and absolute terms, the variation I farm EBILT is like the first farm, however the lower average profitability of the business means that the financial pressure on this second business in more severe.

In four of the 18 years benchmarked this farm has made a loss before interest and lease costs. In ten out of the 18 years, the profit after interest and lease costs was negative. Total after interest and lease profit from the farm over 18 years is -$17,805.

In absolute terms the year to year variation in return on assets under management is not different to the first farm. What is different is that the variation occurs around a substantially different average.

This farm business supported farm income with off-farm income in the form of a business that was not farm related up until 2014. Initially due to small scale the off-farm income represented about 40% of total income, and when it was ceased in 2015 it represented approximately 15% of total income. In the last few years, had it still been carried out it would have represented approximately 8% of total income.



Graph 3. Whilst the variation in farm profits is similar, lower profitability of the farming enterprise means there is significantly more risk associated with the variation

Source: Holmes Sackett Pty Ltd

Whilst on the surface it may seem that this business has not achieved much over the 18 year period in terms of profits made after interest and lease costs a look at the net assets of the business tells a different story.

This farm business has expended the area under management by three times (300%) over this period. Whilst farm equity fell from a high of 95%, down to a low of 40% it has risen back up to 69%.

With capital gain in land and livestock the net assets of this business have grown by 22 times over this period. The business started as a very small-scale operation, with less than a full-time labour unit employed, and now is at a scale that it can employ a little over two full-time labour units.

At the same time the business has developed a significant amount of low productivity land into highly fertile, developed perennial pastures.

In terms of wealth creation, this has been a very successful business and off-farm income was an essential part of that success in the early years. The extent to which off-farm income can help or is needed in for a farm business to be resilient to exceptional circumstances is going to be relative to:

1) **How profitable the farm is in the first instance** — the more profitable the farm the less impact off-farm income will have due to less risk associated with the variation from year to year in profits.
2) **How much debt the busines has** — a business with low equity that subsequently has trouble servicing loans can become capital constrained very quickly.
3) **How big that source of off-farm income is relative to the on-farm income.**

Analysis of off-farm income

6.

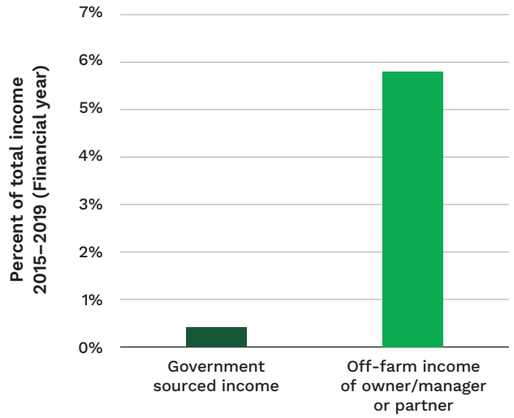
ABARES data analysis

An analysis of ABARES data over the five-year period from the 2014-15 financial year through to the 2018-19 financial year reveals that 5.8% of total farm income has come from off-farm sources that excludes any government assistance or grants other than those given as aid in exceptional circumstances (Graph 4). Exceptional circumstances grant or payments made by government are included in on-farm income.

The states where the highest percentage of total farm income coming from off-farm income over the 2015 to 2019 financial years were NSW, Victoria, and Queensland (between 7-8%). Western Australia has had the lowest percentage of off-farm income over that same period, followed by the Northern Territory, and then Tasmania.

The differences in the Northern Territory appears to be a consequence of higher average scale of the business as depicted in farm assets under management as it also has higher average absolute off-farm income (Graph 5).

South Australia and Tasmania have lower off-farm income as a percentage of total income, lower average absolute off-farm income per farm, but also higher on-farm income. This may reflect higher average intensity with more intensive irrigated industry in these states. The off-farm income as a percentage of total income in Western Australia is lower again but it is largely a function of increased on-farm income per farm with some influence of lower off-farm income.



Graph 4. ABARES statistics show off-farm income represented an average of 5.8% of total farm income over the years 2014/15 to 2018/19

Source: ABARES

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The sectors with the least amount of off-farm income as a percentage of total farm income in the data are grains or mixed grains and livestock, whereas both the sheep and beef sectors had relatively more income coming from off-farm sources (Graph 7).

In absolute terms the grains industry does not average significantly higher off-farm income and therefore the lower percentage is a function of larger asset bases and more on-farm income (Graph 8).

From this analysis it appears that on-farm income is probably the variable most influential on absolute off-farm income. Once on-farm income reaches a threshold level (~greater than $600,000) there is a tendency for off-farm income to plateau or fall as it becomes less necessary to support household income or as a risk management tool for the business.

National Farmers Federation survey

The National Farmers Federation survey showed 22.3% of 'household income' was coming from off-farm income and that earnings from off-farm income was second most used tactic to manage losses on farm with 34.3% of responses using off-farm income.

Note that the question asked is slightly different to the Holmes Sackett survey which looks at off-farm income as a percentage of EBILT. It is likely that household income is less than EBILT and therefore the increased percentage could be influenced by this.

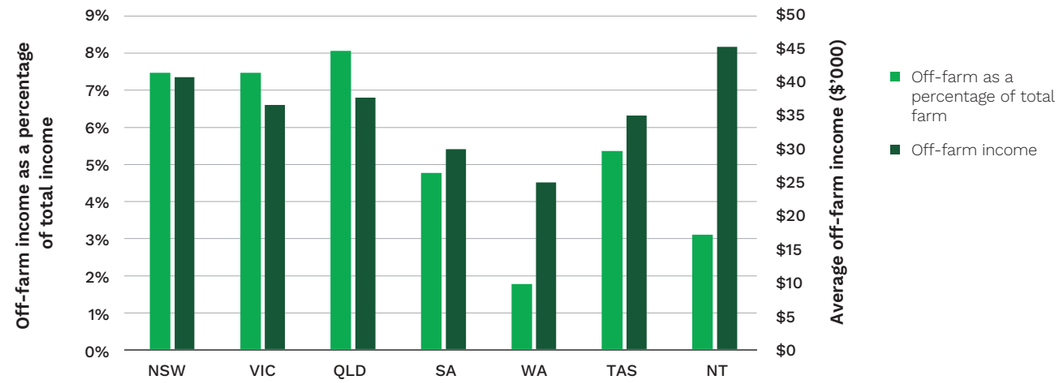
From the NFF survey the most common tactic to handle financial losses is to draw down on loan facilities which was used by 74.7% of respondents. In farming, debt is the most available source of funds, and quite often it is the cheapest, so this response is logical.

Selling off-farm assets, selling down livestock or grain inventory or cutting expenses were nominated by 19% of respondents as a measure to finance losses by releasing cash. These strategies would typically be very expensive means of financing losses as they cut into future profits. These strategies are a concern from a risk management perspective.

Farm management deposits were used by 25.3% of respondents, government assistance by 16% of respondents and an insurance claim by 6% of respondents.

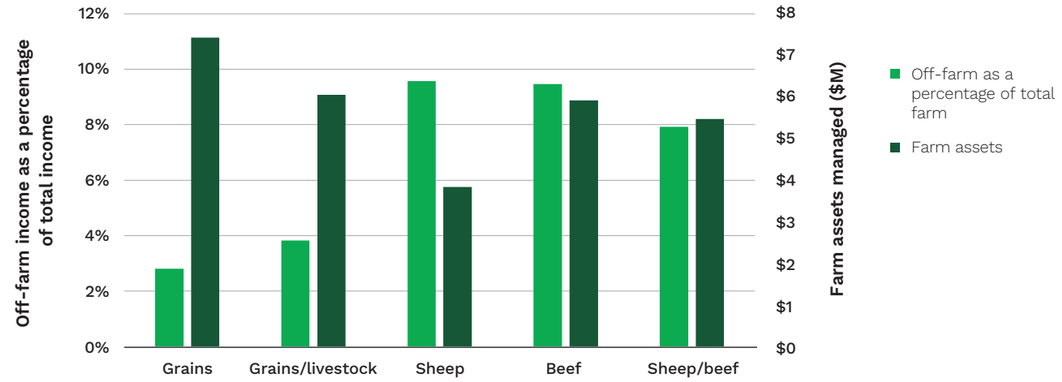
Graph 5. NSW, Victoria and Queensland have the highest percentage of income coming from off-farm

Source: ABARES



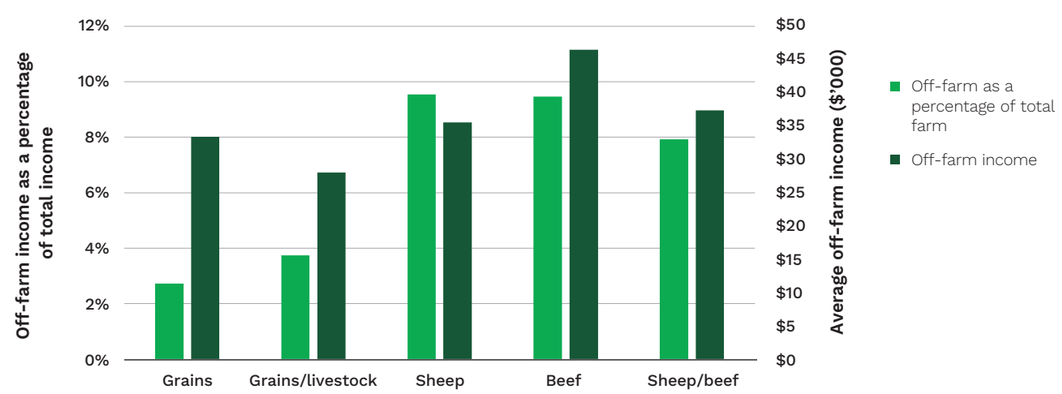
Graph 6. Average off-farm income by state

Source: ABARES



Graph 7. The grains industry has the least amount of income coming from off-farm sources

Source: ABARES



Graph 8. Off-farm income by sector

Source: ABARES

Holmes Sackett survey data

A survey of farmers was conducted to further analyse types of off-farm income, reasons for having off-farm income, and reasons for not pursuing more off-farm income.

The survey collected 86 individual data points with localities shown in Figure 1 below.

The average percentage of income coming from off-farm income sources from the survey data is 4.6%, slightly lower than the 5.8% that was found in the ABARES survey.

Based on the results from ABARES data analysis it is probable this difference largely reflects the difference in average on-farm income between the two datasets, with the ABARES data averaging $638,053 in total income, whilst the average from the Holmes Sackett survey is $1,771,346. The median farm income from the Holmes Sackett survey was $1,143,000 which highlights the impact of a few large farms in a small sample size.

The increased average scale of the businesses in the Holmes Sackett survey was, in part, offset by higher average off-farm income within this survey of $57,384 compared with the $35,669 average of the ABARES dataset.

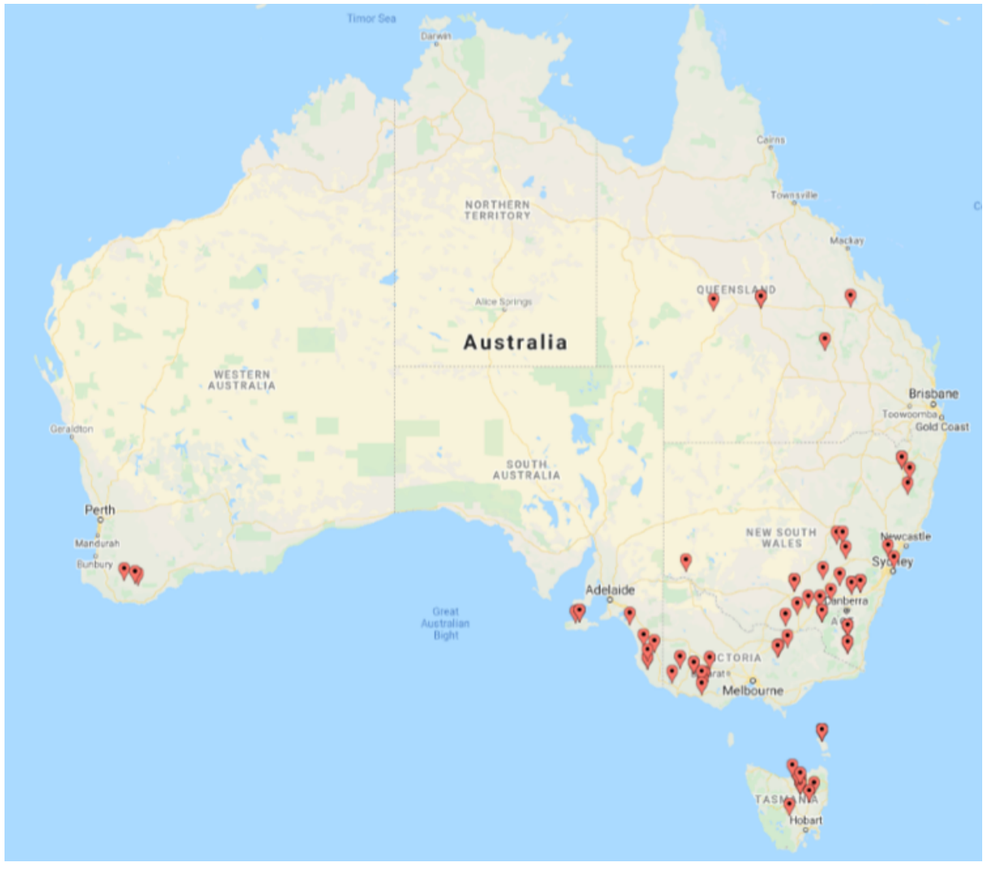
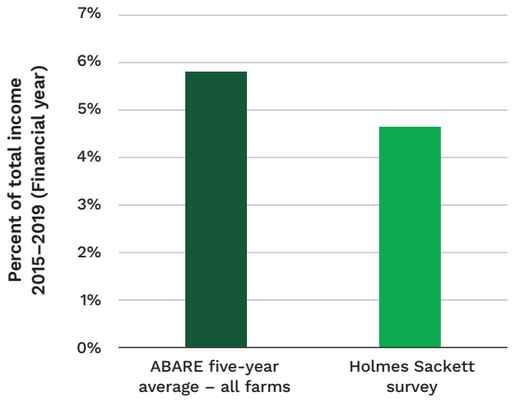


Figure 1. Postcodes of Holmes Sackett survey participants



Graph 9. The slightly lower percentage of off-farm income is most likely a reflection of higher average income partially offset by higher average off-farm income

Source: ABARES, Holmes Sackett Risk Survey

Nearly a third of farms surveyed (31.5%) did not have any off-farm income. These businesses had only slightly higher ($1,790,866) average total income than the businesses with off-farm income ($1,762,368).

With this level of on-farm income, it is likely that off-farm income is not required as either a risk management solution and/or the decision to support household income becomes discretionary.

As the business grows it would take an ever-larger amount of capital invested off-farm to provide enough to smooth out the variation in on-farm income.

The survey reveals more off-farm income as a percentage of total income where farm assets under management (land, livestock, plant and equipment) were below $10,000,000 (Graph 10) however there is substantial variation within each of these categories of farm scale such that it cannot be concluded that farm scale is having a significant effect on off-farm income.

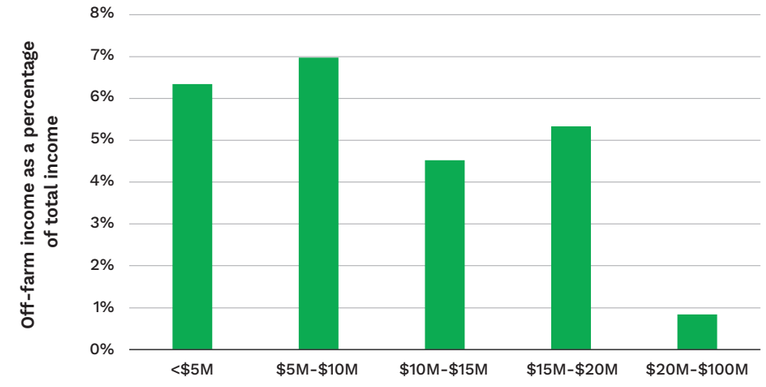
There was substantially more off-farm income generated on farms with farms assets under $5,000,000 ($105,860) than there was for farms with assets under management of between $5,000,000 and $20,000,000 ($55,289). The off-farm income dropped dramatically to $23,215 for business with assets over $20,000,000 however this is a very small sample of farms (10% of total sample).

The off-farm income generated was compared to benchmarked EBILT of the businesses to help understand what impact it is having on risk management in exceptional circumstances.

On average, off-farm income made up 14.6% of EBILT, varying from a low of 0% to a high of 192%.

Of the farms analysed, only 19% had off-farm income that was greater than 20% of their profits in years without exceptional circumstance.

Whilst all off-farm income helps, not a large percentage of the farms surveyed have significant enough off-farm income to substantially remove the potential variation in EBILT from exceptional circumstances.



Graph 10. Relationship between off-farm income and on-farm assets under management

Source: ABARES

Overseas data analysis

Greig et al 2018, in a survey of New Zealand farmers in 2015, found that in 2015 off-farm income represented 24.5% of net profit. Using the New Zealand statistics on national farm profit, that same level of off-farm income would represent 18% of 2019 farm profit.

Given the sampling for this study was done randomly as per ABARES studies it is also likely that the slightly higher percentage of EBILT could be a reflection of the lower average income generated per farm that comes from a better random sample of farms than was generated in the Holmes Sackett survey.

By contrast national statistics from Canada, a country with significantly higher estimated government support as a percentage of gross farm output (~20%) show that off-farm incomes represented 60% of total income, of which the majority comes from employment income.

In the Canadian data average EBILT is $166,529, substantially lower than the survey average of $643,445, which again reflects the lower average farm size in the sample and consequently more dependence on off-farm income.

This difference is significant as both a percentage of total income and in terms of the absolute amounts per farm business. The different in absolute amounts (AU $57,384 versus CA $98,733) equates to roughly a 60% increase in Australian dollars using an exchange rate of one Australian dollar buys $0.94 Canadian dollars.

USDA data for farms with moderate or better income (~$2,000,000 in farm assets under management) shows off-farm income representing 29% of total household income. Income from off-farm income sources has averages $73,180 per annum from 2015 through to 2019 with EBILT coming from farming activities averaging $181,339 per annum. As with the Canadian data this increased percentage of off-farm income as a percentage of total farm income appears to be predominantly a consequence of smaller scale and consequent dependence on off-farm income.

If the sample is restricted to large and very large farms where farm assets managed is greater than $7,000,000 and household income from farming activities averages $493,584 then household income from off-farm sources falls to an average of 2.9%.

Key *et al* (2017) reports that in the United States between 1996 and 2013 farm income declined in volatility by about 10% which meant overall household income volatility declined by 20%. This paper reports higher variability in household income with increasing farm scale due to more dependence on income from farming activities as opposed to off-farm activities as demonstrated above.

It is postulated in the paper that the decline in variation to household income might be a consequence of increased reliance on production contracts, changes in organisation of the farm businesses or an expansion of the Federal crop insurance program. No conclusive analysis if given.

In the United Kingdom off-farm income represented between 28-33% of total household income between 2009 to 2015. Given total income averaged around £46,700 per household it is likely that this high percentage is again a reflection of smaller scale businesses surveyed. This is supported when the data is broken down into industries with dairy and poultry having substantially less off-farm income as a percentage of total household income (14% and 12% respectively) but also much higher average household income (£81,700 and £116,000).

Internationally the data analysed supports the notion that increasing farm income either through scale or profitability will lower dependence on off-farm income, even though volatility of household income might also increase consequently.

Sources of off-farm income

7.

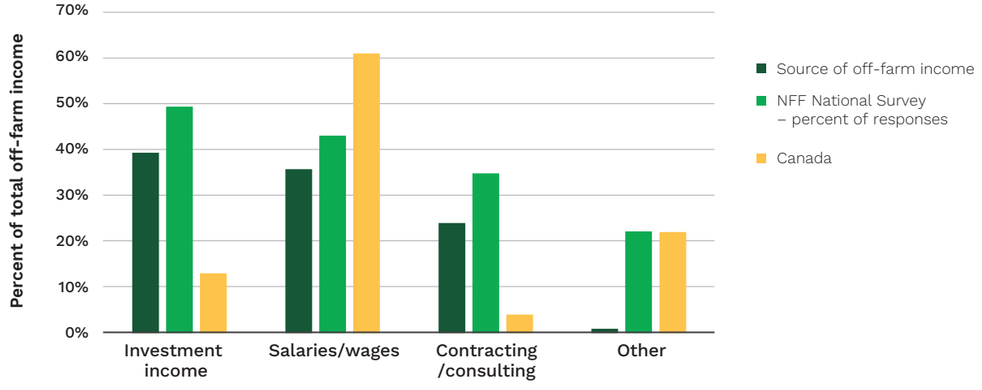
Both the Holmes Sackett survey and the NFF survey showed the sources of off-farm income are from investment activities (shares or real estate), followed by salaries and wages, contracting and consulting, and then other sources such as interest on either Farm Management Deposits or other cash deposits.

Salaries and wages

From the National Farmers Federation survey responses, 43% of farms generated salaries or wages off-farm. In the Holmes Sackett survey salaries and wages contributed a total of 35.7% of total off-farm income whilst in the Canadian data it contributed to 61% of off-farm income.

The Holmes Sackett survey did not demonstrate a strong relationship with salaries and profits earned (Graph 12). If you compare the results from the Holmes Sackett survey the percentage of off-farm income that comes from salaries and wages with the Canadian data, it is significantly lower.

The most likely reason for this is that the scale of the businesses surveyed in Australian is significantly higher than the Canadian businesses, and therefore the reasons for earning salaries and wages off-farm are less related to the needs of the farm business. The average EBILT ($643,445) in the Holmes Sackett survey was significantly higher than the Canadian data ($166,529).



Graph 11. Sources of off-farm income

Source: Holmes Sackett Risk Survey, National NFF Risk Survey, Statistics Canada

From the Holmes Sackett survey data, 38.5% of respondents that generated off-farm income with salaries and/or wages suggested that it was not for business purposes. The most common response in this category was that it was a personal choice of a partner to have a career outside the farm business.

Isolation was mentioned once as a barrier in the Holmes Sackett survey sample for the pursuit of further off-farm income.

Contracting and consulting

Contracting and consulting have been put into one category because they usually require shared labour or plant and equipment resources with the farm business.

The NFF survey results showed 34.8% of respondents used contracting or consulting as an off-farm income source and in the Holmes Sackett survey it made up 24% of total off-farm income.

In Canada contracting and consulting only contributed to 4% of income earned off-farm. It is unclear why there is such a difference between Australia and Canada in the contribution of contracting and consulting but it may be that it is driven by differences in the need or opportunity to more efficiently use plant and equipment on-farm in Australia.

Alternatively, it could be predominantly because salaries and wages a far more dominant source of off-farm income in Canadian data analysis.

In Australian, the need to efficiently use plant and equipment when the enterprise for which it is needed is too small, and the ability to leverage expertise with consultancy are drivers of off-farm contracting income.

These reasons are supported by the fact that all the respondents who used contracting or consulting nominated it as an active strategy to support the farm business.

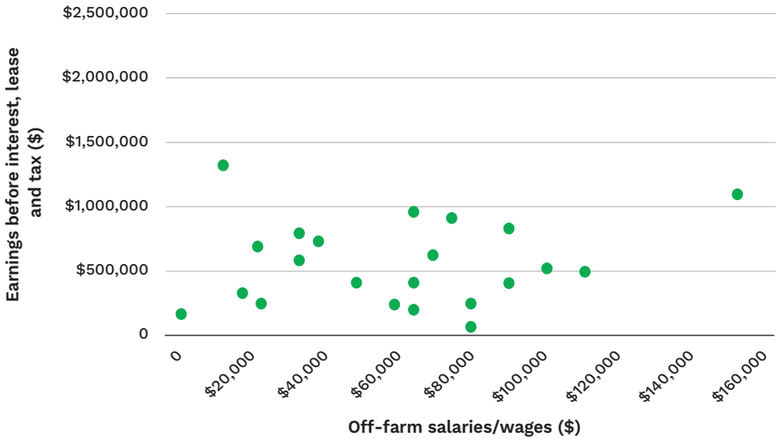
Within this dataset no relationship was found between the level of contracting or consulting income and assets under management or farm EBILT.

Investment income

Income from off-farm investments (shares and real estate investments) made up 49.4% of the responses in the National Farmers Federation survey and 39.3% of all off-farm income from the Holmes Sackett survey. The Canadian data shows 13% of all off-farm income coming from off-farm investments.

In the NFF survey data 31% of responses nominated off-farm income coming from shares and 18.3% nominated off-farm income coming from real estate. Rentals from real estate made up 23.3% of all off-farm income in the Holmes Sackett survey and share dividends made up 16% of all off-farm income.

Overwhelmingly (85% of responses) investments in shares and real estate were classified as an active investment strategy, with a further 12% nominating them as inherited assets.



Graph 12. A significant portion of salaries and wages earned off-farm are not primarily for the purpose of business risk management

Source: Holmes Sackett Risk Survey

Shares (40%) and real estate (50%) made up 90% of all assets held off-farm and these assets were yielding 3.4% and 3.7% in terms of income. For every $50,000 of income to be earned from these sources ~$1,400,000 of assets are required to be held off-farm.

There are two major constraints therefore for building off-farm income from these investments. The first is the large amount of after-tax profit that needs to be accumulated. The second is that with yields of 3.4 and 3.7% the farm must hold enough equity and be profitable enough use equity for the purchase or provide profits to help service and debts used to acquire these assets. This would be aided if debt could be sourced at farm lending rates using farm assets as security.

Investment income is a direct competitor for sources of capital from a farm business. The two most readily available sources of capital are after tax profits and debt, and capital for off-farm investment is at a disadvantage to on-farm investment from both these sources of capital.

The use of farm profits or debt for off-farm investment is at a disadvantage to capital required for on-farm investment because the on-farm investment capital is typically treated favourably as a tax deduction (i.e. instant asset write off schemes or accelerated depreciation schemes).

Where you cannot use farm assets as security the cost of lending is usually higher and the amount available to lend is lower.

Farm Management Deposits

Farm Management Deposits (FMDs) made only 8% of the assets held off-farm in the Holmes Sackett survey (Graph 13). In part this may be because their use is capped to $850,000 per individual but the main reason was that producers felt the return from farm management deposits was not competitive.

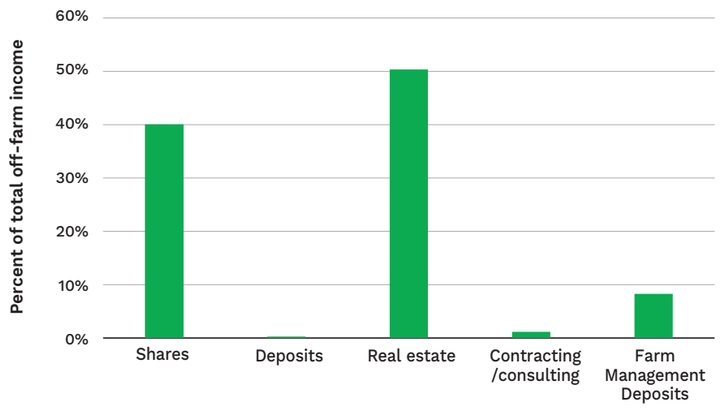
In the Holmes Sackett survey only 10% of producers currently held farm management deposits. In the NFF survey the percentage of farmers that had applied and received farm management deposits in the last five years was 33%.

Farm Management Deposits have a low investment return unless they substantially move the tax bracket for the farm over a short period of time.

Depositing money into FMDs must be weighed against the time over which the likelihood of needing them is going to happen.

For the more profitable farms they will most often be used to manage a marginal tax rate because the return (i.e. a lower tax rate) can be attained more often.

For the less profitable farms, the marginal tax rate is far less of an issue. Surplus cash is less likely to be available and the competing returns from improving farm profitability are higher.



Graph 13. Farm management deposits make up only a small portion of assets held off-farm

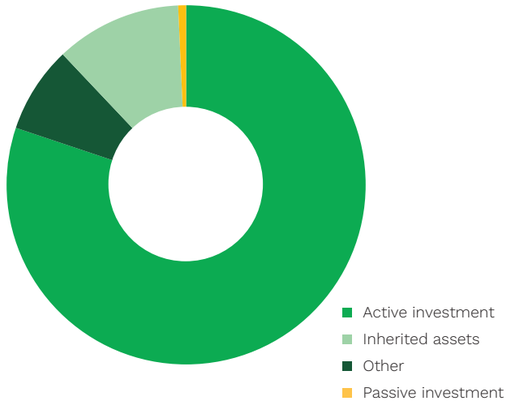
Source: Holmes Sackett Risk Survey

Purpose of off-farm income source

8.

The vast majority of off-farm assets held are a result of an active investment strategy (80%), with a much smaller proportion as a result of an inheritance (8%) or a consequence of a passive investment (i.e. shares granted in the privatisation of a cooperative) (Graph 14).

The vast majority (76%) of responses considered their sources of off-farm income as being uncorrelated to any exceptional circumstances that might pose a risk to the on-farm income. A much smaller number (18%) thought that the off-farm income was correlated to the on-farm income, with a further 6% unsure.

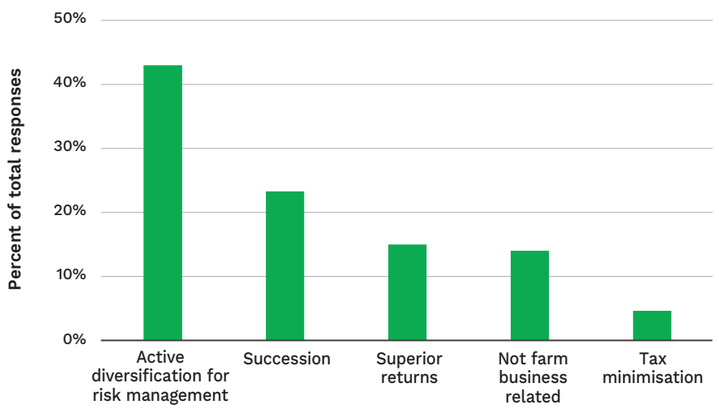


Graph 14. Most investment off-farm is a consequence of an active investment strategy

Source: Holmes Sackett Risk Survey

The results of the Holmes Sackett survey showed the most common reason for having off-farm income is active diversification for risk management (43% of responses), followed by succession planning (23%), superior investment returns (15%), other than farm business related reasons (14%) with tax minimisation nominated least (5%) (Graph 15).

This response clearly shows that farmers do actively seek to diversify their income to help manage financial risks on-farm.



Graph 15. A diversification strategy is the main reason for investing off-farm, followed by a succession strategy

Source: Holmes Sackett Risk Survey

Barriers to building off-farm income as a risk management tool

9.

The primary reason for not investing or devoting more resources to off-farm income is the focus on farm growth and the competing resource needs (primarily capital) to grow the farm business against investment off-farm.

A lack of expertise in other investments was the next most nominated reason, followed by a lack of surplus from the farm to invest. Tax barriers and the isolation of the business were hardly mentioned.

A large (82%) of respondents said they discussed these strategies with their accountants. More than half of the respondents (58%) said existing tax legislation was not helping them build off-farm income.

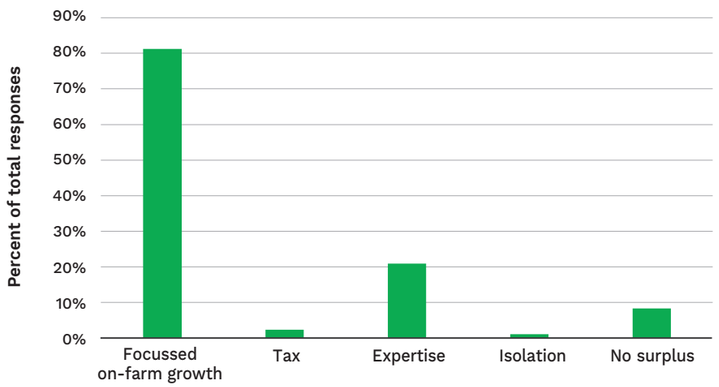
Where respondents said yes, existing tax legislation was helping them build off-farm income, it was predominantly because of using Farm Management Deposits, however the level of use of these is very limited because of the low returns.

There were a few examples however of superannuation being useful where parents in the business were old enough to draw down on superannuation in tougher years. There were also a few who mentioned negative gearing as being useful in acquiring real estate assets.

Where farmer have said that tax legislation is not helping, the overwhelming reason has been that tax legislation largely favours on-farm investment.

A substantial number of farms mentioned that Farm Management Deposits were not useful because either they had low return, were difficult to use in their business structure, or their farm profits were consistently too high to get significant benefit from Farm Management Deposits.

There were only six respondents that listed tax legislation causing difficulty for off-farm investment, three of which identified the difference in tax that would be paid before money could be invested, two mentioned ownership structure of the business causing difficulty with FMDs and one mentioned a specific piece of tax legislation.



Graph 16. A focus on farm business growth is overwhelmingly the reason why producers are not investing more in off-farm income

Source: Holmes Sackett Risk Survey

Making access to debt easier for off-farm investment

10.

The cheapest and most available source of capital in a farm business for investment is debt. The ability to borrow and then service debt is ever increasing due to increasing nominal profits and land values.

This is shown in the average benchmarked EBILT per hectare and land value per hectare from the Holmes Sackett benchmarking database from 1998 to 2020 (Graph 17).

Even without taking into consideration the risk management benefits of a diversified income stream, borrowing only to buy more agricultural land is recognised as not always being the best use of the balance sheet capacity at a given point in time, even for businesses that are intending to expand. This might be because land purchases are often large and therefore can take a business from a comfortable position to an uncomfortable one in terms of serving loans. It may also be because land prices often rise quickly and overshoot the value relative to the potential EBILT.

From a farm income risk management perspective removing barriers to lending for the purpose of asset diversification would be beneficial.

Some survey respondents mentioned that having invested in off-farm assets instead of farm land they found that they did not have access to as much debt for a subsequent expansion of the farm because they could not borrow as much money against those off-farm assets to buy more land. This was a deterrent to further investment off-farm whilst farm expansion was a key business objective.

An example is a business that had purchased a share portfolio over time with profits made from the farm business. This decision was made as a better alternative to building strength back into the business balance sheet than paying down debt. The strategy suits a low interest rate environment.

Subsequently, when trying to borrow to expand the farm business the shares could not be used as security for a loan to acquire the new property. A margin loan could not be taken out against the shares for any other purpose than to buy more shares. The business is therefore restricted in its borrowing capacity and therefore there is a deterrent to continuing to build off-farm assets in the form of a share portfolio.

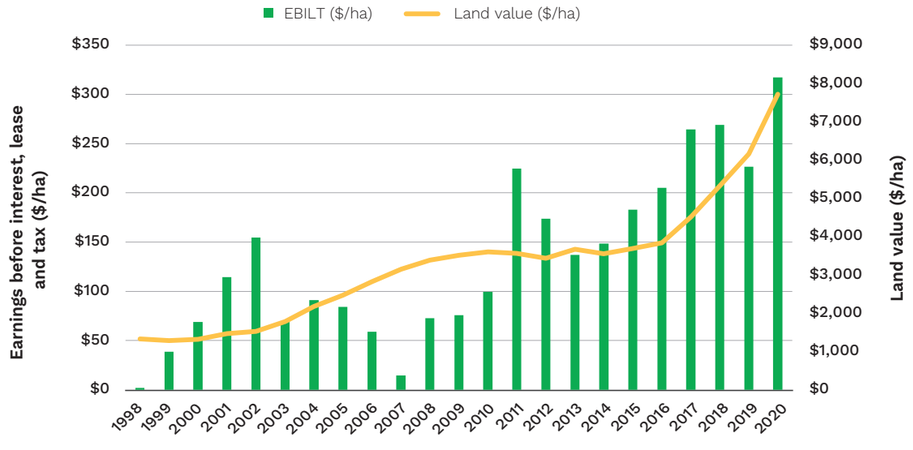
Other survey respondents had encountered difficulty borrowing to acquire off-farm assets using their farm assets as security.

Difficulties in borrowing for off-farm investment are often cited as being related to the need to establish the ‘purpose of the loan’ and then the subsequent lending rules that loan would fall under. As an example, for non-corporate entities, borrowing to buy residential property (even as an investment) triggers the Nation Credit Code (NCC) legislation so the loan becomes a regulated NCC loan and the borrower is assumed not to be a sophisticated investor.

There are additional requirements for lending around borrowing for ‘personal’ purposes (i.e. a residential loan) as opposed to borrowing for business purposes with regard to the assessment of the loan, and the accountability and therefore cost to the bank of lending money. This also deters lenders from wanting to undertake loans of this nature.

Increased access to debt for off-farm investment and less restrictions around using off-farm assets as security for debt for farm business purposes would facilitate more off-farm investment.

Farm income risk management is not a recognised ‘purpose’ to borrow money and invest in off-farm assets which makes lending for this purpose more difficult. A review of how the purpose of a loan is determined may help facilitate lending for this purpose.



Graph 17. EBILT and land values increase in nominal terms over time

Source: Holmes Sackett Pty Ltd

Tax laws directly impacting off-farm income

11.

Effectiveness of FMDs

Farm Management Deposits must be created in individual names and most often this is a different legal entity to the entity that holds the debt in a farm business (partnerships, trusts and companies).

The NFF national survey showed 64% of respondents had not applied for a farm management deposit and a further 2% had applied but not been able to get them. Of those who had used Farm Management Deposits a further 26% were either not satisfied or only somewhat satisfied with them.

The major issue with farm management deposits is that they attract low returns whilst deposited. For more profitable farmers for which tax losses are less frequent, having large sums of money deposited at low interest rates for long periods of time is not attractive.

Legislation permits banks to use FMD as offsets against term debt however doing so is complicated by tax law and prudential management by the bank. Under the tax act there are restrictions in using a deposit in one legal entity to reduce the interest payable in a different legal entity.

From a prudential management perspective the FMD is treated as a deposit (rather than a loan repayment) incurring costs to the bank for liquidity provisions associated withholding deposits, but not reducing costs associated with holding capital required for the loan (because the loan amount has not been reduced).

Farm Management Deposits are useful for managing the tax brackets of farmers, however fixed caps are not appropriate. It would be more appropriate to make the maximum contribution relative to the size of the business.

Tax treatment of carbon or environmental offset 'credits'

At present the Australian Taxation Office treats the creation of a carbon or environmental offset credit as a capital item. When that credit is created and sold it is taxed as income and because that income was created from a purchase (creation) and sale that occurred within a 12-month period there are no concessions available on that income.

This could be a major disincentive to farmers pursuing these sources of income. At present there is no opportunity for grandfathering that capital item (i.e. the carbon or environmental offset, available was created or came with the farm that was purchased 55 years ago).

Tax treatment of off-farm income

There is some potential to perhaps make seeking off-farm income more flexible if establishing that it was contract income was easier. In time where cashflow is short this would enable a work to be undertaken as if by contract without having to reduce the amount brought home by the PAYG amount. The full cash benefit would be received when it is needed rather than the refundable tax amount coming in a year later when tax returns are complete and it is offset with losses that were incurred on the farm a year ago.

Options that could encourage off-farm income or better risk management

12.

Producers overwhelmingly stated that the reason they invested off-farm was for diversification of income, a risk management strategy.

The risk management benefits of off-farm income are widely understood but producers also overwhelmingly stated that investing or reinvesting in the growth of the farming business was the main reason not to invest off-farm.

The majority (82%) said that they relied on professional (accountants) for advice but very few (15%) thought they could achieve better returns off-farm.

The recommendations in this report take into consideration that reinvestment on-farm to make the business more profitable, or increase scale, is itself a risk management option.

If off-farm income is to be further incentivised as a farm risk management tool, the off-farm income, and all of the labour, plant and equipment, and capital required to get off-farm income, needs to be taxed and financed under the same legislation as any other farm operation or investment.

The issues uncovered in the survey that are addressed by the recommendations in this report address are:

- Tax legislation does a very good job at incentivising on-farm investment, but this same legislation means off-farm investment is at a disadvantage.
- The returns from debt reduction (another risk management tool that allows producers to manage volatility better) do not compete against the tax incentives for farm reinvestment and therefore producers may invest in low return farm improvements which due to permanent or temporary tax legislation look appealing against debt reduction.
- Even though off-farm income generation is a real and widely recognised risk management tool for farming businesses it is not treated as a farm related activity when it comes to taxing salaries earned off-farm or using farm assets as collateral for investing off-farm.

The recommendations in this report include changes that address the issues raised. They include:

- Some temporary tax-deductible debt reduction to compete with tax effective reinvestment of profits on-farm.
- Having the rules around access to debt the same for on-farm investment as they are for off-farm investment.
- Allowing producers to seek out casual work without having to pay PAYG tax on casual wages earned.

Incentivising provisions through debt reduction

Current temporary tax measures or permanent tax legislation (i.e. $150,000 instant asset write offs) favour on-farm investment. If this investment is done well, and improves profitability, then it helps farms manage financial risk.

Debt reduction as a risk management tool becomes a collateral casualty of these policies as it must be done with after tax dollars. Particularly in the current environment of low interest rates (2-4%) the return on investment from debt reduction struggles against even poor asset purchase decisions.

$100,000 pre-tax multiplied (1-30%) = $70,000 of debt reduction after tax.

$70,000 of debt reduction saves 3% interest = $2100 per annum return. This is low but it is still better than money held on deposit in Farm Management Deposits (likely to be about 1.5% per annum) and with tax relief it would be even better again.

Return on pre-tax dollars invested in debt reduction is 2.1% at current interest rates. Even without tax relief the return on investment from paying down debt is low.

$100,000 invested in something that attracts the instant asset write off appeals even if it has low expected return today. Losing 30% (or whatever the highest marginal tax rate is) of the capital value up front for a low return is not attractive.

However, most farmers recognise the risks around debt and the possibility that in the future interest rates will return to levels where debt reduction is far more attractive. Levelling the playing field with on-farm investment would help take profits that might otherwise go into low return investments that do not significantly help manage financial risks, and put it into an area that would definitely lower financial risk.

Proposed solution

The proposed mechanism by which this might work is to allow a capped amount of debt to be repaid under a redraw facility as a tax-deductible expense.

The cap should be based on a percentage of the security held by the bank for that loan rather than an annual amount and rather than a limit per individual which cannot account for variation in scale.

The amount deposited cannot be used to pay out a debt totally so that the final repayment on a debt must be done with after tax profits.

It must be in a redraw facility which means it is available to be redrawn under exceptional circumstances where the business requires it. It is treated as income when it is redrawn. When it is withdrawn would not need to be regulated as it would be classified as income in the year it is withdrawn.

The infrastructure for reporting this to the ATO could be piggy backed on the Annual Investment Income Report (AIIR) which banks currently send to the ATO to report on Farm Management Deposits.

In return for a meaningful cap in such a scheme, farmers entering this arrangement could/would waive the right for exceptional circumstances funding.

A meaningful cap would be somewhere in the order of 5% of the assets held as collateral on the loan, which at the upper limits on loan to value ratios would translate to 7-8% of the value of a loan.

Some thought needs to be put into whether a cap should also be put on based on a % of the total value of the loan. Doing so would favour those who have low equity over those who have high equity so consideration would need to be given as to whether that was a desirable target.

Incentivising casual work off-farm

Further incentive for smaller scale farmers or farmers that find themselves with excess labour capacity during exceptional circumstances could be provided by waiving the need for the employer to pay PAYG withholding tax on wages paid.

Under current tax legislation a farmer at a time of exceptional circumstances who undertakes casual work would have PAYG withholding tax taken from their wage, when in all likelihood their tax position for the year inclusive of losses on-farm would be low and they will get that tax returned after the end of the financial year when their tax returns are lodged.

Proposed solution

A tax system change that allowed casual work for primary producers with an ABN to have the full casual wage paid into their account at the time it is earnt with their PAYG commitments worked out concurrently with the subsequent reporting of their annual tax returns for the farm business.

Making access to debt easier for off-farm investment

Farm income risk management is not a recognised ‘purpose’ to borrow money and invest in off-farm assets which makes lending for this purpose more difficult. A review of how the purpose of a loan is determined may help facilitate lending for this purpose.

Proposed solution

Increased access to debt for off-farm investment and less restrictions around using off-farm assets as security for debt for farm business purposes would facilitate more off-farm investment. and a review of how the purpose of a loan is determined may help facilitate lending for this purpose.

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