Taxation

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TAXATION AND THE PRIMARY PRODUCER

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IN THIS AGE of specialization many primary producers engage tax agents or accountants to prepare the annual tax return. This is no doubt to the advantage of both primary producers and accountants, however it has led to a general lack of understanding of taxation by the man on the land.

Income tax is of particular interest to the primary producer since there are a number of concessions applying to agricultural investment. If kept in perspective, these concessions can be employed to advantage. All too often, however, they are over-emphasized and investments are undertaken without a proper assessment having been made.

Concessions

The investment allowance: The investment allowance is a direct subsidy applicable to certain types of investment. Its value can be measured in terms of reduced tax. The investment allowance takes the form of a deduction from taxable income of an amount equal to 20 per cent of the purchase price of the asset.

Unlike depreciation deductions, which must be balanced up for tax when an asset is sold, the investment allowance cannot be brought back to account as income when an asset is sold.

Special depreciation: The special depreciation provisions confer their benefits by providing for a more rapid write-off of certain investments. For instance a tractor might depreciate over 10 years, but be written off over 5. The upshot of this is that depreciation costs are deducted before they occur, and tax rebates are realized before they would normally have been due.

Tax rebates, like any other funds, can be gainfully invested today to increase in value over time. This implies that the sooner we receive our tax refund the more it is really worth to us.

All depreciation deductions, special or otherwise, must be balanced up if an asset is sold. Hence if a $5,000 tractor has for tax purposes been written down to $1,000, and is sold for $2,200, then the "profit" of $1,200 must go in as income. Over the life of an asset, net deductions for depreciation will be no more and no less than the real cost of depreciation.

Capital expenditure: Some capital items such as livestock, machinery, and buildings lose value or depreciate with age. It is normal accounting practice to charge this depreciation as a cost against the business when calculating net income.

Other capital investments, such as improvements to land, can be expected not to

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depreciate. Hence no allowance is made for their cost when calculating income. As an incentive for land development however, Australian tax authorities have decreed that certain of these investments will be deductible in full in the year of expenditure.

The significance of this provision is that productivity increases by land improvement are made more attractive relative to productivity increases by increase in area. Alternatively, encouragement is given to purchasing unimproved land for development as an alternative to purchasing fully improved land.

Generally, capital gains realized on the sale of a property are tax free. However the costs of the improvements which contribute to that capital gain are deductible in full in the year they were incurred. Hence the investor can convert a deductible expense (property improvement) to a non-taxable return (capital gain).

Rates of taxation

In Australia, as in most other countries, the rate of taxation increases as the taxable income of the individual increases. This can be seen in the table.

It should be clear that the rates within each range—for instance 55.0 cents in the dollar for income between $10,000 and $12,000—do not refer to the whole income. They are applied only to that portion of the income lying within the specified range. Thus on a taxable income of $10,950, the rate of 55 cents in the dollar applies only to the last $950. The balance is taxed at the rates applying to a series of ranges starting with $200 to $300 and finishing $8,800–$10,000.

It is a common misconception that the increases in tax rates are such that at some point tax can take all of any addition to income. A quick look at the table will show this to be a fallacy. The highest rate of taxation on extra or "marginal" income is 66.7 cents in the dollar (or 68.3c in the $ after adding the 2½ per cent levy). Hence at very worst a taxpayer will keep one third of the profit from any new or additional undertaking.

INCOME TAX RATES—INDIVIDUALS

TOTAL TAXABLE INCOME. TAX AT GENERAL RATES ON TOTAL TAXABLE INCOME

Not less than— $	Not more than— $	$			$
nil	200	nil	+	0·4 cents for each $	
200	300	0.80	+	1·2 cents for each $ in excess of	200
300	400	2.00	+	2·9 cents for each $ in excess of	300
400	500	4.90	+	4·5 cents for each $ in excess of	400
500	600	9.40	+	6·1 cents for each $ in excess of	500
600	800	15.50	+	8·2 cents for each $ in excess of	600
800	1,000	31.90	+	10·8 cents for each $ in excess of	800
1,000	1,200	53.50	+	12·5 cents for each $ in excess of	1,000
1,200	1,400	78.50	+	14·2 cents for each $ in excess of	1,200
1,400	1,600	106.90	+	15·9 cents for each $ in excess of	1,400
1,600	1,800	138.70	+	17·6 cents for each $ in excess of	1,600
1,800	2,000	173.90	+	19·3 cents for each $ in excess of	1,800
2,000	2,400	212.50	+	21·6 cents for each $ in excess of	2,000
2,400	2,800	298.90	+	24·6 cents for each $ in excess of	2,400
2,800	3,200	397.30	+	27·1 cents for each $ in excess of	2,800
3,200	3,600	505.70	+	29·6 cents for each $ in excess of	3,200
3,600	4,000	624.10	+	32·1 cents for each $ in excess of	3,600
4,000	4,800	752.50	+	35·4 cents for each $ in excess of	4,000
4,800	5,600	1,035.70	+	38·3 cents for each $ in excess of	4,800
5,600	6,400	1,342.10	+	41·2 cents for each $ in excess of	5,600
6,400	7,200	1,671,70	+	43·8 cents for each $ in excess of	6,400
7,200	8,000	2,022.10	+	46·3 cents for each $ in excess of	7,200
8,000	8,800	2,392.50	+	48·7 cents for each $ in excess of	8,000
8,800	10,000	2,782.10	+	51·7 cents for each $ in excess of	8,800
10,000	12,000	3,402.50	+	55·0 cents for each $ in excess of	10,000
12,000	16,000	4,502.50	+	57·9 cents for each $ in excess of	12,000
16,000	20,000	6,818.50	+	60·4 cents for each $ in excess of	16,000
20,000	32,000	9,234.50	+	63·3 cents for each $ in excess of	20,000
32,000	....	16,830.50	+	66·7 cents for each $ in excess of	32,000

When considering an investment, a taxpayer should think in terms of the rates of tax applying to the higher end of his taxable income, since this is the area that will be affected by extra incomes or increased costs.

Averaging incomes for taxation

A primary producer is entitled to have his income averaged, subject to certain limits, before his tax liability is determined. Where averaging applies, a farmer or grazier is taxed on his taxable income at the rate of tax applicable to the average of his taxable incomes of the previous 4 years and the current year.

It should be noted that averaging is used to determine the *rate of tax*, which is then applied to the actual taxable income.

Averaging causes the relationship between rate of tax and taxable income to be less direct.

Under averaging, the *primary effect* of a deduction appears as reduced average income (hence lower rate of tax), which acts upon reduced taxable income. The *secondary effect* works through reduced averages over the following 4 years—that is, reduced rates of tax. These reduced averages occur simply because one lowered taxable income is included in their calculation.

In situations where taxable incomes are fairly constant over time, the effects of a tax deduction will be much the same whether the taxpayer is averaging or not—except of course for the timing of those effects.

Provisional tax

Provisional tax is an extension of the "pay-as-you-earn" principle to those who have income of a form other than a regular salary or wage. It is a means whereby people who have income other than wages and salary (which are subject to regular taxation deductions) are required to pay tax in respect of this year's income more or less at the time they earn it.

The primary producer does not pay his taxation until 9 months after the financial year for which it is due, and the provisional tax he pays is for the taxable income of a year already three-quarters gone. For example, on March, 31, 1969, tax due on taxable income for 1967-8 was payable, as was provisional tax for 1968-9.

The amount of provisional tax paid is based on the assumption that the income of the year in question will be the same as the income of the previous year. The amount of provisional tax can be varied if the taxpayer adopts "self-assessment" in any one year and states what he expects next year's taxable income to be. Self-assessment is not as difficult as it might at first appear, since the income which is to be estimated is that income for the year ending 3 months hence.

The tax bill for any year has three components:

(i) Credit for provisional tax paid in respect of that year;

(ii) tax payable on that year's taxable income; and

(iii) the assessment of provisional tax payable in respect of the following year's taxable income.

Note that *tax payable* is just *one component* of the tax bill. The provisional tax components, debit and credit, serve mainly to shift the commitment from one year to another.

When taxable income increases sharply from one year to the next, the *apparent* increase in tax can be substantial. This is a result of the doubling up of tax, owing to provisional tax being insufficiently offset, or not offset at all, by past credits.

If the amount of provisional tax paid during the previous year was small or nil, then it is possible for the *tax bill* to exceed taxable income. This situation can only apply where the average rate of tax exceeds 50 per cent. This surely is where the "tax takes all" myth originated.

Investment evaluation with tax considered

The aim of any investment is, or at least should be, at increasing net income after tax. This usually means an increase in both net income and tax paid. Many attempts to reduce tax by reducing taxable income are self defeating, since they reduce income after tax also.

The post-tax result of an investment can be defined as the increase in net farm income less the increase in tax.

Net farm income—which is a measure of business success—is not the same as taxable income. Taxable income differs from net farm income in three important respects: It uses depreciation rates unrelated to the longevity of investments; it includes deductions of a "concessional" nature such as investment allowances, and personal deductions; and it includes deductions for capital items such as property improvements, which for tax purposes are written off in 1 year.

Hence the changes to taxable income caused by an investment will not necessarily correspond with changes in net farm income. In particular this occurs because an investment is claimed over 1 or 5 years* and sometimes it has an investment allowance attached to it as well. The initial result will be a lowering of taxable income and tax paid. Later, when the investment has been written off, but whilst returns from it are still accruing, taxable income and tax paid will be higher. Overall post-tax result can be determined by comparing net incomes and taxes paid over the life of the investment.

When considering taxation as a factor in the investment decision, remember that while costs are deductible, returns are also taxable.† Thus, an expenditure which lowers taxable income will usually reduce post-tax income, also. In this context much machinery purchase is suspect.

Taxation, because it takes only a portion of any income increase, generally can do no more than make a profitable investment less profitable and an unprofitable one less costly. Possible exceptions are expenditure for capital gain and expenditure on items subject to the investment allowance. In the latter case, machinery investment can be made marginally more attractive. For tax savings resulting from the investment allowance to be a significant factor in the decision to replace machinery, taxable income needs to be fairly high.

For an investment to be worthwhile, the post-tax return on the funds employed must be greater than from alternative uses.

General and conclusion

Income tax is levied so as to draw off a proportion of taxable income, this proportion increasing as the size of the income increases. At no time does the rate of tax on additional income exceed 68.3 cents in the dollar (for individuals). There are certainly no circumstances in which tax levied on an income exceeds over any range that income itself, although the workings of provisional tax sometimes give this impression.

Hence the effect of income tax as it relates to agricultural investments is generally to make profitable investments somewhat less profitable, and unprofitable investments somewhat less costly. A possible exception is investment for capital gains where "tax savings" make the investment cheaper in relation to its non-taxable earnings (capital gains). Another possible exception, though usually of doubtful effect, is an investment which gives rise to a deduction for "investment allowance".

As a rule, unless taxable income is very high, tax effects arising either out of special depreciation or the investment allowance will have little or no effect on the optimum time at which machinery should be replaced.

The sooner primary producers get away from old ideas about saving tax the better. All too often tax minimization means only one thing—income minimization. Surely a more valid approach would be to maximize what income is left after tax. This means looking very critically at any investments which are being justified on the grounds that they "will save tax".

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* Certain capital (development) items can be written off in 1 year, while other expenditures (for example, on machinery) are written off over 5 years.

† This ignores for the moment those investments where the prospect of a capital gain is an important consideration. Capital gains are usually not taxed.

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