What Your Tax Return Tells You

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HOW MUCH DOES YOUR TAX RETURN TELL YOU ABOUT YOUR BUSINESS?

One of the few legal obligations on a farm business is to have an annual tax return completed, so by default, tax returns remain the number one financial record of a farm business. However, as few farmers know how to read and use them, they are one of the most under-utilised resources in a farming business. Are you getting the most out of your tax return?

Key Points

- If you do nothing else with your finances, at least understand what your tax return is telling you!
- Know what your tax return is not telling you!
- If you want a better business, move your financial understanding beyond your tax return.

Your tax return shows only part of the financial picture of your farm business

THE ANNUAL TAX RETURN

An annual tax return is required by law to be undertaken on each Australian business entity. For some farm businesses this means numerous tax returns as they can have a partnership and a number of trusts, each requiring a tax return.

Prior to the advent of the Goods and Services Tax (GST) in 2000, many farmer used to take their 'shoe box' full of receipts to the accountant annually for the tax return to be completed. With having to submit the Business Activity Statement (BAS) at least quarterly, farm business finances and record keeping improved. The big challenge for farmers is to spend about 20% more time and develop a sound set of farm business management budgets from the financial recording that is already being completed for the tax return(s). The benefit of a tax return is that it is a legal requirement and so these records have to be completed. It sets up a sound financial recording discipline in a business. The main problems with tax returns is that they are completed using the Australian Taxation Office (ATO) guidelines and rules, and so do not provide a very good set of accounts needed to more effectively manage the business. Tax returns are only undertaken to assess tax liability, not vital business information like management profit, business equity and business efficiency.

With a little extra targeted effort, the information collected for tax returns can be turned into a complete set of farm management budgets, which provide the fundamental measure of farm performance and sustainability.

However, as we have tax returns completed, we might as well understand what they are telling us about the business.

Now with the option to utilise cloud accounting technology such as Xero, there is no excuse not to have up to date financial information.

Table 1: Information from a tax return

	Profit & Loss	Balance Sheet
What your tax return DOES tell you	• The profit and loss in the tax return gives some indication of the true management profits of the business. • If the business is making taxable 'losses', then this is an indication the financial performance in that financial year may not be good! • They can indicate financial trends in the business. For example, if taxable losses have occurred over the last few seasons, then these indicate the business is heading in the wrong direction to maintain financial viability. • Note with dryland farming, the use of a financial year means income of one season is lined up against the costs of the next season. So, tax profits are not representative of the same season.	• The balance sheet in the tax return does show what the total debt is on the 30th June each year. • Again, if total liability is increasing from year to year, it indicates an increased reliance on the bank to maintain the business. • This may also not be a good sign for the business, depending on the reasons why the debt is increasing.
What your tax return DOES NOT tell you	• The profit and loss does not take into account the family drawings on the business, because these are not tax deductable items. • In a financial year where the farming business showed taxable losses, the financial performance could be far worse as family drawings have not been taken into account.	• The balance sheet does not have the most valuable capital item, land, included at the current market value. • So, the business's true net worth is not measured in a tax return's balance sheet. • Net worth is the most valuable benchmark that needs to be accurately measured each year in a farming business, to see if real progress is being made.

WHAT IS YOUR LEVEL OF BUSINESS UNDERSTANDING?

There is a chronic need for farmers to understand the financial performance of their business. There is a great saying, 'If you can't measure it, you can't manage it!' So, if you're not measuring business performance, how do you know how well you are doing?

WHAT INFORMATION IS IN A TAX RETURN?

Simply, a tax return essentially tells you what tax, if any, has to be paid to the ATO. Also, importantly, banks put reliance on tax returns because they are legal documents, and are expected to be accurate.

The other two most useful pieces of information are the profit and loss statement, and the balance sheet. However, as these are not fully reported in a tax return, they should not be relied upon as the sole measure of business viability or performance. Table 1 highlights what your tax return does and does not tell you about profit and loss, and balance sheet.

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FAQs

WHAT IS THE BENEFIT OF USING FARM MANAGEMENT BUDGETS OVER TAX RETURN INFORMATION?

To help manage a farming business, you should have information that tells you the relative profitability of each enterprise on the farm, the efficiency of the whole farming business, the state of the cash flow and balance sheet of the farm, and an understanding of profitability, so you can assess how well risks are being managed. A sound set of farm management budgets will give you this information. A tax return at best can only provide an approximation of business profitability, and that's all.

So to clearly steer your business to continual success and sustainability, it would be better to see all the instruments clearly on the 'business dashboard'. This is what a sound set of farm management budgets will give you. Relying solely on tax return information is like steering your business with a 'fog affected' windscreen with little idea of what is on the dashboard!

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TAX MINIMISATION

Tax minimization is an important part of any farm enterprises yearly planning. As the late Kerry Packer said at a government tax inquiry some years ago " If anybody in this country doesn't minimise their tax, they want their heads read because, as a government, I can tell you you're not spending it that well that we should be donating extra". Nothing has changed in recent years to compel us to donate extra tax. However it is important not to spend money for the sake of saving tax. The value of a tax deduction will depend on your average tax rate. For example say your average tax rate is 12%. This means for every $100 of tax deductions you will save $12 in tax and the net cost to cash flow will be $88. Spending money just to save tax doesn't stack up. Sometimes it may be better to pay the $12 tax and keep $88 in cash flow for working capital, reduce debt or invest.

Another consideration or aim is to maintain a low average tax rate. Your average tax rate is calculated by taking the current year plus the last four years taxable income and dividing by 5 to arrive at an average taxable income. The amount of tax is then calculated on this average taxable income to arrive at an average rate. Having consecutive good years can increase the average rate that will have an impact on the amount of tax in future years. Part of your tax planning strategy should include keeping the average rate under control.

WHY DO I HAVE SO MANY LEGAL ENTITIES TO RUN MY FARMING BUSINESS?

Some farming businesses have a number of legal entities such as partnerships, family trusts and maybe a company to run the business. These multiple business structures to assist with tax minimization, family succession to protect the farm assets.

WHAT DOES THE TAX RETURN TELL ME ABOUT THE FUTURE?

By definition, a tax return is an historic record of what has happened in that particular financial year. So, it is directly influenced by the season and the commodity prices experienced in that financial year. As a financial tool to help predict the future it is restricted, and depends on how well it models the seasonal and commodity prices outcome for the coming seasons. For predicting possible outcomes, it is far better to use a good set of farm management budgets with conservative expected yields and commodity prices. You could also go one step further and model both a poor and good season, which will give the range of possible results and help judge the financial risks to the business. Information on these management budgets is available through other fact sheets in this series.

A tax return gives a 'rear view' or historic view of your business. To plan for the future of your business, you need to develop good management budgets.

M STEPS

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WHAT DOES BEING FINANCIALLY SECURE MEAN?

It means assessing your personal and business goals and developing a plan to achieve them.

1. **Goals & objectives**
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3. **Risk plan**
4. **Asset protection plan**
5. **Taxation plan**
6. **Debt plan**
7. **Retirement plan**
8. **Business plan**
9. **Superannuation plan**
10. **Investment plan**

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