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Cash Flow and Tax Planning

Defining Farm Income?

There are many definitions of income for a farm operation and they're all important to a successful farm.

- Taxable income is the amount that is recognized on a cash basis tax return, but it rarely is an accurate reflection of the earnings of the business.
- Cash flow is often used to show the business's ability to meet all of its obligations, but it can be manipulated easily by selling additional grain or delaying expenses to make a 12 month cash flow look good.
- Accrual Basis Net Farm income is the best measurement of farm profitability, but can often show a farm making money and still show a negative cash flow.

Each of these measures of income do work together. If an operation has a high accrual income, but tries to keep their taxable income low, their cash flow will likely not look good. If an operation shows a trend of negative accrual income, there is only a short time until the cash flow and taxable income burn through carryover inventories and also become negative. It seems like the concept that accrual income is very different than cash flow or cash basis taxable income is easy to grasp, but it's often hard to correlate the differences between the latter two. The reality is cash flow and taxable income are calculated in very different ways. Below is a chart showing just some of the big differences between the two:

<u>Table 1</u>	Cash Flow	Taxable Income
Feeder Livestock Purchase	Cash paid during the calendar year	Cost of the cattle sold during the year, regardless of when purchased.
Hedging Activities	Includes Margin Calls/Withdrawals	Includes a Realized Profit or Loss
Coop Equity	Not Included	Included
Principle Payments/ Capital Purchases	Included	Depreciation Only
Family Living/ Income Tax/ Non-Farm Capital Purchases	Included	Not Included
Retirement Plan Contributions	All are Included	Only Deductible Plans Included

The following chart includes some the averages that NFBI collect from operations all across Nebraska. In 2015, the average farm showed a positive cash flow of **\$463**, but that would loosely equate to income subject to tax of over **\$120,000**. To further the confusion, the average accrual net farm income was **\$29,432**.

Average NE Farm Cash Flow	
Cash Income	\$151,276
Net Cash From Investing	\$-202,139
Net Cash From Financing	\$51,326
Net Cash Flow	\$463
Average Accrual Income	\$29,432

Ave. NE Farm Income Subject to Tax	
Cash Income	\$151,276
Asset Sales	+ \$31,711
Capital Purchases *	- \$97,616
Non-Farm Income	+ \$36,087
Total Income	\$121,458

* Assumes Full write off of all capital purchases

The **Net Cash from Investing** includes the assets sales and capital purchases included in the taxable income calculation, but there are also a few things that are not included in the taxable calculation. That includes the sale of non-farm assets (assuming they too wouldn't be taxable) and the purchase of non-deductible assets such as farmland and non-farm assets.

The **Net Cash from Financing** includes the non-farm income that is included in the taxable income, but also includes net money borrowed, family living withdrawals, income and social security taxes and cash gifts and inheritances.

Page 20 of the 2015 Whole State Average Financial Data book contains more details.

Total Income Subject to Tax	\$121,458
½ SE Tax	\$3,791
Health Insurance	\$10,000
Adjusted Gross Income	\$107,667
Standard Deduction	\$12,600
4 Personal Exemptions	\$16,000
Taxable Income	\$79,067
Income Taxes	\$11,355
SE Tax	\$7,582
Total Taxes	\$18,937

The chart to the left takes this one step further and shows the taxable income of this average operation. In order to calculate taxable income, a few assumptions were made. The first being this was a married couple with 2 kids and the second being that they paid \$10,000 per year for health insurance. With those assumptions, the calculated taxable income is close to the top of the 15% tax bracket for 2015. This would be a strategy that many operations have considered a good, acceptable tax strategy for many years.

So is it a "good tax plan" that puts an operation in a break-even cash flow? Of course the answer is "it depends", but it shows that this average information is very close to representing real operations.

Disconnect Between Cash Flow and Taxable Income

Refer back to Table 1 where the big differences between cash flow and taxable income are listed. Those items that typically resolve themselves within a short period of time such as Feeder Livestock Purchase and the Hedging Activities can be eliminated as significant contributors to the problem. Those that are typically relatively small dollar amounts such as Coop Equity and the non-deductible Retirement Contributions can also be disregarded. That leaves the things that really make a disconnect being:

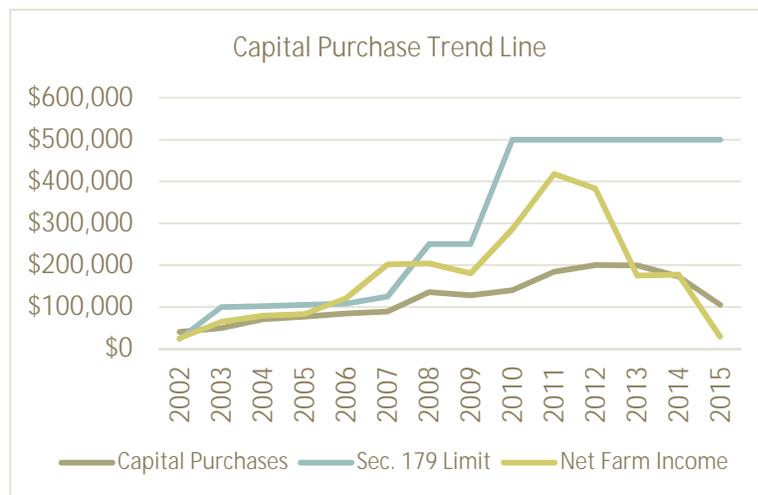
- The difference between the amounts invested in assets (principle payments and cash outlay for capital purchases) and the timing of depreciation
- The amount of cash spent on Family Living, Non-Farm Capital Purchases and Income and Social Security taxes.

Enhanced Depreciation: Friend or Foe

Tax law over the past 15 years has encouraged businesses of all sizes to spend money on capital assets as a way to spur the national economy. While much of the nation was seeing a sluggish economy at best, the agricultural industry (especially the cash grain segment) was seeing a "Super Cycle" with the highest profitably most producers have ever seen. The combination of high profitability and changes in income tax law combined for a perfect storm for many producers looking to improve machinery lines and reduce tax liabilities. The following graph shows the Average Capital Purchases (not including land or non-farm assets) made by the operations

included in the NFBI averages, the Average Accrual Net Farm Income and the limit for Section 179 in each year from 2002 to 2015.

It's hard to know whether it was the tax law or increased income that caused spending to increase but we saw the average amount spent on deductible assets increase from \$40,000 per year to a peak over \$200,000 per year

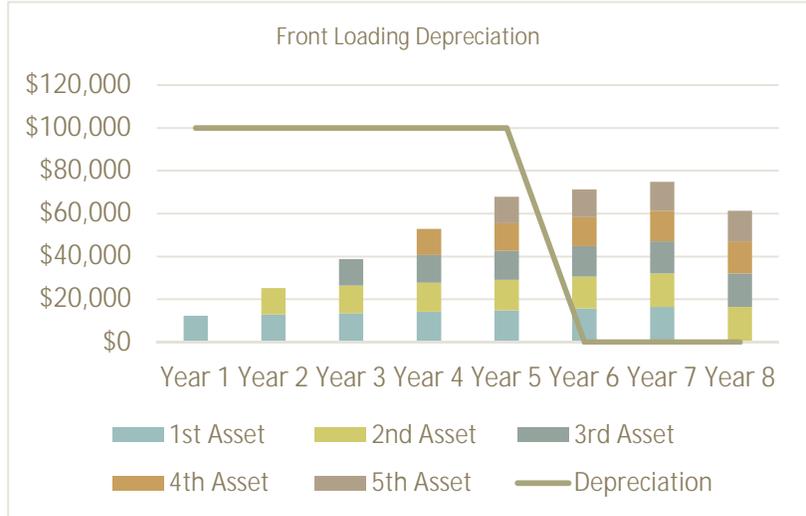


in just 10 years. While we have seen the amount of purchases has dropped off since 2012, the average in 2015 was still over \$100,000 which was three times the 2015 average accrual income of \$29,432. 2015 was also the third year in a row that these purchases were larger than, or essentially equal too, the accrual net farm income. Some of the increase in spending was certainly needed to update the line of equipment that had been "just getting by" for many years but it's hard to find many operations that do not have equipment that exceeds their basic needs for getting the job done. That excessive spending in the name of tax savings doesn't really make financial sense. Spending \$100 to save \$30 means \$70 could have been added to working capital and saved for the future.

A bigger issue that creates the disconnect is using the enhanced depreciation (Section 179 and Bonus Depreciation) and financing the asset purchase. The principle payments on a typical amortized loan and the amount of depreciation on a "regular" schedule actually line up fairly close.

Which means that in any given year of a loan, the principle payment (which is not deductible) and the amount of depreciation deducted on the tax return is relatively close. This prevents a significant disconnect between the amount of cash out of the business on the cash flow and the amount of depreciation being taken on the taxable income. The use of Section 179 and Bonus to take the expense of the capital asset in the year of purchase rather than when the cash is leaving the operation has widely been used in the last 8-10 years.

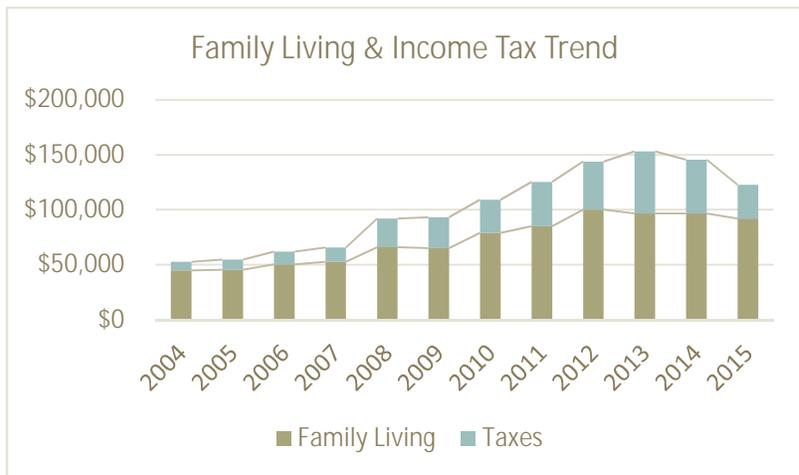
The chart to the right shows a hypothetical example of buying a \$100,000 asset in year 1, taking all the depreciation that year and only having to put cash out for a down payment. Year 2 comes along and another \$100,000 expense would be needed for taxes so another asset is purchased and financed. Again only a small amount of cash is paid for that asset and a second payment is needed on the first year asset.



This has been continuing for several years. Imagine that 2016 is year 6. There is now over \$70,000 in principle payment commitments and no depreciation for tax purposes. The cash flow is going to show a disconnect of taxable income by over \$70,000. While this example is hypothetical, there is a rapid increase in the amount of debt each operation is carrying and this is a real issue many operations will face this year.

Family Living and Taxes

Over the past 10 years, the amount of money spent annually on family living and income taxes has grown dramatically. Prior to 2005, average family living stayed around \$40,000, plus an additional \$10,000 for income taxes. In 2015, family living was \$92,000, with an additional \$30,000 in income taxes. This increase in non-deductible costs has also contributed to a disconnect between cash flow and tax planning. Taxable income must increase as non-deductible costs increase.



To put things into perspective, a salary of \$140,000 per year would be needed to have a take-home check of \$92,000 per year. In addition, nothing is including for principle on a mortgage or contributions to retirement accounts in the \$92,000. Assuming 5% to retirement and a \$1,000 per

month principle payment on a mortgage, the living level of the average farmer would equate to someone making about \$160,000 per year.

There are two separate issues with living expenses at this level.

1. Is there is enough profitability to support this level of spending?
2. Is the operation recognizing enough taxable income to support this level of spending?

If there is not enough profit to support the high level of spending, net worth losses will start to stack up. This is a fundamental management problem. The other issue creates a “Snowball” problem where the deferred tax liability can get out of control, which can lead to a large operating note at the end of the year and large carryover inventories. Consider the following trend:

	2010	2011	2012	2013	2014	2015
Accrual Income	\$50,000	\$75,000	\$100,000	\$150,000	\$75,000	\$15,000
Taxable Income	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000
Family Living	\$40,000	\$45,000	\$50,000	\$55,000	\$60,000	\$65,000
Operating Note	\$5,000	\$15,000	\$30,000	\$50,000	\$75,000	\$105,000
Carryover Inventory	\$15,000	\$55,000	\$120,000	\$235,000	\$275,000	\$255,000

In 2010, there was an accrual income of \$50,000 but only \$35,000 was recognized as taxable income. In order to have cash basis income be \$35,000, \$15,000 of the grain produced in 2010 would not be sold until 2011. The family had already spent \$40,000 on family living so they would need to have an operating note at the end of the year of \$5,000.

In 2011, they have the additional \$15,000 of grain from 2010 and make \$75,000 for a total income of \$90,000. They still only want to recognize \$35,000, so \$55,000 of 2011’s grain is not sold in 2011, but in 2012. This year, their family living needs increased to \$45,000, \$10,000 more than they recognized so they’d need operating proceeds of \$15,000 at the end of the year.

It doesn’t take long to see how this gets to a “snowball” of large proportions. The only way to unwind this is to increase taxable income and/or cut family living costs. Accrual basis losses may start to cut into inventory, but losses will only make the operating note increase at a faster rate.

Working Together

As different as all these approaches are, a good farm manager will work all of them together.

1. A good tax plan needs to take into account the accrual income and cash flow needs of an operation to ensure that a huge snowball isn’t created or it will take a long time to get rid of.
2. A good cash flow plan takes into account the tax consequences of generating that much income and calculates an accrual basis income to know good long term progress is being made.
3. Accrual income shows the true earnings of the business but the timing of recognizing income is sometimes just as important as earning it.