FARM Library

Financial and Risk Management Database

Improving farm management skills one topic at a time

October 2016

Tax Planning in Low Income Years

Producers often feel there is no need to do tax planning in years when there is no profit, but in many ways, it's more important to do tax planning in low income years than it is in high income years. There are many planning strategies that can be used to help save tax dollars over the long term if there is enough time to plan.

For many cash grain operations and even some livestock operations, there is a significant carryover tax liability that has been built during the past 10 years and it is going to take some time to work through. This means that in a low year a producer could prepay less, sell a little more grain, or purchase less equipment. This way cash income will be within the tax planning figures. The growth of the deferred tax liability seems to have happened slowly, but looking at some averages over time, one can see how much has changed.

For example, the following chart shows the average dollars recorded on the December 31st balance sheets for producers included in our average farm data for four current asset categories. In 2002, there was an average of almost $200,000 of crop and livestock assets carried into the year following production. In 2012, that peaked to over $800,000. Coming into 2016, that number has declined, but it is still a long way from the level that was carried prior to the profitability boom of cash grain operations.

There is a similar trend with prepaid expenses. This chart shows that while there is a continued decline in accrual basis income, the cash basis income will not drop off as quickly for most operations. Instead, somethings will need to be done differently than they have been in the past (i.e. prepays, etc.). As a reminder, these are just averages and not all operations fall near the average. A close look the growth of carryover grain and prepaid expenses is important.

	2002	2006	2010	2012	2015
Crop & Feeder Livestock	**$195,969**	**$343,848**	**$611,872**	**$822,786**	**$602,351**
Prepaid Expenses	**$13,683**	**$29,383**	**$61,611**	**$80,132**	**$74,881**
Accounts Receivable	**$5,760**	**$9,378**	**$9,201**	**$56,159**	**$20,769**
Other Current Assets (Non Cash)	**$1,617**	**$3,608**	**$4,028**	**$6,356**	**$5,211**
Total	**$217,029**	**$386,217**	**$578,205**	**$965,433**	**$703,212**

If no inventories have been built, alternative planning strategies need to be looked at.

Nebraska Farm Business, Inc. www.nfbi.net

Avoid Schedule F Losses

It is important that Schedule F losses are avoided if possible. A loss on Schedule F typically means that income could have been recognized free from self-employment taxes. Since the self-employment tax amounts to 15.3%, it is something that should be managed whenever possible. The easiest things to do is sell more grain/livestock or reduce expenses. Sometimes there are management reasons why those shouldn't be done December 31st. Companies may be offering discounts for early prepay or the market is going to have enough volatility that the grain is held until after the first of the year. There are a couple of things to think about before those decisions are made.

Savings Per Bushel Sold

One of the things to look at when the tax plan looks like a time to sell, but the marketing plan says to hold, is the tax savings per bushel. Below are two plans recognizing $50,000 of taxable income:

Option 1

	Year 1	Year 2
Farm Income	-$100,000	$150,000
NOL	$0	$-100,000
Adjustments/ Deductions	$20,300	$28,009
Taxable Income	-$120,300	$20,044
Income Tax Due	$0	$2,085
Self-Employment Tax Due	$0	$18,712
Total Tax Due	$0	$20,797
Two Year Total	$20,797	

Option 2

	Year 1	Year 2
Farm Income	$20,000	$30,000
NOL	$0	$0
Adjustments/ Deductions	$21,713	$22,719
Taxable Income	-$1,713	$7,281
Income Tax Due	$0	$728
Self-Employment Tax Due	$2,826	$4,239
Total Tax Due	$2.,826	$4,967
Two Year Total	$7,793	

As can be seen from the charts above, most of the savings from evening out the income comes from a self-employment tax savings but there are some savings from income taxes. This is due to the use of all the Adjustments/Deductions that are "lost" with a net operating loss (NOL). By evening out the total income of $50,000, over $13,000 in taxes can be saved.

In order to accomplish this, $120,000 of taxable farm income in year 1 needs to be generated. With a cash corn price of $3, that is 40,000 bushels that need to be sold. So the $13,004 tax savings becomes $0.33 per bushel. ($13,004/ 40,000). The market needs to improve by more than 33 cents to make it worth hanging onto the crop. Selling the grain and re-owning it with a marketing plan to take advantage of the tax savings and market potential could be considered.

CCC Loans

Another way to generate taxable income without losing control of the crop is to use commodity loans. More information about these loans can be found at http://www.fsa.usda.gov/programs-and-services/price-support/commodity-loans/.

A commodity loan allows an operator to take a low interest loan for the amount of the loan rate on harvested bushels. These loans can be elected to be treated as income on your tax return. So for the price of some paperwork and patience, income can be brought into a loss year and the operator would still be able to sell the crop when the marketing opportunities arise.

Contract Elections

One other way to generate taxable income is to elect out of an installment sale agreement or what is commonly known as a deferred price contract. A true deferred price contract will be written with the language that the contract is an installment agreement where the producer agrees to receive payment at a later date (often right after the first of the year). The election out of the agreement from a tax standpoint is done by simply recognizing the income in the year the agreement was made instead of when payment is received. This creates some record keeping issues so it's important to keep good track of what is done so that the income isn't taxed.

Avoid NOL

If a negative Schedule F can't be avoided, it is important to try to avoid having a Net Operating Loss (NOL). These are overall losses on the tax return. Sometimes if farm income can't be generated, other non-farm income can be generated and recognized free from income taxes.

Roll Traditional IRA's Into Roth IRA's

Over the past few years of profitability, many producers have used tax deductible IRA's to defer income taxes. If there is going to be an NOL on the tax return, an individual could consider rolling traditional IRA's into a Roth IRA. The transaction would generate taxable income on the tax return, but the earnings would be tax free. If there are farm losses, they can be offset by the income generated from the rollover and no income taxes would be owed on the money rolled into the IRA's.

Liquidate Nonfarm Investments with Profit

In a similar way, if there are nonfarm investments such as mutual funds or stocks owned outside of an IRA that have increased in value, those could be sold and either reinvested in other stocks or right back into the same investments to establish a new basis. The gain would be recognized in the same year as the farm losses, again resulting in no tax on the gain.

Sell Equipment Instead of Trading

One other thought that could save some tax dollars in the long run is to sell equipment outright instead of trading it in on a new piece. A trade results in a like-kind exchange that is a tax deferral strategy. If the old piece of equipment is sold outright, the gain is recognized in the current year as ordinary income subject to income taxes. This would offset farm losses. The purchase of the new asset can be depreciated and will hopefully provide a larger deduction for both income and self-employment taxes in the future when profit returns.

As pointed out in this article, tax planning is just as important in low income years as it is in high income years. All of these strategies are dependent on specific issues related to your operation and tax return. These topics should be discussed with your tax professional before incorporating them into your operation.