AGRICULTURAL ECONOMICS

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Cornhusker Economics

Tax Planning for High Income

Agriculture has always been an industry with cyclical income trends. Prior to 2003, the average farm income reported in our annual data would typically go up and down each year — having a good year and then a bad year and then a good year again. Since then, the trend has been more about longer periods of good, followed by multiple years of down income, etc. These longer stretches also see more extremes and this makes tax planning even more important and more difficult. More important because we are likely not making a decision that only affects one year and more difficult because the extremes make the decisions even bigger. Throw in the fact that Congress keeps changing the rules and there is plenty to talk about!

There are three major ways to deal with high income.

1. Defer Income
2. Prepay Expenses
3. Buy New Assets

While none of these strategies are bad, they should all be used with caution. They all can create a snowball that is difficult to get under control once they get out of hand.

Deferring Income & Prepaying Expenses

Both of these strategies are rooted in the practice of most farmers of filing their income taxes based on a cash basis, which means income is taxable (or expenses are deductible) when they are received (or paid). When income tended to fluctuate year after year, these strategies would allow you to push a high-income year into the following year when income tended to be lower and would even the two years out for tax planning. While we don't need a business purpose to defer income sales to the following year, you do need a business purpose for a prepaid expense to be a qualified expense. This means there should be a reason, other than tax avoidance, for the prepaid expenses, such as qualifying for a discounted price, securing an input with unexpected availability, etc. It is also important that prepaid expenses are purchasing a specific item at a specific price. For example, putting a $9,000 deposit on inputs at the coop is not a qualified prepaid expense. You must have purchased 3,000 gallons of diesel for $3.00 a gallon and you must have a receipt to reflect the purchase. Another rule that is often forgotten is that you can't prepay more than 50% of your normal business expenses. This doesn't mean you can't prepay 100% of your seed bill, but that the total prepaid expenses can't be more than 50% of your normal total Schedule F expenses.

Multi-year stretches of highly profitable years can create a snowball of either prepaying or deferring income to the point that some operations get to where they pay many of next year's inputs and defer all of the crop sales, so they easily get two or more years behind. Each year that you prepay expenses or push income makes the following year more difficult to get to the same taxable income.

Let's look at a quick example. If you have on average $150,000 of income and want to keep your taxable in-

	1st Year	2nd Year	3rd Year	4th Year	5th Year
Accrual Income	$150,000	$150,000	$150,000	$150,000	$150,000
Prior Year Prepaids	$0	+$75,000	+$150,000	$225,000	$300,000
Cash Income		$225,000	$300,000	$375,000	$450,000
Prepays	-$75,000	- $150,000	$225,000	$300,000	$375,000
Taxable Income	$75,000	$75,000	$75,000	$75,000	$75,000

come at $75,000, you must prepay $75,000 the first year. That's usually pretty easy but the second year, you are short the $75,000 of expenses that you pulled into year one, creating a cash basis income ($150,000 that you earned again, plus the prepaid expenses) of $225,000. That means, to get back to $75,000 taxable, you must prepay $150,000. In just five years, you are prepaying $375,000 to stay at your desired income level.

This is a simplified example, but it can show the effects of a snowball. That being said, it's important to remember that prepaying expenses or deferring income are not bad strategies, but they can't be the only strategy in periods of long-term profitability. It is also important to remember in years when profitability is down, that you pull some of those back to have room to use them again in the future.

Capital Purchases

Buying capital purchases to reduce taxable income is a longtime favorite strategy by producers and equipment salesmen! Since the Tax Cuts and Jobs Act of 2017 gave us "permanent" Section 179 at a level of $1 million (indexed for inflation) and extended 100% bonus depreciation through 2022 (scheduled to reduce and go away by 2026), most producers have unlimited depreciation for all their capital purchase needs. This year, the struggle may be the availability of equipment more than how much can be written off. The supply chain struggles are creating a shortage of equipment, which makes it important to review the rules for when you can depreciate an asset. The timing of depreciation is based on the rules governing when an asset is placed in service. In order to be placed in service, an asset must be ready and available for use. This means a pivot that is delivered to the side of the field, but still in a pile, is not placed in service. If the pivot is put together, ready and able to make a turn, it is placed in service, even if you have no intention of using the pivot until next summer. The same applies to a combine. If you order a new combine, it is not placed in service until it is delivered to the farm and ready for use. This means a purchase agreement is not enough to justify the deduction.

The ability to have unlimited depreciation makes using accelerated depreciation an easy choice for controlling income. Similar to prepaying or deferring income, it can also snowball and create problems, especially when these assets are financed. Depreciation is the only expense we get to take for the purchase of assets, since principal payments are not deductible. When the timing of these two expenses gets separated, it can create a tax problem. For example, you can write off a $100,000 tractor purchase in the year the asset was placed in service, giving you a nice tax deduction, even if you finance the purchase. You will have to come up with cash in a later year to make the principal payment and you won't have a deduction. This means your taxable income will have to be higher or you will have to make another purchase (which creates more payments) to lower your income again. We saw a lot of this in years like 2009-2012 and then we had several years with lower income. All those payments inevitability caused some operations to go bankrupt.

Income Averaging

One of the unique tax benefits those in agriculture possess is the ability to use Income Averaging. With the lower tax brackets from 2018-2020, we haven't seen this used as much as prior years. This year it will be an important strategy again. Income averaging allows cash basis taxpayers to carry income back to the three prior years and recalculate the tax in those years. In other words, we get to "pretend" that the income came in those years. This means income that would be pushed into a higher bracket this year could be taxed at the lower brackets you didn't use. The income that you elect to carry back must be carried back evenly. So, if you elect $150,000 of income in 2021, each tax year of 2018, 2019, and 2020 would have $50,000 added to the income reported in those years. This does not affect self-employment taxes. That tax will be calculated on all the income reported in 2021, regardless of any carryback.

Other Income Reducing Strategies

In many farming and ranching operations, the labor of the family members goes unpaid. In periods of high income, you may consider paying wages. You must pay a reasonable wage for the work done. For example, you can't pay a 2-year-old $10,000 per year to help around the farm. However, many children perform considerable work around the operation and can be compensated. This expense reduces your farm income and could be tax-free if their total income is under the standard deduction. This also gives them earned income that they could contribute to a Roth IRA. These funds can be used to pay for college expenses but are not looked at for Federal Financial Aid purposes.

Paying your spouse, who also must contribute to the operation, is another option to consider. While this doesn't create the tax savings that paying your children can, it may mean we can create an employee relationship in which you can provide benefits. The Affordable Care Act has many provisions that limit the flexibility we once had with this strategy, so it's very important to consult a tax professional about your unique situation before implementing any of these plans.

Retirement plans offer a great way to reduce income today. You can use traditional IRAs that have lower limits, or you can consider plans like a SEP plan that allows a significant contribution in high-income years. Either way, you can use them now to avoid high tax brackets and could convert them to Roth IRAs in years of low taxable income. Placing money into a retirement plan locks the money up until you reach age 59½ (unless an exception applies) or you will face a 10% penalty plus tax on the withdrawal.

Contact Your Tax Professional

Remember that paying taxes is not always the evil that we often think it is. Paying taxes should mean that you are making money. That's a better situation to be in than not making money. It is important that you manage your tax bill responsibility so that you are neither creating a nightmare down the road, nor paying more taxes than you need to. The balance of finding ways to have the lowest tax bill over the entire course of your business takes planning and the benefit of a quality tax professional that knows and understands agriculture. Be sure to consult with your tax professional early this year to have time to make the necessary changes before the end of the year is here.

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