Ag in Uncertain Times
Income Tax Planning
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End of Year Tax Management

- **<u>Never</u>** let the tax tail wag the business dog
- The decision must make economic sense
- Some tools work prior to year end
- Some tools work after the tax year has closed

Farm Income Averaging

- Takes advantage of unused lower tax brackets from the 3 previous years.
- Ex: 2015 – $20,000 below beginning of 25% bracket.
  2016 - $25,000 below beginning of 25% bracket.
  2017 - $30,000 below beginning of 25% bracket.

Farm Income Averaging

- Move $60,000 from 2018 and put $20,000 additional income in 2015, 2016, and 2017.
- Income averaging does not reduce self-employment tax, net investment income tax, or phase-out of personal exemptions and itemized deductions

Prepaid Expenses

- Amount paid during the tax year for items that will be used in the following year.
- Must be a payment; not a deposit.
- Must be made for a valid business purpose.
- Must not materially distort income.

Prepaid Expenses

- Deduction is limited to 50% of other deductible non-prepaid expenses.
- Deduction not limited if you are a qualified farm-related taxpayer: (meet 1 of the following 3 rules)
  – main home on farm.
  – principal occupation is farming.
  – a member of the family meets either of the above rules.
- Exception: extraordinary circumstances (flood or drought) caused the prepaid expenses to exceed 50% of non-prepaid farm expenses. (You did not use what you purchased.)

Deferred Payment Contract

- A Deferred Payment Contract requires that the payment will be received in the year after the commodity is sold.
- Requirements:
  - Must be a bona fide arm's-length contract with the buyer.
  - Seller cannot have any right to the commodity after it is delivered.
  - Must avoid constructive receipt so contract must be in place before delivery.

Crop Insurance and Disaster Payments

- Generally report the payment in the year received.
- However can elect to postpone if <u>all</u> 3 of the following conditions are met.
  - Use the cash method of accounting.
  - Receive the insurance proceeds in the same tax year the crops were damaged.
  - Show under normal practices the sale would have occurred in the year after the damage.

Weather-Related Sales of Livestock

- Applies to sales of livestock due to weather-related conditions: flood, drought, or other weather-related condition causing a shortage of water and/or feed.
- Allows taxpayer to postpone recognition of income from the sale proceeds of animals sold in excess of normal practices (to avoid bunching of income).

Two Different Tax Treatments

- Both apply to sales in excess of normal due to weather-related conditions.
- The first applies to sales of any livestock (IRC § 451(e) Deferral of Income from until the following tax year).
- The second applies to sales of livestock (other than poultry) held for draft, breeding, or dairy purposes (IRC § 1033(e) Involuntary Conversion with replacement in mind).

IRC §451(e) Deferral of Income

- Income from the extra animals may be deferred to the next taxable year.

1. Principal business must be farming.
2. Must use the cash method of accounting.
3. Must show that the animals would normally have been sold in the following year.
4. The area has to be declared eligible for Federal assistance.

IRC §1033(e) Involuntary Conversion

- Must plan to purchase replacement livestock within a 2 year period at the end of the drought period. (ex, for sales in 2018, must replace livestock by end of 2021)
- Replacement period can be extended from 2 years to 4 years if the area has been declared eligible for disaster assistance by the Federal government or an agency.

Involuntary Conversion

- Livestock (draft, breeding, or dairy) held for any length of time and a weather-related condition caused the sale.
- Gain realized from the sale can be postponed if the sale proceeds are used to purchase replacement livestock within the time period previously described.
- Replacement animals must be used for the same purpose as those sold. (dairy for dairy and breeding for breeding)

Drought Sales of Livestock

- When does the replacement period expire in a continuing drought situation?
- It does not expire until the end of the first TAX year that ends *after* the first DROUGHT-FREE year for an applicable region (county) taking into consideration the original replacement period (4 years due to Oklahoma's designations).

Drought-Free Year

The first drought-free year for an applicable region is the first 12-month period ending on August 31 that meets both of the following:

- It ends in or after the last year of the taxpayer's 4-year replacement period.
- It does not include any weekly period for which exceptional, extreme, or severe drought is reported for any location in the applicable region.

Applicable Region

- The applicable region is the county that experienced the drought conditions causing the sale or exchange of the livestock and all counties that are contiguous to that county.

Increase Taxable Income

- Sell grain and livestock in 2018 that could be sold in 2019
- Delay paying expenses until 2019
- Collect fees, rents, and accounts in 2018
- Delay payments on repairs until 2019

Note: be sure it makes economic sense!

Decrease Taxable Income

- Make needed repairs
- Pay accrued interest on loans
- Establish a retirement plan and deduct contributions (traditional IRA, SEPIRA, Simple IRA)

Tax Planning and Management

- Year-round every day job.
- Basic tax law knowledge needed.
- When you don't know, ask questions.
- Ask "what if" rather than say 'this is what I did'. (The oops cannot always be fixed.)
- Professional advice may be needed.
- Year-end tax planning is always useful (level taxable income over lifetime).

Questions?

- Thank you for your attention!!

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