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CORNHUSKER ECONOMICS

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<http://agecon.unl.edu/cornhuskereconomics>

University of Nebraska–Lincoln Extension

To Pay Tax or Not to Pay Tax: That Is The Question

Market Report	Yr Ago	4 Wks Ago	9/13/13
<u>Livestock and Products,</u>			
<u>Weekly Average</u>			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.....	\$126.97	\$125.00	\$123.50
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.....	162.91	182.24	181.96
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.....	153.29	158.34	163.54
Choice Boxed Beef, 600-750 lb. Carcass.....	191.50	192.13	193.71
Western Corn Belt Base Hog Price Carcass, Negotiated.....	63.46	96.85	94.95
Pork Carcass Cutout, 185 lb. Carcass, 51-52% Lean.....	78.05	102.85	96.05
Slaughter Lambs, Ch. & Pr., Heavy, Wooled, South Dakota, Direct.....	84.00	117.75	120.00
National Carcass Lamb Cutout, FOB.....	317.08	282.15	273.97
<u>Crops,</u>			
<u>Daily Spot Prices</u>			
Wheat, No. 1, H.W. Imperial, bu.....	8.58	6.76	6.61
Corn, No. 2, Yellow Nebraska City, bu.....	7.67	5.84	4.94
Soybeans, No. 1, Yellow Nebraska City, bu.....	17.09	13.94	14.47
Grain Sorghum, No. 2, Yellow Dorchester, cwt.....	13.07	8.82	7.48
Oats, No. 2, Heavy Minneapolis, MN, bu.....	3.99	4.05	3.37
<u>Feed</u>			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.....	247.50	245.00	*
Alfalfa, Large Rounds, Good Platte Valley, ton.....	212.50	165.00	160.00
Grass Hay, Large Rounds, Good Nebraska, ton.....	185.00	160.00	117.50
Dried Distillers Grains, 10% Moisture, Nebraska Average.....	292.00	215.50	212.50
Wet Distillers Grains, 65-70% Moisture, Nebraska Average.....	103.63	72.50	79.50
*No Market			

That's actually a pretty silly question, right? Who wants to pay taxes? I rarely hear of anyone who thinks they don't already pay enough income tax, although I did hear a story of a woman who sent an extra \$250 in with a note that she'd like to help with the national debt, only to have the Internal Revenue Service (IRS) return it, saying they couldn't process extra money! It's still not surprising they don't include an extra line for "voluntary additional tax" on the Form 1040.

Regardless of whether we want to pay taxes, it's getting to be that time of year when we start thinking about tax planning for farmers. Farming is one of the few industries that really has the ability to choose how much tax they want to pay. Unlike the majority of industries, most farms can choose to use the cash method of accounting. This allows for deferral of grain sales and prepayment of expenses (up to 50 percent of your deductible farm expenses for the year).

With the high profitability of the past four to five years, tax planning has taken on a new challenge in deciding the right amount of tax to pay. In the past, we often saw a circular pattern of a good year - followed by a bad year - followed by a good year. You can see the trend line of net income from 1985 - 2000 in Figure 1 on the next page, showing what we typically saw. This allowed us to find a place below the peaks and above the dips that averaged out the income so we could use the good years to balance out the bad years, keeping cash income even.

The trend over the past few years has really changed what had been the typical strategy. Other than a few minor dips (less than ten percent drops), we have



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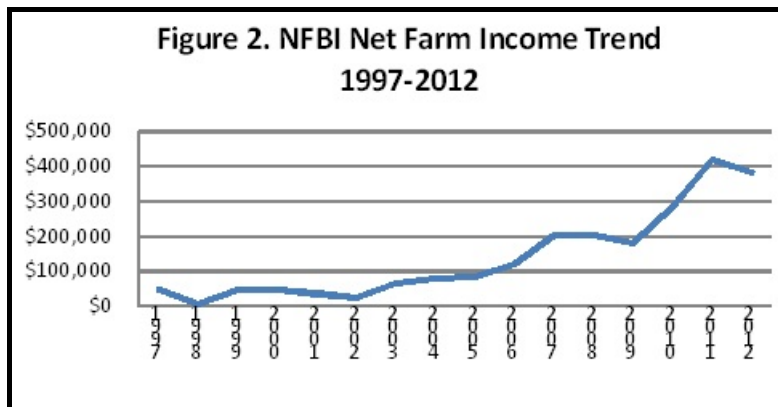
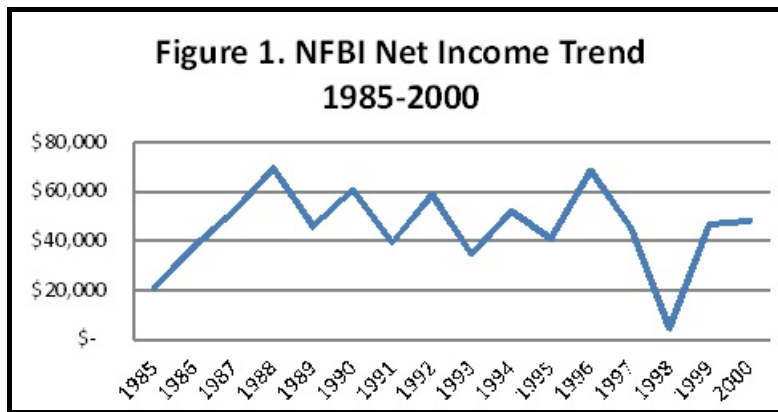
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seen nothing but rising incomes since 2002 (Figure 2). This means that if we are holding taxable income steady at the same point we did in the 1990's, the deferral of income has been increasing in size every year.

Let's look at some numbers to make more sense of this. Assume in the 1990's your accrual income was equal to our average farm income, but you were keeping your taxable income about \$45,000. That would have been close to the long-term average accrual income. Table 1 (at end of article) lists the average accrual income for each year. The taxable income was the assumed amount each year. The annual deferred income is the difference between the accrual income and the taxable amount. Finally, the accumulated deferral is a running total of the annual deferred income.

So, over the course of six years you accumulated a deferral of \$40,674. It's almost a full year's income, but not a number that can't be handled. If you continued with the same strategy through 2012, the deferral would have been magnified. I carried the same table out from 1990 through 2012, but only put a few years here. The gap years actually show three years when the deferral income goes negative, and it may have been hard to generate the \$45,000 of taxable income.

You can see in Table 2 (at end of article) that with the increased accrual basis income and keeping the same tax strategy, your income deferral (through prepaids or grain deferrals) would have grown to over \$1.5 million. That would mean that if you quit farming or even continued to farm, but didn't make any money, it would take 34 additional tax years of recognizing \$45,000 to fully use up the deferred income. When put on paper to look at what would happen, it seems silly, but I think this has been the strategy many producers have continued to take. Even if you started doubling the amount of income you paid



taxes on in 2006, the deferral would still be \$1,231,573 in 2012, and it would take 14 years of no additional income to wipe that out.

So What Does This Mean?

It is getting more and more obvious that the strategies of old don't make sense in today's farm economy. After you have prepaid all you can for next year's crop, deferred all of this year's income to next year, and purchased the annual Section 179 limit for equipment,

there's not much left that you can do to reduce income. What you're left with is paying tax on last year's crop and deducting next year's expenses, or potentially you are two year's off balance paying tax on the crop from two years ago.

So what's the right answer? How much tax should a farm be paying? Besides the deferred tax, what other problems are we creating for the operation?

One strategy for deciding how much tax to pay may be to look at your family living and other non-deductible costs. Why? If you are paying tax at a level below your non-deductible costs, you must be borrowing money to pay for them. This causes increasing debt. You can see the difference in our averages in just ten years. Debt has more than doubled and has risen consistently in every category of debt (Table 3 at end of article).

How Do Debt and Taxes Go Together?

Let's look at some more average data to show how it works. In Table 4 (at end of article) I have compiled an average taxable income from which I have taken non-deductible costs, including: family living, income taxes, term debt payments and cash used to replace equipment each year.

The accrual income earned has covered the costs listed, so the average farm is not in financial trouble. However, by not recognizing enough taxable income

each year to cover these costs, debt must increase. When this happens with grain deferrals or prepaids, the operating note is usually what increases. The only way to reduce debt (measured on 12/31 of each year) is to recognize more income than you are spending in all costs. Even if you are happy paying debt as scheduled, in 2012 the average farm was \$40,000 short of paying the debt with the income recognized on the tax return. If your goal is to get out of debt quicker, you must show a positive in the net cash available. Monitoring your non-deductible costs may be a good strategy for what your taxable income should be. It is also a good tool if your goal is to reduce debt.

Depreciation

The one topic we haven't talked much about is the use of accelerated depreciation. Since 2001, we have had high limits for depreciation with either the Section 179 or Bonus Depreciation, and sometimes both. This has allowed us to significantly reduce taxable income. Only time will tell what Congress will do with further extending or permanently increasing the limits, but if and when the enhanced depreciation does expire, the challenge of keeping taxable income reasonable will become increasingly difficult.

Another place we are seeing increased debt is in the intermediate position. What I think we are seeing is a lot of capital purchases made with borrowed money, but the cost of the equipment is being written off in the year of purchase. This means that payments will need to be made in the future, and there is no remaining depreciation to offset them.

What To Do

So what do you do? Could the farm economy take a turn for the worse and you lose \$300,000 to \$400,000 a year for the next three years? Your deferred income would be gone and your problems would be worse than having a tax problem. You could continue to keep taxable income below your non-deductible costs and continue to borrow more debt at the end of each year, letting the problem deal with itself down the road. The answer may lie in how many more years you plan to be actively farming, and your comfort level with how much debt you have. The closer you are to retirement the harder it will be to undo taking the easy road, and it may end up costing you significantly more in tax than you would have had to pay.

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Table 1.

	1990	1991	1992	1993	1994	1995	1996
Accrual Income	\$60,840	\$39,629	\$58,804	\$34,915	\$51,969	\$40,860	\$68,657
Taxable Income	\$45,000	\$45,000	\$45,000	\$45,000	\$45,000	\$45,000	\$45,000
Annual Deferred Income	\$15,840	\$-5,371	\$13,804	\$-10,085	\$6,969	\$-4,140	\$23,657
Accumulated Deferral	\$15,840	\$10,469	\$24,273	\$14,188	\$21,157	\$17,017	\$40,674

Table 2.

	2005	2006	2007	2008	2009	2010	2011	2012
Accrual Income	\$83,091	\$120,977	\$201,822	\$203,883	\$180,197	\$285,799	\$417,521	\$382,316
Taxable Income	\$45,000	\$45,000	\$45,000	\$45,000	\$45,000	\$45,000	\$45,000	\$45,000
Annual Deferred Income	\$38,091	\$75,977	\$156,822	\$158,883	\$135,197	\$240,799	\$372,521	\$337,316
Accumulated Deferral	\$69,058	\$145,035	\$301,857	\$460,740	\$595,937	\$836,736	\$1,209,257	\$1,546,573

Table 3.

	2003	2012	Difference
Current Farm Debt	\$172,132	\$348,030	\$175,898
Intermediate Farm Debt	\$78,361	\$135,567	\$57,206
Long-Term Farm Debt	\$174,963	\$378,435	\$203,472
Non-Farm Debt	\$13,439	\$51,105	\$37,666
Total Debt	\$438,895	\$913,137	\$474,242

Table 4.

	2008	2009	2010	2011	2012
Accrual Income	\$203,883	\$180,197	\$285,799	\$417,521	\$382,316
Taxable Income*	\$89,000	\$101,000	\$104,000	\$130,000	\$135,000
Family Living	-	\$65,783	\$65,188	\$85,028	\$100,040
Income Taxes	-	\$26,078	\$27,844	\$40,354	\$43,740
Term Debt Payments	-	\$44,739	\$65,430	\$54,104	\$61,777
Cash Replacement	-	\$14,813	\$18,791	\$29,112	\$29,827
Net Cash Available	=	\$-62,413	\$-76,253	\$-78,598	\$-100,384

* Taxable income is an estimate based on tax paid because it is not tracked in our averages. Intermediate and long-term interest has been added back since they are included in the term debt payments.