Financial Impact of the Tax Cuts and Jobs Act on Ag Producers

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Financial Impact of the Tax Cuts and Jobs Act on Ag Producers

The dust still hasn’t completely settled from the changes made in December of 2017 to the tax code by the Tax Cuts and Jobs Act (TCJA), but we are starting to dig through the law to make some sense of what this will look like for ag producers. What we know for sure is that the changes are far reaching and complex. We also know that for most producers, the changes will result in a lower tax liability. The largest unknown is exactly how the new 199a deduction (20% pass-through) will need to be implemented. We are currently still waiting on regulations from IRS, which is expected to be hundreds of pages of details pertaining to this law alone. When we do get this release from the IRS, it is expected to just be the basics of the rules with more specific details following over the next couple of years. In difficult situations like this, it’s best to start with what is easy to sort out.

Like-Kind Exchanges, other than Real Property

When thinking about Section 1031 exchanges, most people think only of land, but the tax deferral of a tractor trade (or any other business property) also fell under Section 1031. The TCJA eliminated the ability to use Section 1031 exchanges on any property that isn’t real property. This means we can only use it on real estate now and the trade of a tractor is going to be a taxable event.

Example: You have a tractor with a fair market value of $50,000. You have previously used all the depreciation of the purchase cost on your tax return so you have a tax basis of $0. You take that...
tractor to the dealer and trade it in on a new tractor that is worth $150,000. In the past, we would have recorded the basis of the new tractor as $100,000 (the trade difference plus any remaining basis in the old tractor). No gain would have been recognized at that time. Starting in 2018, we need to record two transactions on your tax return. The first will be the sale of the old tractor for $50,000. Since the basis is $0, the full $50,000 will be recognized as gain. The second transaction will be the purchase of a $150,000 tractor which will be subject to depreciation.

The impact of this law change will likely be insignificant for at least eight years on your Federal tax return. The trade off for removing the 1031 exchange was enhancing the Section 179 and Bonus Depreciation rules so that any gain recognized on the sale of the old asset could be offset by the extra depreciation causing a no-change. The only caveat to that is that the elimination of 1031 exchanges for personal property is a permanent change, while the changes to bonus depreciation phases out by 2026. While $1,000,000 of Section 179 seems like a lot, if you start applying full purchase costs of the asset, many operations that purchase even one brand new tractor and a combine with a couple of heads, will be close to using that full amount.

For most self-employed taxpayers, there will actually be a savings recognized. The extra depreciation will offset self-employment taxes while the gain on the sale of the equipment will be subject to just ordinary income tax rates. Those affected will likely be partners in a partnership and those filing Schedule F. The actual tax cut will depend on many factors including tax brackets, volume of trades, and other individual situations, but it could be a significant change.

The impact of this change will also be significant to many states. Several states, including Iowa, do not allow the same amount of depreciation as the Federal does, so those producers will not be able to offset the entire gain on the sale of assets with extra depreciation. In Nebraska, we report the value for personal property taxes as the Federal depreciable basis, so instead of a value of $100,000 on the tractor example above, the value will be 50% higher at $150,000. Nebraska’s Legislature did pass a law that allows you to use the trade in value as a credit on the valuation if you used Section 179 on the new asset. This law is in place only for the 2018 and 2019 years.

### Depreciation

There are a lot of changes to how we depreciate farm assets, some are minor and some are major. An example of one of these minor changes is the life class of NEW farm equipment. The life class has changed from seven years to five; however, it will remain at seven years for used equipment. This doesn’t include grain bins, fences, or some other assets that continue to have a seven-year life class. Another small change is the rule on depreciation method. In the past, farm assets were required to use a 150% declining balance instead of a 200% declining balance that other businesses could use. The new change allows for farmers to use the 200% starting in 2018. These are small technical changes, but they will affect the way we calculate depreciation.

The big changes come in the form of Section 179 and Bonus Depreciation. The TCJA essentially gave all ag producers unlimited depreciation in the year of purchase by increasing the Section 179 limit to $1 million and expanding bonus depreciation to 100% and to include both new and used assets. With a few exceptions, the only assets we will not be able to write off completely in the year of purchase will be those purchased from a related party. While the Section 179 limit does not have a phase out or sunset (and is indexed for inflation), the bonus depreciation percentage will phase out starting in 2023.

### Losses

In the past there has been a provision limiting losses on Schedule F if an applicable subsidy was received for the year. The rule was put in place during the years when FSA payments were coming in the form of Direct payments, Counter Cyclical Payments, and CCC Loans. Since the ARC and PLC payments were implemented, the only applicable subsidy was the CCC Loans so we were not seeing a large impact of the limited losses.

The TCJA expanded the excess loss rules to include all businesses (non c-corp) and expanded the limit to $500,000 for a married filing joint return. Any losses over $500,000 will be treated as a Net Operating Loss (NOL) and will not be available to offset other income on the current tax return. This probably won’t be as impactful for most full-time farm operations as it will for part-time operations or those with significant non-farm income. The...
Excess Business Loss rules will sunset after the 2025 tax year.

Another change is the way we treat Net Operating Losses. In the past, a NOL could be carried back two years for all taxpayers and farmers could carry a loss back five years. The TCJA eliminated the ability for taxpayers (other than farmers) to carry a NOL back at all, and reduced the farm NOL carryback to two years. Instead, you can carry a NOL forward indefinitely (previously limited to 20 years), but the deduction is limited to 80% of taxable income. This means that even if you carry forward a significant NOL, you will still be paying some tax in the future years, and it will take longer to absorb the NOL. This rule DOES apply to c-corporations as well as individual taxpayers. These changes to the NOL rules are permanent changes, with no sunset.

**Estate Tax Changes**

The estate tax changes are some of the easiest with a significant increase in the Federal Exclusion (the amount you can pass through to your heirs tax free). The exclusion was raised from a $5 million base to a $10 million base, indexed for inflation. This means for 2018, an individual can pass $11,180,000 of net assets (assets – liabilities) to the next generation and a married couple can pass $22,360,000. The downside is the law was passed with a sunset provision after the 2025 tax year which means we are back to uncertainty for individuals with estates over the $5 million mark.

**C-Corporation Rate Changes**

The tax rates for a c-corporation (c-corp) had previously been a tiered structure ranging from 15% to 39%. This tiered structure was replaced with a flat 21% tax. While this was very exciting for large corporations, many farming corporations will actually see a tax increase, as one common strategy was to hold income levels at the top of the 15% bracket. Those individuals will see a higher tax rate, but the potential exit of a c-corp structure became significantly cheaper.

**Interest Deductions**

There was a lot of talk and concern about the elimination of the interest deduction. While it was discussed and ultimately passed, the exceptions they put in will keep most farm operations from being impacted. The first exclusion is a gross income test of $25 million. If your gross income is less than that, you have no worries, you can fully deduct all business interest. The second exclusion is a farming business election. If your gross income is over $25 million, you can elect to be treated as a farming business. You will be required to use the Alternative Depreciation System for any assets with a life class of ten years or more. This is essentially farm buildings. So the summary of this is that it is not a big deal for any farm operation, but if you gross more than $25 million, you do need to work with your tax preparer to make sure you are following all the guidelines.

**General Individual Changes**

There has been extensive coverage of some general tax law changes that affect all taxpayers, so I don’t want to focus on them. These are things like the lower individual tax brackets, increased child tax credits, and changes to itemized deductions. The only farm specific thing that needs to be considered is if you no longer have enough deduction to itemize, you may consider gifting grain to charities rather than cash to take full advantage of those donations. If you think this is an option for you, please consult your tax preparer.

**Section 199a – The 20% Pass-through**

Few tax laws get labeled by the code section that governs them, but this one seems to have no name other than Section 199a. The idea for this law was simple. Any business other than a c-corp (who just got the large flat tax break) is now eligible for a 20% deduction of net business income. In other words, these businesses won’t pay tax on the first 20% of their income. While this sounds great, things then became complicated. The original law that was passed included ten pages of law that defined what kind of income qualified, overall income limitations, exceptions for capital gains, and at the last hour, a special provision for members of a cooperative. One of the eliminated tax provisions was Section 199, or what we referred to as the Domestic Production Activities Deduction (DPAD). The cooperatives had been receiving this special deduction (as well as anyone who produced a good or service in the United States) since 2004. These cooperatives were unhappy that the DPAD was cut, so they negotiated a special provision for their members. This provision stated that in addition to the 20% of net income, cooperative members would get 20% of the income they received from cooperatives. Most thought this was 20% of a patronage dividend,
but the language clearly stated that *per unit retains* were included, which essentially made this a deduction of 20% of grain sales to a cooperative. This would have virtually eliminated tax paid by most farm operations. In March they passed the *Grain Glitch Fix* to eliminate this provision, but the result was an even more complex interpretation of the law. We are currently waiting for the regulations from the IRS on the interpretation of this new rule. There was hope that the hundreds of pages of regulations would be released by July 1, 2018. However, more than a month after this deadline we still have not heard anything, so at this point calculations and savings projections are good guesses at best.

At this point, these estimates will include multiple calculations of this rule based on a percentage allocation of sales made to cooperatives and sales made to private business. Once the allocation is made, we have different sets of rules to follow. These rules involve tests that are based on different elements. These elements include total income limits, wage limits, investment of business property, and capital gains. There is nothing simple about these rules and it will likely take years to get all the details ironed out. Just like the old DPAD rules, we will likely be really close to becoming experts on it right as it goes away. This law will sunset in 2025 so we are looking at 8 years, unless congress acts again.

As you can tell, there are a lot of big changes coming. Some of these changes are *permanent* (nothing is really ever permanent but they are not set to change), and some have sunset provisions (they will automatically go away). Tax planning will be more important than ever because keeping things *the same as last year* isn’t going to be your best strategy. It is also going to take more time for these appointments and for the actual preparation of tax returns, which likely means the professional costs will be higher. The tradeoff is going to be reduced taxes, which should far outweigh the additional professional costs.

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