Will taxes kick back?

Deferring taxes is a useful tool, but policy changes may mean there's a price for 'kicking the can down the road.'

Despite the continual ups and downs of farming, growers in recent years haven't had much to complain about. Generally speaking, agriculture in the U.S. has registered relatively good incomes for the past six or so years. Times have been even better for those involved in the grain production side of agriculture.

Good incomes are great, but they usually lead to increased federal and state income taxes as well as self-employment taxes. Fortunately, we now have means to mitigate some of the increased tax liabilities through the use of bonus depreciation and the IRS Expense Election. Unless federal legislators enact an extension of these policies, however, managing tax liabilities in 2013 could be more difficult than it's been in recent years.

Growing at different rates

To illustrate this, consider that average (accrual) net farm income for a five-year period from 2007 to 2011 was $196,671. Net farm income for the previous five years (2002 to 2006) was only $72,320. This means a substantial increase of $124,351 in average net farm income between these two recent five-year periods. This is no surprise: It's evidence of good yields in most area and increased commodity prices practically everywhere.

Average income and Social Security taxes paid (federal and state) for the five-year period from 2007 to 2011 was $17,264, compared to just $9,157 for the five years from 2002 to 2006. This is an increase of $8,107 in taxes paid between the two five-year periods.

It would seem that adding more than $100,000 in net farm income while adding barely $8,000 in income and social security taxes would lead to a larger level of taxes paid. We know that tax rates even at their lowest are not at the 6 percent level. What gives?

Due for a correction?

First of all, we're talking about accrual-based net farm incomes here. The taxes paid are based on Schedule F cash income. But, over time, those differences should begin to wash out. It's very possible that 10 years isn't quite long enough for us to make a correct assessment.

Or there could be other reasons these facts seem at odds with each other. Consider these possibilities:

1 **Effective tax policy.** The Internal Revenue Service (IRS) Code Section 179 Expense Election has been available for more than 20 years. At one point, this amounted to only $10,000 per year. The rapid increase in the limit for the Code Section 179 Expense Election (currently $139,000 for 2012) coming at the same time that incomes have been increasing makes us wonder if there's been a rapid "write-off" of capital purchases. This especially would make sense if those write-offs were for equipment and the IRS Expense Election and/or the Bonus Depreciation was used to create expenses that pushed cash expenses up and cash incomes down. Bonus Depreciation became available in the mid-2000s. The calculation of accrual net farm income uses a slower "economic" depreciation rate.

2 **The increased value of grain inventory.** That value has increased in the recent years because of additional bushels in some years and increased per-bushel prices in some years.

3 **The increasing value of end-of-year prepaid expenses.** Many farm inputs have increased in price over the period in question: fertilizer, seed, chemicals, fuel, etc. Year-end tax planning could have put into place a strategy to keep cash income lower (and pay less in tax). This could mean a grower had to pre-pay increasing amounts of these inputs at the end of the year to keep cash incomes down.

4 **Changes in retirement plan contributions.** Growers may be making more frequent and/or larger contributions to tax-deferred retirement plans (IRA, SEP, 401K and Keogh plans). This defers the income tax until funds in these accounts are withdrawn.

What's down the road?

All this makes us wonder if there might be a "mountain" of deferred income tax that's been building up. Growers might do well to be aware of this possibility.

Maximizing after-tax income year after year is the goal many of us pursue. Good financial management includes good tax management. In the current political lingo, this could be referred to as kicking the can (or the tax liability) down the road. In many case, however, it's employing good financial and tax management with the goal of maximizing after-tax income.

It's worth pondering whether this is a good long-term strategy or whether an operation may be better off not kicking the can down the road indefinitely.

***Note:** Data used in this study comes from the local Farm Business Farm Management (FBFM) Associations across the state of Illinois. FBFM, which consists of 5,500 plus farmers and 60 professional field staff, is a not-for-profit organization available to all farm operators in Illinois.*

Editor's note: Kent Vickre and Dwight Raab write a tax and finance column for each issue of Pioneer GrowingPoint® magazine. Vickre is the state coordinator of the Iowa Farm Business Association. Raab is the state coordinator of Illinois Farm Business Farm Management. They address issues that influence agribusiness success.

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