

Tax Implications of Farm Financial Planning Decisions

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Tax Implications of Farm Financial Planning Decisions

- Income Tax “Basics”
- How is everything taxed?
- Liquidation Issues
- Deferred Tax Issues
- Cancellation of Debt
- Bankruptcy



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Tax Implications of Farm Financial Planning Decisions

- There ARE income tax implications when financial planning with a farm family
- Payment of income tax is part of a profitable business over the long-term – it is also often part of steps taken in difficult financial situations
- Debt is paid off with after tax dollars
- Include tax advisor in the planning process



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Tax Implications of Farm Financial Planning Decisions

- “Income Tax Aspects and Consequences of Financial Distress Transactions”
by Bryan Manny and Mark Wood
<http://www.agmanager.info/finance-business-planning/financial-management/income-tax-aspects-and-consequences-financial>
Risk and Profit Conference Proceedings – 2016
<http://www.agmanager.info/events/risk-and-profit-conference/previous-conference-proceedings/2016-risk-and-profit-conference>



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Income Tax Basics

- Taxable income is generally one of two categories – ordinary income and capital gain
- Ordinary Income
 - Any income received that does not qualify as a capital gain
- Ordinary Farm Income
 - Income derived from the sale of commodities, livestock, and/or custom services provided as part of the farming operation (reported on Schedule F)



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Income Tax Basics

- Tax Basis
 - The amount of investment a taxpayer has in an asset
 - With some items the full basis is deducted (expensed) in the year of purchase – fertilizer, feed, seed, etc
 - Used for computing gain or loss if an asset is sold
 - Usually equals an asset's purchase price (original cost basis) less any accumulated depreciation that has been, or could have been, taken (remaining, or adjusted, tax basis)



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Income Tax Basics

- Capital Assets
 - Anything purchased that must be depreciated (machinery, breeding livestock, buildings)
 - Assets held until disposition but that are not depreciable (i.e. land – you do not get a tax deduction when you purchase land)
 - Assets produced on the farm and held for a sufficient time to receive capital asset treatment (i.e. raised breeding livestock)



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Income Tax Basics

- Remaining Tax Basis
 - Portion that is not taxable when an asset is sold
 - Depreciable assets may have:
 - Capital Gain (amount over original cost basis)
 - Depreciation Recapture (amount of original cost that has been depreciated – is taxed as ordinary income)
 - Remaining Basis – not taxed
 - If an asset has been depreciated out, any proceeds from the sale of the asset are fully taxable
 - Expensing (utilizing Sec 179 Expense Deduction) or bonus depreciation in year of purchase will use up basis quickly



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Income Tax Basics

- Remaining Tax Basis
 - With non-depreciable assets (i.e. land) will usually be equal to the original cost basis of the asset
 - May have some adjustments due to additional investment to improve the asset, partial sale, other activity
 - Inherited capital assets have initial basis equal to the value at date of inheritance in most instances (“stepped up” tax basis)
 - Gifted capital assets have initial basis equal to that of the giver at the time of the gift



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Income Tax Basics

- Sale of Capital Assets
 - Sale of Capital Assets are generally reported as “Depreciation Recapture” or “Capital Gain” (Reported on 4797 and Schedule D)



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Income Tax Basics

- Remaining Tax Basis
 - Raised breeding stock have no tax basis since the cost of production have already been deducted
 - Generally ordinary gain if held less than 24 months (cattle and horses – 12 months all other livestock)
 - If held 24 months or more (cattle and horses – 12 months all other livestock), all proceeds from the sale of raised breeding stock receive capital gain treatment



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Income Tax Basics

- Depreciation
 - Qualifying capital assets (machinery, breeding livestock, buildings, land improvements such as drainage tile) cannot be deducted as an ordinary farm expense the year that they are purchased – the expense must be spread over a period of years



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Income Tax Basics - Depreciation

Modified Cost Recovery System (MACRS)

Purchase: \$200,000 Tractor (7 year property)

1	2	3	4	5	6	7	8
\$21,429	\$38,265	\$30,066	\$24,498	\$24,498	\$24,498	\$24,498	\$12,249

Straight Line (Same Asset)

1	2	3	4	5	6	7	8
\$14,286	\$28,571	\$28,571	\$28,571	\$28,571	\$28,571	\$28,571	\$14,286



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Income Tax Basics - Depreciation

Sample Depr Schedule

Description	Year Purchased	Purchase Cost	Depr. 2008	Depr. 2009	Depr. 2010	Depr. 2011	Depr. 2012	Depr. 2013	Depr. 2014	Depr. 2015	Depr. 2016	Depr. 2017
Tractor A	2008	\$200,000	\$200,000									
Skid Steer	2009	\$55,000		\$55,000								
Chisel Plow	2010	\$50,000			\$50,000							
Total Depr. For Year			\$200,000	\$55,000	\$50,000	\$0	\$0	\$0	\$0	\$0	\$0	\$0



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Income Tax Basics - Depreciation

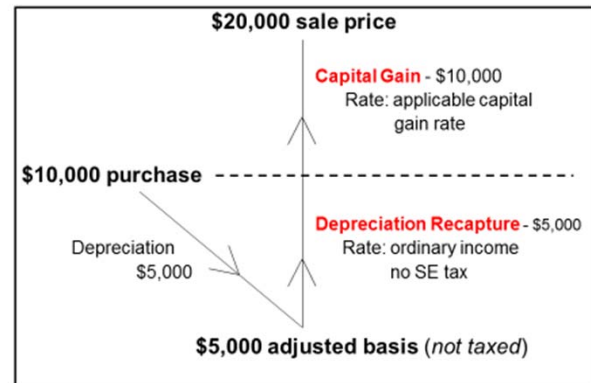
Sample Depr Schedule

Description	Year Purchased	Purchase Cost	Depr. 2008	Depr. 2009	Depr. 2010	Depr. 2011	Depr. 2012	Depr. 2013	Depr. 2014	Depr. 2015	Depr. 2016	Depr. 2017
Tractor A	2008	\$200,000	\$21,429	\$38,265	\$30,066	\$24,498	\$24,498	\$24,498	\$24,498	\$12,249		
Skid Steer	2009	\$55,000		\$5,893	\$10,553	\$8,268	\$6,737	\$6,737	\$6,737	\$3,368		
Chisel Plow	2010	\$50,000			\$5,357	\$9,566	\$7,516	\$6,124	\$6,124	\$6,124	\$6,124	\$6,062
Total Depr. For Year			\$21,429	\$44,158	\$45,976	\$42,332	\$38,751	\$37,359	\$37,359	\$25,110	\$9,492	\$6,062



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Depreciation Recapture



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How is everything taxed?

- Wages, business income, investment income on federal tax return
 - Rate depends upon filing status and type of entity
 - Rates run from 10% to 39.6% currently
- For Kansas income taxes, rates have changed in 2017 and business income is again taxable



How is everything taxed?

- Rental/Investment Income (Passive)
 - Taxed at the current bracket rate
 - Generally not subject to SE Tax
- Wage Income
 - Taxed at the current bracket rate
 - FICA and Medicare withholding on W-2



How is everything taxed?

- Income subject to self-employment tax
 - Farm business and Non-farm business income is taxed at the current bracket rate (regular tax)
 - Self employment tax is 15.3% (12.5 % OASDI & 2.8% Medicare) – OASDI cap is \$127,200 for 2017 (up from \$118,500 in 2016)

How is everything taxed?

- Long-term capital gain
 - If gain fits in the 10% or 15% = 0%
 - If gain fits in the 25%, 28%, 33% or 35% = 15%
 - If gain fits in the 39.6% = 20%
- Un-recaptured 1250 gain (Buildings)
 - Difference between accelerated and SL depr. = 25%

How is everything taxed?

- Installment sale of capital gain property
 - Gain is taxable as dollars are received
 - Land, Raised Breeding Stock
- Installment sale of property where there is depreciation recapture involved
 - Immediate recognition depreciation recapture in year of sale regardless of dollars received
 - Machinery, purchased breeding stock



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Income Averaging

- Available for Farmers and Fishermen
- Performed on “Schedule J” – Federal Form 1040
- Is a blending of the tax rates rather than averaging income



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Alternative Minimum Tax (AMT)

- AMT is a completely separate tax calculation
- Taxpayer owes the higher of the regular tax or the AMT tax
- Taxpayer can qualify for a credit in future years when AMT is not owed
- **Caused by high income, large capital gains and large itemized deductions**



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Deferred Tax Liability

- Deferred tax liability on a balance sheet becomes very important in a situation that may involve liquidation
- Many tax planning activities do not remove tax liability...they just defer the liability
- Pre-paid farm expenses and deferred sales are reconciled during a farm liquidation



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Farm Liquidation

- Tax consequences are dramatically different from one plan to another
- Planning is important to understand the tax consequences of alternatives
- If you are working with a situation that will involve liquidation of farm property, make sure to have a tax advisor involved
- An estimate of the approximate tax due can be entered as an override entry in FINPACK



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Bankruptcy

- A last resort? – pursue other options first
- The purpose of the federal bankruptcy laws enacted by congress is to provide a financial “fresh start” in certain circumstances through discharge of debts
- Generally four types – Chapter 7, 11, 12 and 13



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Cancellation of Debt

When debt is cancelled or forgiven, the amount forgiven may be includable in taxable income.

Exceptions and exclusions include:

- Debt is forgiven as a gift
- Sale is seller financed and the price is reduced which requires basis adjustment
- If debt is deductible (i.e. an account payable that is for a deductible item) and taxpayer uses cash method for tax filing



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Bankruptcy – Chapter 7

- Chapter 7: Liquidation
 - Primarily will be a farmer not planning to farm in the future
 - Debtor may be an individual, partnership, corporation or other business entity
 - A trustee is appointed to liquidate all nonexempt assets and distribute the proceeds to creditors
 - Bankruptcy court oversees sale of assets as well as any cancelled debt



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Bankruptcy – Chapter 12

- Chapter 12: Reorganization
 - Designed specifically for the reorganization of family farms (started in 1986; amended in 2005)
 - Only available to persons who meet the definition of “family farmer” set forth in the statute – A family farmer may be an individual, corporation or partnership
 - Involves a reorganization plan that usually lasts 3-5 years – If plan is followed, court will discharge debt agreed to in the plan



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Bankruptcy – Chapter 11

- Chapter 11: Reorganization
 - Allows debtor to enter into an agreement with creditors under which debts are restructured to allow the debtor to continue all or part of the business operation
 - May provide an option for those farms that are too large for Chapter 12
 - In general, any partnership, corporation or limited liability company except a governmental unit may be a debtor in a Chapter 11 case



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Bankruptcy – Chapter 12

- Chapter 12: Reorganization
 - In a Chapter 12 Bankruptcy farm debt cannot exceed \$4,153,150 (tied to inflation since 2005)
 - At least 50% of the debt (excluding primary residence) must be related to the farming operation
 - More than 50% of the gross income of an individual, or husband and wife, must have been from farming in the preceding three tax years
 - See United States Courts website (www.uscourts.gov) for further information



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Questions or More Information

Kansas Farm Management Association (KFMA)

✓ www.AgManager.info/KFMA

Extension Agricultural Economics

✓ www.AgManager.info

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