EXTENSION

Rancher's Thursday Lunchtime Series

Tax Strategies for the Cow/Calf Enterprise

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Tax Management Objectives

- After tax profit maximization is the objective.
- Must consider tax as a cost, like any other cost of doing business.
- Do not let the tax tail wag the business dog – minimizing taxes can and often will result in over-investment in capital assets.
- Tax management = minimum legal tax
- Tax evasion = Jail

Why It Is Important to Pay Taxes!

- It means you are making a profit! (The more taxes you pay, the more profit you are making.)
- You increase your Social Security Benefits when you <u>retire</u> through the payment of Social Security or Self-Employment Taxes.
- You obtain <u>disability</u> and <u>survivor</u> benefits through the payment of Social Security or Self-Employment Taxes as well.

Tax Management Update

- Net Operating Losses
- Deferring Income
- Income Averaging for High Income Years
- Prepaying Farm Expenses
- Depreciation Alternatives
- Errors in Reporting Sales

New Net Operating Loss Rules

For tax years beginning after December 31, 2017 and before January 1, 2026

- NOL deduction limited to 80 percent of taxable income in any year
- NOL carryback is eliminated except for farm businesses (farm: 2 year carryback)
- NOL can be carried forward vs back, carry to subsequent tax years until fully absorbed subject to 80% limit

Income Averaging

- Spread income tax liability over 4 years
- Works best when income in prior years is lower than the current year
- Move selected farm income from current year and apply it evenly among prior 3 years
- Does not impact Self-Employment Tax
- This tool is underused according to IRS

Deferring Receipt of Income

- Sell/deliver production in the current year for agreed upon price, receive payment in the following year
  - Cash basis taxpayer
  - Must avoid constructive receipt
  - Deferred payment contract
- Weather related sales of livestock
- Crop damage payments

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.)

Depreciation Update

- First year additional (Bonus) depreciation
  - new or used assets
  - 100% for 2022 and 80% for 2023 (sunsets January 1, 2027)
- Section 179 expensing election
  - made permanent ($1.08 million max. for 2022)
- MACRS changes
  - Shorter recovery period for new farm mach/equip now 5-year property (used assets still 7-year)
  - 200% declining balance 3, 5, 6, & 10-year property (was 150%)

Bonus vs Section 179

Bonus Depreciation

- Must elect out of bonus depreciation and can elect out on certain classes of assets
- Can create a farm loss and can offset W-2 wages as well as other income
- Conversion to personal use does not require recapture of excess over regular MACRS depreciation

Bonus vs Section 179

Section 179

- Must elect to use but can elect to use on only one specific asset or a group
- Can't create a farm loss but can offset W-2 wages
- Conversion to personal use causes partial recapture (amount over regular deprec.)
- Can use a percent (≥50%) of the asset's cost to apply Section 179

Farm Depreciation Changes

- New Farming and Machinery Depreciation
  - Applies to property placed into service after December 31, 2017:
  - Cost recovery period is now 5 years for **<u>new</u>** machinery and equipment; **<u>used</u>** is still 7 years
  - Grain bins, fences, cotton ginning equipment, and land improvements are 7-year assets (did not change)
  - 200% declining balance can be used on 3-, 5-, 7-, and 10-year assets

What is New Property?

- Never placed in service (used) by anyone other than the current owner (original use by the taxpayer)
- New Heifer - original use applies to the owner when she is bred for the first time.
- New Bull - original use applies to the owner when he is first used as a sire.

Errors with Reported Livestock Sales

- Some preparers not familiar with agriculture
- Livestock sales being reported on the wrong form
- Sale of cull breeding animals reported on Schedule F and not on Form 4797
  - Subjected to Ordinary Income Tax and Self-Employment Tax
  - Should get the more favorable Capital Gain Treatment

Errors with Reported Livestock Sales

- Schedule F: Profit or Loss from Farming
  - Ln 1: Sales of Purchased Livestock
  - Ln 2: Cost or other Basis
  - Ln 3: Net Sale
  - Ln 4: Sale of Livestock Raised
- Net Farm Income is subject to the 15.3 % self-employment tax
- Only sales of market animals should be reported here

Errors with Reported Livestock Sales

- Form 4797: Sales of Business Property
  - Sale of Raised Breeding Animals
  - Sale of Purchased Breeding Animals
- Cows, Bulls, Replacement Heifers
- If held more than 2 years, long-term capital gain treatment
- If not held more than 2 years, short-term capital gain treatment
- Not subject to SE tax

2022 Tax Rates (Married Filing Jointly)

If Taxable Income Is:	**The Tax Is:**
Not over $20,550	10% of the taxable income
> $20,550 but ≤ $83,550	$2,055.00 plus 12% of excess > $20,550
> $83,550 but ≤ $178,150	$9,615.00 plus 22% of excess > $83,550
> $178,150 but ≤ $340,100	$30,427.00 plus 24% of excess > $178,150
> $340,100 but ≤ $431,900	$69,295.00 plus 32% of excess > $340,100
> $431,900 but ≤ $647,850	$98,671.00 plus 35% of excess > $431,900
> $647,850 and over	$174,253.50 plus 37% of excess > $647,850

Capital Gain Tax Rates Projected

2022 Tax Rate (Percent)	Single Filer Total Taxable Income Breakpoints	Married Filing Joint Total Taxable Income Breakpoints
0 %	≤ $41,675	≤ $83,350
15 %	≤ $459,750	≤ $517,200
20 %	> $459,750	> $517,200

Weather Related Sales

- Two different tax treatments
  1. Elect to defer income from sales in excess of normal for 1 year (IRC § 451(g))
  2. Elect to postpone gain recognition from sales in excess of normal by replacing animals (IRC § 1033(e))

Two Different Tax Treatments

- Both tax treatments or rules apply to sales in excess of normal or usual business practice due to weather-related conditions.
- The first applies to sales of any livestock (**IRC § 451(g) Deferral of Income for 1 Year**).
- The second applies to sales of livestock (other than poultry) held for draft, breeding, or dairy purposes (**IRC § 1033(e) Involuntary Conversion**).
- IRC References to share with your tax advisor.

1. Deferral of Income for 1 Year IRC §451(g)

- *The drought, flood, or other weather-related condition must be of such severity that an area affecting the taxpayer's area is designated as eligible for Federal disaster assistance.*
- A taxpayer needs to show that the weather-related condition caused the sale of more animals than normal.
- Farmer (taxpayer) must use the cash method of accounting.

1. Deferral of Income for 1 Year IRC §451(g)

- Applies to any livestock (including draft, breeding, or dairy animals) sold due to weather-related conditions.
- Sale proceeds (income) may be deferred to the next taxable year, however certain requirements **must be** met.

1. Deferral of Income for 1 Year

IRC §451**(g)**

Requirements that **must be** met by the taxpayer:

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 weather related condition that caused the area to be declared eligible for Federal assistance must have caused the sale.

1. Deferral of Income for 1 Year

IRC §451**(g)**

- The livestock <u>do not</u> have to be raised or sold in the declared disaster area, but the weather-related condition that caused an area to be declared eligible for federal assistance must have caused the early sale of the livestock.

1. Deferral of Income for 1 Year

IRC §451**(g)**

- The sale can take place <u>before</u> or <u>after</u> an area is declared eligible for federal assistance as long as the same weather-related condition caused the sale.
- Taxpayer's history is used to determine the number of animals that would have normally been sold compared to those sold prematurely.

1. Deferral of Income for 1 Year

IRC §451(g)

- The sale proceeds from those animals that were sold prematurely, can be deferred and reported as income in the year following the year of the sale.
- Example, animals would normally be sold in 2023. Due to shortage of pasture, animals were sold in 2022.

2. Involuntary Conversion
IRC §1033(e)

- Must purchase replacement draft, breeding, or dairy livestock within a 2 year period. (example, for sales in 2022, must replace the livestock by end of 2025). This provision does not apply to poultry or market animals.
- 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 by one of its agencies.

2. Involuntary Conversion
IRC §1033(e)

- 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)

2. Involuntary Conversion
IRC §1033(e)

- If exceptional, extreme, or severe drought persists, the replacement period is extended until the end of the taxpayer’s first tax year ending after the first drought free year for the applicable region. **(an IRS Notice is published every Sept. listing counties by state qualifying for the 1033(e) deferral treatment)**
- The applicable region is the county that experienced the drought condition and all contiguous counties to that county.

2. Involuntary Conversion
IRC §1033(e)

- A 2 year replacement period exists if the drought area does not receive a federal disaster declaration.
- A 4 year replacement period occurs when the drought area receives a federal disaster declaration.
- Secretary of the Treasury can further extend the replacement period if the drought persists for more than 3 years.

2. Involuntary Conversion
IRC §1033(e)

- There is no requirement that the weather-related conditions cause the area to be declared a disaster area by the Federal government for the involuntary conversion rules to apply.
- A taxpayer needs to show that the weather-related conditions caused the sale of more animals than normal.

2. Involuntary Conversion
IRC §1033(e)

To make the election to defer, attach a statement to the tax return showing:

- Evidence of the weather-related condition.
- Computation of the amount of gain realized.
- Number and kind of livestock sold.
- Number and kind of livestock that would have been sold under normal or usual business practices.

Should you want to PAY taxes?

- **<u>Yes!</u>**
- It means that you are making a profit
- Uncle Sam will never take <u>all</u> your profit

  (Max ordinary income tax rate = 37%)
- However, you do not want to pay more than what is required under the tax law

  (Do not leave a tip!)

Questions and Comments

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