

Chapter 5 *

MANAGING THE TIMING OF INCOME AND DEDUCTIONS

Introduction

Uncertainty is a significant component of an agricultural operation. These businesses, like non-farm businesses, are subject to general economic market factors that impact availability of inputs such as labor and supplies. In addition, agricultural operations also see fluctuations in input and output prices, and production risk due to weather, disease, and other natural phenomena. Together, these factors often result in annual variations in farm business income, requiring operators to plan ahead in order to manage taxable income and the amount of income tax paid.

Because marginal tax rates increase as income increases, significant fluctuations in taxable income from year-to-year may result in a higher amount of tax paid over a period of time compared to consistent farm income year-to-year. Fortunately, most agricultural operations use cash basis of accounting to calculate taxable income, which allows great flexibility in managing the ups and downs of farm income. A primary goal of tax management is to avoid wide fluctuations in annual income to avoid swings in marginal tax rates.

Marginal Federal Income Tax Rate

A taxpayer's *marginal federal income tax rate* is the rate that applies to the taxpayer's last dollar of taxable income. Each year the IRS publishes rate schedules for each filing status, adjusting the taxable income brackets for inflation. Figure 5.1 shows the 2022 tax rate brackets for a married taxpayer filing a joint return. It is important to recognize that marginal tax brackets are just that—marginal. The marginal tax bracket applies only to each incremental dollar of income.

Figure 5.1. 2022 Federal Income Tax Rates Joint Returns

Married filing jointly or Qualifying widow(er)			
If taxable income is over	but not over	the tax is	of the amount over
\$0	\$20,550	10%	\$0
20,550	83,550	\$2,055.00 + 12%	20,550
83,550	178,150	9,615.00 + 22%	83,550
178,150	340,100	30,427.00 + 24%	178,150
340,100	431,900	69,295.50 + 32%	340,100
431,900	647,850	98,671.00 + 35%	431,900
647,850	-----	174,253.50 + 37%	647,850

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Example 5.1: Marginal Federal Income Tax Rate

Bob is a married farmer who has \$44,238 of taxable income in 2022. Applying the 2022 tax rate schedule in Figure 5.1, the first \$20,550 of income is taxed at a 10% rate. The remaining \$23,688 (\$44,238 – \$20,550) is taxed at a 12% rate. Bob’s marginal federal income tax rate is 12%.

Because the federal income tax rate brackets are indexed for inflation, a taxpayer with the same amount of income for two consecutive years might find that a higher portion of their income is taxed at lower rates in the second year.

Example 5.2: Application of Marginal Tax Rate

If Bob (in Example 5.1) increases his taxable income above \$83,550, he will move into a 22% marginal federal income tax bracket (see Figure 5.1). Therefore, if Bob’s income rises from \$83,550 to \$83,551, the federal income tax is 22¢ of that last dollar, **but only of the last dollar**. Moving into a 22% marginal bracket does not mean that he will be taxed at a 22% rate on **every** dollar. All of the income up to \$83,550 is still taxed in the lower brackets.

After-Tax Income

Although there may be many motives to operate a business, for most agricultural operations, profit is the primary motive. In the long-term, profit is necessary to pay for non-deductible expenses such as income tax, family living expenses, land purchases, or loan principal payments. If profit is a goal of agricultural business managers, incorporating after-tax income into a tax management decision should be part of farm income tax management decisions.

When a manager of an agricultural operation considers *after-tax income*, they are considering not only their marginal tax rate, but also any potential self-employed deductions, other non-business deductions, and tax credits available. Certain deductions and credits are not available if the taxpayer’s adjusted gross income or taxable income exceeds a certain amount. If a manager of an agricultural operation looks at the portion of total income that is retained as after-tax dollars (after-tax dollars divided by total income), they can maximize or optimize the dollars they keep in their pocket.

After-tax dollars can be defined as total income reported on the income tax return, less out-of-pocket expenses reported on the return. Caution must be used when calculating after-tax income as some items deducted on Form 1040 are only reported on the return and require no cash payment. Things like the deduction for one-half of self-employment tax, the standard deduction, or the qualified business income deduction reduce taxable income on the income tax return, but do not require a payment by the taxpayer. Conversely, deductions for contributions to self-employed retirement plans or traditional individual retirement accounts (IRAs) require a cash payment and reduce taxable income. However, these contributions are a deferral of income and still belong to the taxpayer so, at least in the short-term, they could be considered after-tax income retained.

Example 5.3: After-tax Dollars

Jerry is a married taxpayer who files a joint income tax return with his spouse. Jerry is working with his income tax preparer at the end of 2022 and they are projecting his net farm income will be \$65,000. Jerry and his spouse do not have any other sources of income. Their taxable income is \$27,606 which means their marginal tax rate is 12%. Jerry’s total tax liability is \$12,086 (\$2,902 of income tax + \$9,184 of self-employment tax). Their after-tax income would be \$52,914 (\$65,000 total income minus \$12,086 of income tax owed). Their portion of income retained as after-tax dollars is 81.41% (\$52,914 ÷ \$65,000).

Figure 5.2. Jerry’s Effective Tax Rate

Net farm income	\$ 65,000
Deduction for one-half of self-employment tax	– 4,592
Adjusted gross income	60,408
Standard deduction	– 25,900
§199A deduction	– 6,902
Taxable Income	\$ 27,606
Income tax	2,902
Self-employment tax	9,184
Total federal tax liability	\$ 12,086

Example 5.4: Impact of Income Changes on After-Tax Income

Consider Jerry from Example 5.3. If he is able to increase deductible farm expenses enough to decrease farm income to \$55,000, his taxable income would be \$20,171 and his after-tax dollars would decrease to \$45,212 (\$55,000 – \$9,788). However, the percentage of his total income retained as after-tax dollars would increase to 82.20%.

Figure 5.3. Jerry’s Effective Tax Rate

Net farm income	\$ 55,000
Deduction for one-half of self-employment tax	– 3,886
Adjusted gross income	51,114
Standard deduction	– 25,900
§199A deduction	– 5,043
Taxable Income	\$ 20,171
Income tax	2,017
Self-employment tax	7,771
Total federal tax liability	\$ 9,788

Observation

Tax Rate Change

It is important to remember that tax rates have changed over the years and could change again at any time. It is important to factor these changes into to farm management decisions.

Tax-planning strategies for a cash basis taxpayer often involve delaying income or prepaying expenses to move income from a higher effective marginal tax rate to a lower one. A farmer may receive a tax benefit by prepaying supplies, but even though the farmer will ultimately use the supplies, the additional cost of pre-purchasing must be recognized. This cost typically includes the time value of money—interest expense on money borrowed or lost interest income on money taken from savings to make the prepayments. Therefore, a taxpayer gains the most by prepaying expenses that will be used early in the next year. A taxpayer must consider whether his or her marginal bracket is high enough that the tax savings justify taking on a current cost that could have been delayed.

When deciding to prepay expenses, it is important to consider if the expense is necessary as a business expense, and not just an income tax management decision. Spending money on something that would not have been purchased otherwise, simply to save tax, does not make financial or economic sense.

Managing the Timing of Income and Expenses

When it comes to income tax management, a cash-basis agricultural operator has numerous tools at their disposal that can impact the timing of reporting income. Most often, taxpayers focus on methods to decrease taxable income in the current year. However, it might be reasonable for a producer to look for methods to increase taxable income, depending on their situation. If a manager has experienced a poor production year, it may make sense to increase income to maximize the amount of an available income tax credit, to fill up an income tax bracket, to optimize after-tax income, or to plan for a future year where they know they will have a higher level of income. On the other hand, an agricultural operator may have exceptional crops this year and is interested in a way to delay reporting income, allowing them to reduce their current income tax liability.

Shifting income *into* the current year can be accomplished by:

1. Delaying the deduction of expenses to a later year, or
2. Accelerating recognition of income to an earlier year.

Delaying the deduction of expenses can be as simple as not paying inputs or expenses until the following year. It is common for crop producers to prepay for inputs such as seed and fertilizer that will be used in the following year at the end of their tax year to receive discounts or to insure delivery. By delaying payment until after the end of the tax year, a producer may be able to increase taxable income in the current year. However, the decision to delay payment requires accurate year-to-date accounting with careful income tax planning at year end.

If there is not an opportunity for year-end income tax planning, several after-the-fact options are available to delay deduction of expenses. A taxpayer can choose to utilize alternative depreciation methods that reduce the amount of first year depreciation taken on capital asset purchases, thus increasing taxable income. See Managing Depreciation Expense on page 5.11 for more information related to depreciation elections available. In addition, agricultural producers may elect to treat certain repair and maintenance expenses as a capital improvement which would be capitalized (depreciated) rather than immediately deducted. A second option applies to fertilizer that has a beneficial life beyond the current year. In this case the cost of the fertilizer can be capitalized and deducted over its beneficial

life.

The most effective method to accelerate recognition of income is to sell inventory. However, this may not be feasible if you either don't have additional inventory to sell or don't have enough time to deliver your inventory before year end. In addition, it may not be practical if the current commodity price is low and there is an expectation for higher prices in the future. Again, deciding how much inventory to sell requires up-to-date accounting records and careful planning.

An agricultural producer that has year-end inventory of a commodity that is eligible for a CCC Commodity Loan may be able to elect to report the loan proceeds as income rather than treating the proceeds as a loan. While there may be additional paperwork associated with a CCC loan, the added income tax flexibility may be worth the effort. As an added benefit, the election to treat the proceeds as income can be made at the time the tax return is filed, giving a taxpayer options after-the-fact.

An additional option available to agricultural producers is to elect out of installment treatment of a deferred sales contract. A valid deferred sales contract allows a producer to sell inventory, but delay receiving the payment until a later date, usually in the tax year following the current tax year. Typically, these contracts are treated as installment sales where income is reported on the tax return when the proceeds are received rather than when the commodity is sold. However, an election is available to recognize income at the time of sale, even though proceeds were received in a different tax year. Because this election is made on a contract-by-contract basis, it is recommended that commodities are sold using multiple, smaller, deferred sales contracts to be most effective. The election out of installment reporting offers considerable flexibility in that it can be made at the time of the tax return filing. A decision to sell inventory through a deferred sales contract must be made before the end of the tax year.

Cross-Reference

Constructive Receipt of Income

See page 6 and 7 of the 2022 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of when income has to be reported because it is available to you.

If none of the above options are available, it may be reasonable to rollover all, or a portion of, a traditional IRA to a Roth IRA. Because a rollover like this is taxable, additional income may be added to the current tax year. Although the decision to rollover must be made before the end of the tax year, this option offers flexibility because a taxpayer can choose, with careful planning, the amount to rollover.

More often, the goal of year-end tax planning is to delay reporting taxable income. However, this is only an effective tool when the delayed income will be taxed at the same or a lower marginal tax bracket when it is reported in a later year.

Deferring taxable income can be accomplished in one or both of two ways:

1. Delaying the receipt of income to a later year, or
2. Accelerating tax deductions to an earlier year.

A deduction taken this year is not available for a later year. Similarly, if income is not reported this

year, it must be reported in a later year. **Therefore, deferral does not affect the total amount of income reported over a period of years.**

If deferral does not ultimately change the amount of taxable income reported, what does it accomplish? Potentially, it should accomplish two things. First, it can defer the payment of tax for a period of time, as Example 5.5 illustrates.

Example 5.5: Income Deferral

Jane has a choice of selling \$10,000 of crops on December 31, 2022, or waiting until January 1, 2023. Jane is in a 24% marginal tax bracket each year, so \$2,400 of income tax (plus SE tax on the additional income) will be due in either event. If Jane takes the \$10,000 on December 31, 2022, she will pay the additional income tax of \$2,400 on March 1, 2023. If she waits until January 1, 2023, she will not have to pay the additional income tax until March 1, 2024—a full year later. Jane should analyze this deferral by deciding whether the loss of the use of \$10,000 for one day (December 31, 2022, to January 1, 2023) is more than made up by gaining the use of \$2,400 for one year (March 1, 2023, to March 1, 2024).

The second benefit that deferral can sometimes accomplish is taxing the deferred income at a lower marginal tax bracket when it is reported. If this happens, the taxpayer not only delays the payment of tax but pays less tax as well.

Example 5.6: Income Deferral and Tax Reduction

Suppose Jane (from Example 5.5) is in a 32% marginal bracket in 2022 and will be in a 24% effective marginal bracket in 2023. Pushing \$10,000 of crop sales from 2022 to 2023 not only delays the payment of tax by one year, but it also reduces Jane's income tax on this \$10,000 from \$3,200 to \$2,400. Jane would save \$800 due to the lower 2023 tax rate.

There are two strong cautions to consider when deciding to use the deferral concept. The first is that marginal tax brackets can cut both ways. In the above example, Jane saved \$800 due to the lower 2023 marginal tax rate. However, suppose Jane focuses only on delaying the tax and finds that her marginal tax rate goes up in 2023.

Example 5.7: Income Deferral and Tax Increase

Jane (from Example 5.5) pushed \$10,000 of sales from 2022 to 2023. She is in a 24% marginal bracket in 2022, and is in a 32% marginal bracket in 2023. Jane has delayed paying \$2,400 of tax from March 1, 2023, to March 1, 2024. However, on March 1, 2024, she owes \$3,200, not \$2,400, which is \$800 more. Unless Jane can earn \$800 on \$2,400 between March 1, 2023, and March 1, 2024 (a 33% rate of return), her tax planning was a mistake.

The second caution in using the deferral concept is that it may entail risks beyond taxes. For instance, delaying sales to defer income may subject the taxpayer to price fluctuations.

Example 5.8: Income Deferral and Loss of Income

Suppose Jane (from Example 5.5) delayed \$10,000 of sales from 2022 to 2023. Further assume that Jane is in a 32% marginal bracket in 2022 and a 24% marginal bracket in 2023. However, suppose that after delaying her sale into 2023, Jane received only \$7,000 instead of the \$10,000 she would have received in 2022. Figure 5.3 shows a comparison of Jane's after-tax positions.

Figure 5.3 After-Tax Effect of Delayed Sale

	<u>2022 Sale</u>	<u>2023 Sale</u>
Cash received	\$10,000	\$ 7,000
Tax paid	<u>- 3,200</u>	<u>- 1,680</u>
Net cash	<u>\$ 6,800</u>	<u>\$ 5,320</u>

Taxes were deferred, as well as reduced. However, Jane ended up with less after-tax income because of the lower sales price.

Installment Sale Reporting

If a sale qualifies for installment reporting, the gain is included in gross income in future years as payments are received from the buyer. Such a sale avoids the risk of price changes discussed earlier under deferring income, but it does not eliminate the risk that the buyer might default on payment. The seller eliminates market risk but takes on the risks of being the creditor.

Cross-Reference

Installment Sale Tax Rules

See Chapter 10 of the 2022 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the installment sale reporting rules.

Installment reporting may be especially useful when a significant dollar amount of farm assets is being liquidated (including sales to family members) because it can spread the income over future years in which the seller's effective marginal tax rate may be lower.

All three of the following requirements must be met for a sale to qualify for installment reporting.

1. There is a gain on the sale. (Losses are reported in full in the year of sale.)
2. At least one payment is received in a tax year after the tax year of sale.
3. The gain is not ordinary income from depreciation recapture arising from the sale of depreciable property, such as purchased breeding livestock, equipment, and certain farm buildings.

Agricultural producers who report on a cash basis and who are not required to account for inventory on their tax returns can report the sale of crops and market livestock on the installment method. (Accrual-basis taxpayers and those required to account for inventory on their tax returns cannot report the sale of

their products on the installment method, although they can use it for qualifying asset sales.)

If the installment sale contract does not include an interest charge, or if it includes an interest charge that is lower than a required rate, the IRS will treat part of the sales price as interest that is taxed as ordinary income. The minimum rate of interest that must be charged to avoid the adjustment is called the Applicable Federal Rate (AFR). The AFRs are published monthly by the IRS and the appropriate rate will depend on the term of the contract. There are two notable exceptions to the requirement that the AFR be charged:

1. The total sales price is \$3,000 or less.
2. All payments under the contract are to be made within 1 year of the sale date.

In addition, no interest needs to be charged on any payment made within 6 months of the sale date, regardless of the total length of the contract.

Note

Related-Party Farmland Rate

A special rule allows sellers to charge the lesser of the AFR or a 6% rate compounded semi-annually for the sale of farmland (not buildings) between family members. This rule applies only to a total of \$500,000 of land sales in any given tax year. (With the currently low AFRs, this provision is irrelevant but it has been useful with historically higher AFRs.)

Example 5.9: Installment Sale of Crops

Samantha is normally in the 12% bracket, but this year expects to be in the 24% tax bracket due to an exceptionally good apple crop. Sam is concerned that the market price may drop, so she is reluctant to store her crop and sell it next year. She trusts the creditworthiness of the company that has been buying her apples for the last 12 years. Therefore, Sam entered into an installment sale with the buyer. She sold \$50,000 of apples in November (based on the current market price at that time) and agreed to take payment the following January. Even though the AFR rules do not apply (because all contract payments will be made in less than 1 year), Sam convinced the buyer to pay 4.45% interest on the unpaid balance.

Sam reports the \$50,000 of apple income next year as ordinary income from the sale of her crop when she receives the payment. She also reports the interest income that accrues through the date of payment.

The sale of farmland can be reported in much the same way. The computations are somewhat more complex because gain must be calculated by subtracting the taxpayer's cost basis and any expenses of sale from the sales price. This gain is then prorated and reported by the seller as payments are received.

Generally, the terms of payment for the sale of farmland extend beyond 1 year, and an amortization schedule is required to determine the amount of principal and interest included in each payment received.

Example 5.10: Installment Sale of Land

Maurice sold bare farmland for \$1,000,000. He had acquired the land 30 years ago for \$200,000. He paid his real estate agent, attorney, appraiser, and surveyor \$75,000 in closing costs. Maurice agreed to accept a \$100,000 cash down payment plus \$100,000 each year for 9 years, with interest of 6% on the unpaid balance. Maurice’s gain on the sale is calculated as follows:

Sale price	\$1,000,000
Less: basis	– 200,000
Less: cost	<u>– 75,000</u>
Gain	<u>\$ 725,000</u>

Maurice’s gross profit percentage is 72.5% (\$725,000 gain ÷ \$1,000,000 sale price), so 72.5¢ of each dollar of principal received on the sale is taxable. In the year of sale Maurice must pay tax on \$72,500 (72.5% × the \$100,000 down payment). Taxation of the balance of the gain is deferred until Maurice receives each payment during the next 9 years.

Caution

Property Sold Subject to Debt

The property sold may be subject to debt that is assumed by the buyer. Such sales require complex calculations and may trigger unexpected tax results for the seller. Taxpayers should seek competent tax advice in such situations.

As stated previously, depreciation recapture from the sale of purchased breeding livestock, equipment, and certain buildings cannot be reported on the installment method. This may result in a surprise to the taxpayer who sells on a deferred-payment basis and expects to pay no tax until the cash is actually received.

Example 5.11: Sale of Equipment

Amiyah sold some equipment for \$100,000. The equipment originally cost her \$125,000 but she had deducted a total of \$80,000 of depreciation by the time of the sale. Therefore, her adjusted basis in the equipment is \$45,000 (\$125,000 – \$80,000). Amiyah incurred no expenses on the sale, so her gain is calculated as:

Sale price	\$100,000
Less: basis	<u>– 45,000</u>
Gain	<u>\$ 55,000</u>

Amiyah agreed to allow the buyer pay \$20,000 down and \$20,000 annually for the next 4 years, plus interest of 6% on the unpaid balance. Amiyah’s gain is 55% (\$55,000 ÷ \$100,000) of her sale price so she expects to pay tax in the year of sale on \$11,000 (55% × \$20,000 down payment). However, all the gain arose from depreciation recapture, which results in the full \$55,000 being taxable to Amiyah in the year of sale. The income tax impact to Amiyah in the year of sale would be the same even if no cash payment was received in the year of sale.

As discussed earlier, it is possible to elect out of installment reporting and report all of the taxable gain in the year of sale. More often this is utilized for income tax management using an installment sale of an inventory item, such as grain, but is possible with most any sort of installment agreement.

Accelerating Expenses

In tax planning and tax management, it is important to consider the difference between a tax deduction and a tax credit. One dollar of *tax deduction* has the potential to reduce taxable income by one dollar, which will decrease tax liability by the marginal tax rate. In contrast, one dollar of a *tax credit* has the potential to reduce tax liability by one dollar.

Because a taxpayer incurs a personal out-of-pocket cost for a portion of each dollar spent, it is unwise to spend money just for a tax deduction. The taxpayer must gain something of value, in addition to tax savings, to justify additional expenses. This may seem obvious, but there are many taxpayers who want to spend money just to avoid tax, when there may not have been a reasonable business purpose to make the purchase otherwise.

In addition to deferring income, taxpayers may reduce taxable income in the current year by accelerating expenses. Cash-basis taxpayers can accelerate the deduction of expenses by prepaying farm expenses for the coming year. Three rules must be met in order to deduct such prepaid expenses.

1. The expenditure must be a payment and not merely a deposit.
2. The payment must be made for a legitimate business purpose, such as securing a lower price, receiving a discount, or guaranteeing availability.
3. The deduction must not materially distort income.

Taxpayers who are not farmers (and, in some rare cases, those who are farmers) can deduct prepaid expenses only to the extent that the expenses do not exceed 50% of the total of non-prepaid expenses.

Cross-Reference

Prepaid Expenses

See pages 19–20 of the 2022 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the prepaid expense rules.

The deduction of certain expenses cannot be accelerated even if they are prepaid. These generally include interest, rent, insurance, and real estate taxes. Taxpayers may pay and deduct the interest accrued on loans up to year end, but they cannot deduct advance payments of next year's interest until next year. Payments for rent and insurance cannot be currently deducted to the extent that the rental or insurance coverage period exceeds 12 months. If the payment provides a benefit for more than 12 months, the taxpayer must prorate the payment and deduct only the portion with current year benefit.

Example 5.12: Prepaid Rent

Guadalupe rented land from her neighbor for \$12,000 under a 12-month lease agreement. The term of the lease runs from December 1 to November 30. When Guadalupe makes her \$12,000 lease payment in November, she is able to deduct the full amount in the year of payment.

However, if Guadalupe's lease is for a 24-month term (\$24,000) and Guadalupe paid the full lease amount at signing in November, her deduction in the year she made the payment is limited to only \$1,000 ($\$24,000 \div 24$ months). She can deduct \$12,000 in the next tax year and the remaining \$11,000 in the year after that year. If she paid only \$12,000 at signing, she could deduct the full \$12,000 in the year she made the payment because the benefit of the payment does not exceed 12 months.

A common year-end tax-savings tactic for cash-basis taxpayers is to pay off open accounts, because these taxpayers can claim expense deductions only when the amount is actually paid. Before making advance payments on other items, farmers should consider clearing their open accounts.

Another tactic to accelerate expenses is to move needed repairs and maintenance up to the current year. For instance, painting a barn or repairing machinery could be moved from the following spring to the current year.

Managing Depreciation Expense

Deductions can also be accelerated by maximizing the expense deductions available for depreciable property. (See Chapter 4 for more information about depreciation.) Taxpayers can manage the tax effect of depreciation by choosing the depreciation method and the timing of acquisitions. As noted in Chapter 4, taxpayers can deduct 100% of the cost using a special depreciation allowance, often called bonus depreciation, for the cost of farm equipment, dairy or breeding livestock, and buildings (with a recovery period of 20 years or less) purchased and placed in service in 2022. In addition, there is the direct expense election under Internal Revenue Code Section 179 (referred to as §179). The §179 deduction applies to farm equipment, dairy or breeding livestock, and single purpose agricultural structures but does not apply to other farm buildings. Even for the cash-basis taxpayer, equipment is depreciable when it is placed in service. This can generate a deduction with little cash outlay if equipment is purchased using financing or a deferred payment plan.

Although it might initially seem to be beneficial, the special depreciation allowance can sometimes be difficult to incorporate when targeting a certain level of income. Bonus depreciation, or 100% deduction of the capital asset cost, happens by default. A taxpayer must elect to not take the special depreciation allowance, and when this election is made, it applies to all property within the same class (e.g., 5-year recovery period assets). In contrast, a taxpayer can choose to take §179 deduction on an asset-by-asset basis, and can select the amount of §179 deduction for each asset, up to certain limits.

The timing of acquisitions can also affect the amount of depreciation that is allowed. For example, taxpayers must use a mid-quarter convention rather than the half-year convention if the depreciable basis of property purchased in the last quarter of the tax year is more than 40% of the depreciable basis of all

property purchased during the year. Many farmers want to move a planned purchase from the following year to the current year to gain depreciation deductions on the new item. However, accelerating the purchase may trigger the mid-quarter convention, which can result in not only little depreciation gained on the accelerated purchase, but also a reduced total of depreciation deductions for the year.

Without electing an alternative method, most farm machinery and equipment is depreciated using the general depreciation system (GDS) 200% declining balance method. If a taxpayer is interested in reducing depreciation in the year of purchase, elections are available to depreciate using the GDS 150% declining balance, GDS straight-line, or ADS straight-line. These elections do not change the total amount of depreciation taken over time, rather it changes the timing of the depreciation. In some cases, the election to depreciate using ADS straight-line increases the recovery period, spreading total depreciation expense over a longer period. It is important to note that an election to depreciate under a different method applies to all assets within that property class. The election cannot be made on an asset-by-asset basis. Figure 5.4 illustrates the difference in the amount of depreciation in the first year of an asset purchase using various depreciation methods.

Figure 5.4. First-Year Depreciation for a \$100,000 Purchase

	Recovery Period (Half-Year Convention)			
	3-Year GDS/ 4-Year ADS	5-Year GDS/ 7-Year ADS	7-Year GDS/ 10-year ADS	10-Year GDS/ 15-Year ADS
GDS 200% DB	33,330	20,000	14,290	10,000
GDS 150% DB	25,000	15,000	10,710	7,500
GDS SL	16,670	10,000	7,140	5,000
ADS SL	12,500	7,140	5,000	3,330

Example 5.13: Less Depreciation

Don’s only equipment purchases were \$40,000 in September. The equipment is 7-year MACRS property, and Don elects not to utilize special depreciation allowance. With the half-year convention, Don could deduct \$5,716 of depreciation with the default 200% declining balance method.

In a tax-planning attempt, Don moved \$27,000 of equipment purchases (also 7-year MACRS property) scheduled for next year up to December. This triggers the mid-quarter convention ($\$27,000 \div \$67,000 = 40.3\%$). Don’s total allowable depreciation on the entire \$67,000 of equipment is reduced to \$5,248 (\$4,284 + \$964). Don tax-planned himself into less depreciation by triggering the mid-quarter convention.

This example demonstrates that you must be very cautious in the timing of depreciable asset purchases as a tax-planning move. As illustrated, the mid-quarter convention may reduce first-year depreciation. In contrast, triggering mid-quarter convention may increase the overall depreciation deduction if the original purchases were made early in the year.

Example 5.14: More Depreciation

Suppose Don (from Example 5.13) purchased \$40,000 of equipment in March and \$27,000 in December. The mid-quarter convention is triggered and his total depreciation on the purchases is \$10,964. If the timing of his purchases had not triggered the mid-quarter convention, his allowable depreciation on the \$67,000 under the half-year convention would be \$9,574.

The special depreciation allowance and the §179 deduction were ignored in Examples 5.13 and 5.14, but they can be significant tax planning tools when available. There are some additional considerations regarding special depreciation allowance and §179.

1. The full deduction is allowed even if property is purchased on the last day of the year.
2. To maximize the acceleration of deductions, §179 should be taken on property in the class with the longest life. This will increase the deductions in the earlier years of the properties' useful lives.
3. A taxpayer may benefit from delaying purchases into later years to take greater advantage of §179 each year.

Example 5.15: Maximizing §179

Jazlyn purchased \$1,150,000 of used farm equipment in October 2021 and made no purchases in 2022. In 2021, she expensed \$1,050,000 under §179 (the 2021 limit) and depreciated the remaining \$100,000 of her cost using MACRS 200% declining balance depreciation and the mid-quarter convention. She can deduct \$1,053,570 of depreciation and §179 expenses in 2021 and \$27,550 of depreciation in 2022. The remaining \$68,880 of her cost would be depreciated from 2023-2027.

If Jazlyn delayed \$100,000 of her purchases until 2022, she could claim a \$1,050,000 §179 deduction in 2021 and a \$100,000 §179 deduction in 2022. She would not have any regular depreciation because her entire purchase price would be recovered through §179 deductions.

Lease vs. Purchase of Equipment

Leasing is often considered to be a way of reducing taxable income because deductible lease payments can be greater than deductible depreciation and interest. However, taxpayers need to carefully analyze the after-tax cost of a lease versus purchase. If the total cost of leasing is greater than the total cost of owning, the tax savings must exceed that difference to make leasing the better after-tax alternative.

If leasing is the better option, taxpayers must be sure the transaction will be treated as a true lease rather than as an installment purchase contract. Over the years, IRS rulings and court decisions have indicated that the following factors result in a transaction being treated as a purchase rather than a lease.

1. The agreement applies part of each payment toward an equity ownership interest.
2. The lessee receives title to the property upon payment of a stated amount under the contract, in contrast to an option to purchase at reasonable market value.
3. The amount the lessee pays for a short period of time is nearly the amount that would be paid

- to buy the property.
4. The lessee pays much more than the current fair rental value of the property.
 5. The lessee can purchase the property at a nominal price compared to the value of the property at the time of purchase (for example, \$1).
 6. The lessee has the option to buy the property at a nominal price compared to the total amount the lessee has to pay under the lease.
 7. The lease designates part of the payments as interest, or a part of the payments is easy to recognize as interest.
 8. The lessee has an equity interest in the leased item during the lease period.

Trade-ins and Leasing

Trade-ins on leased items can create tax problems. If the lessee has an equity interest in the equipment as a result of the trade-in, the transaction does not qualify as a lease. To preserve lease treatment, the transaction must be structured as a sale of the old equipment. This is a taxable sale for which the gain is generally reportable on IRS Form 4797, Sale of Business Property, as ordinary income that is not subject to self-employment (SE) tax.

Example 5.16: Trade-In Resulting in Installment Purchase

Brenda traded her old tractor for what she thought was a lease of a new tractor. However, the dealer applied the \$25,000 trade-in value of the old tractor to the purchase price of the new tractor and figured the subsequent payments on the balance of the purchase price.

Because Brenda has an equity interest in the new tractor, she is treated as making an installment purchase of the new tractor. Her “lease” payments are treated as installment payments. She cannot deduct the payments as lease payments, but she can deduct the new tractor’s cost through special depreciation allowance, §179 expense deduction, or depreciation. She can also deduct the interest portion of her installment payments.

Observation

Constructive Receipt of Income

As discussed earlier in this chapter (see Example 5.12) prepaid lease payments can be deducted in full only if the benefit does not exceed 12 months. If a trade-in credit covers lease payments that extend beyond 12 months, only the portion attributed to months in the current tax year can be deducted currently.

Example 5.17: Trade-In Treated as a Sale

If Brenda from Example 5.16 sold her old tractor to the dealer for \$25,000, she must report her gain from that sale on Form 4797 as ordinary income that is not subject to SE tax. If her adjusted basis in the old tractor after depreciation is zero, she has a \$25,000 gain to report.

If the dealer applies the \$25,000 sale price to true lease payments, the \$25,000 can be deducted as a lease payment subject to the 12-month rule discussed earlier in this chapter. If the annual lease payments are \$25,000 or more, Brenda can deduct the \$25,000 credit as a lease expense in the year she entered into the lease. However, if the annual lease payment is less than \$25,000, she can deduct currently only the portion of the credit that is prorated to the tax year of the transaction.

Depreciation vs Lease Expense

If the transaction qualifies as a lease for tax purposes, the next step is to consider whether a lease payment deduction is more beneficial than a depreciation deduction. If the asset qualifies for the §179 deduction, the taxpayer can get a bigger first-year deduction by purchasing rather than leasing the asset. (The details of qualifying property and other considerations are discussed in Chapter 4.) Leasing may provide a larger first-year deduction for assets that do not qualify for the §179 deduction, such as general-purpose farm buildings.

Furthermore, leasing may also be a useful tool for the taxpayer whose purchases are great enough to cause the phase-out of the §179 deduction. (In 2022, the deduction is reduced dollar for dollar for total qualifying purchases over \$2,700,000.)

Example 5.18: Leasing to Maximize §179 Deduction

George plans to purchase \$2,900,000 of equipment in 2022. Because this exceeds the \$2,700,000 limit on qualifying property by \$200,000, his §179 deduction is reduced by \$200,000 from \$2,080,000 to \$1,880,000. If he leases the \$200,000 of excess equipment, he could claim the full \$2,080,000 §179 expense deduction. The leasing company told George that his first-year lease payment would be \$40,000.

The total deductions available to George for the two alternatives are shown in Figure 5.5 below.

Figure 5.5. Deduction Alternatives

	<u>Purchase Only</u>	<u>Purchase and Lease</u>
§179 deduction	\$1,880,000	\$2,080,000
Lease payment	0	40,000
First-year depreciation*	<u>21,420</u>	
Total first-year deductions	<u>\$1,901,420</u>	<u>\$2,120,000</u>

*10.71% of cost of purchases reduced by §179 deduction

George can increase his first-year deduction by \$218,580 if he leases the excess equipment that would reduce his maximum §179 deduction.

Non-Tax and Other Considerations

Example 5.18 illustrates that using a lease may generate significant first-year tax deductions. Note that the lease payment in the example is \$40,000, whereas the depreciation expense on \$200,000 of equipment would be only \$21,420. However, the producer needs to consider the total cost of leasing versus purchase over the life of the asset. A lease may include a different interest component than the financing available for purchase. The purchase option amount must be factored in. The lease term may also be shorter than the loan term, making it necessary to consider the time value of money. In making the decision, the farm producer should consider a cash-flow analysis that takes into account all of these factors.

State income taxes, such as incentives for capital purchases, also influence the decision, and there may be non-tax considerations favoring the lease such as:

1. The lease obligation not being included as a financial statement liability,
2. No lost capital on the financial statement for the leased item, and
3. The ease of replacing leased equipment if it becomes obsolete or is no longer needed.

Summary

Because the federal income tax rates are graduated (a higher tax rate applies to income in the higher brackets than in the lower brackets) farmers who use cash-basis accounting can manage their tax liability by shifting income away from the high-income years and deductions away from low-income years. However, the tax rules impose some limits on making these shifts and there are some non-tax factors to include in the analysis of the costs and benefits of the shifts.