

Managing Income Taxes After Year-End

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Introduction

As the end of the year approaches, farmers and ranchers start to think about the tax liabilities which result from the current year's business activities. After a year-end tax estimate appointment, they may ask the question, "what can I do about my tax bill?", especially if it was a particularly good year. It is always advantageous to do some planning before year-end while there is still time to make adjustments. However, sometimes things can happen that can be a surprise for the farmer or preparer. A taxpayer may want to modify their tax bill either higher or lower at the conclusion of the year. This fact sheet will walk through a couple of provisions that allow them to make those modifications.

A common (but not always recommended) strategy is to lower taxes for the current tax bill as much as possible. This involves recognizing the greatest amount of expense and lowest amount of revenue. While it may maximize current tax benefit, sometimes it can have a detrimental effect in later years. Another strategy is comparing current-year income and tax rates with prior and future years. It can be advantageous to recognize income in the current year if the effective rate is lower than previous years or tax rates are expected to rise in the future.

Decreasing Taxable Income

Depreciation is a common provision that can be utilized for tax management. It is worth noting that a farm cannot purchase equipment after year-end to be depreciated on the current tax return. But for items that were purchased during the current tax year, decisions can be made relative to the type of depreciation treatment they will receive. There are provisions such as §179 or §168(k) additional first year depreciation, commonly referred to as bonus depreciation, that allow accelerated depreciation and greater expense to be recognized in the year of purchase. Should a farm want to recognize more depreciation expense in later years, they may decide to forego accelerated depreciation and even choose a slower recovery method such as straight-line (SL) depreciation or the Alternative Depreciation System (ADS), allowing it to be recovered over a greater number of years. It is

important to note that these provisions do not allow any more or less depreciation, they ***simply change the timing*** of when it is recognized.

Farmers can make an election to treat *CCC loans* as income (sale of crop); the presumption is that CCC loans will be treated as a loan. The election can be made or revoked yearly; thus, giving flexibility in the planning process. Making the election allows a farm to change timing of that income, as it could either be recognized in the current year (if the loan proceeds are treated as a sale), or treated as income when the crop is subsequently sold (if treated as a loan). This decision can be made after the year has been completed, while preparing the tax return.

Sometimes a farm may be subject to a natural disaster during the year and receive either *crop insurance* or be forced to *sell livestock* that they did not plan to sell. In certain instances, the farm can defer this income until the following year, if it can be shown that it is their normal practice to sell in the following year. If it is advantageous for the farm to recognize this income in the current year, no adjustments need to be made.

Income averaging is a provision election available to commercial farming and fishing operations. This allows farmers/ranchers/fishers to compare the prior three years tax brackets and tax rates. If there are portions of lower brackets available, they can apply the prior-year's lower rates to electable current year income. It is important to note this does not change or amend prior year returns, but is using prior-year information to make the calculation. If a farm has experienced a significant increase in income during the year, it may be an opportunity to utilize income averaging.

While not specifically for farm or ranch businesses, all taxpayers have some options to make contributions after year-end that can lower their taxable income. This includes *retirement-plan contributions* and *health savings accounts (HSAs)*. IRAs, SEP, and SIMPLE retirement plans all allow contributions until the tax filing deadline. IRAs and SEP plans can even be established after year-end but before the filing date, including extensions. SIMPLE plans must be in place by October 1 of the prior year to make post-year contributions. If a taxpayer is part of a high-deductible health plan (HDHP), generally they have the option of a health-savings account. These accounts allow a taxpayer to set aside pre-tax money to cover qualified medical expenses. Contributions to a health-savings account are allowed after year-end until the tax filing deadline. Each account mentioned here has slightly different guidelines,

so it is important to check the details if these situations applies the farmer or rancher's specific fact pattern.

Increasing Taxable Income

Deferred payment contracts or installment sales allow a farmer to sell crops in the current year but not receive payment until the subsequent year, thereby recognizing income in the year following production of the crop. The presumption for installment sales tax law is that income will be recognized in the subsequent year(s). It is advisable to have, for example, ten \$10,000 grain sale contracts instead of one \$100,000 contract, as each contract stands alone. Thus, after year-end, if a payment agreement was in place but the farmer decides to recognize income in the current year, they have the option to do so by making the election out of installment reporting. However, it cannot go in reverse where a deferred payment or installment agreement can be set up after year-end to defer payment until the next year.

Typically, because of an annual election to expense, fertilizer is deducted in the year applied, even though the benefits of the soil amendment last for a longer time. This election is made by reporting and deducting the fertilizer expense on the current tax return. If done continually, for both the farmer and the tax preparer, this election is "how it is done". However, the tax law provides that fertilizer and other soil amendments are to be amortized over a useful life, e.g., five years. Tax law for *fertilizer amortization* allows a portion to be expensed this year, with remaining amounts recognized as expenses over subsequent years. This would result in less expense and greater income being recognized for the current year.

During the year, farms will often have *repairs and maintenance* for items on the farm. Generally, these are expensed in the year they are paid as "ordinary and necessary business expenses". However, an annual election can be made to capitalize these costs as improvements to property. The type of item repaired determines how many years it will be depreciated. The election can be determined each year, which allows for flexibility to the farmer/rancher to base the decision to capitalize repairs on that year's amount of income and expense, and what help is needed to achieve and manage taxable income for the current and subsequent years.

Conclusion

Working with a professional tax preparer can help advise farmers/ranchers how these provisions might be used to manage the current and future years' tax

liability. As mentioned, prior planning and conversations during the tax year can go a long way toward managing and determining the "sweet spot" of income and self-employment taxes owed. However, these are a few options to make adjustments after the close of the year, if the farmer/rancher and preparer determine it is best to do so.

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Additional Topics

This fact sheet was written as part of Rural Tax Education a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org. *This information is intended for educational purposes only. You are encouraged to seek the advice of your tax or legal advisor, or other authoritative sources, regarding the application of these general tax principles to your individual circumstances. Pursuant to Treasury Department (IRS) Circular 230 Regulations, any federal tax advice contained here is not intended or written to be used, and may not be used, for the purpose of avoiding tax-related penalties or promoting, marketing or recommending to another party any tax-related matters addressed herein.*

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