Tax Planning for High Income

Managing your taxes in a high-income world.

*by **Tina Barrett,** Executive Director, Nebraska Farm Business Inc.*

For the past five years, I've been writing articles for crop farmers on how to manage the unprecedented amount of income flowing through their operations, and now it's the livestock producer's turn to worry about what to do with all the extra income.

Agriculture has always been an industry with cyclical income trends. Prior to 2003, the average farm income reported in our annual data would typically go up and down each year, having a good year and then a bad year and then a good year again. Since then, nothing has been typical when looking at the farm income trends, and 2015 seems to be another year that no one projected could have been this extreme.

Cattle producers are looking at astonishing prices for their livestock in 2014 and 2015, which are leading many to be concerned about the tax bill that will inevitably follow this period of prosperity and how to keep it manageable.

Prepaying expenses

There are usually two things that come to mind for the agricultural producers I work with when it's time to look at reducing income. The first is to buy equipment, and the second is to prepay expenses for next year. Buying new equipment is fun, and prepaying expenses is a habit built in those cyclical years of having alternating good and bad years. I will get to purchasing equipment in just a minute, but for now let's look at prepaying expenses. With alternating years, prepaying in the good years is a great way to even things out with the next bad year. With multi-year stretches of highly profitable years, prepaying can become a snowball of growing problems. Many crop producers will tell you that prepaying expenses will only work for so long. The first year of high profitability, prepayment is easy. The next year, you have to prepay all that and add additional expense to get to the same place.

Let's look at a quick example in Table 1. If you have, on average, $150,000 of income and want to keep your taxable income at $75,000, you must prepay $75,000 the first year. That's usually pretty easy, but the second year, you are short the $75,000 of expenses that you pulled into year one, creating a cash basis income ($150,000 that you earned again plus the prepaid expenses) of $225,000. That means in order to get back to $75,000 taxable, you must prepay $150,000. In just five years, you are prepaying $375,000 to stay at your desired income level.

This is a simplified example, but it can show the effects of a snowball. That being said, it's important to remember that prepaying expenses is not a bad strategy, but it can't be the only strategy in periods of long-term profitability.

Capital purchases

Using capital purchases to reduce taxable income is a longtime, favorite strategy for producers. The grain producers were given a gift along with their prosperity of enhanced accelerated depreciation. Their good times came at the same time as a national recession, and one of the federal government's solutions was to encourage purchasing by the nation's businesses by increasing the amount of assets they could write off in the first year from $25,000 to $500,000 and adding an additional write-off of 50% of any brand new assets. After a short-term fix for 2014, these laws were again allowed to expire on Jan. 1, 2015. There will certainly be discussion in 2015 of another extension, but at this time it's not something we can count on.

Without Congressional action, the law stands that we will have a limit on Section 179 of $25,000 (indexed for inflation) for 2015 and no bonus depreciation. That means that for capital purchases made in 2015, you can fully deduct the first $25,000 you spend, and the remainder will be subject to regular rates. Table 2 shows some typical farm assets and the first year "normal" depreciation rates.

Without the enhanced accelerated depreciation rates, the immediate benefit of purchasing capital assets is greatly reduced. For example, if you purchase a $100,000 tractor, you could write off the first $25,000 and then the remaining $75,000 would be subject to the rate of 10.71%, which would give an additional expense of $8,033 making the total depreciation $33,033. If that expense reduced self-employment taxes of 15.3% and income taxes at a 25% rate, the $100,000 purchase would save you $13,312 in taxes the first year. That means purchasing the asset strictly to save taxes isn't getting you a very good return of your money. If you needed the $100,000 tractor to improve your operation, the depreciation will be a beneficial part of your plan.

Income averaging

One of the unique tax benefits those in agriculture possess is the ability to use "income averaging." This will be a must-use strategy for all livestock producers this year.

Income averaging allows cash basis taxpayers to carry income back to the three prior years and to recalculate the tax in those years. In other words, we get to "pretend" that the income came in those years. It will be especially beneficial since the past three years have been years with lower profitability for livestock producers. This circumstance means income that would be pushed into a higher bracket this year could be taxed at the lower brackets you didn't use. The income that you elect to carry back must be carried back evenly. So if you elect $150,000 of income in 2014, each tax year of 2012, 2013 and 2014 would have $50,000 added to the income reported in those years. This ability to average income does not affect self-employment taxes. That tax will be calculated on all the income reported in 2015 regardless of any carryback.

Other income reducing strategies

In many farming and ranching operations, the labor of the family members goes unpaid. In periods of high income, you may consider paying wages. You must pay a reasonable wage for the work done. For example, you can't pay a 2-year-old $10,000 per year to help around the farm, but many kids do considerable work around the operation and can be compensated. This expense reduces your farm income and could be tax free if their total income is under the standard deduction. Paying children also gives them earned income that they could contribute to a Roth IRA. These funds can be used to pay for college expenses but are not looked at for Federal Student Aid purposes.

Paying your spouse, who also contributes to the operation, is another option to consider. While this doesn't create the tax savings that paying your children can, it may mean we can create an employee relationship for which you can provide benefits. The Affordable Care Act has many provisions that limit the flexibility we once had with this strategy, so it's important to consult a tax professional about your unique situation before implementing any of these plans.

Retirement plans offer a great way to reduce income today. You can use traditional IRA's that have lower limits, or you can consider plans like a Simplified Employee Pension (SEP) plan that allows a significant contribution in high income years. Either way, you can use them now to avoid high tax brackets and could convert them to Roth IRA's in years of low taxable income. Putting money into a retirement plan locks the money up until you reach 59½ (unless an exception applies), or you will face a 10% penalty plus tax on the withdrawal.

Contact your tax professional

Remember that paying taxes is not always the evil that we often think it is. Paying taxes should mean that you are making money, and that's a better situation to be in than not making money. It is important that you manage your tax bill responsibly so that you are neither creating a nightmare down the road nor paying more taxes than you need to pay.

The balance of finding ways to have the lowest tax bill over the entire course of your business takes planning and the benefit of a quality tax professional that knows and understands agriculture. Be sure to consult with your tax professional early this year to have time to make the necessary changes before the end of 2015 is here. HW

Table 1

	1st year	2nd year	3rd year	4th year	5th year
Accrual Income	$150,000	$150,000	$150,000	$150,000	$150,000
Prior Year Prepaids	$0	+$75,000	+$150,000	$225,000	$300,000
Cash Income		$225,000	$300,000	$375,000	$450,000
Prepays	-$75,000	- $150,000	$225,000	$300,000	$375,000
Taxable Income	$75,000	$75,000	$75,000	$75,000	$75,000

Table 2

Assets	Life class	1st year depreciation rate
Breeding cattle	5	15%
Machinery and equipment	7	10.71%
Farm buildings	20	3.75%
Single-purpose ag structures	10	7.5%
Pickups	5	15%
Wells	15	5%