Income Tax Management: Examine All the Options, Plan for the Future

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Having income tax liabilities at year-end is normally a healthy sign of a strong business. Although no one really enjoys paying income tax it is a great indicator that your business is doing something right. To reduce the year-end income tax bill, farmers have a vast array of options to utilize at their disposal. Many common methods include prepaying crop inputs for next season, utilizing Tax Code Section 179 depreciation on equipment purchases, income averaging, deferring income into the next fiscal year, and many other options.

As a preface to this article, decisions should not be made only for tax purposes but should take the entirety of the farming business into consideration. The objective is not to evade income tax liabilities more so to maximize after-tax income. However, businesses should take advantage of legal methods to avoid or postpone taxes in a fitting manner according to one’s planning horizon.

The last half of 2020 brought in the commodity boom cycle with the end of the COVID-19 meltdown. Producers fortunate enough to have crops in inventory to sell and time the market right will likely have larger than normal revenues and therefore income tax liabilities. With the current tax code and marginal tax brackets it is a common strategy to try to stay in the same tax brackets from year to year.

Buying inputs in the fall often allows farmers to take advantage of discounts dealers offer. This is a great opportunity to take advantage of lower prices and use the expense to reduce taxable income. However, keep in mind that this input expense won’t be used for next year's income statement.

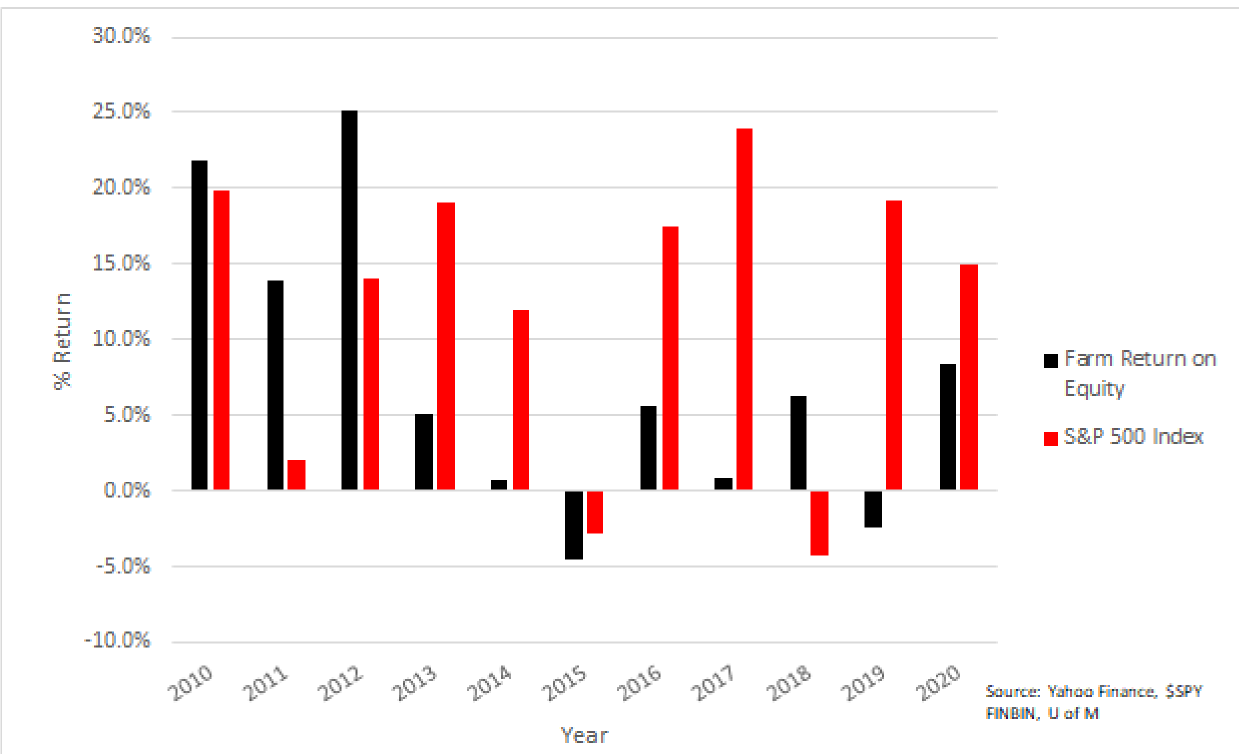
Utilizing Section 179 of the tax code is also a great way to reduce your income tax liability. When a piece of equipment is purchased and put into service the entire purchase price can be deducted from taxable income during the year of purchase up to the yearly limits the tax code allows. Under current law, bonus depreciation allows for a higher deduction then the deduction limit. This bonus depreciation will be phased out at a decreasing rate over several years after 2023.

2021 Section 179 Limits			**Bonus %**	
Deduction Limit:	$1,050,000		2022	80%
Spending Cap:	$2,620,000		2023	60%
Bonus Depreciation:	100%		2024	40%
Maximum Deduction:	$2,100,000		2025	20%

Income averaging is a tool that can be elected that allows a certain amount of farm income to be spread over a three-year period. Consider this method if your current year taxable income places you in a higher marginal tax bracket than prior years. Income earned at the higher rate can be applied retroactively to prior years with lower rates if a farm has abnormally large profits from higher production or prices received. Spreading out income over three years can prevent a farmer from being pushed into a higher tax bracket. Income averaging requires the filing of the 1040 Schedule J. A similar method to income averaging is being able to defer income from business operations such as inventory sales into the next fiscal year.

Another great option to reduce your income tax liability is to save for retirement using 401k contributions. Contributions to 401k's can be tax-deductible investments up to $19,500. Operations that have full time employees makes this method slightly more complicated as the operation must make employee matching contributions and have the plan administered by a financial firm. Making this investment defers income into your retirement years making it a great strategy if you expect your income to be less going into retirement. Young producers have the benefit of time being on their side with even greater potential for growth.

Diversifying capital asset allocations into alternative investments can help grow the farm in tough years. Below is a chart comparing return on equity for farms in North Dakota with an acreage of 1,501-2,000 acres and returns to the Standard and Poor's 500 index fund (SPY ticker, dividends paid were excluded) over the past 11 years. The average farm return on equity was 7.34% and the average return for the S&P500 index was 12.30% over this time period. Data was collected from Yahoo Finance and FINBIN from the University of Minnesota database.



Having equity built into a 401k can aid farm retirement having more liquidity. Many farmers consider the farm as their retirement plan hoping to pass on the operation or collect rental income from farm assets. Land and machinery are relatively illiquid assets that often require more management than some retirees might prefer. Having a diversified approach for retirement can help reduce the risk of returns farming may or may not bring over time.

There are some drawbacks to consider with a 401k to consider. Early withdrawal of the account balance may be subject to an early withdrawal fee along with the normal income tax rate. The IRS will often charge a 10% early withdrawal fee for taking withdrawals before the minimum withdrawal age of 59 and a half. It is best to plan on investing this money for retirement and never touch until you have reached the retirement age. There are possibilities that money can be borrowed against funds in a 401k if money is needed down the road. Loan amounts can be 50% of the funds or up to $50,000.

Work closely with your accountant and financial advisor to determine what tax strategies are best for your operation and goals for the future. Remember to plan for the future and examine all your options to use the best tools at your disposal.

The North Dakota Farm Management Education Program provides lifelong learning opportunities in economic and financial management for persons involved in the farming and ranching business. Visit ndfarmmanagement.com, Facebook @NDFarmManagementEducation, or contact Craig Kleven, State Supervisor for Agricultural Education, at crkleven@nd.gov or 701-328-3162 for more information. The ND Farm Management Education Program is sponsored by the North Dakota Department of Career and Technical Education.

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