YEAR END TAX MANAGEMENT WORKSHOP

by

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Anyone who owns a business can benefit from income tax management.
Recently, inflation, high capital requirements, wide product price fluc-
tuations, fluctuating yields, and rising supply costs make income tax
management increasingly important. Taxes, like many management problems,
cannot be completely farmed out to someone else. While the manager need
not be an expert, he needs to recognize tax problems or opportunities.
Most major business transactions have tax implications.

Effective tax management can often lead to large savings in taxes with
a small investment of time and money at little risk. The objective of good
tax management is not to minimize taxes but to maximize income after taxes.
Farming is a continuous operation and each year's decisions affect future
earnings and tax considerations. Tax decisions must be made in consideration
of the impact of a decision upon the whole operation. Buying unneeded equip-
ment will increase depreciation and thus reduce taxes but the net result
may be lower profits. Postponing sales to shift income to the next account-
ing period in the face of declining prices is another example of a poor
management decision based on tax considerations only.

Tax planning must be based on the proper accounting period, method of
paying taxes, a good accounting system and use of business accounting prac-
tices that insure the inclusion of all allowable business expenses. Also
understanding general tax law provisions and recognizing the importance of
income tax decision making, plus seeking competent professional help at the
appropriate times are necessary. Tax management should be practiced year-

round and routinely included in farm management decisions.

After taking all allowable deductions, there are three categories
of tax management opportunities:

(1) Managing the flow of income

    - between years

    - between tax-entitie's (i.e. family members)

(2) Converting ordinary income to capital gains income

(3) Income and tax deferral.

This workshop will focus on tax deferral and investment credit.

TAX DEFERRAL

The payment of taxes on deferred income is also postponed. That frees
up money that can be reinvested in the business or used to retire loans at
an earlier date. Since tax on deferred income must eventually be paid, the
extent of the advantage is directly related to the profitability of the use
to which temporarily freed tax money is diverted.

Deferral of income to a lower tax bracket

If income is deferred to a tax period in which taxable income is lower,
the tax rate on the deferred income will be reduced. This means that in ad-
dition to the deferral advantage mentioned above, the tax liability is actually
reduced.

Example 1

Suppose that $1000 of fertilizer normally purchased in 1980 is bought
in 1979. The farmers tax bracket in 1979 is 40% and 30% in 1980.

1979	1980
$1000 fertilizer expense	$1000 extra income
.40 tax bracket	.30 tax bracket
$400 saved taxes	$300 added taxes

Table 1. Eligibility of selected assets for depreciation by various methods.

	DEPRECIATION METHOD									
	Straight Line		Sum of Year's Digits		1 1/2 Declining Balance		2 Declining Balance		Additional 1st Year	
Asset	Eligible	Minimum Req. Yrs. of Useful Life	Eligible	Minimum Req. Yrs. of Useful Life	Eligible	Minimum Req. Yrs. of Useful Life	Eligible	Minimum Req. Yrs. of Useful Life	Eligible	Minimum Req. Yrs. of Useful Life
Purchased Breeding & Dairy Animals	Yes	None	Yes[1]	3 years or more	Yes	3 years or more	Yes[1]	3 years or more	Yes	6 years or more
Purchased New Machinery	Yes	None	Yes	3 years or more	Yes	3 years or more	Yes	3 years or more	Yes	6 years or more
Purchased Used Machinery	Yes	None	No	-	Yes	3 years or more	No	-	Yes	6 years or more
New Buildings Purchased After 7-24-69	Yes	None	No[2]	-	Yes	3 years or more	No[2]	-	No	-
Used Buildings Purchased After 7-24-69	Yes	None	No	-	No	-	No	-	No	-

1/ Eligible only if classified as a purchase of a new animal. Used personal property does not qualify for 2 declining balance or sum of year's digits.

2/ Single purpose facilities (for example, milking parlors, chicken houses, and confinement units) are eligible if purchased after August 15, 1971.

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Two advantages from deferral:

    (a) used $400 of tax money for 1 year (also fixed the price of fertilizer)

    (b) Saved $100 of taxes by deferring income from a higher to a lower

         tax bracket year.

Opportunities for farmers to realize tax deferral advantages include:

Accelerate operating expenses

As shown above with the fertilizers, expenses normally incurred during the following tax year may be advanced to the current year, thereby deferring income for one year. Moreover, a one year deferral can often be realized by advancing expenses only a few days or weeks. Expenses easily shifted between tax years for farmers using cash accounting include fuel and oil, feed, chemicals, seed, and other supply items.

Accelerate depreciation

Farmers have considerable flexibility in the rate at which allowable depreciation on depreciable assets is deducted. While annual depreciation may be calculated by any reasonable and consistent method, three methods are outlined in the tax code: (1) straight line, (2) declining balance ($1\frac{1}{4}$, $1\frac{1}{2}$ and 2 times the straight line rate), and (3) sum of year's digits. The three methods differ considerably in the rate at which assets are depreciated. Compared to straight line, both declining balance and sum of year's digits permit more rapid deduction of depreciation. Assets qualifying for depreciation by each method are noted in Table 1.

Additional First Year

In addition to selecting an accelerated depreciation method, depreciation can be advanced by use of the 20% additional first year option. That option can be used in combination with any of the three depreciation methods to increase the amount of depreciation claimed the initial year of a qualifying

basis (cost minus depreciation) of $7,000. The equipment is estimated to have a useful life of 6 years and an $11,000 salvage value. The purchase was made on October 15, 1979 by a farmer who is married, files a joint return on a calendar year basis, and is in the 32 percent marginal tax bracket. A depreciation policy that includes use of the double declining balance method, the half year convention and the 20% additional first year deduction will give example farmer the maximum amount of 1979 depreciation. Here is how to compute the depreciation:

(1) Calculate the 20% additional first year depreciation.

$25,000 qualifying basis (cash)
     .20 additional first year rate

$ 5,000 additional first year depreciation ($4,000 limit)

(2) Reduce basis by $4,000 and calculate regular depreciation by the double declining balance (DDB) method.

$32,000 basis
 -4,000 additional first years depreciation

$28,000 adjusted basis
     .33 DDB rate (twice the straight line rate of $\frac{1}{6}$)

$ 9,240 DDB depreciation for entire 1979
      .5 proportion of the year 1979 that the equipment is owned
                                        (half-year option)

$ 4,620 DDB depreciation for 1979

(3) Add additional first year and DDB depreciation to get the maximum depreciation for 1979.

$ 4,000 additional first year depreciation
  4,620 DDB depreciation

$ 8,620 maximum 1979 depreciation

The smallest amount of 1979 depreciation is computed by the straight line method in the following manner:

assets' life (see Table 1) by 20 percent of its qualifying basis.

The basis is generally the full purchase price for assets acquired without a trade-in. However, it is restricted to the cash paid (to-boot) when a trade-in is involved.

Additional first year depreciation does not have to be pro-rated over that portion of the year the asset was actually owned as is the case with regular depreciation deductions.

For example, if a qualifying property is purchased by a calendar year farmer in November, the entire 20% can be claimed for that year. The depreciation that can be claimed under the 20% first year option on all assets in a given year is limited to $4,000 for joint returns and $2,000 for single returns, corporations, and partnerships.

Half Year Convention

Depreciation may also be accelerated by use of the half-year convention. Assets purchased during the year are depreciable only for the portion of the year owned. However, an alternative is the half-year convention if it is used consistently. The half-year convention allows depreciation to be calculated as if assets are purchased at mid year and disposed of at mid year. Thus when assets are typically purchased late in the year, use of the half year convention moves one-half year of depreciation from the end of the assets useful life to the year of purchase.

If a farmer is experiencing a high income year, it will normally be advantageous to accelerate depreciation on newly acquired assets to the maximum possible degree. To show farmer's flexibility on the amount of first years depreciation consider the following:

Example 2

New equipment is purchased for $25,000 cash and a trade-in with a

Table 2. A comparison of tax savings realized by the slowest and fastest depreciation methods used on equipment with a $32,000 cost basis, $11,000 salvage value, a 6-year useful life, and purchased January, 1979.

Year	(1) Discount Factor @ 12%[1]	(2) Marginal Tax Rate	(3) Slowest Depreciation (straight line) Annual Depr.	(4) Tax Savings[2]	(5) Present Value of Tax Savings[3]	(6) Fastest Depreciation (double decl. bal. + 20% add. 1st yr.) Annual Depr.	(7) Tax Savings[2]	(8) Present Value of Tax Savings[3]
			$	$	$	$	$	$
0	1.0000	.32	3,500	1,120	1,120	13,240	4,237	4,237
1	.8929	.32	3,500	1,120	1,000	6,190	1,981	1,769
2	.7972	.32	3,500	1,120	893	1,570	502	401
3	.7118	.32	3,500	1,120	797	--	--	--
4	.6355	.32	3,500	1,120	712	--	--	--
5	.5674	.32	3,500	1,120	635	--	--	--
Total	xxx	xxx	21,000	6,720	5,157	21,000	6,720	6,407

[1] Equals $\frac{1}{(1 + i)^n}$ where i = 12 percent and n = the year.

[2] Equals marginal tax rate times depreciation.

[3] Equals discount factor times tax savings.

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(1) Compute the depreciable basis.

$32,000 basis (cash paid plus undepreciated value of previous asset)
-11,000 salvage value

$21,000 depreciable basis

(2) Determine depreciation for 1979.

$\frac{\$21,000}{6 \text{ yrs.}} = \$3,500$ straight line depreciation for 1979
$\frac{}{.5}$ proportion of 1979 equipment is owned (half year option)

$1,750 straight line depreciation for 1979.

Thus there is a difference of $8,620 - $1,750 = $6,870 in the amount of 1979 depreciation allowed by the fastest and slowest depreciation methods. Assuming a 32% marginal tax rate, this represents a 1979 tax savings of $6,870 x .32 = $2,198 when the faster depreciation policy is used.

As the example shows, a great deal of flexibility exists on how much depreciation can be claimed during the first year of a newly acquired asset. During a year of higher than normal taxable income if pays to accelerate depreciation since depreciation expenses save more taxes when deducted from a higher income. Moreover, acceleration of depreciation provides a tax deferral advantage.

The tax deferral advantage is shown more clearly by Example 3.

Example 3

Equipment with a $32,000 cost basis is purchased on January 2, a 6 year useful life, and $11,000 salvage value is used in computing depreciation.

Equipment depreciation and associated tax savings over the six-year period are compared for the slowest (straight line) and fastest (double declining balance + 20% additional first year) methods in Table 2. A comparison of the totals of columns 4 and 7 indicate total tax savings are equal for the two methods. Those totals however, fail to take into account the tax deferral

Figure 1. Present value of tax savings for straight line (SL), straight line with 20 percent additional first year (SL+), sum of year's digits (SOYD), double declining balance (DDB), and double declining balance with 20 percent additional first year (DDB+) depreciation methods, selected discount rates, and an 8 percent annual rate of growth in taxable income, example analysis.
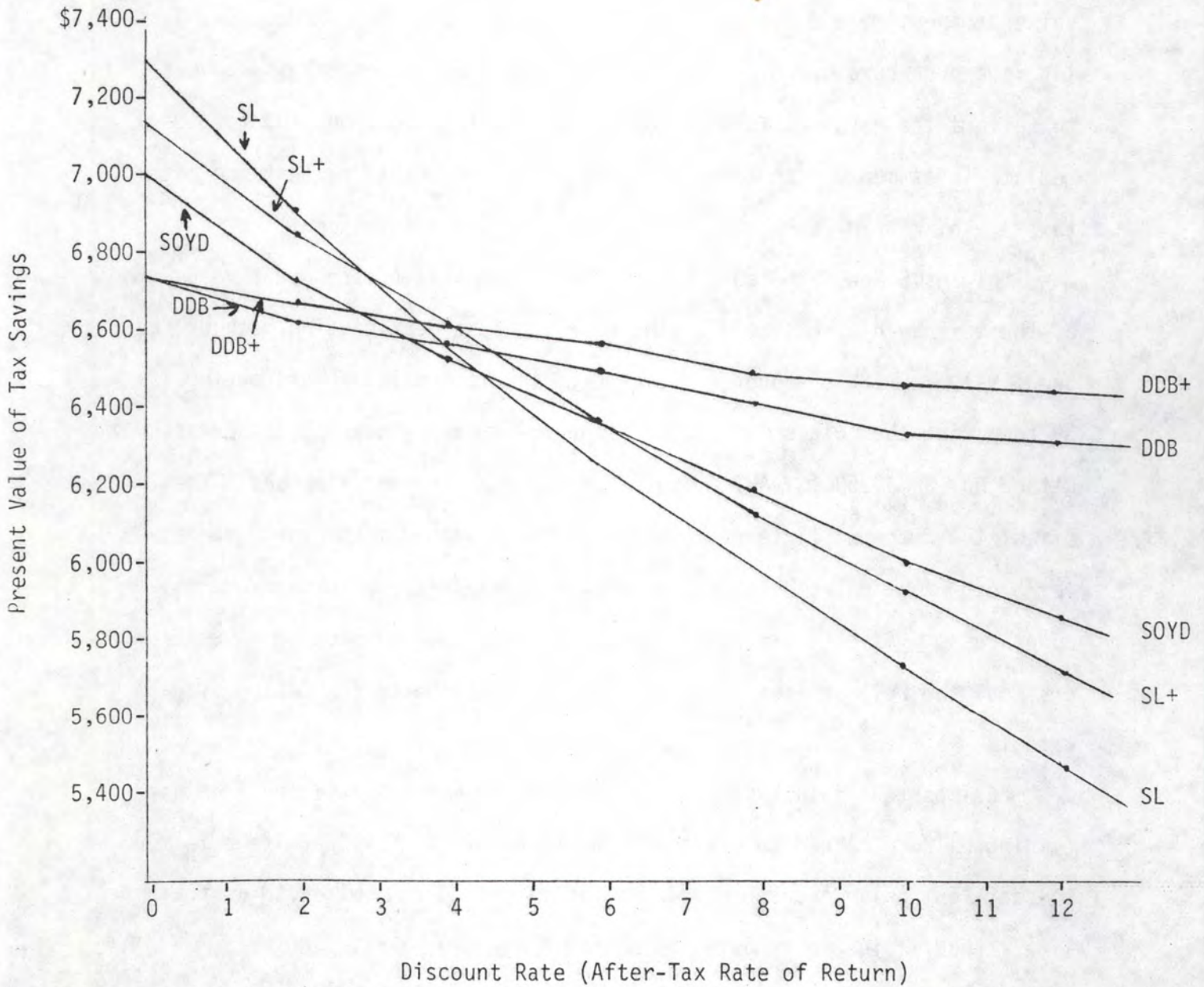
benefit associated with the faster depreciation methods.

To identify the tax deferral benefit and accurately compare the two depreciation methods, it is necessary to account for additional earnings realized from the earlier receipt of tax savings. This can be done by discounting future tax savings to identify their present value, i.e. the value at the time a decision on the depreciation method is made. Discounting is a procedure by which the value of future sums of money is reduced to reflect the earnings foregone by not having the money on hand for immediate investment. The rate used in discounting should reflect the after tax rate of return realizable on the best available investment.

Columns 5 and 8 in Table 2 indicate the present (discounted) value of the tax savings realized for the slow and fast depreciation methods, respectively. A 12% discount rate was used in discounting future savings. By comparing the totals in columns 5 and 8, it can be seen that the fast method has a $1,250 ($6,407 - $5,157) advantage over the slow one. The effect the discount (interest) rate has on the value of the tax savings for 5 depreciation methods used on equipment are graphed for various discount rates. As can be seen in Figure 1, under most discount rates, farmers would be well advised to accelerate depreciation to the maximum legal extent.

An important point is that Federal Tax law permits shifting from declining balance method to straight line at anytime. This permits a farmer to start out on an accelerated depreciation method and switch to a straight line method if income is going to be low for a few years.

Managing Investment Credit

Claiming investment credit reduces the federal income tax liability

purchased for breeding or dairy purposes, milking equipment, milk bulk tanks, manure handling equipment, feed bunks, feed grinders and mixers, bee hives, paved barn yards, and feeding surfaces, fences, canals, chutes, office equipment, single purpose structures used for horticultural or livestock products (i.e. greenhouse, poultry facility, hog confinement unit, milking parlor). Examples of property that do not qualify are land, livestock purchased for resale, horses, and buildings easily adaptable to alternative uses (i.e. garage, machinery shed, barn).

Investment credit must be taken in the year the property is placed in service. This requirement raises the question as to whether or not machinery purchased at the end of 1979 but not used until 1980 qualifies for credit in 1979. Technically, the regulations indicate that the property is placed in service in the year it is "in a condition or state of readiness and available for a specifically assigned function". Consequently, property acquired under the above circumstances qualifies for investment credit in 1979.

There are numerous restrictions which limit the amount of credit claimed on property qualifying under the above 4 criteria. A few of the more important ones are:

(1) Useful life--Only when the estimated life is 7 years or more does 100 percent of the investment qualify.

Life	% Investment Qualifying
7 years	100
5-6 years	67
3-4 years	33
less than 3 years	Does not qualify

(2) Used property--On a joint return, no more than $100,000 of used property can be used in any one year for figuring investment credit.

by $1.00 for each $1.00 of credit realized. The rate used in determining investment credit is currently 10%. Investment credit is calculated by multiplying 10% times the qualifying investment. For example, if a farmer purchases eligible property with a $10,000 qualifying basis, the credit is $10,000 x .10 = $1,000. The credit reduces his taxes by $1,000 and the after tax cost of the investment is reduced by 10%.

A given amount of investment credit will save more tax dollars than an equal amount of deductible business expense. This is because expense only reduces gross income while investment credit reduces income taxes due dollar for dollar. To illustrate, a farmer in the 32% bracket will realize a tax savings of $320 from $1000 of deductible business expenses. However, $1000 of investment credit saves $1000 of income taxes. Also, investment credit is equally as valuable for the small farmer as the large one. A large farmer, by virtue of being in a higher tax bracket, realizes a greater tax saving per dollar of deductible expense than does a smaller one.

To qualify for investment credit, property must:

(1) Have a useful life of 3 years or more.

(2) Be depreciable (may be new or used).

(3) Be placed in service in the farmer's business during the current tax year.

(4) Be tangible personal property or certain other property (except certain types of buildings or their structural components).

Common examples of qualifying property are machinery, trucks, irrigation equipment, concrete canals, water wells, shop equipment, grain storage bins, specialized hay sheds, potato storage facilities, silos fuel storage tanks, fruit trees and vineyards in the productive stage, livestock (except horses)

To illustrate, suppose a useful life of 6 years is estimated for property costing $10,000. The credit initially taken is $\frac{2}{3}$ x $10,000 x 10% = $667. However, after 4 years the property is sold. The credit actually allowable is reduced to $334 (= $\frac{1}{3}$ x $10,000 x 10%). Under the investment credit recapture provision, the difference between $667 and $334 is $333 which must be repaid to the government. The repaid credit, however, has been used by the taxpayer for 4 years at no cost. Assuming at 10% after tax compounded annual return on $333, earnings have been increased $154.55 in the 4 years.

One disadvantage of lengthening the useful life to obtain additional investment credit is that this longer life must also be used for depreciation. Thus it takes longer to realize the tax savings realized via depreciation deductions.

Lengthening the useful life may also qualify an asset for 20% additional first year depreciation. A useful life of at least 6 years is required before that option can be used.

The following example compares the investment credit benefits associated with a longer useful life with the costs of slower depreciation deduction.

Example 4

Combined investment credit and double declining balance depreciation tax savings were calculated for equipment with a $32,000 cost basis and a $11,000 salvage value assuming a useful life of 5 and 7 years (Table 4). Extending the useful life from 5 to 7 years increases investment credit and makes property eligible for 20% additional first year depreciation. The present value of tax savings, assuming a 12% discount rate, was $954 greater for the longer useful life. Consequently, the additional $1,066 of investment credit realized by extending the useful life from 5 to 7 years more

No such restriction applies to new property.

(3) Difference New and Used Property on Trade--When used property is
obtained by a trade and there is no investment credit recapture
on the trade-in, only the cash paid qualifies for investment credit.
No credit is allowed on the adjusted basis (that is cost - accumu-
lated depreciation) of the property traded in. From example 2:

$32,000 cost
-7,000 on depreciated value of trade-in

$25,000 cash paid

Investment credit would be 10% of $25,000 or $2,500. This is in
contrast to new property where investment credit is allowed on
both cash paid and the adjusted basis of the traded property.

$25,000 cash paid
+7,000 adjustment basis

$32,000 total basis

Investment credit would be 10% of $32,000 or $3,200. However,
when used property is obtained by a trade and there is a recapture
of investment credit on the trade-in, investment credit is figured
the same for both new and used property.

(4) Related Seller--If the buyer is a lineal descendant, ancestor, or
spouse of the seller, no credit can be claimed. This restriction
does not apply to a brother, sister, uncle, a father-in-law, or
other persons who do not meet the above definition of a related
seller. Also used property sold and subsequently used by the
seller does not qualify. Examples of where this restriction would
apply are a sale and lease-back arrangement and sale of property
by a father to a son with the father continuing to use the property.

than offsets the $112 reduction in present value of depreciation tax savings.

There is very little incentive to be conservative in estimating the useful life on property qualifying for investment credit. Under most business circumstances, farmers would be well advised to select a reasonable useful life keeping investment credit benefits in mind and use the depreciation methods insuring most rapid write-offs.

An example comparing the slowest depreciation method with investment credit and the fastest is shown in Table 5. In this example with a seven year service life, $1,403 in taxes are saved using accelerated depreciation over the life of the investment, first year depreciation and investment credit. Of that tax savings, $2,874 ($7,034 - $4,160) are realized in the first year. Having that money in your hands to reinvest for 6 more years is worth something to the farmer also.

The investment credit recapture provision should be kept in mind in deciding when to dispose of an asset. By holding the asset for a few days or weeks, recapture of the credit may not be necessary.

It should be recognized that investment credit offers tax savings even though taxable income in any given year cannot exceed the tax liability for that same year, and is limited to $25,000 plus 60% (1979) of the tax liability over that amount. The unused credit can be applied to other years when taxes have been or will be paid. Specifically, any unused credit can be carried back 3 years and if still unused, forward up to 7 years. For example, farmers with unused 1979 investment credit should first apply the credit to taxes paid in 1976 (then to 1977, 1978, 1980 . . .1986). A refund can be claimed by filing form 1040X.

Table 4. A comparison of tax savings from investment credit and depreciation on equipment with a $32,000 cost basis and $11,000 salvage value, useful life of five and seven years.

Year	Discount Factor @ 12%	Marginal Tax Rate	Five-Year Useful Life				Seven-Year Useful Life			
			Investment Credit	Annual Depr.[2]	Tax Savings[4]	Present Value of Tax Savings[5]	Investment Credit[6]	Annual Depr.[3]	Tax Savings[4]	Present Value of Tax Savings[5]
0	1.0000	.32	$2,134[1]	$12,800	$6,230	$6,230	$3,200	$12,000	$7,040	$7,040
1	.8929	.32	-	7,680	2,458	2,195	-	5,714	1,828	1,632
2	.7972	.32	-	520	166	132	-	3,286	1,052	839
3	.7118	.32	-	-	-	-	-	-	-	-
4	.6355	.32	-	-	-	-	-	-	-	-
5	.5674	.32	-	-	-	-	-	-	-	-
6	.5066	.32	-	-	-	-	-	-	-	-
TOTAL	-	-	$2,134	$21,000	$8,854	$8,557	$3,200	$21,000	$9,920	$9,511

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1/ Equals $32,000 x 2/3 x .10.

2/ Double declining balance method.

3/ Double declining balance and 20 percent additional first-year depreciation method.

4/ Equals marginal tax rate times depreciation, plus investment credit.

5/ Equals discount factor times tax savings.

6/ Equals $32,000 x .10.

Summary

Farmers have considerable flexibility in choosing useful life and depreciation methods. Table 6 shows the most important means farmers have for reducing a given years tax obligation. The most important are:

(1) Investment credit

(2) Accelerated depreciation (10%)

(3) Additional 20% first year depreciation (upto $4,000 for a joint return)

Following these suggestions can reduce the years tax obligations as well as get interest free loans from IRS by delaying taxes.

Additional References

1. Weigle, R.N., et. al., Income Tax Management for Farmers, #A9NXT002, Cooperative Extension, University of Wisconsin, Madison, Wisconsin, August, 1977.

2. Willett, G.S., M.H. Becker, Federal Income Tax Management Principles for Farmers, #EM 4505, Cooperative Extension, Washington State University, Pullman, Washington, October, 1979.

Table 5. Comparison of tax savings realized by slowest and fastest depreciation methods plus investment credit and first year depreciation for $32,000 cost basis asset with $11,000 salvage value and 7 year useful life, purchased January, 1979 and filing a joint return.

Year	(1) Discount Factor @ 12% [1]	(2) Marginal Tax Rate	(3) Investment Credit [2]	(4) Slowest Depreciation-(Straight Line) Annual Depreciation	(5) Tax Savings	(6) Present Value of Tax Savings	(7) Total Present Value--1a x 6 Savings	(8) Fastest Depreciation Double Declining Balance + 20% additional first year Annual [5] Depreciation	(9) Tax [3] Savings	(10) Present Value Tax Savings [4]	(11) Total Present Value Tax Savings [7]
0	1.0000	.32	3,200	3,000	960	960	4,160	11,980	3,834	3,834	7,034
1	.8929	.32		3,000	960	857	857	5,706	1,826	1,630	1,630
2	.7972	.32		3,000	960	765	765	3,314	1,060	845	845
3	.7118	.32		3,000	960	683	683	---	---	---	---
4	.6355	.32		3,000	960	610	610	---	---	---	---
5	.5674	.32		3,000	960	545	545	---	---	----	---
6	.5066	.32		3,000	960	486	486	---	---	---	---
Total	---	---		21,000	6,720	4,906	8,106	21,000	6,720	6,309	9,509

1/ Equals $\frac{1}{(1 + i)}$n where i = 12% and n = the year.

2/ Equals 32,000 x .10

3/ Equals depreciation times marginal tax rate

4/ Equals discount factor times tax savings

5/ Double declining balance of 2 times $\frac{1}{7}$ times adjusted basis $28,000 (32,000 - 4,000) plus $4,000 first year depreciation

6/ Total Columns 3 and 6

7/ Total Columns 3 and 10

Table 6. SUGGESTED GUIDELINES FOR DEPRECIATION OF FARM PROPERTY

Kind of Property	Class of Life Guidelines	Eligible for Additional 20% 1st Year Depreciation?*	DEPRECIATION, METHOD AND BASIS			Eligible for Investment Credit?
			Eligibility of Straight Line	Eligibility of Declining Balance	Eligibility of Sum of Years Digits	
New Machinery	(Yrs.) 10	Method: Yes, if 6 yrs. or more life. Basis: cash only.	Method, Yes, if 2 yrs. or more life. Basis: Cash plus unde-preciated balance, less 20% additional 1st yr., if taken, less salvage.	Method: Yes, if 3 yrs. or more life. Limited to 200% of of straight line rate Basis: Cash & undepre-ciated balance of trade, less 20% addition-al, if taken, salvage not deducted.	Method: Yes, if 3 yrs. or more life. Basis: Same as straight line.	Yes Basis: Cash plus unde-preciated balance of trade.
Used Machinery	Est. Life	Same as above.	Same as above.	Same as above, except limited to 150% of straight line rate.	Not eligible	Yes, Basis: Cash only.
Livestock: Breeding Dairy Horses	3-10	Same as above.	Same as above. Salvage must be used.	Same as above, except limited to 200% of straight line rate. Used 150%.	Method: Yes if 3 yrs. or life. Used is not eligibie. Basis: Same as straight line.	Yes (but not horses).
Buildings (Not including res-idential.)	25	Not eligible.	Method: Yes. Basis: Cost less salvage	Limited to 150% of S.L. Used not eligible.	Not eligible.	Not eligible
Fence Silos Grain Storage Drain Tile Feed bunks Paved yards Wells	10 20 25 20 15 20 15	Not eligible.	Method: Yes.	Method: Yes, if 3 yrs. life. Limited to 150% of straight line. Used is not eiigible. Basis: Cost.	Not eligible.	Yes. Basis: Cash plus undepreciated balance of trade.
Groves, Orchards & Vineyards	Est. life	Not eligible.	Same as above except depre-ciation begins with the in-come produc-ing stage.	Same as above except depre-ciation begins with the in-come produc-ing stage.	Not eligible.	Yes, but eligible only as market-able products are produced.

*Limited to a $10,000 cost of property on a single return, a $20,000 cost of property on a joint return.