Agribusiness celebrates the new year with a beneficial tax law

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AT A GLANCE

Major provisions of the new tax law are beneficial to dairymen. The fine print is where some farms may be affected differently than others.

The Tax Cuts and Jobs Act signed into law on December 22, 2017, is the largest overhaul of U.S. tax code in 30 years. Most of the tax-cut provisions are effective immediately for tax year 2018. However, many are temporary and scheduled to sunset or phase out in future years, if no further congressional action is taken. We believe the new law has many tax advantages that will be beneficial to the majority of farmers and dairymen.

There are many general tax provisions provided by the law available to all taxpayers. All tax brackets have been adjusted downward. While the total number of brackets remains at seven, the top rate will fall from 39.6 percent to 37 percent. The amounts of income covered by the lower brackets have also been adjusted upward. The standard deduction for individuals increases to $12,000 for single filers and $24,000 for joint filers. The Alternative Minimum Tax (AMT) still remains for individuals, but exemption amounts are significantly increased and will be indexed for inflation. State and local tax deductions (SALT), deductions for state and local property plus income or sales taxes, are limited to $10,000 annually.

One of the most notable provisions positively affecting farmers and dairymen is the increase in the estate tax exemption that doubles to $11.2 million per individual ($22.4 million for married couples) in 2018. This is great news, since passing the family farm to the next generation has long been a burden to most farmers due to high estate taxes. This provision allows taxpayers to transfer a great deal more wealth to their heirs without having to sell off parcels of valuable land to pay the estate taxes.

Beginning in 2018, there are many enhancements to cost recovery and depreciation that are beneficial to agribusiness. The Section 179 deduction is increased from $500,000 to $1 million. This will allow taxpayers to immediately write off capital purchases such as breeding livestock, farm equipment and single-purpose structures (such as milking parlors) to deduct up to $1 million as a business expense in the year incurred. The phaseout for this expensing provision does not begin until the taxpayer reaches $2.5 million in asset purchases within the year. The bonus depreciation provision is also increased from 50 percent to 100 percent for qualified property purchased after Sept. 27, 2017. The new law also expands bonus depreciation to include new and used property purchased. This is the only portion of the law that is retroactive to include benefits for part of tax year 2017. There is also a provision in which most new farming equipment and machinery (other than any grain bin, fence or other land improvement structure) will have a shortened cost-recovery period of five years, as long as the original use of the asset begins with the taxpayer. The 200 percent declining balance method of Modified Accelerated Cost Recovery System (MACRS) depreciation is also made available for many types of farming property as opposed to the 150 percent declining balance method previously available. This will allow an increased deduction for property placed into service. Please note that many states do not conform to the federal bonus and 179 depreciation provision, thus, depreciation taken at the state level may be different.

Like-kind exchanges, under Section 1031, are now limited to real property only. While farmers and dairymen can still swap land for other land tax-free, livestock, equipment or auto trade-ins will no longer be a tax-free event. Thus, trading in vehicles and other heavy farm equipment will result immediately in capital gains instead of being deferred.

Net operating loss carrybacks have been repealed for most taxpayers, however, there is an exception for farmers who will be allowed a two-year net operating loss carryback for losses incurred in the farming trade or business. The carryforwards for all taxpayers are allowed indefinitely but are now limited to 80 percent of taxable current year income, determined without regard to the net operating loss deduction.

The cash method of tax accounting remains for farmers with average annual gross receipts of under $25 million for the three prior tax years. They won't be required to account for inventories. However, cash-basis taxpayers won't be able to deduct inventory until sold under Section 471. The uniform capitalization rules are also removed for taxpayers under the $25 million threshold.

The corporate tax rate is now a flat 21 percent. While many farmers and dairymen do not operate under the corporate structure, those that do may want to consider their tax brackets. If they fall within the 15 percent tax bracket, they may want to consider converting to an S corporation to avoid that 6 percent tax increase.

The most complicated provision of the new legislation has to do with the deduction for qualified business income or "pass-through" income. This deduction will be taken into account at the taxpayer's individual level, which means on their personal 1040 tax return. With the majority of farmers and dairymen reporting pass-through income from S corporations, partnerships, LLCs or sole proprietors, the 20 percent deduction for qualified business income must be carefully analyzed. The deduction will be taken after the calculation of adjusted gross income and the deduction of either the standard or itemized deductions to total what we will call taxable income before 199A. Generally, an individual taxpayer may deduct the lesser of 20 percent of their domestic qualified business income or taxable income before 199A and reduced by any capital gains. If the taxpayer's taxable income before 199A is less than $315,000 for a married couple and $157,500 for a single taxpayer, you may deduct the entire 20 percent. However, if your income exceeds these amounts, the limit will be the greater of 50 percent of wages paid or 25 percent of wages paid plus 2.5 percent of the cost of certain fixed assets. Also, please note that the deduction only offsets income tax, not self-employment tax.

There is a great deal of concern

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that the 199A deduction may be of little use to dairy farmers who have two sources of income – one from producing and selling milk, which results in ordinary income, and the other is from raising and selling cows, which results in a long-term capital gain. Since the long-term capital gain income is not included in the calculation of the 20 percent qualified business income deduction, dairymen will not be able to use this deduction to offset their capital gain income.

Prior to the new legislation, dairy farmers were able to offset their income with the Domestic Production Activities Deduction (DPAD), which has been repealed for tax years after 2017. For the farming and dairy industries who rely on cooperatives to market their milk and other products, this is one of the most concerning issues. The DPAD was a significant deduction for taxpayers that marketed their products through cooperatives. As a result, many cooperatives have accelerated that pass-through deduction to patrons before the end of 2017. Under the new law, the agricultural cooperatives now will have a 20 percent deduction which will reduce the cooperative income. However, unlike the DPAD, this is taken at the cooperative levels and isn't directly passed on to patrons. To adjust for this loss of deduction, Congress put in a fix under the new Section 199A which allows patrons to take advantage of the new 20 percent deduction on all qualified business income, like every other smaller business, but on top of that, farmers can deduct up to the amount of their taxable income (not including capital gain income) an amount equal to 20 percent of their qualified cooperative dividends and retains. Congress and others in the agricultural sector have acknowledged there are unintended consequences in the current language and are working on a resolution. Frazer LLP recommends that taxpayers wait until the IRS issues regulations that interpret the Section 199A before any changes are made to your farming or dairy operations.

The final issue we will explore is that every business regardless of its form, including farmers, will be limited on deducting interest expense when their taxable income exceeds $25 million. Taxable income is computed at the filer level without regard to certain adjustments, such as business interest expense and net operating losses. If applicable, the interest deduction cannot be more than the business interest income plus 30 percent of adjusted taxable income. There is, however, a special election farmers may consider to avoid that limitation if their income exceeds $25 million. The only catch is that they are required to use an Alternative Depreciation System (ADS), which is a slower depreciation method that must be used on farm property with a recovery period of 10 years or more (i.e., greenhouses, milking parlors, barns, etc.), and no bonus depreciation may be taken.

As we have explored, the new provisions are complex, and the impact of many provisions in the new tax law will differ depending on each taxpayer's situation. The decrease in the tax brackets and the increases in the estate tax and depreciation provisions will prove very beneficial to taxpayers. The 199A 20 percent deduction for pass-through will be beneficial to most businesses, but if there are high capital gains, the impact of this deduction may be limited. As always, we encourage taxpayers to consult with their financial advisers when tax planning.

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