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Year-End Tax Planning

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Harvest is coming to an end as this article is being written. It appears yields are up and prices are well above average. Consequently, many producers will be faced with higher net farm profits. Along with higher profits come higher federal and state income taxes and self-employment tax. In order to defer these taxes, many farmers will prepay 2007 expenses or enter into contracts deferring the receipts from the 2006 crop until 2007. These transactions must be approached with caution to withstand IRS scrutiny.

Prepaid farm supplies are deductible by qualified farm-related taxpayers using the cash method of accounting in the year of purchase, subject to some limitations. A qualified farm-related taxpayer is a taxpayer whose principal residence is on a farm, has a principle occupation of farming, or is a member of the family of a taxpayer who lives on a farm or is a farmer. A corporation may also be a qualified farm-related taxpayer. The prepaid farm supply deduction may not exceed 50% of deductible farm expenses (other than prepaid supplies) for the year.

The prepayment must be for an actual commodity, not a mere deposit. Therefore, the purchase should be for a specific quantity of a specific product. The taxpayer may not have a right to a refund for unused purchases. The taxpayer must not have the right to substitute a different product at a later date. The seller should report the transaction as income in the year received. In the event of an audit, the taxpayer should have an invoice detailing the transaction. If the taxpayer has taken delivery of the commodity IRS is unlikely to question the transaction. If large checks are written at year-end, the taxpayer should be able to prove that the recipient had access to the check and that funds were available to cover the check.

A farmer may enter into a transaction with an elevator where he agrees to deliver a specific quantity of grain on a specific date for a specific price. Unless he has a contract with the elevator preventing him from receiving payment after year-end, the income from the sale is taxable in the year the grain is delivered. For example, Farmer Smith sells 10,000 bushels of corn to Country Elevator for \$3.21 per bushel. He delivers the corn on October 31, 2006. He tells the elevator manager he will be in to pick up the check on January 2, 2007, but nothing in the contract prevents him from requesting the check before year-end. The IRS will consider the entire sale of \$32,100 as “constructively received” in 2006. Constructive receipt also applies to any checks the taxpayer receives during the year, even though he has not deposited them into his account.

The cash method of accounting allows farmers tremendous flexibility in planning their tax liability. However, they must be sure they have fully complied with the laws. Failure to dot an “i” or cross a “t” can be a costly mistake.