Volume 9, Issue 12 December 2021

RightRisk™

RightRisk News

Tax Management versus Tax Minimization

Dates to Remember

Spring-planted crops sales deadline:
- March 15, 2022

Noninsured Crop Disaster Assistance Program (NAP) Deadline for springseeded forage and all other crops
- April 1, 2022

For more information see:
https://www.rma.usda.gov
https://www.fsa.usda.gov

All business owners must pay income and self-employment taxes -- provided they realize profits from their business activities. There are many strategies for minimizing taxes in a particular year; the object of good tax management should be to maximize after tax income and net worth over time. However, the question remains "What amount of tax should be paid while pursuing financial your goals?"

$ The objective of good tax management should be to maximize income and net worth after taxes.

Tax Reduction

A common strategy to reduce taxes in a particular year is to purchase a capital asset. Depreciation and interest on borrowed funds reduce taxable profits, thus reducing tax liability. The Section 179 Expense Election allows individuals to deduct the cost of qualifying property in the year the asset is purchased, subject to a maximum dollar limit. For the 2021 tax year, the maximum deduction is $1,050,000 with the deduction beginning to phase out at about $2.5 million.

$ Capital purchases should be based on sound business principals rather than impulse or emotion.

However, the primary reason for purchasing a capital asset (tractor, planter, grain bin, etc.) should be for its contribution to the operation, not only because the purchase cost can be deducted and thus reduce taxes owed in the current year.

It is critical that a tax practitioner be consulted before a capital asset is purchased. It is important to know and understand the tax, as well as the financial implications over the life of the investment.

Cash Flow Impact

Purchase of a capital asset can impact cash flow both positively and negatively over the life of an investment. Debt payments and other expenses that result from the purchase will have a negative impact, while tax savings and any increased production or possible reduced expenses will have a positive impact. It is important to estimate the net impact for each year of the asset life. The manager must determine if the investment can be subsidized with cash from other sources within the business where year-to-year deficits cannot be eliminated.

How Much Risk is Right for You?

One consideration before taking the Section 179 Expense Election (or using accelerated depreciation) to reduce taxes is that profits will be needed to service the debt in subsequent years. Not only are profits needed to make the payment, but the principal portion of the debt payment is not a deductible business expense. In other words, the business will need cash profits without gaining a matching tax deduction. As a general rule, any depreciation expense should be approximately equal to the non-deductible portion of debt service.

Present Value

The time value of money is a second, important consideration when purchasing a capital asset. What is the present value of a future series of funds? Is it better to expend money now or hold the funds for a purchase at some time in the future?

Nearly all managers have positive time preferences for money, wealth, and other desired objectives. For most, a dollar received today is preferred to a dollar received tomorrow, or conversely, a dollar spent tomorrow is better than one spent today. These time preferences for money occur because there are valuable opportunities for using the funds. Interest rates reflect the opportunity costs of not immediately putting the money to its best use.

Discounting is a term used to describe the estimated value of money in today's dollars that could be spent or received in the future. It accounts for the uncertainty of receiving the money in the future, alternative uses for the money, and inflation all factored together into a single estimate.

Example

An example might help to explain the financial issues related to the purchase of a capital asset. Assume you are consulting with a tax preparer about an estimated tax liability. You learn that you will owe a significant amount of tax this year.

You are considering the purchase of a new piece of equipment. The dealer will loan you the entire $30,000 purchase cost with $0 down, a 2.9 percent interest rate, and a 4-year repayment period. The accountant computes the annual payments to be about $8,000 per year with interest expense totaling $2,206 (Table 1).

The accountant computes the cost recovery allowances possible for the purchase of the new equipment. The Internal Revenue Service (IRS) depreciation tables allow a deduction for depreciation this year and each of the next five years, providing a tax savings

Table 1. Matching Depreciation with Cash Flows – An Example

Assumption: A producer is considering the purchase of a capital asset for a total cost of $30,000. A loan will be required to pay for the asset with $0 down, an interest rate of 2.9%, and a 4-year repayment period. The producer's total tax rate is 35%, including U.S. income taxes, self-employment taxes, and any state income taxes.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Total
Loan Payments							
- Interest	0	870	662	447	227	0	2,206
- Principal	0	7,182	7,390	7,604	7,825	0	30,000
MACRS Depreciation							
- Depreciation	4,500	7,650	5,355	4,998	4,998	2,499	30,000
- Tax Savings	1,575	2,982	2,103	1,906	1,829	875	11,272
- Revenue required	0	7,799	9,147	9,455	9,574	0	35,975
Section 179 Expense Election							
- Expense election	30,000	0	0	0	0	0	30,000
- Tax savings	10,500	305	232	157	79	0	11,272
- Revenue required	0	11,918	12,031	12,146	12,265	0	48,360

Notes:

1/ Tax savings = (interest + depreciation) X tax rate.

2/ Revenue required = after tax income needed to cover the principal payment.

of just over $11,000 over the 6-year period. However, the accountant estimates you will need $35,975 in revenue to make the payment and any income and self-employment taxes. Remember the principal payment is not a deductible expense.

A second possibility is to elect to make a Section 179 Expense Election and thereby deduct the entire $30,000 this year. While this strategy will save $10,500 in taxes this year, there will be little tax savings in future years. In addition, you will need $48,360 in revenue to make the principal payment and pay the taxes.

The challenging, but important question is, “What effect will the tax savings this year have on future revenue needs and tax liabilities?”

Summary

Income and cash flow difficulties are two of the leading causes of business failure. These challenges are often the result of poor decision making used to make investments in land, machinery, buildings, vehicles, and other capital assets. Purchasing capital assets is necessary to carry out production over time. The evaluation of alternative investments and the impact on profitability and cash flow is critical in the planning process. Purchases of capital assets typically do reduce taxes in the year the asset is purchased. However, net cash flows are generally negative in subsequent years.

Before making a capital purchase, managers should ask:

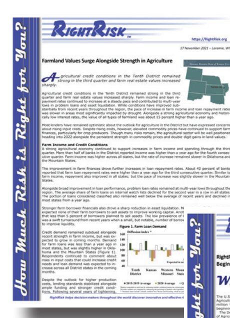
1. Is the purchase necessary to maintain or improve business operations?
2. Can the business afford the purchase and increased cash flow requirement?
3. Should the asset be replaced now or at some later time?
4. Will the purchase decision be based on sound business principles rather than impulse or emotion?
5. Are there other, profitable alternatives to purchasing the asset, such as leasing or custom hire?

~ Other RightRisk News ~

News Release - November 17 | RightRisk

Farmland Values Surge Alongside Strength in Agriculture

Agricultural credit conditions in the Tenth District remained strong in the third quarter and farm real estate values increased sharply. Farm income and loan repayment rates continued to increase at a steady pace and contributed to multi-year lows in problem loans and asset liquidation. While conditions have improved substantially from recent years throughout the region, the pace of increase in farm income and loan repayment rates was slower in areas most significantly impacted by drought. Alongside a strong agricultural economy and historically low interest rates, the value of all types of farmland was about 15 percent higher than a year ago . . .



News Release - November 24 | RightRisk

RightRisk Wyoming Supports Growing Beginning Farmers and Ranchers in Wyoming

Wyoming RightRisk helps sponsor new program targeting beginning farmers and ranchers in the state. The goal of Growing Beginning Farmers and Ranchers in Wyoming is to provide education, mentoring, and technical assistance to offer beginning farmers and ranchers the knowledge, skills, and tools needed to make informed decisions for their operations and enhance their sustainability . . .

For more see: RightRisk.org\News

Highlighted Recording:
Risk Concepts - Organizational Structures for Business

RISK CONCEPTS are a series of recently completed 4-page, 4-color bulletins covering seven common forms of business ownership. In addition, a series of recorded presentations was recently posted covering Sole Proprietorships, Partnerships, Limited Liability Companies (LLC), and Corporations.

To read more or to access the recordings, see:
RightRisk.org > Resources > Recorded Presentations
RightRisk.org > Resources > Risk Concepts

November 2 | Social Media Post
Management Succession: Where Are We?

November 18 | Social Media Post
Ag in Uncertain Times

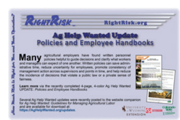
November 4 | Social Media Post
Risk Management Profiles | RightRisk

November 23 | Social Media Post
¿Cuáles son los reglamentos Estado Unidenses para el trabajo de menores en agricultura?

November 9 | Social Media Post
¿Cuáles son los reglamentos Estado Unidenses para el trabajo de menores en agricultura?

November 25 | Social Media Post
Evaluating Lease Agreements via RightRisk Analytics

November 11 | Social Media Post
Risk Scenario Planning with RightRisk Analytics



November 30 | Social Media Post
Policies and Employee Handbooks

November 16 | Social Media Post
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RightRisk helps decision-makers discover innovative and effective risk management solutions

RightRisk News is brought to you by the RightRisk Team

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How much risk is right for you and your operation?

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