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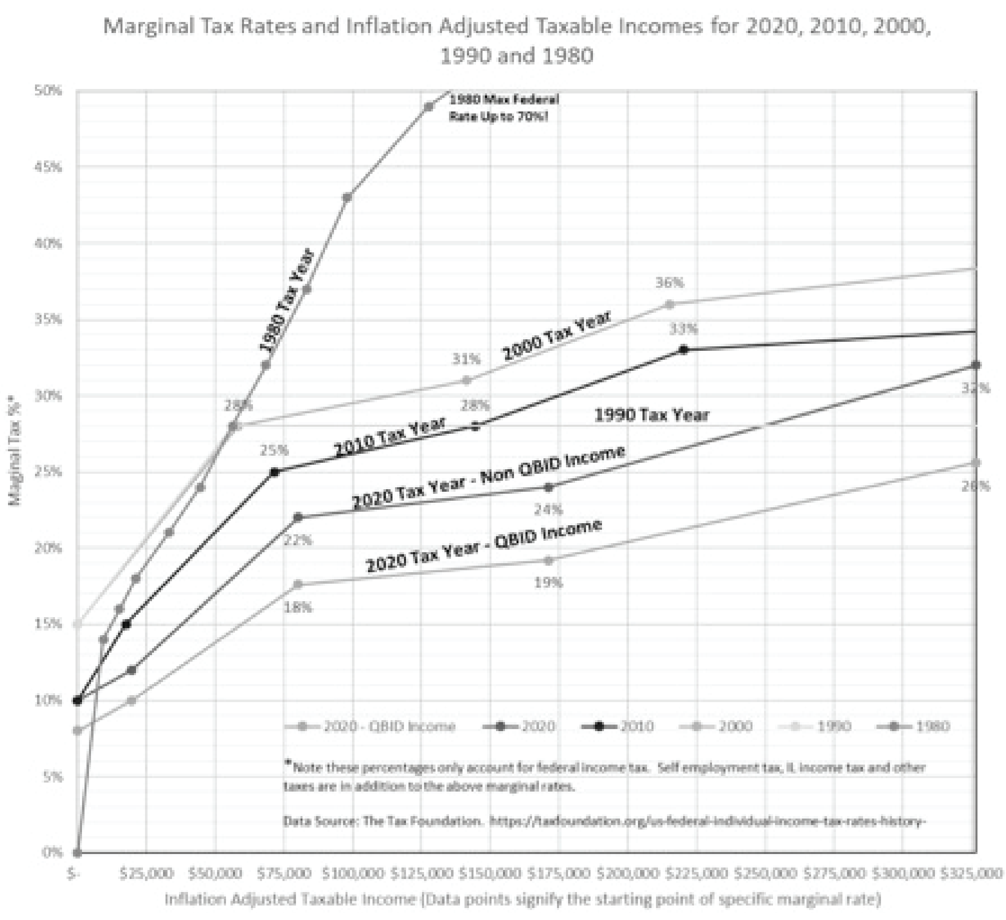
Tax Planning in Historically Low Federal Income Tax Rates

Deferring the recognition of taxable income may not be a good strategy with today's relatively low federal tax rates. The Tax Cuts and Jobs Act (TCJA) started with 2018 tax returns and most provisions expire after the 2025 tax year. Here is a snapshot of how 2020 married filing joint tax (MFJ) marginal tax rates compare to inflation adjusted MFJ tax brackets from the beginning of the 4 previous decades.



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Not only did the TCJA reduce marginal tax rates for all taxpayers, it created the Qualified Business Income Deduction (QBID). Most farmers with less than $326,600 of taxable income qualify but certain exceptions apply that could reduce or fully eliminate the QBID. As shown above taxpayers are seeing a significant decrease in rates, especially those with QBID income. A big unknown is will the TCJA continue past 2025? With unprecedented federal spending and the economic setbacks due to COVID-19 there is a risk that the benefits of the TCJA could be rolled back after 2025.

When making tax planning decisions before the close of the calendar year consider increasing your taxable income to decrease the amount of deferred income you have. For cash basis taxpayers to get an idea on the amount of deferred income they have, add up the following as of 12/31/2020:

- Grain inventory & grain on deferred payment (to be collected in 2021)
- Crop insurance proceeds to be received or elected to be taxed in 2021
- Prepaid expenses for the 2021 crop (Paid for in 2020 tax year)
- (-) Minus 2020 crop year expenses to be paid in 2021 (i.e. cash rent paid in January 2021 for the 2020 crop year)

Dependent upon the stage of your farming career there are different urgencies to decreasing this deferred income. Farmers who are within 5 years of retirement should consider spreading this deferred income during the known life of the TCJA. Though this will likely create some large tax bills for the next few years, it will ensure you pay a lower federal income tax rate than waiting all until the end. Ideally to get the best benefit of the QBID you should plan to stay under the $326,600 income level each year.

Those with 5 or more years from retirement should at least ensure that their deferred income level does not increase any from year to year. To gauge if the level of deferred income is increasing complete the above calculation for 12/31/2019 and projected for 12/31/2020. Is your tax plan for 2020 increasing our deferred income? If so, some adjustments should be made.

It is always important to remember that federal tax is a marginal tax system, see 2020 rates in chart below. A common analogy is each % rate is a bucket and only so many dollars of taxable income fit in that rate. Once one bucket is full of dollars of income you spill over into the next bucket at a higher rate. This creates incentives for using up lower rates. For example, many taxpayers want to use up the 12% rate since there is a large rate increase as taxable income increases over $80,250. But all situations are different and this may be too much or too small of a level of taxable income for your situation.

Taxable Income (MFJ)	2020 Marginal Rate
$0 to 19,750	10%
$19,751 to 80,250	12%
$80,251 to 171,050	22%
$171,051 to 326,600	24%
$326,601 to 414,700	32%
$414,701 to 622,050	35%
$622,051 +	37%

If you find you need to increase your taxable income consider the following solutions before year end:

- Instead of taking expense election (Section 179) on machinery purchases stretch out the depreciation by depreciating them out over a 5- or 7-year life. This is especially important when the machinery purchase is financed with a term loan
- Sell grain or livestock in 2020 and collect payment in 2020
- Take a CCC commodity loan before year end and elect to report CCC loan proceeds as income on your tax return
- Delay the payment of crop expenses for 2021 until 2021, especially those with no significant cash discount for paying early
- Sell excess machinery or equipment
- Take a distribution from a tax deferred retirement plan (applies to those age 59 ½ or older only)
- Rollover funds from a tax deferred retirement plan to a Roth IRA

In conclusion, be sure to take the time after harvest to update your accounting records and sit down with your tax professional to put together a tax plan. The TCJA provides a valuable opportunity for decreasing deferred income or at least limiting the growth of deferred income.

Brad Carroll, EA
Specializing in farm accounting, tax, & consulting services

CARROLL FARM BUSINESS SERVICES LLC

210 N Plum St
Pontiac, IL 61764
815-844-9365 (Call, Text, Fax)
www.carrollfbs.com
brad@carrollfbs.com