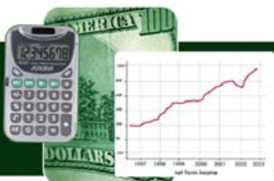

Ag Business Management

Informing farm families and ag businesses about management issues.

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EXTENSION

Deferred Payment Contracts and Pre-Paid Farm Expenses

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Introduction:

Year-end tax planning for calendar year 2008 is upon us. This publication addresses two issues of concern for farm operators as they execute year-end tax planning strategies.

Note: This information piece is offered as educational information only and not intended to be legal or financial advice. For questions specific to your farm business, consult with your tax preparer.

Deferred Payment Contracts:

Farm managers should be aware of the implications of ***deferred payment contracts***. A deferred payment contract is not a price later or hedge to arrive contract. A deferred payment contract is where the farm operator transfers ownership of the grain and/or livestock and signs a contact which requires payment early the following year.

With a deferred payment contract, the taxpayer is an ***unsecured creditor*** after delivery and before receiving payment. Deferred payment sales are not covered by state bonding requirements to cover the claims of grain producers in the event of an elevator failure. That means if the grain elevator fails while you are holding this contract, you will be the last person paid out of the bankruptcy court.

If performed correctly, deferred payment contracts may be an effective tool for year-end tax planning. From a risk management standpoint, producers should exercise caution when using deferred payment contracts.

Always consult with your tax advisor to examine your individual situation.

Pre-Paid Farm Expenses:

In recent years, farming has been a profitable enterprise. Many cash-basis tax filers utilize pre-paid expenses at year-end to balance expenses with income. This practice also allows farm producers to guarantee delivery and lock-in prices on crop inputs for the following year. However, there is a limit as to how much a farm operator may pre-pay.

The concern on this topic is caused largely because this past summer, many crop inputs experienced substantial price increases. In prior years, if a producer has been getting close to the maximum pre-paid amount, this year's price increases will make it very easy to go over the limit.

If you (the farm operator) use the cash method of accounting to report your income and expenses, your deduction for pre-paid farm expenses in the year you pay for them is limited to 50% of the other deductible farm expenses for the year (all Schedule F deductions minus pre-paid farm expenses). This limit does not apply if you meet all the exceptions described below.

Example: During 2007, you bought fertilizer ($4,000), feed ($1,000) and seed ($500) for use on your farm in the following year. Your total pre-paid farm expenses for 2007 are $5,500. Your other deductible farm expenses totaled $10,000 (total schedule F expense minus pre-paid expenses) for 2007; therefore, your deduction for pre-paid farm supplies cannot be more than $5,000 (50% of $10,000) for 2007. The excess pre-paid farm supplies expense of $500 ($5,500 - $5,000) is deductible in the later tax year you use or consume the supplies.

Exceptions: This limit on the deduction for pre-paid farm expenses does not apply if you are a farm-related taxpayer and either of the following applies:

1. Your pre-paid farm expense is more than 50% of your other deductible farm expenses because of a change in the business operations caused by unusual circumstances.
2. Your total pre-paid farm expense for the preceding three tax years is less than 50% of your total other deductible farm expenses for those three years.

The maximum pre-paid amount is calculated each year based upon the final figures on the Schedule F.

Always consult with your tax advisor to examine your individual situation.

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