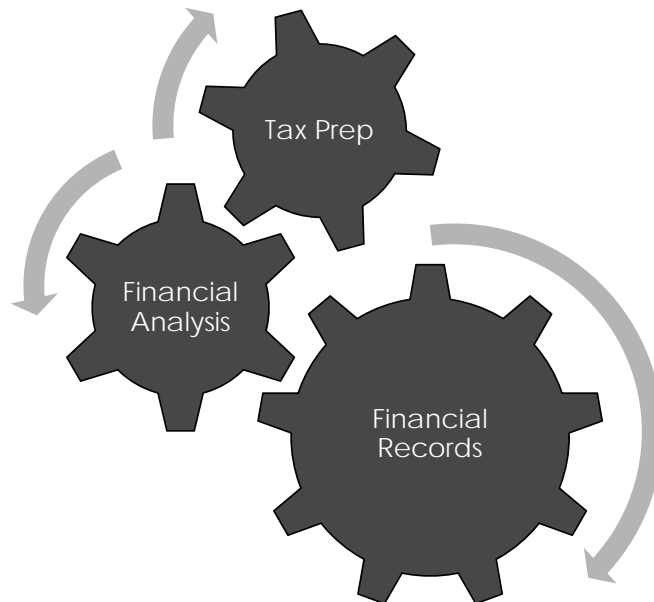
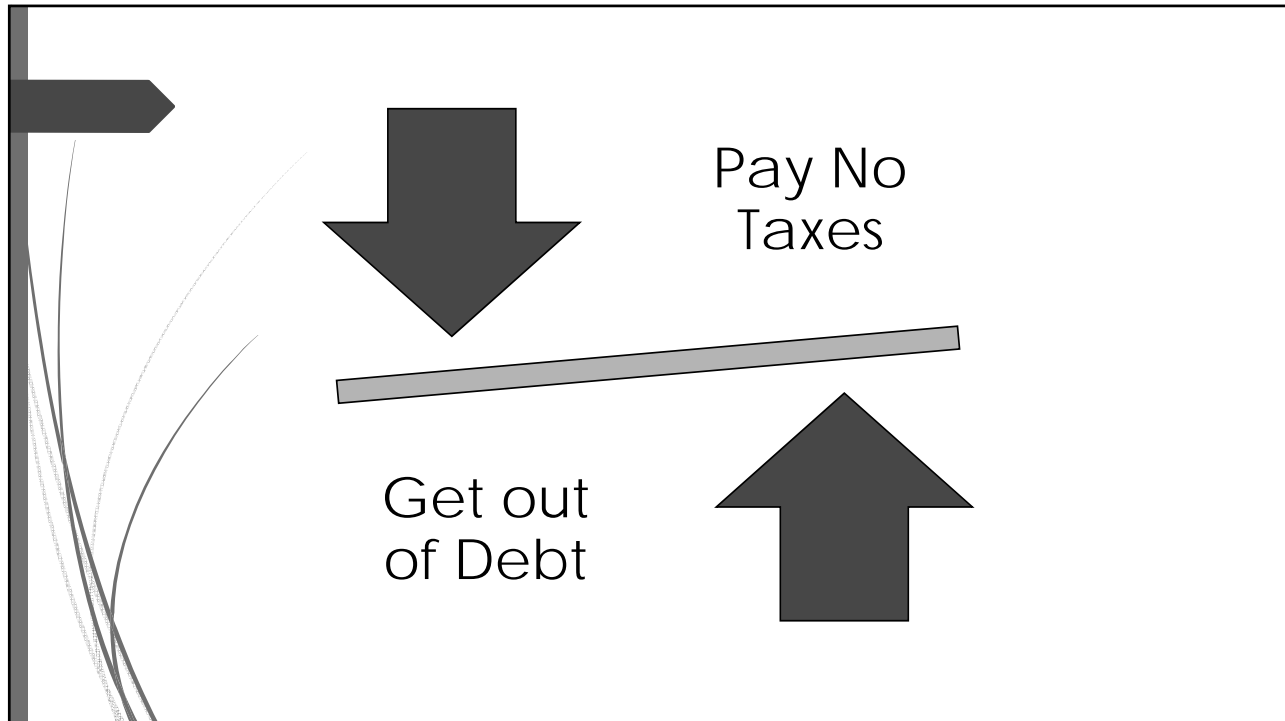




Cash Flow Planning and Tax Considerations

Tina Barrett
Nebraska Farm Business, Inc.

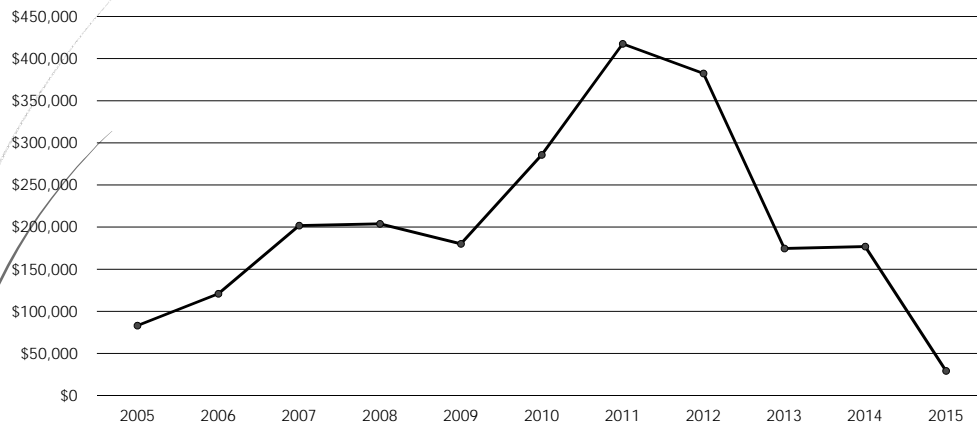




Definitions of Income is Different

- ▀ Accrual Net Farm Income
- ▀ Cash Flow
- ▀ Cash Basis Taxable Income
- ▀ Accrual Basis Taxable Income

Accrual Net Farm Income Trend



Cash Flow vs Taxable Income

Cash Flow

- Includes cash expenses such as:
 - Cash paid for feeder livestock purchase
 - Principle Payments/Capital Purchases
 - Family Living Expense/Non Farm Capital Purchases
 - Income Taxes
 - All Retirement Contributions
 - Margin Calls/Withdrawals

Cash Basis Taxable Income

- Includes:
 - Cost of feeder livestock sold
 - Qualified Equity from Co-op's
 - Depreciation
 - Only Deductible Retirement account contributions
 - Hedge Income = Realized Profit/Loss

Cash Flow vs Taxable Income

- Typically, a positive cash flow = Higher Taxable Income

Average NE Farm Cash Flow		Ave. NE Farm Income Subject to Tax	
Cash Income	\$151,276	Cash Income	\$151,276
Net Cash From Investing	\$-202,139	Asset Sales	+ \$31,711
Net Cash from Financing	\$51,326	Capital Purchases*	- \$97,616
Net Cash Flow	\$463	Non-Farm Income	+ \$36,087
		Total Income	\$121,458

- * Assumes FULL write off of all capital purchases

Cash Provided by Investing Activities

Sale of Breeding Livestock	(+)	\$2,953
Sale of Machinery & Equipment	(+)	5,720
Sale of Titled Vehicles	(+)	432
Sale of Farm Land	(+)	10,475
Sale of Farm Buildings	(+)	0
Sale of Other Farm Assets	(+)	12,131
Sale of Non-Farm Assets	(+)	2,448
Purchase of Breeding Livestock	(-)	18,165
Purchase of Machinery & Equip.	(-)	65,135
Purchase of Titled Vehicles	(-)	5,992
Purchase of Farm Land	(-)	103,734
Purchase of Farm Buildings	(-)	8,324
Purchase of Other Farm Assets	(-)	7,602
Purchase of Non-Farm Assets	(-)	27,346
Cash Provided by Investing Activities	(=)	-\$202,139

Cash Provided by Financing Activities

Money Borrowed	(+)	\$874,937
Principle Payments	(-)	761,654
Personal Income	(+)	36,087
Family Living/Owner Withdrawals	(-)	82,691
Income and Social Security Tax	(-)	27,616
Capital Contribution	(+)	305
Capital Distribution	(-)	0
Dividends Paid	(-)	969
Cash Gifts and Inheritances	(+)	12,927
Gifts Given	(-)	0
Net Cash Provided by Financing Activities	(=)	\$51,326

Cash Flow vs Taxable Income

- Typically, a positive cash flow = Higher Taxable Income

Average NE Farm Cash Flow		Ave. NE Farm Income Subject to Tax	
Cash Income	\$151,276	Cash Income	\$151,276
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Net Cash Flow	\$463	Non-Farm Income	+ \$36,087
		Total Income	\$121,458

- * Assumes FULL write off of all capital purchases

- Average Accrual Net Farm Income = \$29,432**

Taxable Income

Total Income Subject to Tax	\$121,458
½ SE Tax	\$3,791
Health Insurance	\$10,000
Adjusted Gross Income	\$107,667
Standard Deduction	\$12,600
4 Personal Exemptions	\$16,000
Taxable Income	\$79,067
Income Taxes	\$11,355
SE Tax	\$7,582
Total Taxes	\$18,937

Disconnect Between Checkbook and Taxable Income



"You Need to Spend Some Money"

- ▶ "I don't have any money left?"
- ▶ "My operating note is already maxed out!"
- ▶ "How is it possible I made money when my lender says I lost net worth?"



How does this disconnect happen?



Disconnect

Not Likely

- Feeder livestock purchase
- Margin Calls/Withdrawals
- Retirement Contributions

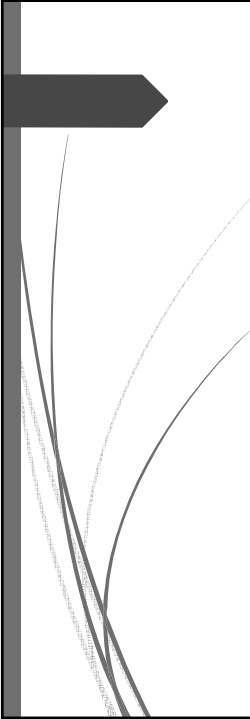
Likely Due to

- Depreciation/Principle Payments/Capital Purchases
- Family Living Expense/Non Farm Capital Purchases/Income Taxes



Depreciation/ Principle Payments/ Capital Purchases

How Tax Law and Profitability have put many farmers in a tough spot.



Section 179 – New “Permanent” Rules

- Allows the expense of capital assets in the year of purchase.
 - New or Used Assets with life class of less than 20 years.
- Annual limit on \$'s of expense of \$500,000
- Annual purchase limit on \$'s of qualifying property \$2,000,000

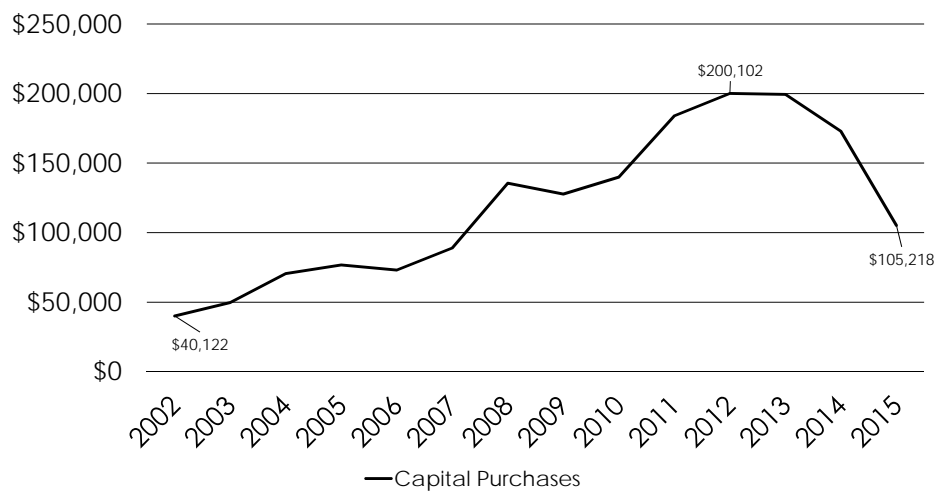
- Indexed for inflation in increments of \$10,000

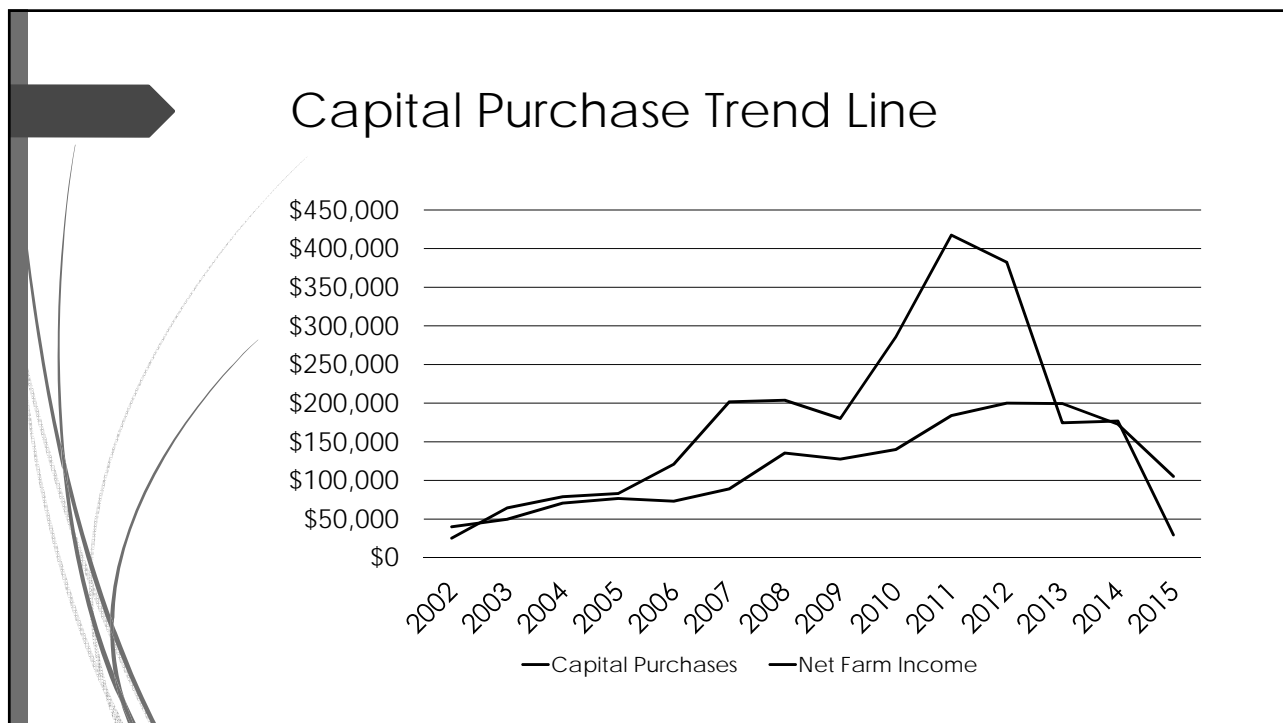
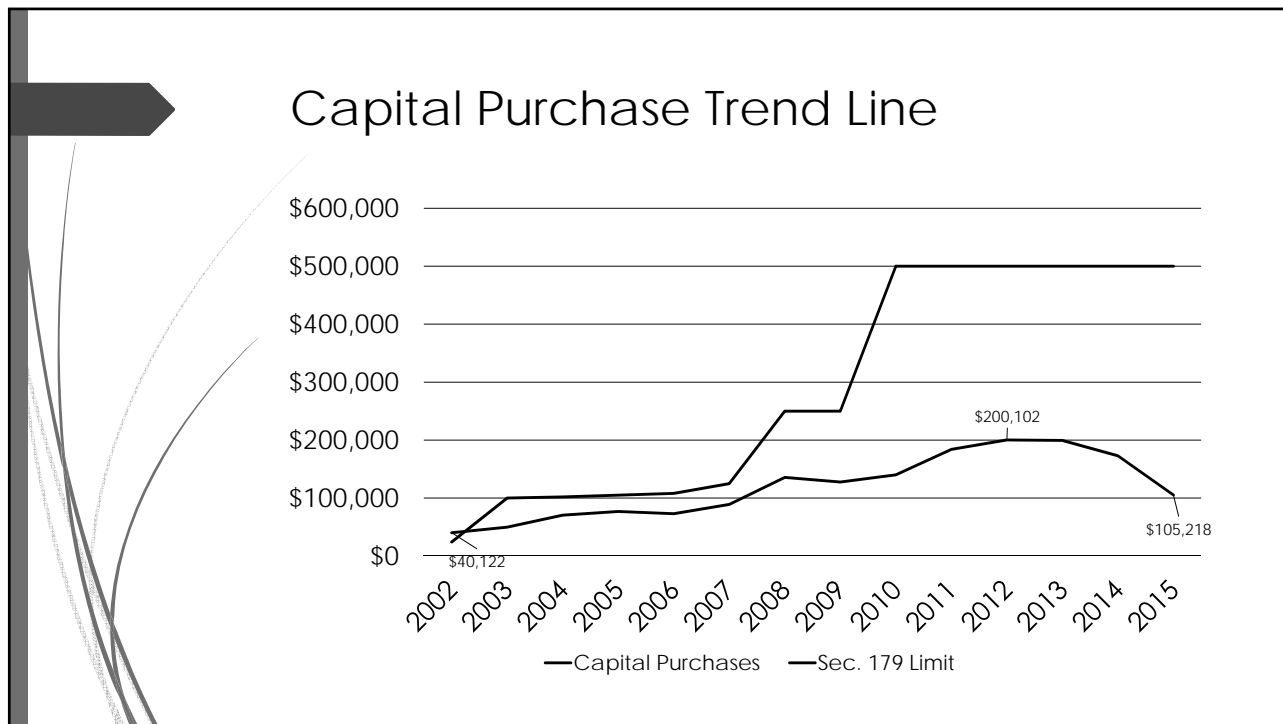
Bonus Depreciation

- ▶ Another option for enhanced depreciation
 - ▶ Must be NEW with a life class of 20 years or Less
- ▶ Limited Extension through 2019

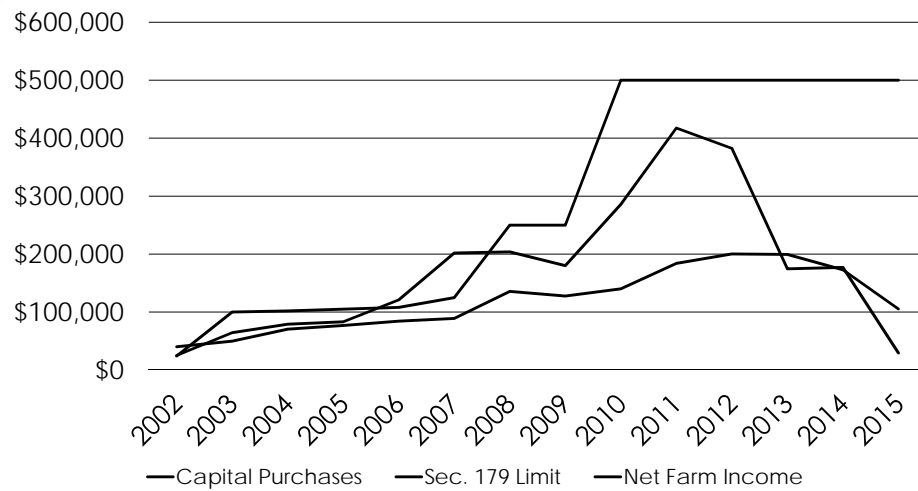
	2015-2017	2018	2019	2020
Limit	50%	40%	30%	0%

Capital Purchase Trend Line





Capital Purchase Trend Line



Capital Purchase Caution #1

- Buying equipment you don't need may be fun but doesn't always make **FINANCIAL MANGEMENT** sense
 - Spending \$100,000 to save \$30,000 leaves you short \$70,000 cash
- Tax savings will vary by taxpayer

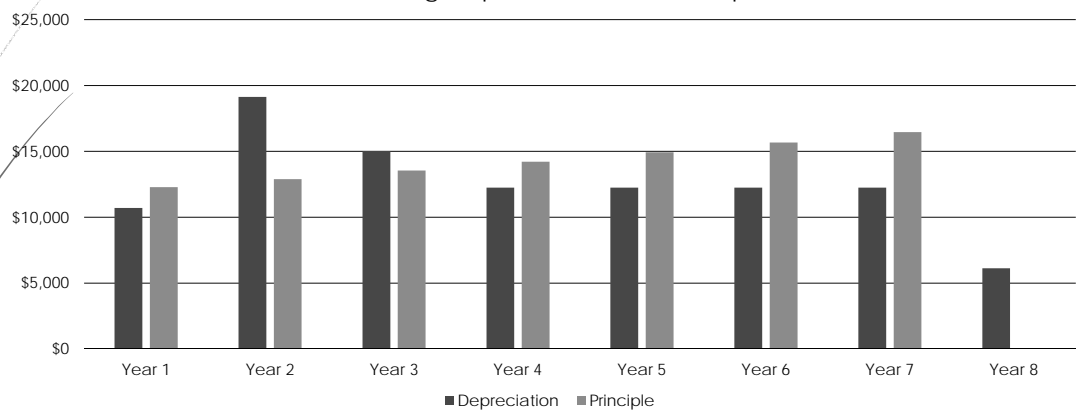
Capital Purchase Caution #2

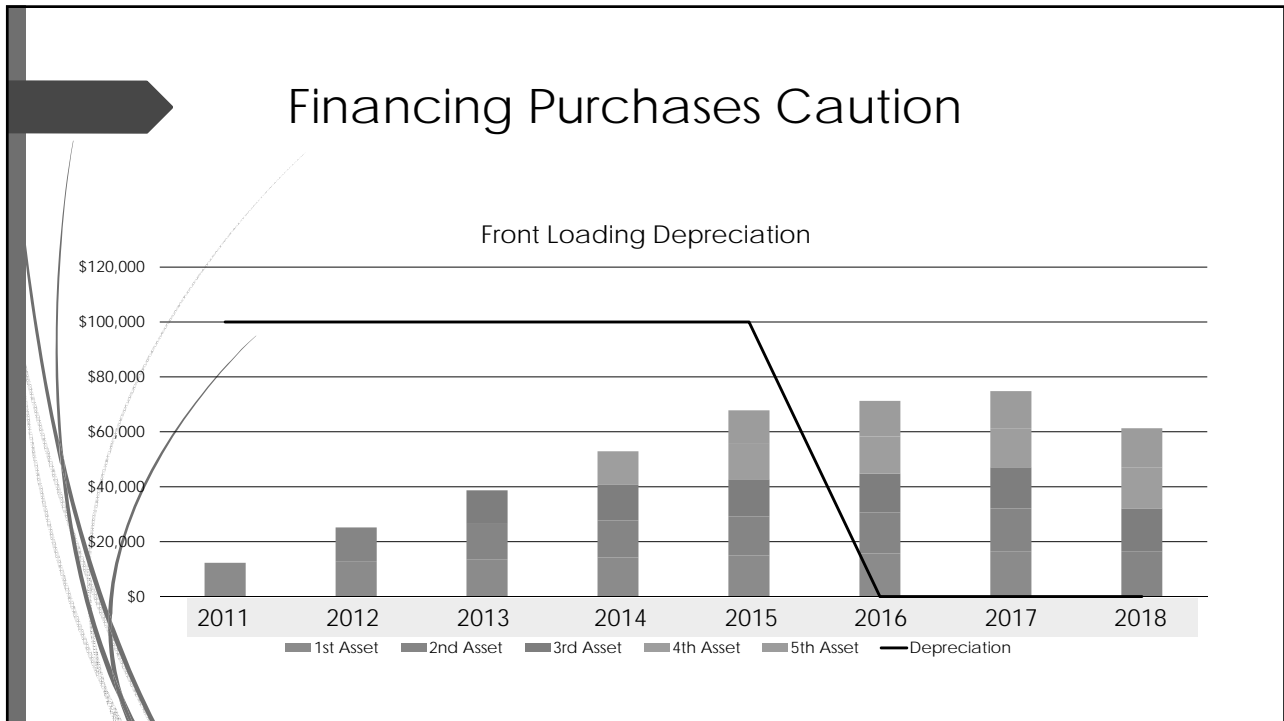
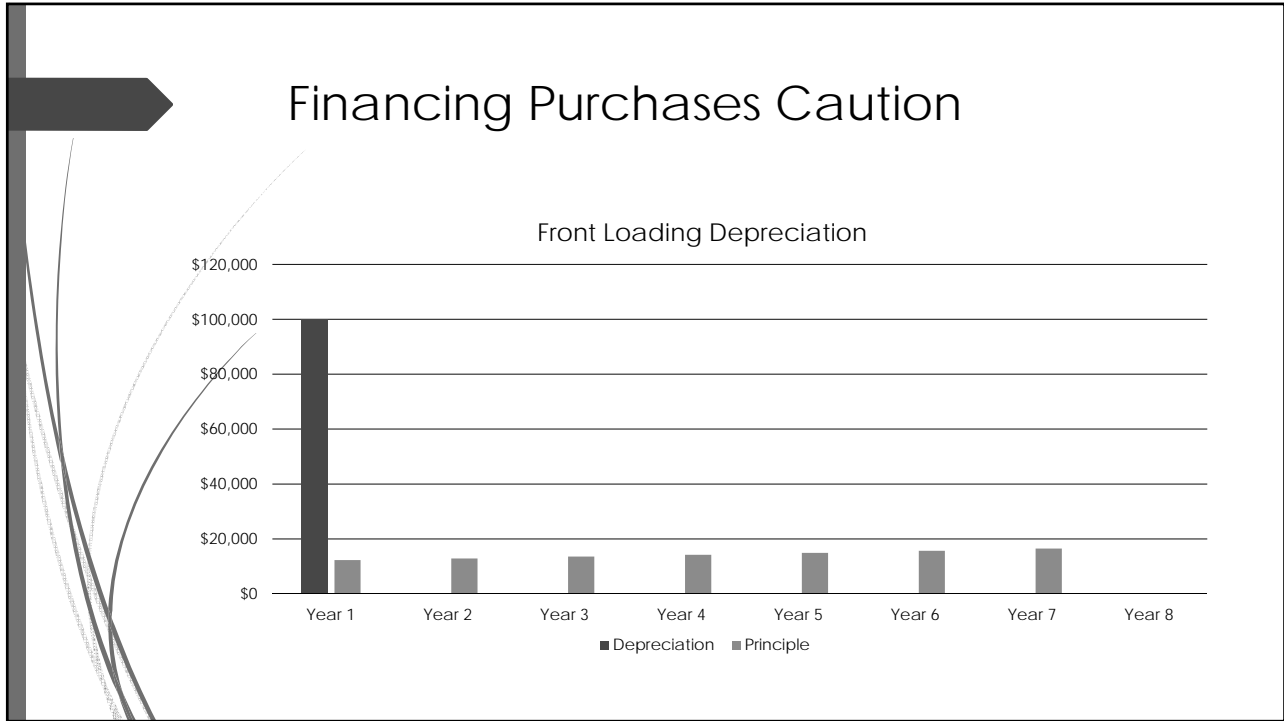
- Using enhanced depreciation on financed assets separates the deduction and payment
- If you take the entire deduction up front, you have to generate taxable income to make the payments in the future.

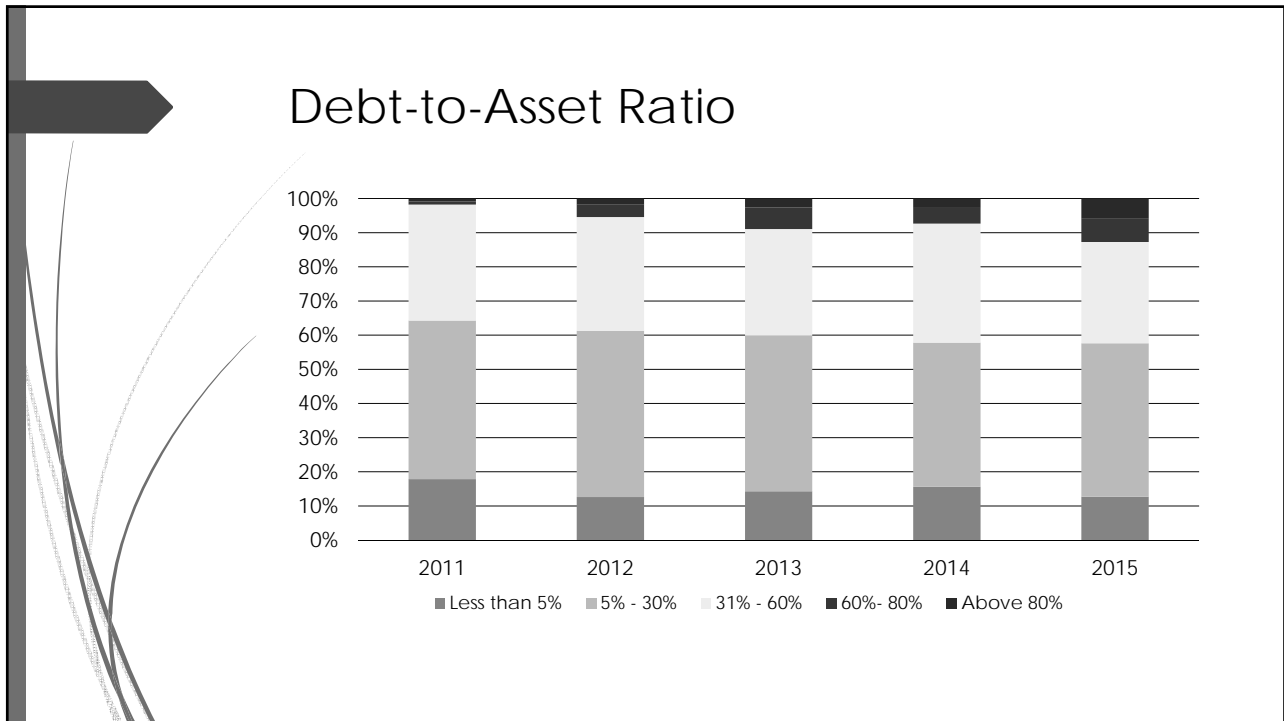
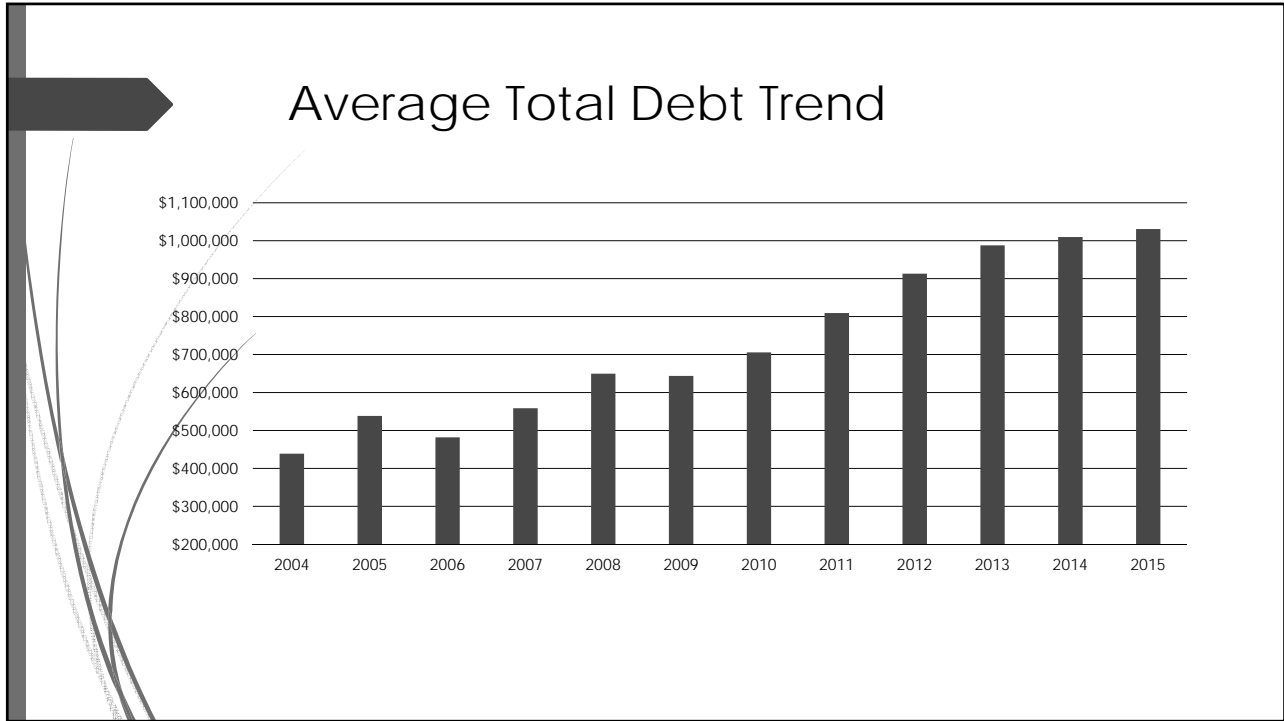


Financing Purchases Caution

Matching Depreciation and Principle

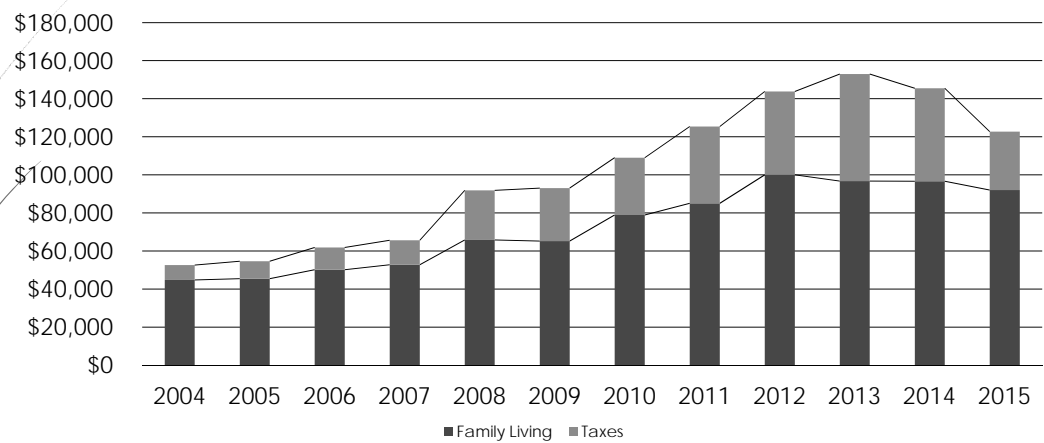






Family Living Expense/ Non Farm Capital Purchases/ Income Taxes

Skyrocketing Non-Farm Costs are causing a debt snowball



2015 Non-Farm Expense Summary

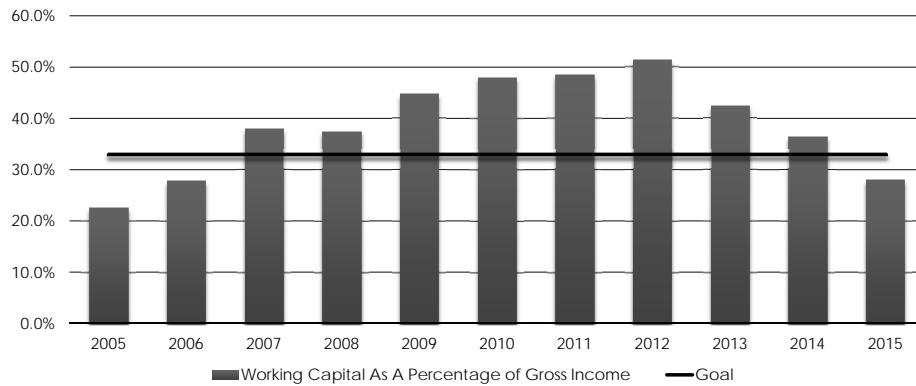
	2015
Family Living	\$91,991
Income Taxes	\$30,727
Furnishing & Appliances	\$1,121
Non-Farm Vehicle	\$4,402
Non-Farm Real Estate	\$17,772
Other Non-Farm Capital Purchases	\$2,767
Non-Farm Savings & Investments	\$15,166
Total Cash Family Living, Investment & Non-Farm Capital Purchases	\$163,946

2015 Non-Farm Expense Summary

	2015
Total Cash Family Living, Investment & Non-Farm Capital Purchases	\$163,946
Farm Income	\$27,432
Non Farm Income	\$36,087
Non-Farm Spending Over Income	\$100,427

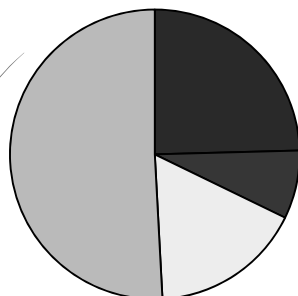
Where does the overspending come from?

Working Capital As A Percentage of Gross Income



Behind the Numbers

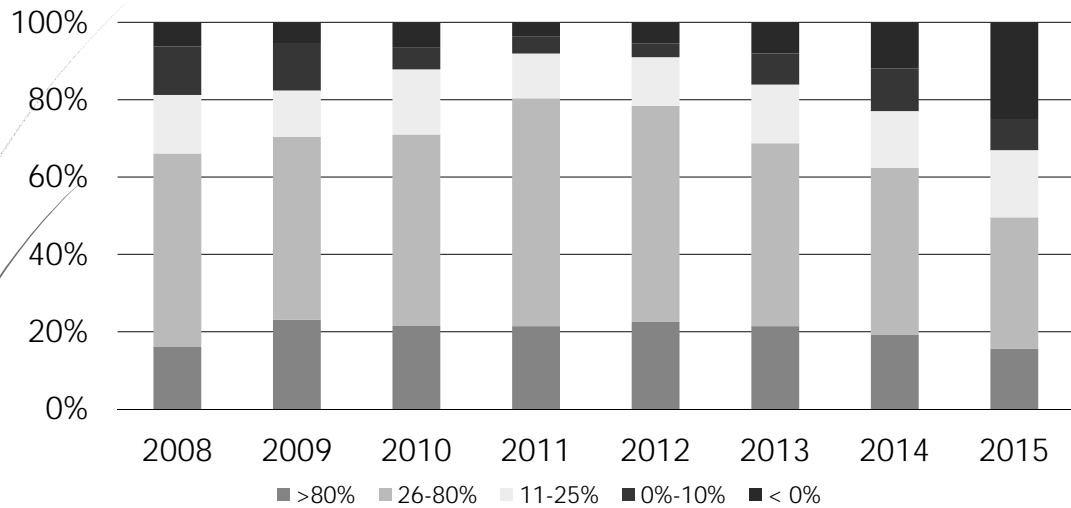
1/1/2016 Working Capital to Gross Revenues



■ < 0 ■ 0% - 10% □ 10% - 25% □ > 25%

- 24% of farms have negative working capital.
 - 26% overall are in the "red"
- 51% of farms are sitting in a good position.
- 18% of farms are sitting with more than 80% of working capital to gross revenues.

Working Capital to Gross Revenue



Deteriorating Working Capital

- What could be the cause?
 - Lack of income
 - "Sloppy" financing – putting land and equipment purchases on the operating note the past few years.
 - High non-farm costs
 - Drop of inventory values
 - Purchase of land with cash
 - Many others...



How Does This Affect Tax Planning

Cash Flow	
Principle Payments	\$80,000
Family Living	\$90,000
Income Taxes	\$30,000
AGI Needed	\$200,000

- ▶ What happens if we don't recognize this much income?
 - ▶ The operating note will have to cover the cash out that is not deductible.
 - ▶ Certainly no reduction in the operating note.

Snowball Effect

	2010	2011	2012	2013	2014	2015
Accrual Income	\$50,000	\$75,000	\$100,000	\$150,000	\$75,000	\$15,000
Taxable Income	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000
Family Living	\$40,000	\$45,000	\$50,000	\$55,000	\$60,000	\$65,000
Operating Note	\$5,000	\$15,000	\$30,000	\$50,000	\$75,000	\$105,000
Carryover Inventory	\$15,000	\$55,000	\$120,000	\$235,000	\$275,000	\$255,000

Snowball Effect

	2010	2011
Accrual Income	\$50,000	\$75,000
Taxable Income	\$35,000	\$35,000
Family Living	\$40,000	\$45,000
Operating Note	\$5,000	\$5,000
Carryover Inventory	\$15,000	\$55,000

Year 1 - 2010

- Earned \$50,000 but recognized \$35,000
- Inventory of \$15,000 wasn't sold
- Spent \$40,000 on Family Living but only had cash income of \$35,000
- Operating Note was \$5,000 to cover additional expense

Snowball Effect

	2010	2011
Accrual Income	\$50,000	\$75,000
Taxable Income	\$35,000	\$35,000
Family Living	\$40,000	\$45,000
Operating Note	\$5,000	\$15,000
Carryover Inventory	\$15,000	\$55,000

Year 2 - 2011

- Earned \$75,000 but recognized \$35,000
- Inventory of \$40,000 wasn't sold
Added to previous inventory
- Spent \$45,000 on Family Living but only had cash income of \$35,000
- Operating Note was increased by another \$10,000 to cover additional expense

Snowball Effect

	2010	2011	2012	2013	2014	2015
Accrual Income	\$50,000	\$75,000	\$100,000	\$150,000	\$75,000	\$15,000
Taxable Income	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000	\$35,000
Family Living	\$40,000	\$45,000	\$50,000	\$55,000	\$60,000	\$65,000
Operating Note	\$5,000	\$15,000	\$30,000	\$50,000	\$75,000	\$105,000
Carryover Inventory	\$15,000	\$55,000	\$120,000	\$235,000	\$275,000	\$255,000

Nebraska Data

	2010	2011	2012	2013	2014	2015
Crop & Feeder Livestock	\$611,872	\$775,403	\$822,786	\$738,424	\$695,964	\$602,351
Prepaid Expenses	\$61,611	\$77,567	\$80,132	\$83,968	\$81,312	\$74,881
Accounts Receivable	\$9,201	\$20,493	\$56,159	\$15,647	\$54,338	\$20,769
Other Current Assets (Non Cash)	\$4,028	\$9,077	\$6,356	\$6,187	\$9,056	\$5,211
Total	\$578,205	\$882,540	\$965,433	\$844,226	\$840,670	\$703,212

Nebraska Data

	2002	2006	2010	2012	2015
Crop & Feeder Livestock	\$195,969	\$343,848	\$611,872	\$822,786	\$602,351
Prepaid Expenses	\$13,683	\$29,383	\$61,611	\$80,132	\$74,881
Accounts Receivable	\$5,760	\$9,378	\$9,201	\$56,159	\$20,769
Other Current Assets (Non Cash)	\$1,617	\$3,608	\$4,028	\$6,356	\$5,211
Total	\$217,029	\$386,217	\$578,205	\$965,433	\$703,212

Average Farm – Inventory Burn Rate

- ▶ Taxable Farm Income = \$78,000
- ▶ Inventory = \$700,000
- ▶ Years of \$0 profit to absorb inventory = 9 years

Reducing Debt Means Paying Taxes

	2015	2016	2017	2018	2019	2020
Accrual Income	\$15,000	\$35,000	\$30,000	\$50,000	\$65,000	\$75,000
Taxable Income	\$35,000	\$70,000	\$70,000	\$70,000	\$70,000	\$70,000
Family Living	\$65,000	\$55,000	\$55,000	\$60,000	\$60,000	\$65,000
Operating Note	\$105,000	\$90,000	\$75,000	\$65,000	\$55,000	\$40,000
Carryover Inventory	\$255,000	\$220,000	\$180,000	\$160,000	\$155,000	\$160,000

Reducing Debt Means Paying Taxes

	2015	2016
Accrual Income	\$15,000	\$35,000
Taxable Income	\$35,000	\$70,000
Family Living	\$65,000	\$55,000
Operating Note	\$105,000	\$90,000
Carryover Inventory	\$255,000	\$220,000

2016

- Recognized \$70,000 of cash income, but only made \$35,000
- Carryover inventory drops \$35,000
- Family Living & Taxes \$15,000 Less than Recognized Income
- Operating note drops \$15,000

Income Tax Difference

Income	\$35,000	\$70,000
Adjustments	\$12,000	\$14,473
Standard Deduction	\$12,600	\$12,600
Personal Exemptions	\$16,000	\$16,000
Taxable Income	Negative	\$26,927
Tax	\$0	\$3,162
SE Tax	\$4,945	\$9,891
Earned Inc Credit	\$3,148	\$0
Child Tax Credit	\$2,000	\$2,000
Tax Due	-\$203	\$11,053

Reducing Debt Means Paying Taxes

	2015	2016
Accrual Income	\$15,000	\$35,000
Taxable Income	\$35,000	\$70,000
Family Living	\$65,000	\$55,000
Operating Note	\$105,000	\$90,000
Carryover Inventory	\$255,000	\$220,000

2016

- ▶ Recognized \$70,000 of cash income, but only made \$35,000
 - ▶ Carryover inventory drops \$35,000
- ▶ Family Living & Taxes \$15,000 Less than Recognized Income
 - ▶ Operating note drops \$15,000
 - ▶ **Income Taxes Increased \$11,000 so Family Living Needs to Drop MORE (\$26,000)**

Reducing Debt Means Paying Taxes

	2015	2016	2017	2018	2019	2020
Accrual Income	\$15,000	\$35,000	\$30,000	\$50,000	\$65,000	\$75,000
Taxable Income	\$35,000	\$70,000	\$70,000	\$70,000	\$70,000	\$70,000
Family Living	\$65,000	\$55,000	\$55,000	\$60,000	\$60,000	\$65,000
Operating Note	\$105,000	\$90,000	\$75,000	\$65,000	\$55,000	\$40,000
Carryover Inventory	\$255,000	\$220,000	\$180,000	\$160,000	\$155,000	\$160,000

Reducing Debt Means Paying Taxes

	2015	2016	2017	2018	2019	2020
Operating Note	\$105,000	\$90,000	\$75,000	\$65,000	\$55,000	\$40,000
Carryover Inventory	\$255,000	\$230,000	\$190,000	\$170,000	\$165,000	\$170,000
Current Ratio	2.43	2.55	2.53	2.62	3.00	4.25
Working Capital	\$150,000	\$140,000	\$115,000	\$105,000	\$110,000	\$130,000

* Current Ratio Improves from 2.43 to 4.25 in 6 years.



Reducing Debt Means Paying Taxes

- You must be willing to:
 - Recognize taxable income higher than non-farm costs
 - Controlling family living costs
 - Pay more in taxes



Tax Consequences of Liquidation

The other solution to the Working Capital Deterioration

How to Fix Deteriorating Working Capital? #1 - Sell Non-Current Assets

Pros:

- Generates Cash to reduce current debt
- Improves current ratio & working capital

Cons

- If asset is highly leveraged, it reduces the cash available to pay current debt
- If the asset was written off (used Section 179), the income tax consequences can wipe out remaining cash
- The sale of income producing assets can be counter-productive.

Sale of Farm Equipment, Buildings and Purchased Breeding Livestock

	Sale Price	Basis	Net Gain	Tax Rate *	Tax Due
Tractor	\$100,000	\$0	\$100,000	25%	\$25,000

- Enhanced depreciation has left little to no basis.
- If Financed, could be very little equity after deferred tax liability

- * Only Includes Federal Income Taxes

Sale of Raised Breeding Livestock & Land

	Sale Price	Basis	Net Gain	Tax Rate *	Tax Due
Raised Lvst	\$100,000	\$0	\$100,000	0%, 15%, 20%	\$15,000
Land	\$1,600,000	\$600,000	\$1,000,000		\$150,000

- ▶ Raised livestock has no basis (cost of raising the animal has already been deducted)
- ▶ Financing is likely not more than costs basis unless some refinancing has occurred.
- ▶ * Only Includes Federal Income Taxes

Sale of Inventory, Pre-paids, Receivable's, Etc.

	Sale Price	Basis	Net Gain	Tax Rate *	Tax Due
Inventory	\$100,000	\$0	\$100,000	???	\$40,000

- ▶ Inventory items have no basis (cost of raising the crop has already been deducted)
- ▶ Tax rate complicated
 - ▶ Self-employment taxes on first \$118,500 (indexed for inflation) – 15.3%
 - ▶ Ordinary income tax rates (10% - 39.6%) – 25%
 - ▶ Additional Medicare Tax on earnings over \$250,000 – 0.9%
- ▶ Likely there is an operating note liability that will take all available cash.
- ▶ * Only Includes Federal Income Taxes

Farm Liquidation

	FMV	Basis	Net Gain	Tax Rate *
Inventory Items	\$850,000	\$0	\$850,000	Self-Employed
Raised Breeding Livestock	\$75,000	\$0	\$75,000	Capital Gains 20%
Purchase Breeding Livestock Machinery & Buildings	\$900,000	\$150,000	\$750,000	Ordinary Rate 39.6%
Land	\$2,000,000	\$400,000	\$1,600,000	Capital Gains 20%
Total	\$3,825,000	\$550,000	\$3,275,000	\$940,000

■ * Only Includes Federal Income Taxes

Farm Liquidation

FMV of Assets	\$3,825,000
Deferred Tax Liability	\$940,000
Average Debt	\$1,009,704
Cash Remaining	\$1,875,296
Cash/Assets	49%

How to Fix Deteriorating Working Capital? #2 – Refinance Debt

Pros:

- Improves current ratio & working capital
- Keeps income producing assets working for you.

Cons

- “Band-Aid” for bigger problem
- Need to fix underlying issue or you’ll be back in the same boat in 2-3 years.

Cash Flow Problem

	Assets		Liabilities
Current Farm Assets	\$761,571	Current Farm Liabilities	\$794,756
Intermediate Farm Assets	\$890,912	Intermediate Farm Liabs	\$148,587
Long Term Farm Assets	\$1,822,387	Long Term Farm Liabs	\$460,202
Total Farm Assets	\$3,474,870	Total Farm Liabilities	\$1,403,545
Non-Farm Assets	\$273,652	Non Farm Liabilities	\$42,486
Total Assets	\$3,748,522	Total Liabilities	\$1,446,031
	Net Worth	\$2,302,491	
Current Ratio	0.96	Scheduled Term Payments	\$91,727
Working Capital	-\$33,185	Projected Cash Flow	-\$250,000
Debt-to-Asset Ratio	38.6%		

Cash Flow Problem

- ▶ How to Fix?
 - ▶ Term out \$500,000 of Operating Debt?
 - ▶ 15 year note, 5% interest = \$48,397.52 annual payment.

Cash Flow Solution

	Assets		Liabilities
Current Farm Assets	\$761,571	Current Farm Liabilities	\$294,756
Intermediate Farm Assets	\$890,912	Intermediate Farm Liabs	\$148,587
Long Term Farm Assets	\$1,822,387	Long Term Farm Liabs	\$960,202
Total Farm Assets	\$3,474,870	Total Farm Liabilities	\$1,403,545
Non-Farm Assets	\$273,652	Non Farm Liabilities	\$42,486
Total Assets	\$3,748,522	Total Liabilities	\$1,446,031
	Net Worth	\$2,302,491	
Current Ratio	2.58	Scheduled Term Payments	\$140,125
Working Capital	\$466,815	Projected Cash Flow	\$201,602
Debt-to-Asset Ratio	38.6%		

Easy Fix?

- ▶ Short term Solution
 - ▶ Potential Bandaid
 - ▶ What's the REAL problem?
- ▶ Long Term – More Interest Paid
- ▶ Could give us breathing room to get through tough times.

- ▶ Beware that it may make it **FEEL TOO** good! (Allows overspending!)



Take Home Points

- ▶ Don't make management decisions **because** of the tax implications.

- ▶ Don't make management decisions **without** considering the tax implications.



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