Planning Ahead: Understanding those year-end effects

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Agriculture is ever changing and if we have learned anything about the past, it is to plan ahead and to plan for change. With year-end behind us and all that 2023 has thrown at us, conversations are being had with our clients about tax planning and what to do.

Speaking of 2023, we should recognize that commodity prices will have a decent effect on our cash flows. Other parts of our area have taken advantage of good yields, and in all, a cash flow year that has been pretty decent. All of this may lead to some year-end tax planning with topics of prepays, capital purchases, and depreciation. The benefit of utilizing prepaids over capital purchases at year-end is that you are maintaining your working capital. As the cash may no longer be in your checkbook, it is still a cash asset and we are just adjusting where we placed that money on the balance sheet. We all know that a new piece of machinery looks and feels better than stocking up on inputs and supplies but taking advantage of locking in some of those rising costs of inputs and the guarantee of inputs, may be more important to your operation.

It is important to understand the IRS rules and requirements you must meet to be permitted to deduct the purchase of farm supplies during the current tax year that will be consumed in the following tax year. Here are those requirements:

1. Actual Purchase vs. Deposit: The expenditure must be an actual purchase and not a deposit to purchase the supply in the future. An expenditure is considered a valid purchase if there is a binding commitment to accept the delivery of the farm supplies at a fixed price. To meet this requirement, the farmer must obtain a detailed invoice or receipt that specifies a description of the goods, quantity purchased, unit price, and the total amount of the purchase.
2. Legitimate Business Purpose: The expenditure must have a business purpose other than tax avoidance. As producers, we usually prepay in order to secure adequate quantities, obtain discounts, and hedge the expectation of rising prices. All of these reasons provide a business purpose for prepaying.
3. No Income Distortion: The purchase of prepaid farm supplies must not materially distort income. To determine if a producer meets this requirement, it is important to consider the relationship between the quantity of supplies purchased and the quantity to be used, the amount expended in relation to the total income for the year, the timing of the purchase, and the amount purchased in comparison to past purchases.

None of us know what the future holds or what next year’s market changes to either our income or expenses will be. Prioritizing prepays at year-end usually has a positive return on investment in more than one way while providing balance sheet working capital for financial strength to your farm and some security for the unknown future. Be sure to have up-to-date farm records for your accountant to do a year-end estimate and look at prioritize prepays at year-end over those capital purchases.

The North Dakota Farm Management Education Program provides lifelong learning opportunities in economic and financial management for persons involved in the farming and ranching business. Visit ndfarmmanagement.com or Facebook @NDFarmManagementEducation. The ND Farm Management Education Program is sponsored by the North Dakota Department of Career and Technical Education.

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