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RightRisk™

RightRisk News

Making Sense of Depreciation

Farmers and ranchers purchase many items each year to operate their businesses and produce products for sale. The Internal Revenue Code (IRC) recognizes three major types of expenses by farmers, ranchers, and other business operators.

One type of expense pertains to items purchased and used during a single year. Examples include fertilizer, fuel, livestock feed, and rents. A second type of business expense includes items purchased for resale. Producers using the cash method of accounting will deduct the cost of such purchases in the year of sale, not in the year the items were purchased. For example, if a rancher purchases 50 feeder lambs in 2016 and sells them in 2017, the cost of the animals is deducted in 2017.

Internal Revenue Code recognizes three major types of expenses by farmers, ranchers, and other business operators.

The third type of expense pertains to items with a useful life of more than one year, sometimes called capital or depreciable assets. The cost of such assets is recovered over a period of years. Depreciation is an annual allowance recognizing that such assets contribute to business earnings for more than one year and wear out or become obsolete over time. Most capital assets – such as buildings, machinery, vehicles, breeding livestock, and fences – are depreciated.

Depreciable property must be owned and used in a business or income-producing activity, and have a useful life that extends substantially beyond the year the property is placed in service. Property is considered owned even if it is subject to debt. Leased property is depreciated only if the lessee retains the incidents of ownership. Land is never depreciated.

"Basis" refers to the cost of purchasing the capital asset plus any adjustments. Basis is the value used to compute depreciation. If the property is used for both business and personal or other non-business purposes, the basis must be allocated according to use. For example, if a vehicle is used 75 percent for business and 25 percent for personal purposes, the amount to be depreciated is 75 percent of the basis.

The methods and recovery periods for determining depreciation are identified in the IRC Modified Accelerated Cost Recovery System (MACRS). Most farmers and ranchers use the General Depreciation System (GDS) unless required or electing to use the Alternative Depreciation System (ADS). Recovery periods under GDS are ten years for single purpose agricultural structures, seven years for machinery and equipment, five years for breeding livestock, and 20 years for multi-purpose farm buildings. The recovery periods under ADS are generally longer than under GDS.

Depreciation begins in the year in which the asset is ready and available for use. For example, where a rancher purchased a livestock handling facility in December, if the facility was ready for use the cost would be depreciated beginning in that year. However, if the facility was not ready for use until January, depreciation would not begin until the following year.

Section 179 of the IRC allows qualifying capital assets to be expensed in whole or in part during the first year the asset is placed into service. The assets must be eligible property, acquired for business use, and acquired by purchase. Examples include equipment, grain bins, milk tanks, breeding livestock, and single-purpose agricultural structures.

Dates to Remember

Margin Protection Program Dairy (MPP-D)
- 2018 crop year
July 1 - Sept. 30th, 2017

Fall crops sales closing date
- September 30th

Forage Insurance
- September 30th

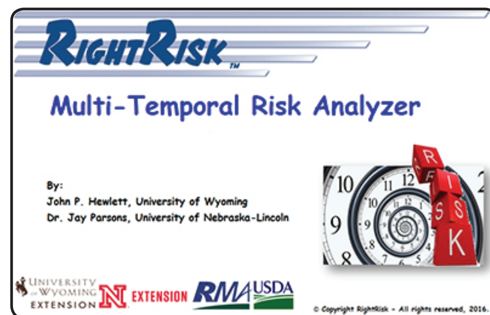
RI-PRF Coverage
November 15th, 2017 for 2018 crop year coverage

Acreage Reporting:
- November 15th

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

How Much Risk is Right for You?

Highlighted Tool



The Multi-Temporal Risk Analyzer (MTRA) tool offers farm and ranch managers much-needed assistance in evaluating risk management strategies that span multiple time periods. MTRA utilizes a partial budgeting framework which incorporates four basic adjustments: added returns; reduced costs; added costs; or reduced returns. From these, the net benefit of making a change may be calculated. MTRA expands the approach to evaluate the impact of risk over time. MTRA offers users a chance to allow inputs to vary in describing proposed management changes. In addition, the user may enter a variable time horizon for each input, ranging up to 20 years. Results describe possible outcomes using a cumulative distribution graph that indicates the probability of earning a net return at or below a given value on a cash basis or when incorporating the time value of money over the period of interest.

MTRA represents a better way to address the presence of uncertainty by describing results in terms of distributions, rather than using a "best guess" single estimate for uncertain numbers. In this way, the tool embraces the uncertainty involved and brings it into the decision-making process to create a more robust approach to evaluating proposed management changes. Access to MTRA is free of charge and the accompanying guide with included examples makes getting started easy.

For More Information on the *Multi-Temporal Risk Analyzer* tool, see http://RightRisk.org > Resources > Risk Management Tools.

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Section 179 allowances are generally limited to $500,000 and cannot create a business loss. A "50% Bonus Depreciation" on qualified property can generally be taken after the Section 179 limit is reached and is available for new equipment only.

Farmers and ranchers are often tempted to depreciate the cost of purchased property as fast as possible, to reduce income taxes. This strategy can lead to greater tax liabilities and financial management problems in future years. When depreciation deductions are matched to principal and down payments of assets, the cashflow required to service the debt is minimized for that year. Conversely, aggressive use of Section 179 on purchases with small down payments and heavy financing will generally trigger higher cashflow needs in future years because principal payments are not tax deductible.

Farmers and ranchers should take a multi-year view of managing their tax liabilities. Depreciation and Section 179 deductions are useful tools for reducing profits and lowering taxes. However, if not used wisely, taxable profits may not match actual farm/ranch profit and may reduce opportunities for future investments.

Business owners should consult with their tax preparers. They should talk about not only the taxes owed in a particular year, but also how accelerating depreciation and other deductions might impact future tax liabilities.

RightRisk helps decision-makers discover innovative and effective risk management solutions.

- Education
- Coaching
- Research

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RightRisk News is brought to you by the RightRisk Team

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University of Wyoming Extension

How much risk is right for you and your operation?