

Potential Tax Strategies for Depreciating Broiler Chicken Houses



Depreciation of a farm asset results from the item in question wearing out or becoming obsolete over time. There are two types of depreciation, economic and tax, which may be calculated differently.

From an economic perspective, a farm business should be generating enough revenue to have covered depreciation costs when an asset reaches obsolescence. From a tax perspective, managing depreciation has important consequences to a farm's business tax liabilities and its ability to meet financial obligations.

This document focuses on the use of different depreciation management strategies to manage tax liabilities and improve cash flow of the farm business. Due to the complexities of the federal tax code, it's impractical to go into detailed examples of the ultimate income tax liability of any given taxpayer. As a result, this fact sheet focuses solely on the income attributable to a broiler chicken operation.

The information provided in this document is hypothetical and for informational and educational purposes only. It should not be considered as a recommendation for any specific action. Nothing in this document should be taken to replace the advice provided by a qualified tax professional, and the authors and their employers do not warrant or represent that the information contained in this document is complete or accurate. Nothing in this document should be taken as specific to a particular individual's situation nor should it be interpreted as accounting, legal or tax advice. Tax laws are complex and change frequently, and a qualified tax professional should be consulted before taking any action.

Alternative Depreciation Strategies

Poultry houses are defined as a single-purpose agriculture structure under the guidelines set forth by the Internal Revenue Service (IRS). Single-purpose structures have a tax depreciable recovery period of 10 years under the General Depreciation System. Due to the size of the investment and length of the loan associated with poultry houses, a depreciable recovery period of 10 years will reduce taxable income during the period depreciation expenses are incurred. Once the poultry building has been fully depreciated, taxable income will increase. The increase in taxable income generally occurs at a time when the contract grower is still making principal and interest payments on the poultry house loan.

An alternative to depreciating the poultry house over 10 years, from a tax perspective, is to use the Alternative Depreciation System, which allows for a 15-year recovery period for single-purpose agricultural structures. The difference in depreciating the house over a 10- or 15-year period refers solely to the house itself and not the equipment contained in the house. The equipment contained in the house falls into a different depreciable property class. Should a producer select to use the Alternative Depreciation System, depreciation must be calculated using the straight line method. Producers who elect to use the General Depreciation System are able to use either the 150 percent declining balance or straight line approach to calculating depreciation. The declining balance method may be referred to as the MACRS method (Modified Accelerated Cost Recovery System). Depreciation percentages allowed annually under each method are shown in Table 1. The selection of a permitted depreciation method must be made by the due date of the return (including extensions) for the year the property is placed in service (Internal Revenue Service Publication 946, page 43).

The IRS defines "placed in service" as when property is ready and available for a specific use, normally the production of income or for trade or your business (Internal Revenue Service Publication 225, page 37). If a poultry house is not being used, it may still be defined as in service. The determination of whether the house is in service depends on if the house is built and is available for its specific use of raising chickens. Should a poultry house be completed in March and not used until June, the date the asset was placed in service is March according to IRS regulations. A contract with a company to build a poultry house does not qualify as the placed-in-service date, since the asset (the house) is not in the possession of the owner and in condition to be used for its intended purpose. This is regardless of whether or not there is a need for the poultry house on the date the contract is signed.

In addition, the same depreciation method, i.e. General Depreciation System or Alternative Depreciation System, must be selected for all property acquired in a given class in a given year. As an example, Joe Farmer purchases and puts into service four poultry houses in 2011. The four houses collectively must be placed into either the Alternative or General Depreciation System and be depreciated using the same method (either declining balance or straight line). Mr. Farmer could not put three houses in the Alternative Depreciation System straight line method and one house in the General Depreciation System straight line method. Should

Mr. Farmer purchase and place into service additional houses in 2013, however, those houses could be placed in a different depreciation system than the houses placed into service in 2011.

If poultry houses are placed into service under the General Depreciation System, the houses may be switched to the Alternative Depreciation System. This is provided that the houses have not been completely depreciated. If returns have been filed for only one year on the houses, the contract grower may file an amended return using the Alternative Depreciation System. If more than two returns have been filed, the process becomes more complicated, but there are no fees associated with the transition between depreciation systems. Should a grower decide to switch from the General to the Alternative Depreciation System (or vice versa), the individual should contact his or her tax professional for details on how make the change from one depreciation system to the other.

Section 179 Deductions

Section 179 deductions are allowed under the IRS tax code, which allows for depreciable assets to be treated as a business expense. In 2010 and 2011, the maximum Section 179 deduction was \$500,000 and is currently scheduled to decrease to \$25,000 in 2012 and be indexed for inflation in future years. Since the maximum Section 179 deduction has varied in recent years, contact a qualified tax professional or the IRS to determine the maximum qualifying deduction. Single-use structures such as poultry houses qualify for this deduction as do other agricultural assets purchased for the farm business, but multipurpose structures such as equipment sheds do not qualify. Only the cash or loan funds involved in the purchase of the new or used asset(s) may be used in the qualifying deduction. If a producer purchases more than \$2 million worth of assets that could qualify for Section 179 deductions, the producer must reduce the dollar limit by the amount over \$2 million. For example, if Joe Farmer purchased \$2,035,000 worth of qualifying assets, the maximum Section 179 deduction would be \$465,000 (\$500,000 minus \$35,000), since the investment is \$35,000 greater than \$2 million.

The reduction in taxable adjusted gross income is immediate when using a Section 179 deduction but it will reduce the depreciation that can be taken in subsequent tax years. This is a result of the reduction of the basis (cost value) that is used to calculate depreciation in future years. As an example, a producer purchases \$250,000 worth of Section 179 eligible depreciable assets. Electing to take a Section 179 deduction on \$200,000 of the purchased assets would leave only \$50,000 to depreciate over the remaining allowable cost recovery period. This would result in a lower amount of depreciation that may be taken toward the end of the useful life of the assets. An increase in taxable income would result if all other revenues and expenses remain constant. The cash flow of the

business would be affected and might put the operation under financial strain due to the combination of higher taxes and ongoing loan payments on the purchased assets at the end of the allowable cost recovery period.

A Section 179 deduction can never be used to show a loss on a tax return when accounting for all businesses, trades, and wages, tips and salaries. If the amount of the Section 179 deduction elected exceeds the amount that can be reported in the current tax year, the excess may be carried forward to future years. Use of deductions allowed under Section 179 speeds up the cost recovery period and is more likely to be used on longer-life assets than shorter-life assets. Consideration of current and future tax liabilities, as well as capital asset purchases, should occur before deciding to take advantage of Section 179 depreciation. The implications of the use of a Section 179 deduction affect the entire tax return, not just the Schedule F. It is strongly recommended that producers use extreme caution if electing to use a Section 179 deduction on poultry houses due to the rapid decrease in total expenses in the second year of operation that will increase net farm profit or taxable adjusted gross income when loan payments are being made.

Tax Cash Flow Examples

As an example, consider the possibility of expanding broiler production on an existing farm in 2011. Expected revenues are \$35,000 per house per year from selling broilers. Additional revenues will come from broiler litter sales and utility allowances for each additional house built. Litter sales are expected to be \$1,250 per house per year with utility allowances expected to be \$3,500. Total revenue is expected to be fairly constant across the expected life of the broiler house. Noninterest and depreciation expenses from existing broiler houses suggest annual production costs will be \$17,000 – accounting for fuel, litter, labor, litter clean-out, repairs, supplies and operating interest. Costs are expected to rise by 2.5 percent per year based on farm records. Each additional house will cost \$150,000 to build. A 20-year loan with an annual interest rate of 7.5 percent can be obtained with no down payment expected.

Prior to building the broiler house, the annual tax liabilities are considered. Although depreciation is not a cash expense, depreciation does affect the level of taxable income that is reported from farming or business activities. There is no remaining depreciation that can be expensed on the existing broiler houses, which were depreciated using the General Depreciation System declining balance method. Although the producer learns of the alternative depreciation strategies, expenses are only part of the equation that leads to taxable income. Past and anticipated revenue streams are the other factors that contribute to tax liabilities and cannot be ignored when deciding on the appropriate depreciation strategy for an operation. An operation with a history of low or

negative taxable income may see a benefit in spreading out depreciation of the purchased asset over a longer period (the Alternative Depreciation System straight line method). Individuals who are just beginning to farm also may find it beneficial to extend the cost recovery period through use of the Alternative Depreciation System.

Operations that are in the growth or mature phase of the business cycle or that have a history of high taxable incomes may opt for a more rapid depreciation method since the operation will not be affected from a cash flow standpoint. Tables 2 through 4 illustrate the differences between the different potential depreciation strategies.

The dollar values shown in the accompanying tables are only reflective for the proposed additional broiler house. Existing broiler production and other farming activities would need to be added to the change in taxable income shown in Tables 2 through 4 to determine total tax liabilities from the farming operation. Any off-farm work also would add to the individual's tax liabilities.

Use of either of the methods under the General Depreciation System results in a net decrease in taxable income from an additional broiler house in the second through 10th years of operation. An increase in taxable income occurs from years 11 through 16 as the poultry house is completely depreciated. Use of the General Depreciation System declining balance method (Table 2) would maximize taxable income compared to the General Depreciation System straight line method (Table 3). Given the stability in expected earnings generated by the additional broiler house, the ability to depreciate the proposed house over 15 years as in the Alternative Depreciation System straight line method (Table 4) is the option that maximizes taxable income among the three depreciation methods. The Alternative Depreciation System straight line method extends the depreciation through the majority of the years that the grower is making payments on the broiler house loan. This improves the cash flow of the farm business over the allowable depreciation period for the broiler house. Additional taxable income in the first year the house is in operation is a result of the use of the half-year convention by the IRS that spreads the first year's depreciation between the first and final year of the life of the asset, regardless of which depreciation system is used.

It is rare that only one house would be added, but the results are similar if a grower adds more than one broiler house. The major difference would be that additional houses would see drastic increases in taxable income occur in years 12 or 17, which coincide with the first years that houses are completely depreciated under each respective depreciation system. Under the Alternative Depreciation System straight line method, additional taxable income would be \$11,338.29 in year 16 compared to \$21,634.60 in year 17 if two houses were built. Also, this example does not include equipment needed for an additional broiler house; so its effect on tax liabilities should not be ignored. Equipment required and its cost for

a house would vary by integrator. Inclusion of equipment would increase depreciation expenses for the first seven years of the analysis and reduce net farm profit during that time.

In the preceding example, a Section 179 deduction was not used by the producer on the purchased broiler house. If the producer elected to use a Section 179 deduction, that deduction could not exceed \$6,505 under the Alternative Depreciation System straight line method since a loss cannot be created through the use of a Section 179 deduction and no other income is assumed in that example. If there was other income present on the individual's tax return, a larger Section 179 deduction possibly could occur. Under the Alternative Depreciation System straight line method, the producer would only be able to depreciate \$143,495 over the 15-year period allowed given the above Section 179 deduction. The producer would show a taxable income of \$216 in year one from broiler production with taxable income of approximately \$1,764 in year two. Taxable income from broiler operations would decrease from year three until years 14 and 15 when it would be approximately \$950. At year 16, additional taxable income would be \$5,885.76 and would grow to more than \$11,000 by the time the mortgage was paid off in year 20. The producer should be cautious on use of a Section 179 deduction, which is generally not recommended for broiler houses.

Summary

Proper tax planning can assist contract poultry growers in managing tax depreciation and pretax cash flows. Although poultry houses are single-purpose structures, growers can elect to extend depreciation from the normal 10 years under the General Depreciation System to 15 years under the Alternative Depreciation System. This change must be requested by the grower because poultry houses are automatically placed under the General Depreciation System. Producers should strive to maximize after-tax profits and not minimize tax liabilities in a given tax year. Minimization of tax liabilities in a given year can lead to financial strain since cash flow is limited or negative. Maximizing after-tax income provides the funds to further invest (or re-invest) in the business or additional funds for family living expenses or to prepare for retirement. The use of Section 179 deductions should be carefully considered in light of the objectives with regard to taxes the farm business faces.

The examples included in this document are for educational purposes only and do not replace the advice provided by a qualified tax professional. Tax laws change frequently, and qualified tax professionals can be more responsive to questions from individuals because of their familiarity with changes in the tax codes.

Additional Cash Flow and Farm Tax Resources:

- Broiler Production: Considerations for Potential Growers
(Oklahoma Cooperative Extension Service Publication AGECE-202):
<http://pods.dasnr.okstate.edu/docushare/dsweb/Get/Document-3099/AGECE-202web2010.pdf>
- Internal Revenue Service's Farmer's Tax Guide (Publication 225):
<http://www.irs.gov/publications/p225/index.html>
- Internal Revenue Service's How to Depreciate Property (Publication 946):
<http://www.irs.gov/pub/irs-pdf/p946.pdf>
- Rural Tax Education:
<http://www.ruraltax.org>

Table 1. Percentage of Depreciation Allowed Under Half-Year Convention

	General Depreciation System		Alternative Depreciation System
	150% Declining Balance	Straight Line	Straight Line
Year 1	7.50%	5.00%	3.33%
Year 2	13.88%	10.00%	6.67%
Year 3	11.79%	10.00%	6.67%
Year 4	10.02%	10.00%	6.67%
Year 5	8.74%	10.00%	6.67%
Year 6	8.74%	10.00%	6.67%
Year 7	8.74%	10.00%	6.67%
Year 8	8.74%	10.00%	6.67%
Year 9	8.74%	10.00%	6.67%
Year 10	8.74%	10.00%	6.66%
Year 11	4.37%	5.00%	6.67%
Year 12			6.66%
Year 13			6.67%
Year 14			6.66%
Year 15			6.67%
Year 16			3.33%

Source: IRS Publication 946

Table 2. Cash Flow Using General Depreciation System, 150% Declining Balance Method

	Additional Farm Revenue	Production Costs	Interest Expense	Depreciation	Additional Farm Expenses	Change in Taxable Income
Year 1	\$39,750.00	\$17,000.00	\$11,250.00	\$11,250.00	\$39,500.00	\$250.00
Year 2	\$39,750.00	\$17,425.00	\$10,990.21	\$20,820.00	\$49,235.21	(\$9,485.21)
Year 3	\$39,750.00	\$17,860.63	\$10,710.94	\$17,685.00	\$46,256.57	(\$6,506.57)
Year 4	\$39,750.00	\$18,307.14	\$10,410.73	\$15,030.00	\$43,747.87	(\$3,997.87)
Year 5	\$39,750.00	\$18,764.82	\$10,087.99	\$13,110.00	\$41,962.81	(\$2,212.81)
Year 6	\$39,750.00	\$19,233.94	\$9,741.05	\$13,110.00	\$42,084.99	(\$2,334.99)
Year 7	\$39,750.00	\$19,714.79	\$9,368.10	\$13,110.00	\$42,192.88	(\$2,442.88)
Year 8	\$39,750.00	\$20,207.66	\$8,967.17	\$13,110.00	\$42,284.82	(\$2,534.82)
Year 9	\$39,750.00	\$20,712.85	\$8,536.17	\$13,110.00	\$42,359.02	(\$2,609.02)
Year 10	\$39,750.00	\$21,230.67	\$8,072.84	\$13,110.00	\$42,413.51	(\$2,663.51)
Year 11	\$39,750.00	\$21,761.44	\$7,574.77	\$6,555.00	\$35,891.21	\$3,858.79
Year 12	\$39,750.00	\$22,305.47	\$7,039.34	\$0.00	\$29,344.81	\$10,405.19
Year 13	\$39,750.00	\$22,863.11	\$6,463.75	\$0.00	\$29,326.86	\$10,423.14
Year 14	\$39,750.00	\$23,434.69	\$5,845.00	\$0.00	\$29,279.68	\$10,470.32
Year 15	\$39,750.00	\$24,020.55	\$5,179.83	\$0.00	\$29,200.39	\$10,549.61
Year 16	\$39,750.00	\$24,621.07	\$4,464.78	\$0.00	\$29,085.85	\$10,664.15

Table 3. Cash Flow Using General Depreciation System, Straight Line Method

	Additional Farm Revenue	Production Costs	Interest Expense	Depreciation	Additional Farm Expenses	Change in Taxable Income
Year 1	\$39,750.00	\$17,000.00	\$11,250.00	\$7,500.00	\$35,750.00	\$4,000.00
Year 2	\$39,750.00	\$17,425.00	\$10,990.21	\$15,000.00	\$43,415.21	(\$3,665.21)
Year 3	\$39,750.00	\$17,860.63	\$10,710.94	\$15,000.00	\$43,571.57	(\$3,821.57)
Year 4	\$39,750.00	\$18,307.14	\$10,410.73	\$15,000.00	\$43,717.87	(\$3,967.87)
Year 5	\$39,750.00	\$18,764.82	\$10,087.99	\$15,000.00	\$43,852.81	(\$4,102.81)
Year 6	\$39,750.00	\$19,233.94	\$9,741.05	\$15,000.00	\$43,974.99	(\$4,224.99)
Year 7	\$39,750.00	\$19,714.79	\$9,368.10	\$15,000.00	\$44,082.88	(\$4,332.88)
Year 8	\$39,750.00	\$20,207.66	\$8,967.17	\$15,000.00	\$44,174.82	(\$4,424.82)
Year 9	\$39,750.00	\$20,712.85	\$8,536.17	\$15,000.00	\$44,249.02	(\$4,499.02)
Year 10	\$39,750.00	\$21,230.67	\$8,072.84	\$15,000.00	\$44,303.51	(\$4,553.51)
Year 11	\$39,750.00	\$21,761.44	\$7,574.77	\$7,500.00	\$36,836.21	\$2,913.79
Year 12	\$39,750.00	\$22,305.47	\$7,039.34	\$0.00	\$29,344.81	\$10,405.19
Year 13	\$39,750.00	\$22,863.11	\$6,463.75	\$0.00	\$29,326.86	\$10,423.14
Year 14	\$39,750.00	\$23,434.69	\$5,845.00	\$0.00	\$29,279.68	\$10,470.32
Year 15	\$39,750.00	\$24,020.55	\$5,179.83	\$0.00	\$29,200.39	\$10,549.61
Year 16	\$39,750.00	\$24,621.07	\$4,464.78	\$0.00	\$29,085.85	\$10,664.15

Table 4. Cash Flow Using Alternative Depreciation System, Straight Line Method

	Additional Farm Revenue	Production Costs	Interest Expense	Depreciation	Additional Farm Expenses	Change in Taxable Income
Year 1	\$39,750.00	\$17,000.00	\$11,250.00	\$4,995.00	\$33,245.00	\$6,505.00
Year 2	\$39,750.00	\$17,425.00	\$10,990.21	\$10,005.00	\$38,420.21	\$1,329.79
Year 3	\$39,750.00	\$17,860.63	\$10,710.94	\$10,005.00	\$38,576.57	\$1,173.43
Year 4	\$39,750.00	\$18,307.14	\$10,410.73	\$10,005.00	\$38,722.87	\$1,027.13
Year 5	\$39,750.00	\$18,764.82	\$10,087.99	\$10,005.00	\$38,857.81	\$892.19
Year 6	\$39,750.00	\$19,233.94	\$9,741.05	\$10,005.00	\$38,979.99	\$770.01
Year 7	\$39,750.00	\$19,714.79	\$9,368.10	\$10,005.00	\$39,087.88	\$662.12
Year 8	\$39,750.00	\$20,207.66	\$8,967.17	\$10,005.00	\$39,179.82	\$570.18
Year 9	\$39,750.00	\$20,712.85	\$8,536.17	\$10,005.00	\$39,254.02	\$495.98
Year 10	\$39,750.00	\$21,230.67	\$8,072.84	\$9,990.00	\$39,293.51	\$456.49
Year 11	\$39,750.00	\$21,761.44	\$7,574.77	\$10,005.00	\$39,341.21	\$408.79
Year 12	\$39,750.00	\$22,305.47	\$7,039.34	\$9,990.00	\$39,334.81	\$415.19
Year 13	\$39,750.00	\$22,863.11	\$6,463.75	\$10,005.00	\$39,331.86	\$418.14
Year 14	\$39,750.00	\$23,434.69	\$5,845.00	\$9,990.00	\$39,269.68	\$480.32
Year 15	\$39,750.00	\$24,020.55	\$5,179.83	\$10,005.00	\$39,205.39	\$544.61
Year 16	\$39,750.00	\$24,621.07	\$4,464.78	\$4,995.00	\$34,080.85	\$5,669.15

Acknowledgements

Special thanks to Keith Kightlinger (Extension Economist, University of Georgia-Tifton) for his thorough review and assistance with this publication.

Author

J. Ross Pruitt
Assistant Professor
Department of Agricultural Economics and Agribusiness



Visit our website: www.LSUAgCenter.com

Louisiana State University Agricultural Center, William B. Richardson, Chancellor
Louisiana Agricultural Experiment Station, John S. Russin, Vice Chancellor and Director
Louisiana Cooperative Extension Service, Paul D. Coreil, Vice Chancellor and Director

Pub. 3188 (online only) 7/2011

The LSU AgCenter is a statewide campus of the LSU System and provides equal opportunities in programs and employment.