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Hidden Taxes of a Volatile Industry

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by Danielle Emel

You may find yourself in financial ruin following 2009's devastating year for the dairy industry. With the losses you will carry forward from 2009, you may assume it could be some time before you will need to worry about giving Uncle Sam another penny.

You could be mistaken. Lurking in the shadows of our complicated tax code are tax laws waiting for your circumstances to fall within their requirements.

Income from this year, in conjunction with losses from last year, could create a tax liability even if your losses from 2009 are greater than the taxable income you generate this year. I'll explain how.

Self-employed individuals essentially pay three types of taxes.

These taxes include:

1. Income tax (including capital gains)
2. Self-employment tax (roughly 15% on the first $106,800 of income and nearly 3% on the remainder)
3. State tax (up to 10% in many states)

Not what you think

You may think you will avoid all of these taxes with your extensive losses from 2009, but think again. A net operating loss cannot be used against future self-employment income *(number 2 above)*, and in some cases, state taxable income.

Let's look at an example of what you could pay in taxes over a two year period despite significant losses in the first year:

Year 1 – Your taxable loss: $1,000,000.

Year 2 – Your taxable income: $750,000.

Net loss over 2-year period: $250,000

No tax would be due for the first year under this example. However, in the second year you have lost any benefit you would have received from self employment losses from the prior year. You stand to pay self-employment tax of about $35,000 for that second year.

More to consider

Almost all states impose their own income tax. Some states choose not to conform to all federal tax laws. For example, the state of California has suspended net operating loss deductions for large businesses, or those businesses with over $500,000 of net business income. In California, the operating loss from our example would not be allowed for state purposes, leaving $750,000 of taxable income subject to almost 10% of state tax.

In the example above you realize a $250,000 loss over a two year period could easily cost a dairy producer more than $100,000 in tax!

Possible new taxes

Unlike the federal government, states do not realize as many opportunities to borrow money. States look for other ways to finance their spending and potential new state taxes pose significant problems for taxpayers in the coming years. Oregon recently passed a gross receipts tax. This creates a tax liability for a business even if its gross revenues were the same as its expenses, and it is highly likely other states will follow suit.

Estate taxes

As I write this article, Congress has yet to react to the repeal of the estate tax, which went into effect for 2010. Don't presume you can escape an estate tax liability by dying this year. Along with the repeal of the estate tax was the elimination of step-up in basis. Step-up in basis is a key factor in determining the taxability of your estate to your heirs.

Previously, heirs inherited a new basis in assets they acquired from a decedent's estate. The basis was "stepped-up" to the fair market value at the date of the decedent's death, thus eliminating potential income taxes should heirs decide to sell those assets soon after they are inherited.

Ultimate liability

Under the new law, the value of your assets will be passed on to your heirs at the LESSER of your cost (or basis) or fair market value at the date of death. Lower basis is likely to result in a gain on the sale of inherited assets, and ultimately an income tax liability.

Congress will likely reinstate the estate tax AND make it retroactive. It will cost something to have your estate plan revised, especially when the estate tax is set to return in 2011. But a more costly risk could be to sit back and do nothing. Having your estate plan reviewed to ensure it provides flexibility for these possible and future conditions could bring you piece of mind in this unstable environment.

In summary

Under current tax laws, a loss in one year combined with less income in the next, will not equate to zero taxable income, and tax laws continue to change. Prudent business and tax planning continues to be as essential now as when times are good.

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