# TAX MANAGEMENT TIPS FOR FARMERS

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## 2005 - End-of-Year Tax Planning

1. The basic management guideline is to <u>avoid wide fluctuations in taxable income</u> because a relatively uniform income from year-to-year results in the lowest income tax and largest Homestead and Farmland Preservation Credits over time.

   (a) Even in a low-income year, plan to have enough income to use personal exemptions ($3,200 each) and the standard deduction ($5,000 single, $10,000 married filing jointly).
   (b) If taxable income is over $58,000 married ($40,250 single), the Alternative Minimum Tax (AMT) may apply and must be calculated to see if it increases your income taxes.

2. Tax Rates:

   (a) The 10% bracket on taxable income increased to $7,300 for single and $14,600 for married filing jointly. The 15% bracket for married is double that of singles ($29,700 and $59,400). The higher brackets are 25%, 28%, 33% and 35%. The additional first-year bonus depreciation deduction has expired for almost all situations.
   (b) For capital assets sold and installment payments received, capital gains rates for sale of long-term capital assets held for 12 months or longer (24 months for breeding cattle and horses) are 15% if taxable income is in the 25.0% bracket or higher and 5% for that portion of capital gain between taxable ordinary income and the top of the 15% bracket ($29,700 single and $59,400 married). To the extent of depreciation on depreciable real estate, it comes under 1250 rules and may be taxed as ordinary income or unrecaptured 1250 gain at a maximum rate of 25%.
   (c) The sale of principal residence after May 6, 1997 is tax free on up to $500,000 of gain for married filing jointly ($250,000 single) if occupied by owner for two of last five years. The combination of a sale of a principal residence with a like-kind exchange of real estate property used in a trade or business may allow some planning opportunities.
   (d) Penalty free IRA distributions may be taken to pay for medical expenses and/or health insurance premiums to the degree expenses exceed 7.5% of adjusted gross income.
   (e) The section 179 (direct expense) deduction for capital purchases is $105,000 in 2005, with the phase out beginning at $420,000 of qualified property placed in service.
   (f) The income averaging provision for farm income (Schedule J) is permanent and negative taxable income can be used from the three base years. A new law coordinates AMT with Farm income averaging so that averaging does not increase AMT.
   (g) A 5-year or 2-year net operating loss carry-back for farm losses is available, or use current losses by converting regular IRAs to Roth IRAs.
   (h) When an asset is traded-in, the book value of the asset traded-in (or carryover basis) can be added to the boot and set up on a new depreciation schedule.
   (i) The self-employed health insurance deduction is 100% on the front of the Form 1040.
   (j) Child tax credit remains at $1,000 for children 16 and under as of December 31, 2005. This amount will remain at $1,000 through 2010.

3. Depending on your tax situation, you may wish to reduce or increase net income for 2005. Following are some of the best income eveners:

   (a) Buy or delay purchase of supplies such as fertilizer, seed, farm supplies, small tools, and repairs (tax shelters can only deduct items when used). Note: these expenses should normally not exceed 50% of your total Schedule F expenses for the year for which economic performance has occurred. In most cases, it will be hard to reach that level of expenditure.
   (b) Pay in 2005 or delay payment to 2006 on real estate taxes and other annual bills. (Insurance premiums, real estate rental for 2006 and interest cannot be paid in advance to obtain an earlier tax deduction, but 2005 expenses of insurance, rentals and interest can be deferred to 2006 if income is low this year).
   (c) Watch the timing of sales of livestock and crops ready for market near year-end. Perhaps they can be held for sale next year at little cost or sold earlier to even out taxable income. CCC loans can count as borrowed funds or as income if the appropriate forms are filed.
   (d) Some expenses are deductible as current year business expenses even though not made every year. These include minor repairs on improvements and machinery, painting of buildings, purchase of small tools and supplies, and within limitations, cost of approved soil and water conservation expenses. Get these jobs done and paid for before year-end if you wish to reduce net income.
   (e) Where capital purchases have been made, or can be made, study the depreciation alternatives carefully. The direct expense deduction of up to $105,000 can be taken on current year capital purchases. Its use, however, cannot reduce your taxable income from farming (plus other <u>earned</u> income) below zero. Taxable income from farming includes net farm profit plus gains on the sale of business assets such as breeding livestock. Where pre-productive expenses are not a consideration, there are three choices for depreciation: Modified Accelerated Cost Recovery System (MACRS) which is 7-year 150% declining balance on machinery; General Depreciation System (GDS), which is 7 year straight line for machinery; and the Alternative Depreciation System (ADS), which is 10-year straight line on machinery. For the first year of depreciation the mid-year convention is used (1/2 year's depreciation), unless 40% or more of your capital purchases after direct expensing are made during the last 3 months of the year. In that case, the mid-quarter convention is used (87.5% of a year's depreciation for purchases made during the first 3 months, 62.5% for purchases in second quarter, 37.5% for third quarter, and 12.5% in final quarter).
   (f) Pay your children wages for work actually performed for the farm. If the child is under 18 and works for a parent's trade or business, their wages may be subject to income tax withholding, but are exempt from social security and Medicare taxes.
   (g) For Michigan income tax an individual who is eligible to be claimed as a dependent on someone else's return and has an adjusted gross income of $1,500 or less is entitled to a refund of all Michigan tax withheld.
   (h) Frequently unrecorded and forgotten expenses include:
      (1) Educational expenses that maintain or improve your skills, such as magazine subscriptions, books, fees at extension or other agricultural organization meetings.
      (2) Travel expenses connected with your business, particularly if it includes meals and lodging.
      (3) Entertainment expenses when hosting others where the predominant purpose is the furthering of your farm business operation.

4. Social Security and hospital insurance rates for the self-employed are 12.4% and 2.9% for a total of 15.3% on 0.9235 of net farm profit up to $90,000 for 2005. One-half of the Social Security tax will be deducted as an adjustment to income. In addition, the 2.9% hospital insurance tax continues on

income over $90,000. The 2006 social security wage base is $94,200. To earn one quarter of coverage in 2005, $920 of earnings are required.

## Long-Range Tax Planning

1. Maintain a good set of records to insure that all expenses are taken. Small cash purchases are easily forgotten. A good record keeping system is essential for end-of-year tax planning, as well as working with credit agencies.

2. Where income is high enough, plan the purchases of machinery to fully utilize the direct expense deduction.

3. Plan your personal deductions. Many medical expenses and contributions formerly spread over 2 years can be paid in 1 year and itemized as deductions. In the next year, the standard deduction may be taken. Itemized deductions include medical expenses in excess of 7.5% of AGI, no personal interest is deductible, moving expenses are an itemized deduction and most miscellaneous deductions are deductible only to the degree they exceed 2% of AGI (Adjusted Gross Income).

4. Investigate a Self-employed Retirement Plan. A Simplified Employee Plan (SEP IRA) requires that certain employees also be covered. A SIMPLE plan is best for small employers to encourage employee retirement savings without costly administration. Another alternative is an Individual Retirement Account (IRA). Employees do not have to be covered if a self-employed person utilizes an IRA; however, the maximum contribution is $4,000 per year in 2005, with an additional $4,000 in an unemployed spousal IRA ($4,500 for those over 50). An IRA deduction cannot be utilized if the contributor is eligible to participate in another retirement plan and when AGI exceeds $80,000 for a married filing joint taxpayer, or $60,000 for a single taxpayer with reduced contribution limits for AGI down to $70,000 and $50,000, respectively.

5. Where income is low or negative, consider the transfer of regular IRA balances to a Roth IRA to take advantage of future non-taxable income. However, adjusted gross income cannot exceed $100,000 to be eligible for a transfer.

6. Your farm business is a built-in deferred compensation and tax loss program. Investments and current expenses are made that substantially improve the value of the business property which can be sold at a later date, frequently at capital gains rates. Establishing a fruit orchard and increasing the size of a breeding livestock herd, for example, fits this situation. Crops that fit this category are timber, fruit trees, and Christmas trees as well as the build-up in year-end inventories.

7. Use installment sales of capital items to spread income over a number of years. However, with fewer and wider tax brackets and depreciation recapture considerations, an installment sale may not be advantageous.

8. If approaching retirement, plan for more of your income from rent, dividends, interest, and pensions rather than earned income so that income will not be taxed as self-employment income for Social Security or reduce Social Security benefits. Earned income level that will decrease Social Security

benefits for 2005 is $12,000 per year for those under full retirement age. The decrease is $1 for every $2 of excess earnings. In the year that full retirement age is reached, the decrease is $1 for every $3 of earnings in excess of $31,800 until the month that age is attained. There is no limit on earnings when full retirement age is attained. That is age 65 years plus six months (born in 1940), but Social Security taxes are still paid on earned income.

9. Be sure to deduct as large a portion of business-personal expenses as is justified in your situation. Frequently, considerably more than 50% of the electricity and phone costs can be considered business. Also, choose the method for auto deductions, which is best for you. The standard mileage rate for 2005 is 40.5 cents per mile for business mileage before Sep. 1 and 48.5 cents per mile after Aug. 31, 2005. Mileage for charitable purposes can be itemized at 14 cents per mile, for medical purposes, 15 cents per mile before September 1 and 22 cents per mile after August 31, 2005.

10. Be aware of the Alternative Minimum Tax in tax planning. Alternative Minimum Taxable Income (AMTI) includes tax preference items such as tax-free interest. There is a $58,000 exemption for those filing joint returns ($40,250 single) and a tax rate of 26% on the first $175,000 of alternative minimum taxable income and 28% on AMTI in excess of $175,000. It is paid to the degree the tax exceeds your regular tax and is affecting more returns every year.