

## 2006 Farm Income Tax Planning

Farm incomes vary due to yield risks, price risks, and fluctuating farm input costs. Because of this variation in net farm income, agricultural producers have specific tax planning advantages written into tax laws, rules, and regulations. For example, most qualified farmers use the cash accounting method rather than accrual, and do not necessarily have to file estimated taxes quarterly if they file income taxes by March 1 (*Farmer's Tax Guide, IRS Publication 225*). These farmer-friendly tax rules, along with standard tax regulations, make it worthwhile for producers to invest time in year-end tax planning. There are several strategies farmers may employ in effective year-end tax planning:

- 1. Keep good records so information is available for tax planning.** Records will not only help comply with tax requirements, but can also help with monitoring the business, preparing financial statements, and substantiating items in case of an Internal Revenue Service (IRS) audit. All farm incomes, expenses, potential sales, and purchases can be considered in tax planning. Some actions, such as paying bills, making sales, and placing equipment into service, must be taken prior to the end of the tax year, which is the calendar year for most farmers. Other decisions, such as depreciation adjustments and retirement contributions, have some flexibility and can be finalized after December 31.
- 2. Maximize the benefit of the lowest applicable tax brackets.** Ordinary income bracket rates for 2006 are 10, 15, 25, 28, 33 and 35%. The tops of the lower two brackets of taxable income are \$7,550 (10%) and \$30,650 (15%) for single (S) and \$15,100 (10%) and \$61,300 (15%) for married, filing jointly (MFJ). Short-term capital gains rates are the same as ordinary rates, while long-term capital gains rates are less than ordinary rates. Long-term rates are 5% for taxable income in the 10 and 15% ordinary brackets, and 15% in the 25% and higher ordinary brackets. Because these long-term capital gains rates are less than ordinary rates, ensure that eligible capital gains are taxed at long-term rates. A multiple-year approach is to maximize use of the lower tax brackets (10 and 15%) each year, if possible. This strategy is preferable to having income fall into the 25% bracket one year and falling short of the dollar limit of the 15% bracket another year.
- 3. Plan net farm profit so that Self Employment (SE) tax is not paid on the maximum every year.** For the average American worker, the social security tax may be their highest tax expense when both the employer's and the employee's shares are considered. For business owners, the SE tax can be substantial since it is paid at the rate of 15.3% on up to \$94,200 of 92.35% of net farm profit and 2.9% above that. Therefore, rather than pay SE tax on \$90,000 two years in a row, pay SE tax on \$70,000 one year and \$110,000 the next year. Be aware that there are many credits and deductions with phase-out limits that may complicate your planning when using this approach.
- 4. Maximize contributions to retirement accounts and other adjustments to income.** The bottom of the front page of Form 1040 lists items subtracted from total income resulting in an adjusted gross income (AGI). The AGI is often used to determine whether deductions and credits are allowable or reduced. Farmers typically might subtract self-employed health insurance, contributions to traditional Individual Retirement Accounts (IRAs), Simplified Employee Pension (SEP), Savings Incentive Matched Plans for Employees (SIMPLE) or other qualified retirement plans, and one-half of SE tax. Increasing deductible retirement plan contributions will reduce taxable income. For traditional IRAs, the maximum contribution for a married couple is \$4,000 each or \$8,000 (\$5,000 each or \$10,000 if both husband and wife are 50 years or older).

SIMPLEs and SEPs have higher contribution limits. Roth IRAs use contributions from after tax income but won't be taxed on the income when qualified distributions are taken. The Domestic Production Activities Deduction may also apply (discussed in part 13).

**5. Plan taxable income so that all deductions and exemptions are used each year.** Many farmers use the standard deduction: \$10,300 for MFJ, \$7,550 for head of household, or \$5,150 for S or married, filing separately. Note that the MFJ is currently twice the single amount. If itemized deductions are higher than the standard deduction, a phase-out occurs a higher incomes. Exemptions are \$3,300 each. Although SE tax may be owed on Schedule F net farm profit, income taxes are less in the long run if the deductions and exemptions are fully used each year.

**6. Use all available tax credits.** Credits are dollar-for-dollar reductions in the amount of tax owed. Some credits are refundable, which means the taxpayer gets credit for them even if they owe no income tax for the year. Others are nonrefundable, which means you only get the tax credit if you have an income tax liability for the year. Phase-outs of credits can occur; for example, the Hope and Lifetime Learning Credits begin phasing out at \$90,000 modified AGI for MFJ and \$45,000 modified AGI for S. The child tax credit of \$1,000 for each child under age 17 begins to phase out at \$110,000 (MFJ) and \$75,000(S). The strategy in these cases is to reduce income to become eligible for the credits.

**7. Delay or accelerate sales to shift income from one tax year to another.** Stored crops are most suitable to deferred receipts from sales, although some farmers have been successful with milk receipts. You cannot delay income by holding a check until after January 1<sup>st</sup> or asking the buyer to wait and pay you next year. This violates the principle of constructive receipt. If you have a right to the funds this year, then the funds generally count as income unless a contract prevents payment until the next year. Producers may elect to have Commodity Credit Corporation (CCC) loans treated as either income or loans; this designation can change from year to year if the appropriate forms are filed with the IRS. If property is sold on an installment basis (at least one payment in another tax year), then the taxable gains are spread over multiple years in proportion to the payment each year. Note that recapture of depreciation may all occur in the year of sale and is usually taxed at ordinary rates.

**8. Delay or accelerate purchase of supplies and feed.** If farming inputs are paid for in one year but won't be used until the next year, those inputs do not have to be stored on the farm, but there should be a specified quantity and description of the purchases. Quantity and description are necessary because a deposit on account does not meet IRS requirements for prepaid expenses. Taking advantage of early discounts and locking in prices demonstrate valid business purposes, which meet the IRS requirements; however, the IRS does not consider reducing income taxes a valid business purpose. Payment must actually occur; a note promising to pay is not a payment. If cash is tight, consider borrowing money from a third party to make these purchases. Similar to borrowing for prepaid expenses, credit card purchases for your business are an expense when the transactions occur because the money is borrowed from a third party.

**9. Choose the amount of direct expense.** Purchasing capital items such as machinery, equipment, or trucks with a Gross Vehicle Weight Rating (GVWR) of more than 6,000 pounds allows flexibility in choosing the amount of depreciation and expensing during the year that items are placed in service. The 2006 Section 179 direct expensing limit for qualifying items is \$108,000, with a phase-out beginning at \$430,000 of property placed in service. The amount of direct expensing is selected by the taxpayer for any qualifying items in any amount up to the limit.

The law now limits large SUVs to \$25,000 of direct expensing. The 50%/30% bonus depreciation has expired for almost all situations. Producers may use either 150% declining balance or straight line for regular depreciation and often can choose between a shorter and longer time period to fully depreciate capital purchases.

**10. Pay family members for farm labor.** Farm families can pay their children for work actually performed on the farm. Keep records of the hours worked and pay children with a check so there is a paper trail. In some situations, there will be no social security tax or income tax due on their income.

**11. Consider Farm Income Averaging.** There are three completely different methods for farmers to calculate the amount of income taxes due, and our strategies concentrate on the standard method. Another method is Farm Income Averaging (Schedule J), which may reduce taxes for some farm businesses. A portion of ordinary farm income and/or capital gains from 2006 (called elected farm income) is equally split into thirds and applied to the three previous years: 2003, 2004, and 2005. Income tax brackets are “borrowed” from those years and may make a difference in tax liability if lower brackets from previous years are available compared to current tax rates. The amount of elected farm income to choose for income averaging may require trial and error, so a computer program is helpful when using this strategy.

**12. Be aware of the Alternative Minimum Tax (AMT).** The AMT is the third method to calculate income taxes due. It is affecting more middle-income taxpayers each year because it is not indexed to inflation. If the amount of taxes calculated for AMT is greater than the standard method, then AMT is due. A new law coordinates AMT with farm income averaging so that income averaging will not increase AMT. The AMT has a \$62,550 exemption for MFJ (\$42,500 S) and a tax rate of 26% on the first \$175,000 of income in excess of the exemption amount and 28% above that. Most computer programs calculate AMT and will alert you when it begins to affect your tax calculation.

**13. The Domestic Production Activities Deduction (DPAD).** For many farmers, Qualified Production Activities Income (QPAI) is net Schedule F income added to the gain from the sale of raised animals used for dairy, breeding or sporting purposes. The amount of the deduction will be the *smallest* of three calculations:

- a. 3% of QPAI
- b. 3% of an individual's adjusted gross income or the taxable income of an entity
- c. 50% of total Form W-2 wages of an employer (probably box 5 wages which show what's subject to Medicare).

This 3% deduction increases to 6% in 2007 and 9% after 2009.

These are a few techniques farm businesses may wish to consider when implementing year-end tax planning. Tax calculations are complicated by many limits, phase-outs and interactions. Consider scheduling a tax planning session with your tax preparer, District Farm Management Extension Agent, or Agricultural Extension Agent before the end of the year to address your specific situation.