

## Farm Income Tax Planning in 2007

What is the goal of tax planning? Is it to minimize this year's income taxes or taxes over multiple years? Is it to insure qualification for social security or disability? The answer changes for each individual situation and affects the choices available. The income level and tax rates limit the choices taxpayers can make. For farmers, the income level this year depends on costs, yields and prices. Tax rates are lower than at times in the past and increase after 2010 when the 10% tax bracket disappears and other rates go up.

Assuming your **records** insure that all income and expenses are recorded, there are some tremendous tax planning techniques to lower income taxes. These techniques can increase expense deductions, defer income, or reduce adjusted income and are available to farmers using cash basis accounting. This planning should help be more tax efficient or get profits or money out of the farm business while minimizing taxes.

**Increasing expense deductions** for the farm business decreases both income taxes and self employment taxes. Direct expensing of items that normally must be capitalized was increased in May to \$125,000 of qualified property (for example, machinery and equipment or purchased breeding or dairy animals placed in service). If more than \$500,000 is spent, then the limit is reduced by each dollar over that. For example, if \$550,000 of farm machinery and cows are placed in service, then direct expensing is reduced by the amount spent over \$500,000 or \$50,000. Direct expensing could only be a maximum of \$125,000 - \$50,000 or \$75,000. If \$625,000 or more of qualified property is placed in service, then the direct expensing available is zero.

Another method for most farmers who use cash accounting is to **prepay expenses**. Buying inputs this year for use next year allows the expenses to be deducted on this year's tax return. There must be a business purpose not just a tax avoidance purpose. Acceptable business purposes include assuring a supply or receiving a discount for early payment. Always specify a quantity and description of the inputs. A deposit on account does not qualify as a prepaid expense.

**Deferring income** or not selling produce until next year postpones paying income taxes. Farmers can defer income until next year by contracting ahead of time to deliver this year but not be allowed to receive payment until next year. Just having the elevator or milk company hold the check until next year after delivering products this year is not adequate for the IRS. There must be a binding contract that the money cannot be received until some date the next year. Of course, there is some risk in delivering products without receiving money.

**Adjustments to income** (bottom page of the front of Form 1040) lower the amount that is subject to income taxes but still may be subject to self employment taxes. These adjustments include deposits for retirement such as traditional Individual Retirement Accounts, SIMPLE, 401(k) or SEP. Health Savings Accounts are becoming more common and are available. Putting money in these before the deadlines (some are calendar year deadlines while others are prior to filing your tax return) should lower

taxable income. The Domestic Production Activities Deduction doubled from 3% in 2006 to 6% in 2007 of qualified income. Qualified income is approximately net Form 1040 Schedule F profit plus sales of raised, cull or breeding animals. Paying hired labor is a key element of eligibility for this deduction because the deduction cannot exceed 50% of farm wages paid that were subject to social security tax.

Compared to the normal approach for calculating federal income taxes, the **Alternative Minimum Tax (AMT)** is a second approach. It's a completely separate way and has its own rules for deductions, exemptions and tax rates. Last year it had an exemption amount of \$62,550 for married, filing jointly (MFJ) or \$42,500 for single (S). If Congress does not act, then the current amount is \$45,000 for MFJ or \$33,750 for S. It's expected that the law will be passed to make it similar to 2006 but has not been changed yet. The federal tax rate for AMT begins at 26%.

The **Income Averaging** provision for farmers is a third approach for calculating income taxes. It allows the taxpayer to choose an amount of elected farm income from this year and borrow tax brackets from the three previous years. For example, a taxpayer that is married, filing jointly has ordinary taxable income of \$93,700 this year after adjustments, deductions and exemptions. This puts them in the 25% tax bracket for \$30,000. Assume that there were tax brackets left in the previous years due to lower income in those years of 15% in 2004, 10% in 2005 and 0% in 2006. It is allowable to elect an amount such as \$30,000 to average over the three previous years by splitting the \$30,000 into three equal amounts and using the leftover brackets. Instead of paying 25% on the \$30,000 we would pay 15%, 10% or 0%. In our case the 2004 bracket would save us 25% - 15% or 10% on \$10,000 or \$1,000. The 2005 bracket would save us 25% - 10% or 15% on \$10,000 or \$1,500 and the 2006 bracket would save us 25% - 0% or 25% on \$10,000 or \$2,500. \$1,000 plus \$1,500 plus \$2,500 is a total of \$5,000 savings in federal income taxes in this example.

Some methods of lowering taxes are becoming less useful. Two years ago the **Kiddie Tax** only applied to children under 14 years old. Now the Kiddie Tax applies to children under 18 and in 2008 it will apply to a child under 19 or full-time students who are dependents under age 24. Unearned income (not wages) over \$1,700 may get taxed at the parents' tax rate in this situation rather than at the child's normally lower rate.

**Pickup trucks** over 6,000 pounds of gross vehicle weight rating (GVWR) can be totally direct expensed rather than depreciated over several years. Large SUVs are limited to \$25,000 of direct expensing. If an automobile or small pickup (less than 6,000# GVWR) is purchased in 2007 and used 100% for business purposes, then the maximum depreciation allowed (including direct expensing) is just over \$3,000.

Similar to the expiring Single Business Tax (SBT), the new **Michigan Business Tax (MBT)** is not assessed on agriculture. Agricultural production is exempt but at \$350,000 of retail sales at a farm stand, it probably does apply.

Many deductions and exemptions have **phaseouts** as income increases. Lowering taxable income from a high level may allow some of these to become available. For example, the Hope and Lifetime education credits for qualified tuition and fees phase out from \$94,000 to \$114,000 for MFJ and from \$47,000 to \$57,000 for S. Lowering adjusted gross income to less than \$94,000 may allow the full amount of the credit to be refunded.

If taxable income is in the lower part of the 15% bracket or below, then the Earned Income Credit or Retirement Saver's Credit might be available. **Credits** are generally preferable to deductions because each dollar of credit lowers taxes by one dollar while the deductions only lower tax by the percentage of federal, state and self employment taxes which is usually less than fifty percent.

These are a few general ideas. There are often additional restrictions for everything mentioned. To complicate matters further, most tax practitioners expect tax rates to increase after the next federal election. Some items like the 10% income tax bracket sunset or disappear in the future under current law. Perhaps this is a good year to **pay down debt** although this results in increased income taxes. Any deductible expenses associated with items purchased from the debt may have already been used as expenses so the cash used to repay the debt isn't used for deductible expenses and it becomes taxable income. With our current lower tax rates, maybe a Roth IRA should be funded (\$4,000 per person or \$5,000 if 50 years or older). Roths are funded with after tax dollars but distributions are not normally taxable when withdrawn for retirement.

Most techniques must be used prior to the end of your tax year although final depreciation and direct expensing decisions may be made when you file. Some tax planning with your qualified Extension Agent or tax practitioner may result in a high return on an hourly basis of your time.

For further suggestions see Tax Tips for Farmers under resources at [www.canr.msu.edu/telfarm/](http://www.canr.msu.edu/telfarm/)