TAX MANAGEMENT TIPS FOR FARMERS

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2007 - 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) Plan to have enough income to use personal exemptions ($3,400 each) and the standard deduction ($5,350 single, $10,700 married filing jointly).
   (b) If total income is over $45,000 married ($33,750 single), the Alternative Minimum Tax (AMT) may apply and must be calculated to see if it increases your income taxes. (It is expected that Congress will increase these exemption amounts for 2007)

2. Tax rates and adjustments to income:

   (a) The 10% bracket on taxable income increased to $7,825 for single and $15,650 for married filing jointly. The 15% bracket for married ($63,700) is double that of singles ($31,850). The higher brackets are 25%, 28%, 33% and 35%.
   (b) For capital assets sold and installment payments received, capital gains rates for sale of long-term capital assets held over 12 months (over 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 ($31,850 single and $63,700 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 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 used in a trade or business may allow some planning opportunities. Some exceptions may occur to the two of five years rule.
   (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 $125,000 in 2007, with the phase out beginning at $500,000 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. This is useful in higher income years if there are lower bracket amounts leftover from the three previous years. The 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 offset current losses by converting regular IRAs to Roth IRAs.
   (h) When an asset is traded-in, an election can be made for the book value of the asset traded-in (or carryover basis) to 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, 2007. This amount will remain at $1,000 through 2010. Phaseout begins when modified adjusted gross income is $110, 000 for married, filing jointly, or $75,000 for singles.

(k) The Domestic Production Activities Deduction is available to farmers if they hire labor. It has doubled from 3% of qualified production activities income in 2006 to 6% in 2007.

3. Depending on your tax situation, you may wish to reduce or increase net income for 2007. 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 2007 or delay payment to 2008 on real estate taxes and other annual bills. (Insurance premiums, real estate rental for 2008 and interest cannot be paid in advance to obtain an earlier tax deduction, but 2007 expenses of insurance, rentals and interest can be deferred to 2008 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) For farmers using cash method accounting, crop insurance or disaster payments may be reported in the year received or may be postponed one year under qualifying circumstances.
   (e) The gain may be postponed one year for livestock sold in excess of normal business operations if it's due to a weather-related lack of feed or water. For dairy, draft or breeding livestock sold in excess of normal practices, gain may be deferred if replacement livestock are purchased within two years of the end of the tax year of the excess sale. This may become four years or more under some conditions.
   (f) 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.
   (g) Where capital purchases have been made, or can be made, study the depreciation alternatives carefully. The direct expense deduction of up to $125,000 can be taken on current year capital purchases. Its use, however, cannot reduce your taxable income from farming (plus other earned 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 half-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). Most fruit farmers must us ADS straight line because their crops take more than two years to produce. If not, then they must track pre-productive expenses.
   (h) 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

(i) 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.
(j) Sell, rather than trade-in, machinery used in your trade or business to increase income. This income is not subject to self-employment taxes.
(k) 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 $97,500 for 2007. 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 $97,500. The 2008 social security wage base is $102,000. To earn one quarter of coverage in 2007, $1,000 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 system is essential for end-of-year tax planning and working with credit agencies.

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

3. Plan your personal deductions to use bunching. 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 2007, with an additional $4,000 in spousal IRA (plus an additional $1,000 for each one 50 or over). A traditional IRA deduction cannot be used if the contributor is eligible to participate in another retirement plan or when AGI exceeds $103,000 for a married filing joint taxpayer, or $62,000 for a single taxpayer (reduced contributions can be made for AGI down to $83,000 and $52,000, respectively). A Roth IRA contribution can be made with after tax dollars, but proper distributions should be tax exempt.

5. Where income is low or negative, consider the transfer of regular IRA balances to a Roth IRA and increase income this year and take advantage of future non-taxable income. Adjusted gross income cannot exceed $100,000 to be eligible for a transfer. This $100,000 limit will be eliminated in 2010.

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, but check your expected tax bracket and consider that all depreciation recapture occurs in the year of sale.

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 2007 is $12,960 per year ($1,080 per month) 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 $34,440 per year ($2,870 per month) 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 10 months (born in 1942) and age 66 years for those born from 1943 to 1954, 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. Considerably more than 50% of the electricity and phone costs may be considered business. Also, choose the method for auto deductions which is best for you. The standard mileage rate for 2007 is 48.5 cents per mile for business mileage. Mileage for charitable purposes can be itemized at 14 cents per mile, for medical purposes at 20 cents per mile.

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 $45,000 exemption for those filing joint returns ($33,750 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. Congress is expected to raise the exemption amounts but has not done so yet.

11. Consider alternatives for health insurance. The Health Savings Account (HSA) requires a high deductible health insurance plan but allows income tax free contributions to be made to an account which can build up over time. Distributions may be tax free if used for qualified expenses.

12. The 5% long term capital gain rate becomes 0% next year and remains there until 2010. This applies for long term capital gain below the top of the 15% ordinary income bracket ($63,700 for MFJ in 2007, it will be a little higher in 2008). Where taxable income is in the 25% bracket, long term capital gain rate remains at 15%. Portions of gain often are taxed at both rates because the lower rate applies until the 25% taxable income bracket is reached, then the higher rate applies.

13. Next year the Kiddie Tax applies to dependent children who are either under 19 years or full-time students under 24 years old. Unearned income (not wages or scholarships) over $1,700 will be taxed at their parents' tax rates rather than the child's normally lower rate.