

TAX MANAGEMENT TIPS FOR FARMERS

L.R. Borton
Michigan State University

2017 - Tax Planning

1. The basic management guideline is to avoid wide fluctuations in taxable income because a relatively uniform income from year-to-year results in the lowest income tax and largest Farmland Preservation Credits over time and Homestead credit, if eligible.
 - a. Plan to have enough income to use federal personal exemptions (\$4,050 each) and the standard deduction (\$6,350 single, \$12,700 married filing jointly, extra for those 65 or older).
 - b. If total income is over \$84,500 married (\$54,300 single), the Alternative Minimum Tax (AMT) may apply and must be calculated to see if it increases your income taxes.
 - c. Qualified farmers (2/3 of gross income from farming in 2016 or 2017) do not have to pay estimated taxes if they file *and* pay all of the taxes due by March 1, 2018.

2. Tax rates and adjustments to income:
 - a. The 10% bracket on taxable income increased to \$9,325 for single and \$18,650 for married filing jointly. The top of the 15% bracket for married (\$75,900) is double that of singles (\$37,950). The higher brackets are 25%, 28%, 33%, 35%, and 39.6%.
 - 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 falls within the 25% bracket up to the 35% bracket and 0% for that portion of capital gain between taxable ordinary income and the top of the 15% bracket (\$37,950 single and \$75,900 married). The 20% long term capital gain rate applies to taxable income in the 39.6% bracket which is over \$418,400 for single or over \$470,700 for married. Capital gains rates on collectibles remains at 28%.
 - c. The 3.8% net investment income (NII) tax applies to individuals, estates and trusts with modified adjusted gross income (MAGI) above \$250,000 for married filing jointly, \$200,000 for singles and \$12,500 for estates and trusts. NII includes gross income from interest, dividends, capital gains, rental and royalty income, nonqualified annuities, income from business involved in trading of financial instruments or commodities plus passive activity income. NII does not include wages, unemployment income, trade or business income, social security benefits, alimony, tax exempt interest, self employment income and distributions from most retirement plans.
 - d. 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. Some exceptions may occur to the two of five years' rule and any use for other than a principal residence may reduce the non-taxable portion. 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.
 - e. Penalty free IRA distributions may be taken to pay for qualified higher education expenses and certain expenses for a first-time homebuyer.
 - f. The section 179 (direct expense) deduction for capital purchases is \$510,000 in 2017, with the phase out beginning at \$2,030,000 of qualified property placed in service.

- g. The income averaging provision for farm income (Schedule J) allows negative taxable income to be used from the three base years. Higher income years may use bracket amounts with lower rates leftover from the three previous years to reduce the tax due. The law coordinates AMT with farm income averaging so that averaging does not increase AMT.
 - h. 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.
 - i. When an asset is traded-in, an election can be made for the remaining depreciable value of the asset traded-in (or carryover basis) to be added to the boot and set up on a new depreciation schedule.
 - j. The self-employed health insurance deduction is 100% on the front of the Form 1040 which still makes it subject to self-employment tax.
 - k. Child tax credit remains at \$1,000 for children 16 and under as of December 31, 2017. Phase-out begins when modified adjusted gross income is \$110,000 for married, filing jointly, or \$75,000 for singles. This nonrefundable credit (must owe tax to get the credit) may become refundable up to 15% of earned income in excess of \$3,000.
 - l. The Domestic Production Activities Deduction (DPAD) is available to farmers if they hire labor. It is now 9% of Qualified Production Activities Income (QPAI). QPAI is approximated by adding net schedule F income to gains from sales of raised breeding livestock or raised dairy animals. The deduction cannot be greater than 50% of W-2 wages paid by the farm employer for qualified production activities and cannot be greater than 9% of taxable income. If cooperatives pass on DPAD to members, the amount goes directly on Form 8903 without restrictions at the farm or taxpayer level.
 - m. The phase-out of personal and dependent exemption deduction returned in 2013. The 2017 exemption deduction of \$4,050 each begins phase-out at \$261,500 for singles and \$313,800 for married filing jointly. It decreases 2% for each \$2,500 that exceeds the threshold.
 - n. The overall limitation of itemized deductions returned for 2013 and continues in 2017. Using the same thresholds for exemptions, itemized deductions are reduced by 3% of the taxpayer's excess over the threshold to a maximum of 80%. The limitation does not apply to deductions for medical expenses, investment interest, nonbusiness casualty and theft losses, or gambling losses. This does not apply if a taxpayer uses the standard deduction rather than itemizing deductions.
3. Depending on your tax situation, you may wish to reduce or increase net income for 2017. 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 other Schedule F expenses for the year for which economic performance has occurred. The new repair and capitalization regulations changed little for cash accounting farmers that prepay supplies.
 - b. Pay in 2017 or delay payment to 2018 on real estate taxes and other annual bills. (Insurance premiums, real estate rental for 2018 and interest cannot be paid more than 12 months in advance to obtain an earlier tax deduction, but 2017 expenses of insurance, rentals and interest can be deferred to 2018 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 either 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. Under the new repair regulations, a farmer without an Applicable Financial Statement (most farmers do not have one) can deduct any item purchased up to \$2,500 without an IRS audit contesting it. The amount can be reduced below \$2,500, if desired. This election is made on the tax return.
- g. Where capital purchases have been made, or can be made, study the depreciation alternatives carefully. The direct expense deduction of up to \$510,000 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 use ADS straight line because their crops take more than two years to produce. If not using ADS, then they must track pre-productive expenses (including overhead expenses) and begin depreciation when the trees begin economic production.
- h. The 50% additional first year depreciation applies in 2017 and then begins phasing out. It was required for most new, farm depreciable property. Fruit and vineyard farmers normally cannot use this because they elected out of the uniform capitalization rules and must use the Alternate Depreciation System (ADS) which disqualifies them from this bonus depreciation. Taxpayers may elect out of this by class of property (3, 5, 7, 10, 15 or 20-year property). It is taken after direct expensing and before normal depreciation. Even if required to use ADS, a special rule enables bonus depreciation to be taken on the cost of fruits, vines and nuts in the year planted.
- i. Pay your children wages for work actually performed for the farm. Be reasonable and age appropriate for work and wages. 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.
- j. 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. The Michigan income tax rate for 2017 is 4.25%.

- k. Sell, rather than trade-in, machinery used in your trade or business to increase income. This income is not subject to self-employment taxes.
 - l. Frequently unrecorded and forgotten expenses include:
 - i. Educational expenses that maintain or improve your skills, such as magazine subscriptions, books, fees at extension or other agricultural organization meetings.
 - ii. Travel expenses connected with your business, particularly if it includes meals and lodging.
 - iii. Entertainment expenses when hosting others where the predominant purpose is the furthering of your farm business operation.
4. Self Employment Tax: Most taxpayers and many farmers pay more in SE tax than federal income tax.
- a. 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 \$127,200 for 2017. In addition, the 2.9% Medicare tax continues on income over \$127,200. A 0.9% additional Medicare tax applies to wages and SE income over \$200,000 for single filers and \$250,000 for married filing jointly.
 - b. To earn one quarter or work credit of coverage in 2017, \$1,300 of earnings are required. 50% of the Self Employment tax will be deducted as an adjustment to income on the federal form.
 - c. In 2017, farmers who have less than \$7,800 gross farm income may elect to pay SE tax on 2/3 of their gross farm income or if gross farm income is greater than \$7,800 may elect to pay SE tax on \$5,200. This allows a taxpayer to earn four quarters or work credits each year towards social security and disability eligibility. The amounts are indexed for the future to increase with inflation. Much or all of the SE tax paid may be returned through the Earned Income Credit.
 - d. Conservation Reserve Program payments for those receiving social security or certain disability payments are not included in self-employment income and were not subject to SE tax beginning in 2008. For those receiving social security payments prior to their full retirement age, the CRP payments will not count as earned income for the \$16,920 annual earned income limit in 2017. The recent Morehouse decision from the 8th Circuit Court does not apply to Michigan. It said that non-farmers are not subject to SE tax on CRP payments. The IRS disagrees and still contends that CRP payments are subject to SE tax.

Other Tax Planning Ideas

- 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 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 10.0% 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 with a limit of \$54,000) requires that certain employees also be covered. A SIMPLE plan is best for small employers

to encourage employee retirement savings without costly administration (up to \$12,500 plus \$3,000 for those 50 or older). 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 \$5,500 per year in 2017, with an additional \$5,500 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 and modified AGI exceeds \$119,000 for a married filing joint taxpayer, or \$72,000 for a single taxpayer (reduced contributions can be made for AGI down to \$99,000 and \$62,000, respectively). A Roth IRA contribution can be made with after tax dollars, but proper distributions should be tax exempt. Phase-out's for Roths are \$186,000 to \$196,000 for joint returns and \$118,000 to \$133,000 for single filers. Some taxpayers contribute to a traditional IRA with after tax dollars and then transfer it to a Roth IRA. If wanting to do this, check ALL the rules closely.

5. Where income is low or negative, consider the transfer of traditional IRA or 401(k) retirement balances to a Roth IRA and increase income this year and take advantage of future non-taxable income.
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 remember that all depreciation recapture occurs in the year of sale even if no money is received until the following year. Before scheduling a sale of the farm business due to retirement or bankruptcy, check into the income and self employment taxes. Gains from the sale of property may result in significant tax consequences without careful planning.
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 2017 is at \$16,920 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 \$44,880 per year (\$3,740 per month) until the month that age is attained. There is no limit on earnings when full retirement age is attained. That is 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 2017 is 53.5 cents per mile for business mileage. Mileage for charitable purposes can be itemized at 14 cents per mile, for medical or moving purposes at 17 cents per mile.
10. Be aware of the Alternative Minimum Tax in tax planning. It is a completely separate method to calculate income tax due. Alternative Minimum Taxable Income (AMTI) includes tax preference items such as tax-free interest. There is an \$84,500 exemption for those filing joint returns (\$54,300

single) and a tax rate of 26% on the first \$187,800 of alternative minimum taxable income and 28% on AMTI in excess of \$187,800. It is paid to the degree the tax exceeds your regular tax.

11. The lower long term capital gain rate is 0% permanently. This applies for long term capital gain below the top of the 15% ordinary income bracket (\$75,900 for MFJ in 2017). 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. The 20% rate will apply when taxable income is above \$418,400, single (or \$470,400 MFJ).
12. The Kiddie Tax applies to dependent children who are either up to 18 years or full-time students under 24 years old. Unearned income (not wages or scholarships) over \$2,100 will be taxed at their parents' tax rate rather than the child's normally lower rate.
13. Credits may reduce taxes. Refundable credits can be received even if no taxes are owed. Non-refundable credits can be used only if income taxes are owed.
 - a. Earned income Credit (refundable) – Maximum of \$6,318 with 3 children, AGI phase-out completed by \$53,930 for married, filing jointly. Maximum of \$5,616 with 2 children, \$3,400 with one child, and \$510 with no children. Phase-outs change for other than married, filing jointly. Michigan also has an EIC which is 6% of the federal EIC.
 - b. Education Credits – The American Opportunity Credit is a maximum of \$2,500 per student in their first four years of college. AGI phase-out of \$80,000-\$90,000 single or \$160,000-\$180,000 married, filing jointly. Lifetime learning credit of 20% of qualified, educational expenses up to \$2,000 but phases out at \$56,000-\$66,000 single or \$112,000-\$132,000 married.
14. For tax years beginning after December 31, 2009, the penalty for failure to file a partnership or S corporation return increased to \$195 per partner per month up to a maximum of 12 months. Exceptions to this penalty may allow small partnerships to avoid this penalty.
15. Farm businesses are still required to issue Form 1099-MISC for \$600 or more payments for rents and services except for payments to corporations. An LLC is probably not a corporation and payments for renting land or custom machine work still requires a Form 1099. Give a Form W-9 to the landowner or operator to obtain the necessary information. Note that even veterinary services that are corporations must be given Form 1099 if \$600 or more is paid for services since they are part medical services. Penalties can be up to \$500 each for failing to file an information return with the IRS and an equal penalty for not giving one to the recipient. This might even occur when a retired member of the family rents land to an operating entity.
16. Properly donating commodities to charitable organizations may reduce income compared to selling the commodity and then donating cash. For example, donate grain the year after it is produced and all the costs of production were deducted the prior year for cash method of accounting. There is no charitable deduction but the reduced income saves in income tax as well as self-employment tax.
17. The annual exclusion for gifts is \$14,000 per individual while the gift tax applicable exclusion amount is \$5,490,000. If properly elected, the amount of the exclusion that is unused by the estate of the first spouse to die can be used by the surviving spouse.

18. If unsolicited emails are received from the IRS asking for information or money, then it's probably a scam. Any attachments will probably try to put a virus on your computer. Beware! Do not open the email; just delete it. If someone calls claiming to be the IRS and wants money, don't send money because it is a scam.

19. The Michigan income tax rate for 2017 remains at 4.25% and the personal exemption is \$4,000. Many Michigan credits have disappeared. Also, the home heating credit and homestead credit are based on Household Resources while the Farmland Open Space and Preservation credit is still based on Household Income.

20. The Affordable Care Act (Obamacare) has an individual shared responsibility provision requires you and each member of your family to either:
 - a. Have minimum essential coverage, or
 - b. Have an exemption from the responsibility to have minimum essential coverage, or
 - c. Make a shared responsibility payment when you file your 2017 federal income tax return in 2018.

You will report minimum essential coverage, report exemptions, or make any individual shared responsibility payment when you file your 2017 federal income tax return in 2018.