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. Farmers may employ several strategies in effective year-end tax planning.

Maintain Good Records

Keep good records so information is available for tax planning. Records will not only help comply with tax requirements, but also can 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.

Maximize Use of Lower Tax Brackets

Maximize the benefit of the lowest applicable tax brackets. Ordinary income bracket rates for 2004 are 10, 15, 25, 28, 33 and 35%. The top of the lower two brackets of taxable income are $7,150 (10%) and $29,050 (15%) for single (S), and $14,300 (10%) and $58,100 (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.
Don’t Pay Maximum SE Tax Every Year

Plan net farm profit so that the Self Employment (SE) tax is not paid on the same amount 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 92.35% of net farm profit up to $87,900 and 2.9% of net farm profit above $87,900. Therefore, rather than pay SE tax on $85,000 two years in a row, pay SE tax on $60,000 one year and $110,000 the next year. The SE wage base projection for 2005 is $89,400, so the remaining $20,600 ($110,000 - $89,400) would be subject to the 2.9% rate rather than the 15.3% rate. Be aware that there are many credits and deductions with phase-out limits that may complicate your planning when using this approach.

Maximize Your Adjustments to Income

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 $3,000 each or $6,000 ($3,500 each or $7,000 if both husband and wife are 50 years or older). SIMPLEs and SEPs have higher contribution limits.

Plan For Using All Deductions, Exemptions

Plan taxable income so that all deductions and exemptions are used each year. Many farmers use the standard deduction: $9,700 for MFJ, $7,150 for head of household, or $4,850 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 for up to 80% of those deductions at the rate of 3% of AGI in excess of $142,700. The exemptions are $3,100 for each, with phase-out beginning at $214,050 for MFJ and $192,700 for S. Even though SE tax may be owed on Schedule F net farm profit, income taxes are reduced in the long run if the deductions and exemptions are fully used each year.

Use All of Your Available Tax Credits

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 $85,000 modified AGI for MFJ and $42,000 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.

Delay or Accelerate Sales to Shift Income

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 1st or asking the buyer to wait and pay you next year. This violates the concept 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.

Delay or Accelerate Feed Purchases

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.

Choose the Amount of Depreciation Expenses

Choose the amount of depreciation expenses. Purchasing capital items such as machinery, equipment, or trucks with a Gross Vehicle Weight Rating (GVW) of more than 6,000 pounds allows tremendous flexibility in choosing the amount of depreciation and expensing during the year that items are placed in service. The 2004 Section 179 direct expensing limit for qualifying items is $102,000, with a phase-out beginning at $410,000 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. A new law limits large SUVs to $25,000 of direct expensing.

Taxpayers are required to take the 50% bonus depreciation on eligible property unless an election is made to use the 30% bonus depreciation or to use no bonus depreciation. Note that bonus depreciation applies to all items within a property class, not by individual item. Most original-use farm property is eligible for bonus depreciation. Automobiles and smaller trucks may also be eligible for bonus depreciation if used more than 50% for business. Further, 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.

Pay Your Family Members

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, no social security tax or income tax will be due on their income.

Consider Farm Income Averaging

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 2004 (called elected farm income) is equally split into thirds and applied to the three previous years: 2001, 2002, and 2003. 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 elected farm income to choose for income averaging may require trial and error, so a computer program is helpful when using this strategy.

Be Aware of the Alternative Minimum Tax

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 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 beginning in 2004. The AMT has a $58,000 exemption for MFJ ($40,250 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.

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 Extension Dairy Agent before the end of the year to address your specific situation.