



# SPECIAL REPORT

## Annual Tax Strategy Report 2011

*Our Constitution is in actual operation; everything appears to promise that it will last; but nothing in this world is certain but death and taxes. —Benjamin Franklin*

*Death and taxes may be inevitable, but they shouldn't be related. —J.C. Watts Jr.*

*We have long had death and taxes as the two standards of inevitability. But there are those who believe that death is the preferable of the two. "At least," as one man said, "there's one advantage about death; it doesn't get worse every time Congress meets." —Erwin N. Griswold*

*[As the Roman Empire declined] the resources of the farmers were exhausted by outrageous burdens of all taxes, the fields were abandoned, and the cultivated land reverted to waste. —Lactantius*

*You have to be oblivious to common sense to believe that taxing people who do work and paying people who don't work results in more people working. That's just not the way the world works. —Arthur B. Laffer (creator of the Laffer Curve)*

*The state has grown used to treating its taxpayers as a farmer treats his cows, keeping them in a field to be milked. —James Dale Davidson and Lord William Rees-Mogg*

*In some places they raise more corn to feed more hogs to buy more land to raise more corn to feed more hogs. —Author unknown*

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One of the many services of certified public accountants is to assist clients in legally reducing the tax burden imposed. As the late Chief Justice William Rehnquist noted, there is no duty to pay more taxes than legally required. A person may structure his or her affairs in such a manner as to reduce the tax burden. In compiling this special study, *Pro Farmer* desires to assist its members in evaluating the opportunities for deferring and sometimes permanently reducing their tax burden. (A tax that is deferred is a tax that may never be paid.)

The goal of this special study is not so much to answer all of the questions about how the law applies to a particular issue or to arrive at the appropriate tax plan. The goal is to provide ideas. Some of the ideas may apply to your particular set of facts and circumstances; others will not. Ultimately, you may need professional assistance to determine which ideas will work best for you. When you visit with your tax professional, you will be better armed to discuss the various means that may be available to reduce your overall tax burden.

The following discussion is targeted to farmers using the cash basis of accounting for tax purposes. Some of the following concepts also apply to accrual-basis farmers. Either way, remember that this special study is not a complete and full discussion of each and every tax planning maneuver that is available. Moreover, the concepts discussed here should be reviewed with your professional tax adviser to ensure that the technique is appropriate to your situation.

Unless otherwise stated, it is assumed that the taxpayer's year-end is December 31.

### New for 2011-12

Several changes to the tax laws have been enacted over the last several years that apply for 2011 and 2012. A recap of the major changes is:

- An extension of 100% bonus depreciation to all new farm assets placed in service in 2011 and 50% bonus depreciation for all new farm assets placed in service in 2012. Farmers who purchase new equipment or construct new farm buildings and placed in service in 2011 will be entitled to completely write off the asset in 2011. Any qualified farm building will be 100% deductible as long as it is constructed and placed in service in 2011. If started in 2011 and placed in service in 2012, then it will be 50% deductible in 2012. The Senate has currently proposed extending the 100% bonus depreciation into 2012, but the bill has not yet passed.
- A 2% reduction in the employee portion of Social Security tax for 2011 including self-employed farmers. This reduces the tax rate from 6.2% to 4.2% and the maximum savings is \$2,136.
- Four additional lines on Schedule F related to the reporting of credit card proceeds. Back in 2008, Congress passed a law requiring a new form 1099-K that will report the proceeds from credit card transactions. As a result of this provision, the 2011 form Schedule F has four new lines labeled "Specified" items of income. These specified items are any transactions that farmers receive through the use of a credit card. This would mostly apply to farmers with a fruit and vegetable stand on their farm or perhaps custom farmers who accept credit cards, but be aware that you must report these transactions on these new lines, or you will get a friendly letter from the IRS suggesting that you owe additional tax for not reporting the income even though it reported it on other lines of Schedule F.
- The increase of the lifetime estate/gift tax exclusion to \$5 million and reduction in the tax rate to 35%. This law passed at the end of 2010 and applies for gifts and estates in 2011 and 2012. With the substantial increase in land appreciation over the last few years, this may be a great time to consider making large lifetime gifts.

### Record gathering

The first step in any tax planning strategy is to gather the

appropriate information. You can't know the measure of improvement unless you know where you stand today. "Today" is a day sufficiently before year-end so you can make plans to prepay expenses and defer income that otherwise may be received. Tax planning is a process that occurs before year-end. Tax compliance is the preparation of the tax return. The options to target a specific income level are substantially limited after the year-end.

Appropriate books and records must be kept to verify the income and expenses claimed on the tax return. The books and records are necessary not only for tax purposes, but also to provide the measurement for you to know if and when you need to make changes in your operation. You need to know whether a particular enterprise is worth the time and effort.

Computerized accounting systems provide the best support for the accuracy of the books and records. In addition to having the information to report income and expenses on tax returns, you need to be prepared for an IRS or state revenue department tax audit. Upon examination, the IRS will be determining if the detail of the expenses includes nondeductible expenses. The IRS will review your other bank accounts to determine if income has been deposited in any non-farm accounts. The best practice is to deposit all farm income into the farm account and pay all farm bills from the farm account. If you need money in other savings and personal accounts, transfer the funds (through the owner draw account in your books) to these other accounts. All of your farm activity should be recorded in the farm records.

If your farm operation is incorporated, make sure to keep the corporate records separate and distinct from the personal records. You should not be paying personal expenses with corporate checks, and you should not deposit income from personal activities into the corporate account. If the corporation needs more funds,

lend the corporation money. Borrowing transactions should be documented with notes requiring the pay-



## TIP!

IRS published interest rates, called the Applicable Federal Rate (or AFR), are at an historic low. If you have borrowed from your corporation, now is the time to lock in low rates of interest. If you borrowed for personal reasons, the interest isn't deductible. Even if you secured the loan with a home equity loan not exceeding \$100,000, the interest expense is an itemized deduction. Consider drafting a promissory note, documenting the loan, calling for interest at the AFR.

ment of interest at or above rates published by the IRS.

If your accounting records are not on a computerized system, the first recommendation is to get them onto such a system. Checks can be written directly through the computer; once written, the expenses will be automatically recorded into the correct accounts. The computer should substantially simplify the record keeping and check writing. As always, however, watch out for the GIGO (garbage in, garbage out) principle of accounting. The accounting records are only as good as the information recorded and the accuracy of the recording.



## TIP!

A computer system will assist in meeting the filing requirements for Forms 1099. Many "off the shelf" accounting programs provide for the accumulation and aggregation of data necessary for arriving at amounts reportable for Form 1099 purposes. The penalties for not filing your form 1099 can be substantial.

If you don't have a computerized system, is your accounting system a double entry accounting system, or single entry? If double entry, the same principles apply: The financial information derived is only as good as the information recorded. If single entry, you may want to double-check your numbers. The "double entry" refers to writing the transaction twice. For example, in writing a check, one entry is to reduce the balance in the checking account. The other entry records the increase in the expense account. When depositing funds, one entry is to record the deposit in the bank account; the other entry is to record the income. In addition to reconciling the bank account, double-entry bookkeeping accounts for the expense as the check is written. In a single-entry system, it is easy to miss adding a specific check to the expense listing.

### Single-entry accounting

A single-entry accounting system may be as simple as a list of income and expenses extracted from your check register. It is easy to miss deductible and taxable items. If you don't consistently deposit all farm receipts into one farm checking account, make sure to include in your total income the amounts deposited into other accounts.

Income might not flow through your checking account. If receipts are applied directly against your line of credit, remember to record these receipts as income. Another common error is including transfers from other accounts or loan receipts as income. Borrowings from the bank are not taxable income items and repayments of loans are not a tax deductible expense.

Remember also that not all checks written are deductible items for tax purposes. Equipment purchased may need to be capitalized (discussion to follow). Owner draws are not deductible. For a sole-proprietor farmer, or a farmer involved in a partnership, your income is not dependent on the amount of draws you receive from your farm checking account; you are taxed on the farm income regardless of the draws from the farm bank accounts.

Once you have determined your taxable income for the year to date, you have a base from which to plan for ascertaining the desired level of taxable receipts and disbursements through the end of the year.

Computerized accounting systems are a necessity in today's farm environment. If you have a computerized accounting system, you (or your tax adviser) may need to make adjustments, such as the following:

- Classify income and expenses properly
- Reconcile purchased inventory
- Record debt on newly acquired, financed equipment
- Update depreciation on existing assets
- Compute depreciation on newly acquired assets (including financed portion of purchase price)
- Consider Section 179 (which may be one of the last components of planning)
- Consider bonus depreciation on new equipment and certain other new farm assets
- Record sales of depreciable equipment and apply the remaining net book value of the equipment sold against the sales price
- Reconcile debt and compute interest portions of payments on debt

Let's look at each of these in more detail.

### ***Classify income and expenses properly —***

The proper classification of income and expenses may not make a difference in the tax planning aspect of your business. An income item recorded as a reduction of an expense, or a repair item classified as supplies, won't change the taxable income. But comparing totals from one year to the next will assist in determining if expenses are out of line with the norm, or if assets (which should be capitalized and depreciated) are improperly recorded as expenses. For example, make sure that federal income tax payments are recorded in an account separate from property tax and payroll tax expenses. Likewise, state income tax payments are separately deductible for the individual taxpayer as an itemized deduction and not as a business expense. The "cleaner" your books are in the proper classification of expenses, the less

time your tax adviser and preparer will need to spend with your records.

Classification is also important to determine which gross receipts relate to “domestic production” for the Section 199 deduction, an Internal Revenue Code section that became effective for years beginning in 2005. Section 199 has significant potential for many farmers and will be discussed later in this report.

#### **Reconcile purchased inventory —**

Purchased inventory may not be expensed as acquired. For example, if you purchase feeder pigs for fattening to market weight, the purchase price of the feeders is “inventory,” which is not deductible until sold. (Feed that is fed to the pigs during the growing process is currently deductible.) Reconcile the number of head on the farm at year-end to the purchase records. A FIFO (first-in, first-out) method may be used to determine the inventory value at year-end if consistently applied. Alternatively, you may use specific identification, which involves tracking each specific animal’s cost to apply against the sales price.

#### **Record debt on newly acquired/financed equipment —**

The total purchase price of newly acquired and financed equipment needs to be recorded as an asset on the balance sheet, not as an expense on the income statement. The down payment probably appears in your depreciable asset account; the financed portion of the purchase price needs to be included as well. Increase the depreciable assets account by the financed portion and record a liability for the debt.

Some states impose a sales tax on all farm equipment, while others impose a sales tax on only some pieces of farm equipment. Regardless of the method, the sales tax becomes part of the purchase price; it is not a separately expensed item. The total cost of the asset placed in service—purchase price, freight, installation expenses, and sales tax, if applicable—is the amount on which depreciation expense (or Section 179) is computed. If your state imposes sales tax on farm equipment and supplies, and you have purchased the item over the Internet or from a nearby state without paying sales tax, you may be liable for use tax to your state.

Even though sales and use tax (if applicable) is part of the purchase price for income tax purposes, many states do not consider such taxes to be part of the purchase price for personal property tax purposes. If your farm equipment is subject to personal property taxes, check out your local rules to determine if, when listing equipment on the assessment report, the equipment should be listed without the sales and use tax.

#### **Update depreciation on existing assets —**

Determining depreciation expense is one of the more complex computations necessary to arrive at taxable income. To the extent that you have not

expensed your equipment purchases in prior years using the Section 179 deduction (it may be wise not to deduct equipment purchases, even if doing so would reduce the current year tax liability), depreciation expense must be computed. There are many methods of computing depreciation expense.

Most farm equipment is depreciated using a seven-year schedule (which actually computes the expense over eight years) using accelerated depreciation methods. The IRS provides tables on the percentage of the asset’s original cost to deduct each year. Livestock may have shorter cost-recovery periods. Many farm buildings are depreciable over 20 years, but livestock feeding structures such as swine confinement buildings and poultry barns are depreciable over 10 years. Vineyards and orchards are also depreciable over 10 years, but must use a straight-line method for computing depreciation after reaching a mature state.

Elections are available so that depreciation is computed using slower methods over longer lives if you don’t need as much depreciation expense in the year of purchase. Once you choose a depreciation method and life, however, you have to stay with that method and life for (a) that piece of equipment and (b) all equipment that falls in the same “class life” purchased in that year. This is a choice you can make each year for purchases of equipment and other capitalized assets.

#### **Compute depreciation on newly acquired assets; Section 179 —**

Newly acquired assets may be expensed under Section 179 of the Internal Revenue Code. For tax years which begin in 2011, you may expense up to \$500,000 of equipment-type assets (including livestock purchased for dairy, breeding, or other non-inventory purposes). As will be discussed later, it may not be in your best interest to fully use this deduction.

For 2012 and beyond, expensing under Section 179 is scheduled to be limited to \$125,000, however Congress seems to fiddle with this amount each year or two, so there is a chance that this amount will change.

Section 179 is available even though you haven’t fully paid for the asset. The Section 179 deduction may be claimed on just one asset, or spread among several assets. To provide the greatest benefit, claim Section 179 on the longest-lived qualifying asset. Most farm buildings, such as shops and machine sheds, do not qualify.

Remember that the Section 179 deduction is not \$500,000 for each asset; the maximum deduction that may be claimed in the tax year beginning in 2011 is \$500,000, not to exceed the taxable income from your farm and other trades or businesses in which you actively participate. For this purpose,

wages received by you and your spouse are included as income from an active trade or business, even though such wages may not be subject to payroll taxes. (See the commentary on wages paid in the form of commodities.)

If you have a regular (C) corporation, it has a separate Section 179 limit.

S corporations and partnerships each have a Section 179 limit at the entity level. The owners of these entities are each allowed their own Section 179 limit. If you have several partnerships and/or S corporations reporting your share of Section 179 deductions, your total limit of \$500,000 for tax years beginning in 2010 and 2011 includes the amounts passed through from those entities. Be careful to coordinate the deduction if you have several entities. If too much Section 179 is passed out to you, the deduction does not carry forward and is wasted.

For tax years beginning in 2010 and 2011, if you place in service more than \$2 million of assets, the maximum amount of the Section 179 deduction available to you decreases dollar-for-dollar.

**Note:**

Certain qualified real property improvements qualify for a limited §179 deduction for years beginning in 2010 and 2011. However, this is a narrow provision that has limited application to agricultural assets. If you make leasehold improvements to assets subject to a lease between unrelated parties, ask your tax adviser how this provision may affect you. If you own an interest in a restaurant or qualified retail store, a temporary §179 election may benefit you as well.

**Bonus depreciation —**

For new assets acquired in calendar year 2011, 100% bonus depreciation is provided. The bonus depreciation allows the farmer to deduct 100% of the cost of the asset in the year acquired; the balance of the purchase is depreciated under the normal schedule.

Section 179 is computed before bonus depreciation.

Only new assets qualify for bonus depreciation. Additionally, some assets, such as farm buildings, qualify for bonus depreciation even though they do not qualify for Section 179. Note that the increased Section 179 limits and the bonus depreciation provision do not have the same time frames. The increased §179 limit is available for new or used equipment purchases in tax years beginning in 2011; bonus depreciation applies to new equipment and farm building purchases placed in service during calendar year 2011.

For 2012, this 100% bonus depreciation is reduced to 50%, however, at the time of this publication the Senate has proposed increasing this to 100%.

**Record sales of depreciable equipment; apply net book value against the sales price**

Adjustments may also need to be made for expensing the remaining net book value (the undepreciated portion)

of equipment and other depreciable assets sold during the year. If the asset sold hasn't been held long enough to claim depreciation against its entire purchase price, the remaining net book value is claimed in the year of sale as a deduction against the sales price. Also, remember to remove the asset from your depreciation schedule as well as your personal property tax listing. States that impose property taxes on farm equipment often request a copy of the depreciation schedule to determine equipment on hand, to assist in assessing the value of the equipment and thus the property tax due. In many states that assess property tax on farm equipment, you must actually dispose of the equipment to be able to remove the equipment from the property tax listing. You may be required to pay property tax if you keep the equipment in the "bone pile" or as "parts machines."

**Reconcile debt; compute interest portions of payments on debt —**

When you make your annual or monthly payments on long-term debt, do you record the interest portion of the debt separately? The interest portion is a current expense as paid. Reconcile the liability balances in your books to the balances as determined by the lender. Interest and other fees should be the reconciling items. Interest may not be deducted until it has economically accrued; you may not deduct "prepaid interest" even though other prepaid expenses are available as deductions for cash-method farmers. (Some prepaid expenses are available as deductions for accrual-method farmers.)

In some financing arrangements, the bank requires that receipts on the sales of farm commodities be collected directly by the bank to be applied to the operating loan. These directly applied funds must be recorded into the accounting system under the correct income and liability accounts. Unrecorded deposits should be discovered in the reconciliation of the liability accounts.

**Remainder of the year**

The income you choose to collect and the expenses you choose to pay will depend on what is available (to collect and pay) and the target that you plan to reach. The steps in this process include the following:

- List income you know will be coming in before year-end.
- List expenses you know will be paid before year-end.
- Determine additional income that may come in before year-end.
- List deferred payment contracts that call for payment to be received after the end of the year.
- Determine additional expenses that may be paid before year-end.

The last three items are the flexible items. You know where you are today (after the adjustments to the records discussed previously) and further, you

know the income that will be received and expenses that must be paid. The use of the flexible items will assist in achieving your income target. But we aren't ready to determine the target income just yet.

### Changes in personal situation

In discussions with your tax adviser, make sure to note any changes in your personal life, such as:

- Marriage, divorce, or widowhood
- New children, or children that are no longer dependents
- Children no longer qualifying for the \$1,000 child tax credit
- College education expenses paid by you, your spouse, or dependent
- Investment income of children subject to the "kiddie tax" (discussion to follow)

Your marital status will determine the level of income that you may have while still not exceeding certain tax brackets. For 2011, married couples filing joint income tax returns receive a standard deduction (those who do not itemize deductions) of \$11,600. For a single person, the standard deduction for 2011 is \$5,800. Each personal exemption is a deduction for \$3,700. The following illustrates how much income may be earned but still be in the 15% tax bracket:

	Married	Single
Top of the 15% tax bracket	\$69,000	\$34,500
Personal exemption — taxpayer	\$3,700	\$3,700
Personal exemption — spouse	\$3,700	
Standard deduction	\$11,600	\$5,800
All income taxed at 15% or below	\$88,000	\$44,000
<i>Add \$3,650 for each qualifying dependent.</i>		

Each qualifying dependent adds an additional \$3,700 exemption deduction.

In addition, consider that the tax due may be offset by child tax credits and education credits.



**TIP!**

If your spouse died during the year and you have not remarried, the "married filing joint" status is available. In addition, certain widowed taxpayers with a dependent child may qualify for the married filing joint status for the first two years after the year of the spouse's death. The married filing joint status is desirable, as more of your income is taxed in the lower tax brackets.

### Non-farm issues

Sole-proprietor farmers and farmers operating through partnerships also need to contend with nonfarm income and expenses. Make sure to consider off-farm income when you are determining the amount of farm income necessary to target a specific level of income. Your spouse's income is also a factor.

State income taxes may play a part in determining your taxable income. State income taxes may be paid

with the state tax return, may have been withheld from wages, or may be prepaid through required or optional estimated tax payments. The level of desired state income tax deductions may depend on whether you itemize deductions each year or every other year.



**TIP!**

It may be possible to use an "every other year" process of paying state income taxes. You may have paid your state income tax for the 2010 tax year with your tax return on April 15, 2011. Before December 31, 2011, you may prepay to the state the approximate amount due for the 2011 tax year. In 2012, then, you won't have a state income tax deduction, which might mean that the standard deduction gives a better result. Remember that married couples filing a joint return are given a standard deduction of \$11,600 for 2011. To the extent that itemized deductions are less than the standard deduction, the standard deduction may be used. Thus, try to combine two years of itemized deductions (state income tax payments, home mortgage interest expense, certain investment interest expense, charitable contributions, and others) into one year, to take the standard deduction in the other year. The value of this technique may be limited if you are at risk of being subject to the alternative minimum tax (AMT).

Taxpayers may choose to deduct either state income taxes paid, or state and local general sales taxes. The sales tax deduction may be based on tables issued by the IRS that take into account your income and the number of people in your household. In addition to the table amount, you may include the sales tax paid on motor vehicles, boats, aircraft, homes, and substantial additions to, or major renovations of, a home. For home improvements, the sales tax must be paid directly by you. (Certain exceptions apply, depending on state law.) Rather than using the IRS-provided tables plus tax paid on those specified items, you may deduct the total actual sales taxes paid if you keep track of your sales tax receipts.

### Tax-Exempt Income —

You may have income that is not taxable. Inheritances and gifts received are not taxable, even though they increase your wealth. Life insurance received is also not taxable in most situations.

Some types of farm income may appear to be non-taxable, but really have the effect of reducing expenses. For example, the Internal Revenue Code provides that certain cost-share program receipts are not includable in income. Further reading of that Code section, however, reveals that receipts that are excludable are limited to receipts associated with a capitalized item. If the receipt relates to a deductible expense (cost share to reimburse for an expense), the receipt is taxable. If the cost share receipt relates to a capitalized item, the tax basis of the asset created is reduced by the amount of the excluded cost share. Information from the USDA's Natural Resource Conservation

Service may not provide the full story and may require clarification. Tax “advice” provided by the USDA cannot be relied on if it conflicts with the Internal Revenue Code.

### **Kiddie Tax —**

The so-called “kiddie tax” refers to the tax computation of the income for a child under age 19 for the year. For children attending college full-time, the kiddie tax applies until the child is 24, if the child’s income doesn’t exceed one-half of the amount of their support. The general rule is that if you can claim the child on your income tax return, the child’s unearned income is subject to the kiddie tax. The rules are much more detailed than this and there are exceptions. (If the child is married using a married filing joint status, the computation does not apply.)

The kiddie tax applies when the child has more than \$1,900 (2011) of unearned income. Earned income, such as wages, is not subject to this tax computation. Thus, consider paying your children (even if subject to kiddie tax) reasonable wages for the work they do. The first \$5,800 (2011) of earned income is not subject to tax due to the child’s standard deduction.

The unearned income of a child subject to kiddie tax is taxed at the parents’ tax rate. (If the parents are divorced, the custodial parent’s rate is used.) A gift of commodities to a child will not change the effective tax rate on the child’s income, but will provide a benefit in that self-employment tax will be avoided on the income from the sale of the commodities. (As discussed later, the self-employment tax savings continue, even if the kiddie tax applies.) Remember that for a transfer to be treated as a valid gift, the child must have control of the funds after turning 18.

When it comes time to apply for college federal financial aid, the funds paid and accumulated by the children will “count” against them in the qualification process. Often, however, the tax savings generated over many years will provide more benefit than the federal grants. (Loans have to be repaid.)

### **Cancellation of Debt Income —**

The forgiveness of debt is income to the debtor (borrower). The question to be answered, however, is whether this forgiveness generates taxable income. There are many types of debt cancellation income. In specific circumstances, it may be possible for the debt cancellation income to be excluded from taxable income. This usually comes at a cost, though, as “tax attributes” always need to be reduced when debt is cancelled. Tax attributes include loss and tax credit carryovers, tax basis in depreciable property, and tax basis in land. The rules of debt cancellation income are beyond the scope of this special study. If debt cancellation applies to you, consult a tax advis-

er who is familiar with Section 108 of the Internal Revenue Code.

### **Determine desired taxable income**

After you have determined the taxable income expected for the current year—based on the actual results year-to-date, plus what you know will be additional income and expenses through the end of the year—the next question to ask is, “What level of taxable income should I target for the year?”



### **TIP!**

Reducing income to zero is usually not an appropriate tax-planning technique. Certain “free” tax deductions and credits are provided each year. If you have children under the age of 17, you may qualify for the \$1,000 child tax credit (for each qualifying child). Education credits may be available to you for tuition and fee payments for college, even if your child is responsible for the payments. If you provide more than one-half of the support for the child, you may be allowed to claim the child as a dependent, which allows you to claim the education credit. The child credit and education credit, if not used, are lost.

The appropriate taxable income will depend on your “typical” level of income. Review with your tax advisers the last several tax returns. On average, is your taxable income \$50,000? \$100,000? \$150,000? More? Perhaps the appropriate taxable income level for you is the top of the 15% tax bracket, if your average taxable income is between \$60,000 and \$120,000.



### **TIP!**

If your average taxable income over several years is greater than the top of the 15% tax bracket (\$69,000 for 2011 for a married couple filing a joint return), don’t waste any part of the 15% tax bracket. Make sure your taxable income—taking into account nonfarm income and expenses and itemized deductions or the standard deduction—exceeds \$69,000. The income that would have been taxable in the 15% bracket for 2011 might end up being taxable at 25% in 2012 (or possibly a higher rate, depending on what Congress and the President do with the expiring “Bush tax cuts”).

Taxpayers who will be reporting a tax loss often don’t believe they need tax planning. They might understand that the farm loss will generate a net operating loss that can be carried back five years and forward 20 years. But there are other considerations as well. Some tax benefits will be wasted if not part of the net operating loss computation, such as:

- Traditional IRA
- Personal exemptions in the current year
- Personal exemptions of the carryback/carryforward year
- Non-business deductions (including the standard deduction) exceeding non-business income

- Personal tax credits, such as the child credit and education credits

If you have a net operating loss (NOL) from a farm, review carefully your alternatives for the use of this loss. A farm NOL must be carried back five years, unless an election is made to forgo the five-year carryback, in which case the loss must be carried back two years. An election is also available to forgo the two-year carryback, and then the loss may be carried forward for up to 20 years. The losses carried back are used in the earliest year first, and then carried forward to offset the income of the succeeding year, until the loss is fully absorbed. Any loss not absorbed in the years before the loss year is used to offset taxable income in the succeeding years, in order. The election to forgo carryback periods is an “all or nothing” election.

In addition to the “normal” carryback and carry-over rules for NOLs, a loss incurred in a presidentially declared disaster area is carried back three, rather than two, years if the five-year carryback period isn’t applicable. Individual NOLs from property losses arising from fire, storms or other casualties, or from theft, also have a three-year carryback period.

If you have, or might have, a net operating loss, careful planning with your tax adviser will assist you in making the most of an unfortunate situation. The best time to plan for a loss is before year end, so you can target the most beneficial level of loss.

### Achieving targeted income

Once you’ve determined the appropriate level of taxable income, how do you get there? Do you need more income? Consider the following techniques:

- Accelerate sales, if appropriate in the market to do so
- Accelerate income, if possible, even without collecting the cash
- Accelerate collection of income
- Delay payment of expenses
- If you own stock in your closely held corporation that has excess or available funds, pay a dividend to yourself (and all other shareholders)
- Convert a traditional IRA to a Roth IRA
- Elect to include cost-share receipts into income

### Accelerate sales —

If you find that your taxable income will be too low, you could consider selling some of your commodities to increase taxable income. A good tax adviser, however, will not recommend that you sell commodities merely because you need additional taxable income. The timing of sales should be based on your interpretation of the market, and not merely for tax purposes. A good adviser will attempt to match the tax planning with the economic decisions that are appropriate under the circumstances.

### Accelerate income without collecting the cash —

Typically, taxpayers expect that they must collect the income to be taxed on the income. That isn’t necessarily so. Since the 1980 Installment Sales Revision Act, the sale of farm commodities on a deferred payment contract, under many circumstances, may be seen as an installment sale. The taxpayer may choose to elect out of the installment method, thus triggering the gain in the year of the sale. This is a sale-by-sale election. If each truckload of corn is considered a sale as delivered, you can choose which, and how many, truckloads of corn to bring into income, even though you haven’t collected the cash.



### TIP!

Double-check that appropriate notations are made by the tax preparer and in your records so that taxable income isn’t duplicated when you actually receive the money in the following year.

### Accelerate collection of income —

It may be possible to accelerate the collection of income previously deferred. If you have a contractual agreement that payment will be made after year-end, the buyer need not consent to your request to be paid before year-end. But the buyer might consent to the request because you are a good supplier, dealing fairly and equitably, and the buyer wants to maintain good relations with you. Still, it would be wise not to use this method with the same supplier in consecutive years (to maintain healthy relationships with suppliers). Additionally, if there is a history of changing the timing of income collection, the IRS may argue that you are in constructive receipt of the income. Moreover, you must not be able to demand early payment. If you have a right to demand earlier payment, you are in constructive receipt, causing the income to be taxable at the point that you have the right to demand the payment.

### Delay payment of expenses —

If it won’t damage business and personal relationships to do so, consider delaying the payment of expenses until the following year. Even though rent payments are due before the end of the year, a landlord may agree to delaying collection. Of course, this might disturb the landlord’s tax planning. As in most aspects of life, communication is key to maintaining relationships. The landlord may be able to make other adjustments to achieve his or her tax planning objectives. If your landlord has a fiscal year-end, a delay of payment until after December 31 (your year-end) shouldn’t damage the landlord’s tax planning.

Likewise, if you control a related regular (C)

corporation with a fiscal year-end, the delay of payment to that corporation may be the best opportunity for delaying the payment of expenses without damaging relationships.

**Example:**

You are a sole-proprietor livestock farmer with a related regular corporation that raises feed for your livestock operation. The corporation has an October fiscal year-end for tax purposes. Typically, you purchase feed on a monthly basis as you feed the livestock. If you delay your December payment until January, you can claim the deduction in the next calendar year, but you will not affect the corporation from a tax perspective.

**Pay a dividend to yourself —**

Dividends received from domestic corporations are taxed at the same rates as long-term capital gains. If you will be in the 15% or lower tax bracket for the year, consider declaring and paying a dividend from your closely held corporation to yourself. For 2011 and 2012, such long-term capital gain income is taxed at zero percent. The amount of additional income shouldn't exceed what would be taxed at 15% if the income were ordinary income. State income taxes need to be considered, of course. The dividend must be paid out before the end of the calendar year to be included with the current-year income.

For those with taxable income less than \$69,000 (for 2011, for a married couple filing a joint return), bringing in more capital gain or qualified dividend income means receiving tax-free income. Don't lose out on this opportunity if it is available to you!

**Convert a traditional IRA to a Roth IRA —**

Unlike for a traditional IRA, no tax deduction is available for contributions to a Roth IRA. Withdrawals at retirement from a traditional IRA will trigger taxable income; a withdrawal from a Roth IRA will be nontaxable.

Since withdrawals from a Roth IRA are nontaxable if distributed after age 59½ (there are other events that may allow penalty-free withdrawals from a Roth IRA), the conversion from a traditional IRA to a Roth IRA in a loss year may have the effect of permanently exempting this investment income. When the investment was made into the traditional IRA, a tax deduction was granted. A conversion of that traditional IRA (some or all) in a loss year may permanently exclude the balance of the account (investment and earnings) from being taxed.

The value of the traditional IRA, less any nondeductible contributions, will be taxable in the year

of conversion. You must convert the entire balance of the traditional IRA. But you may be able to split the IRA into two or more accounts and choose one or more of the accounts to convert. Again, determining the optimal conversion level is a task that will require complex computations so that the tax benefits of a net operating loss, earned income tax credits, and various other deductions and credits aren't reduced.

For years after 2009, all taxpayers may convert traditional IRAs into a Roth IRA. There is no income limit, as previously existed for years before 2010. An added benefit for 2010 conversions is that the income from the conversion may be reported over two years, with one-half being reported in 2011 and the balance being reported in 2012. If you did a Roth conversion in 2010, make sure to include the amount taxable in 2011 and 2012 as part of your overall tax plan for 2011 and 2012. (Farmers who normally file by March 1 may avoid estimated tax penalties by sending an estimated tax payment to the IRS by January 15, 2011.)

The conversion to a Roth is most appropriate for older taxpayers whose estates will be subject to estate tax and who expect themselves and their heirs to be in higher tax brackets in the future than they are today. By October 15, 2012, tax advisers will have more information to evaluate the direction of future tax rates. Also, if the value of the investments has dropped, it may be beneficial to wait to convert. The lower the value of the IRA at the time of conversion, the lower the income tax will be on the conversion.



**TIP!**

If you expect to be in a high income bracket in future years and you are nearing retirement, a conversion to a Roth in 2011 will trigger income taxed at 2011 tax rates, rather than the higher tax rates expected for later years.

An added benefit for taxpayers whose estates will be subject to estate tax: the federal (and state, if applicable) income tax paid on the conversion will reduce your taxable estate, cutting the effective income tax cost in half. Your beneficiaries will benefit from not having to pay income tax on withdrawals from the Roth. The greatest benefit is achieved by paying the tax on the conversion from non-retirement funds.

**Elect to include cost-share receipts into income —**

As discussed earlier under tax-exempt income, certain cost-share receipts may be excluded from income. You can elect to include the receipts into income, which usually will allow an enhanced depreciation deduction from the asset associated with the cost share.

What can you do to reduce taxable income? Consider these techniques:

- Prepay expenses
- Further delay income that otherwise would be received before year-end

#### **Prepay expenses —**

A cash-basis farmer (and to a limited extent, an accA cash-basis farmer (and to a limited extent, an accrual-basis farmer) may prepay expenses. A live-stock farmer may purchase feed to be consumed within the following 12 months. A row-crop farmer may purchase seed, chemicals, and fertilizer to be applied within 12 months. There must be appropriate business reasons to do so, such as to lock in a supply or to lock in a price. The prepaid amounts must be consumed within the next 12 months.

The prepayment must be more than a mere deposit. The IRS has held that the following are indicators of a deposit:

- The absence of specific quantity terms
- The right to refund any unapplied credit at the termination of the contract
- The seller's treatment of the expenditure as a deposit
- The right to substitute other goods or products, except to accommodate current diet requirements, for the ingredients specified in the contract

The author does not believe the third item—the seller's accounting treatment—has anything to do with the bona fides of treatment as a prepaid expense; this is not under the buyer's control.

Clearly, the commitment to purchase X bushels of corn at \$y.yy per bushel with payment due upon entering the contract, for delivery at a later date, is not a deposit. Treatment of this as a prepaid expense should be upheld.

But what do you do if the seller is not willing to commit to a purchase price, or you don't want to lock in a price if the price declines? A contract to purchase 30,000 bushels of corn (within 12 months), priced at the time of delivery, with a down payment of \$50,000, for example, should not be treated as a mere deposit, as long as there is no right of refund or right to apply the payment to some other commodity. A good business reason exists to do so (locking in a supply, but not a price). Locking in a quantity of fuel, chemicals, feed, seed, and the like should be a valid prepayment for tax purposes, as long as no right of refund or application to another product exists.

Do you damage the bona fides of a prepayment if later, because of weather conditions, you change your previous agreement for purchasing one chemical to instead purchase another chemical that will work bet-

ter under the different conditions? That depends on whether you had a right to change the agreement. To maintain good relationships with its customers, specifically you, the chemical supplier may agree to the substitute. But since you don't have the right to change the agreement, the chemical supplier may deny the substitute. After all, the supplier may have committed to purchasing a specific quantity of the chemical based on your contract.

An invoice that merely states "\$50,000 for chemicals and fertilizer" will be viewed as a deposit. The invoice must be more specific about what is being purchased.

#### **Defer receiving income —**

Deferring the receipt of crop income has long been a technique for deferring the recognition of income for tax purposes. The concern is with the doctrine of constructive receipt, which holds that if you had a right to receive the proceeds from the sale of the commodity, you are taxed in the year of the sale, regardless of when you came into possession of the funds.

It may very well be that you could have requested payment at the time of the sale as part of the sale agreement. That does not cause you to be in constructive receipt of the income. It is not important what agreement you could have had. What is important is the actual agreement that you made with the buyer at the time of the sale.

Assuming a valid deferred-payment arrangement entered into at the time of sale, you are in constructive receipt of the income when you can demand payment and the buyer has the financial ability to pay.

#### **Example:**

On September 19, Year 1, Tom entered into an agreement to sell Kurt 40,000 bushels of corn for \$5.00 per bushel. Kurt agreed to pay Tom by December 15, Year 1. Before December 15, Tom visits with his tax adviser, who advises him to collect only \$50,000 of the \$200,000 contract amount. Will this modification be respected?

If, before December 15, Tom and Kurt modify their agreement in writing to state that \$50,000 will be payable December 15, Year 1, with the balance due January 5, Year 2, the agreement should be respected as a valid modification to the original terms of the agreement. Note that a written agreement must be modified in writing. Further, the agreement must be modified before the date on which Tom could have demanded payment: December 15, Year 1.

Without substantial evidence that Kurt does not have the ability to pay Tom on December 15, a modification on or after that date will not further defer Tom's recognition of income.

Merely holding a check for deposit after the year-end will not suffice. If a check is received before midnight on December 31, the income will be taxable in that year, even though the banks are closed and there is no opportunity to convert the check into cash. The receipt of the check is the taxable event, not the deposit of the check.

## Year-end maneuvers

Most of the preceding discussion has related to specific tax-planning ideas. Moving income between the current year and the next year, either as deferrals of net income or acceleration of net income, is the most common. In more general terms, however, tax planning should include not only the current and immediately following tax year, but also the amount of tax that will be paid for several or many years to come. These tax-planning ideas include:

- Deferral of income
- Prepayment of expenses
- Purchase of equipment and other assets qualifying for Section 179
- Purchase of new equipment or other assets qualifying for bonus depreciation
- Charitable contributions of commodities
- Family gifts of commodities
- Charitable contribution direct from your IRA (expired as of this writing)
- Payment of wages to children

### **Deferring and prepaying —**

Deferral of income and prepayment of expenses have been covered at length already. These techniques are useful not only to shift income between years, but the shifting should be done with the idea of targeting the income for the lowest reasonable tax rate. It doesn't make sense to lower the income of the current year if the income will instead be taxed at a higher rate in later years.

Self-employment taxes must be considered in this analysis. The shifting of income that has the effect of creating a self-employment loss at the cost of causing the income to be taxed next year at 15.3% (the self-employment tax rate for 2010) makes little sense, even if the income tax bracket is 15% in both years. Remember that in paying income taxes for a farm or other self-employed business, you are also paying self-employment (Social Security and Medicare) taxes and for many farmers the self-employment tax is substantially higher than the income tax.

### **Equipment purchases —**

Consider spreading out equipment purchases so that you can maximize Section 179 deductions in all years. Of course this is only a generalization. There may be good tax and non-tax reasons to purchase

more than the Section 179 allowance amount in the current year. For example, because of crop rotations or expansion of the number of acres to be farmed next year, you anticipate that you don't need any Section 179 deductions for next year. Purchasing the needed equipment this year may be the appropriate business decision. Since the §179 limitation for 2011 is \$500,000, this issue may not be important for you. Remember, however, that §179 phases-out as the total basis of §179 assets placed in service exceed \$2 million for this year.

### **Charitable contributions of commodities —**

If you are charitably inclined, consider giving commodities to a charity.

#### **Example:**

Let's assume that you'd like to give your church \$5,000 a year. Your state income tax itemized deduction (see the detailed discussion earlier) is also \$5,000. You have no other itemized deductions. The charitable contribution of cash to your church will not provide a tax benefit, as the standard deduction is greater than your total itemized deductions. If you give the church 1,000 bushels of corn when the corn price is at \$5.00 per bushel and let the church sell the corn to collect the proceeds, you still won't receive a tax deduction for the contribution. But you won't have to sell the corn yourself and pay the income tax on the proceeds. If you are in the 15% bracket and pay self-employment tax, this technique could save you over \$1,500 in taxes.

There are specific rules for charitable contributions of commodities. Foremost, the charity has to be in control of the commodity. The charity decides when to sell the corn. The charity is responsible for arranging the hauling of the corn to the market (if the corn is in your home storage). If the corn is in your home storage, the charity should pay you a storage fee. The charity may desire to insure the corn. All of the burdens and benefits of owning the corn belong to the charity.

As a good steward, you may decide that the church needs funds monthly to properly finance the operations. Consequently, this technique may not fit entirely with your personal goals and beliefs.

### **Family gifts of commodities —**

Gifts of commodities may also be given to family members. For the full benefit of this planning, the gift must be of a crop harvested in the prior tax year. The rules that apply to charitable gifts also apply. If the gift is of a prior-year crop, the family member will receive the commodity with a zero tax basis. When the family member sells the commodity, a short-term capital gain (if held less than one year) will be real-

ized. The technique provides a benefit if the family member to whom the commodity is given is in a lower tax bracket than you are.

A gift of the current-year crop to a family member does not provide the same level of tax benefit. You may not deduct the costs of raising that portion of the crop. Instead, these costs become the basis of the commodity given to the family member.

Gifts to non-charities of less than \$13,000 per donor, per donee, per year (this is indexed for inflation) are not taxable gifts, in that they are less than the annual gift exclusion.

**Example:**

You desire to give \$6,000 to your son who is 25 years old. You have 1,200 bushels of corn on hand from the prior year's crop. The current bushel price is \$5.00. You project that you will be in the 25% income tax bracket and also pay self-employment tax at the rate of 15.3%. If you sell the corn, you will pay income and self-employment tax of approximately \$2,400. If instead you give the corn to your son who is in the 15% tax bracket, he can sell the corn and pay tax of \$900. The net benefit to the family of the commodity gift is \$1,500. (As noted earlier, the kiddie tax will interfere with this planning if the gift is made to a child in college under age 25, but there will still be no self-employment tax on the sale of the corn by the child.)

Let's assume, however, that you don't have any prior year crop on hand. You give your son 1,200 bushels of current-year corn. Because of the rule about current-year crop gifts, you have to reduce your expenses by the costs of raising and harvesting the corn, which you determine to be \$3.00 per bushel. You saved \$6,000 of income on the gift, but you have to reduce expenses by \$3,600. Net tax savings to you is \$960 (\$2,400 x 40%). Your son, however, has a tax basis in the corn of \$3,600. He sells the corn for \$6,000, realizing a gain of \$2,400 taxed in the 15% bracket. His tax is \$360. Overall, the family saves \$600, or \$900 less than the gift of prior-year crop.

**IRA distributions to charities for 2011 —**

The 2006 Pension Protection Act added a temporary provision for those over age 70½. If you have turned age 70½, you may direct your IRA trustee to distribute directly to a charity up to \$100,000 of your IRA account. No deduction is available for the distribution, but you don't have to include the distribution in your income. This benefits you if your itemized deduction for charitable contributions would be limited, if you generally don't itemize deductions, or if your deductions are limited because of phase-outs keyed to your adjusted gross income (AGI).

This distribution also qualifies for the required

minimum distribution rules. The distribution is considered to come first from deductible contributions to the IRA.

**Payment of wages to children —**

Children under age 18 should be paid cash wages for the work they do. Cash wages to children in the employ of their parents (including a partnership owned 100% by the parents) are not subject to FICA, Medicare, or FUTA (federal unemployment) taxes. Cash wages paid to such children under the age of 21 are not subject to FUTA, but are subject to the other payroll taxes. (If the child is paid by a corporation, the wages are subject to all payroll taxes, even if the corporation is 100% owned by the parents.) The first \$5,800 of earned income received by the kids will be offset by the child's standard deduction, if the child has no other income. As long as these funds are not used for the child's current support, you should still be able to claim the dependency exemption for the child. If you are in the 15% income tax bracket and pay self-employment tax at the 15.3% rate, this technique will save you approximately \$1,700.

**After year-end:  
Election on tax return**

Your taxable income may be further "massaged" after the end of the year by making various elections. Some elections are permanent; others may be made on a year-by-year basis. The tax laws include the following elections that modify the general rules of inclusion and deductibility (not an all-inclusive list):

- Election out of installment method
- CCC loan treatment
- Crop insurance
- Disaster payments
- Not deducting "soil treatment expenditures"
- Slower depreciation and electing out of bonus depreciation
- Section 179
- Contribution to a deductible IRA or other qualified retirement plan
- Farm income averaging (Schedule J)

The election out of the installment method was discussed earlier. Let's look at the others in more detail.

**CCC loans —**

Commodity Credit Corporation (CCC) loans are usually received after harvest for repayment in the next tax year. There are two methods of reporting income in relation to CCC loans: the loan method and the income method.

Under the loan method, the CCC loan is treated as any other liability. When the loan is received, it is recorded as a liability and not as income. The repayment of the loan will not generate a tax deduction. When you forfeit the commodity that is collateral for

the loan, you will report income of the loan amount at that time.

Under the income method, the receipt of the loan is a taxable event, as if the commodity is sold (to the CCC). Forfeiting the commodity (the collateral for the loan) will not be a taxable event. If the loan is repaid in the following year, with the commodity sold by you, you will in essence have a deduction for the loan payment and income from the sale of the commodity. The tax treatment of repayment of the loan in the same year as the loan is uncertain. For taxpayers who live in states within the jurisdiction of the Ninth Circuit Court of Appeals (generally, certain western states), the repayment does not generate a deduction. In the Fifth Circuit (Texas, Louisiana and Arkansas), the repayment in the same year will cancel the income. Consult with your tax adviser about the tax treatment of repayment in the year of the loan, if you are on the income method.

A taxpayer on the loan method may switch to the income method by merely treating the receipt of the loan as taxable in the year of receipt. A taxpayer on the income method, however, who desires to change to the loan method must file a Form 3115 and comply with the instructions on the form.

#### **Crop insurance and disaster payments —**

Crop insurance proceeds are taxable in the year of receipt. An election is available to defer the taxation of the proceeds to the next tax year. No election is available, however, unless the farmer establishes that, under his normal business practice, the income from this crop would have been included in gross income for any taxable year following the taxable year of the destruction or damage. A court case has held that there must be a pattern reflecting that more than 50% of the crop income is normally collected in the following year. This is an “all or nothing” election. If the crop insurance proceeds are received in the year following the year of destruction or damage, no election is available. Certain disaster payments are treated similarly.

If you have crop revenue (e.g., CRC) insurance, only the portion of the crop insurance proceeds associated with the decline in yield is subject to deferral. This is a complex computation, and you should discuss it with a professional familiar with the complexities.

#### **Soil treatment expenditures —**

Expenses incurred for fertilizer and other materials to enrich the soil are deductible in the year paid if the benefit of such expenditures is not expected to exceed one year. If the benefit to the soil of such materials substantially exceeds a year, however, the costs are capitalized and deducted in the year of the benefit. An election is available to deduct such costs in the year paid. Most farmers will deduct the fertilizer, lime,

ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming. If the deduction isn't needed, however, you can choose not to deduct that portion that benefits future years. The deductions are allowed in the years the soil is benefited.

#### **Slower depreciation —**

Equipment, buildings, livestock, and so on placed in service during the year are depreciated (unless Section 179 applies). The default rules provide accelerated methods for computing the depreciation expense. If you don't need to claim depreciation at the fastest rate, you can choose to use the straight-line depreciation method. You can also choose to use a longer life for depreciating the asset. All assets of a similar class life (e.g., seven-year assets) must be depreciated using the same life and method. Thus, you could choose to depreciate your purchases of animals (usually shorter lives than agricultural equipment) using accelerated methods, and the equipment purchased using straight-line.

Once an IRS depreciation method and life are chosen, you have to continue to use that method until the asset is fully depreciated. You can choose to use slower depreciation only on assets placed in service during the current tax year. Assets placed in service in earlier years must continue to be depreciated using the methods and lives chosen in the years placed in service.

If fewer expenses are desired in the current year, you can elect out of the 50% bonus depreciation on the new assets acquired, but the election applies to all new assets with the same “class life.”

#### **Section 179 amount —**

Section 179 is available to elect to expense the purchase of up to \$500,000 of depreciable assets (for years beginning in 2011). Assets that qualify for the election include tangible personal property (e.g., equipment and livestock) used in a trade or business. Other tangible property may also qualify for Section 179 if used in manufacturing, production or extraction. Many assets used in agriculture are used in manufacturing or production. Thus, it may be possible to expense the costs of hog or other livestock facilities. Other tests may apply.

The Section 179 deduction is limited to the amount of income generated from the active trade or business reported on the tax return. For this purpose, wages are treated as active trade or business income. The trade or business activity on the tax return need not be the same trade or business activity in which the equipment was placed into service.

The assets must be “purchased.” For this purpose, the amount of tax basis associated with the trade-in of another asset does not qualify. But the additional

amount paid or to be paid for the acquired asset does qualify. Assets acquired from certain related parties do not qualify for Section 179.

**Example:**

Pam trades in a tractor during the year. It has a remaining net book value as listed on the tax depreciation schedule of \$40,000. She acquires a new tractor for \$150,000. She is given a trade-in allowance of \$60,000 for the old tractor and finances the balance due of \$90,000. The total depreciable basis of the new tractor is \$130,000. The portion that qualifies for Section 179 is \$90,000.

If the total of Section 179 assets acquired during the year exceeds \$2 million for years beginning in 2011, the limit on Section 179 decreases. The Section 179 deduction is scheduled to decrease back to \$125,000 in 2012, unless Congress changes the law.

Section 179 also reduces self-employment income of proprietors and partners. But you may not want to claim the full amount of the Section 179 deduction. To the extent that the deduction creates a self-employment loss, consider reducing the deduction so that depreciation expense may be claimed on the asset in later years.

**IRA or other qualified retirement plan —**

Contributions may be made to a traditional IRA by April 15 of the year after the tax year. The earlier you contribute, the more time the fund has to accrue tax-deferred earnings. The deductible amount is \$5,000, with an additional contribution amount of \$1,000 available for those who are 50 or older at the end of the tax year.

The deduction for “active participants” in another qualified retirement plan is phased out if modified adjusted gross income (AGI) exceeds certain levels. The phase-out begins at modified AGI of \$89,000 on married filing joint tax returns. If you are not an active participant but your spouse is, you may deduct an IRA contribution in full if the combined modified adjusted gross income is less than \$167,000. (This is indexed for inflation.)

If modified AGI exceeds the phase-out levels so that you cannot deduct some or any of your IRA contribution, you may choose to contribute to an IRA on a nondeductible basis. In certain circumstances, you can contribute instead to a Roth IRA, for which no tax deduction is available. If certain tests are met, however, earnings on the Roth IRA are not taxed when withdrawn after age 59½.

IRA and qualified retirement plan rules and details are beyond the scope of this special study. Advice from your CPA or qualified investment adviser should be sought to determine the various options that are available for funding retirement plans. In addition to IRAs and Roth IRAs, SIMPLE, SEP, Section 401(k) and

other tax-driven retirement accounts are available, each fitting a particular need. Warning: Some of these retirement plans must be created before December 31 or perhaps even October 1 in order to be effective for the tax year.

**Income averaging (Schedule J) —**

Another election available for farmers is farm income averaging. Schedule J is used to compute the tax. Unlike the other elections that deal with the amount of income that is taxable, Schedule J merely moves the income between years, artificially. You choose how much farm net income to elect to carry back to the three prior years, one-third to each year. If you are in the same tax bracket each year, the election will provide no benefit. There may be a reason, however, to income average even if no benefit is provided. It is usually best to reduce as much as possible the taxable income of the current year, to position yourself better should future income averaging provide a benefit. Farm income averaging will not, by itself, trigger the alternative minimum tax (AMT). The specific examples are beyond the scope of this study.

**Observation:**

Suffice it to say that the farm income averaging computation is very complex. The author has amended tax returns prepared by other tax professional to lower tax liabilities by tens of thousands of dollars. The preparers of the original returns either were not aware of farm income averaging, or didn't fully understand how to make the computation. If this is a situation that could affect you, it would be wise to ask if your tax preparer is familiar with farm income averaging.

**When you have a tax loss**

Even if you believe that you cannot plan your income so as to arrive at a specific taxable income (so certain deductions won't be wasted), there are other reasons to meet with the tax adviser for tax planning. If you have dependent children who qualify for the \$1,000 child tax credit, a specific mix and level of earned income may yield an earned income tax credit. The maximum credit for a taxpayer (married or single) with two qualifying children is over \$5,000 (one child, over \$3,000). It may be that as you bring in more income, you “earn” a higher credit. Depending on the income, as income increases by \$1,000, you can earn an additional \$400 tax credit. That's a negative 40% tax rate!

Other considerations when you have a tax loss include trying to collect non-business income. If your non-business deductions exceed non-business income and you have a loss, the collection of non-business

income may end up being nontaxable and not reduce your net operating loss. Again, you need to consider all of the variables so that the proper mix of business and non-business income and expenses will achieve the greatest possible benefit. That particular mix of income and expenses may allow for an IRA contribution. Then, however, you'd choose to invest in a Roth IRA rather than a regular IRA, as it is most likely that no tax benefit would be realized if an investment is made to a traditional IRA in a loss year.

It may be beneficial to elect the optional self-employment tax method. Although you will be paying additional self-employment tax, you will earn four quarters of coverage in the Social Security system. Forty quarters of coverage are necessary to qualify for disability and old-age benefits.

As discussed earlier, it may be advisable to convert a traditional IRA into a Roth IRA.

## Section 199

Congress created Section 199 of the Internal Revenue Code, the "production deduction," effective for years beginning in 2005. It provided a 3% deduction computed on income generated in the United States from manufacturing, producing, growing, and extracting (MPGE) activities. The deduction increased to 6% for 2007, 2008, and 2009. The deduction is fully phased in at 9% of qualifying income for 2010. The growing and storage of crops and the raising of livestock are included in the qualifying activities. This means that if your entire farming operation involves growing your commodities, you may claim a deduction in 2011 of 9% against the net income from such farming operations. But if your non-production gross receipts exceed 5% of your total gross receipts, an allocation must be made to determine the net income on which the deduction may be claimed.

The IRS has provided simplified methods for determining the production deduction. All farmers who may use the cash method of accounting may use the "small business simplified overall" method of allocating expenses to production activities.

The production deduction may not be claimed against self-employment income. But the deduction will reduce income subject to the alternative minimum tax (AMT). The deduction is computed on the lesser of income derived from MPGE activities or taxable income. A loss may not be created or increased by the deduction. Further, the deduction is limited to 50% of gross wages subject to payroll taxes deducted on your tax return. (Thus, wages paid to children under age 18 in the employ of their parents are not qualifying wages for computing the Section 199 deduction limitation. Likewise, wages paid in the form of commodities are not qualifying

wages.) If you are also involved in nonfarm activities, such as hauling or storing a neighbor's commodity or providing custom hire services, the income and related expenses of such activities are not included in the income on which the 9% deduction is computed.

### **Example:**

Your Schedule F income is \$70,000. The income includes very little custom-hire income (such that you meet a de minimis exception). You are in the 15% tax bracket. The production deduction will be \$6,300 (9% of \$70,000), yielding a tax benefit to you of \$945. Remember that no benefit is provided against self-employment income.

### **Observation:**

Many cooperatives have received rulings from the IRS with respect to how the §199 deduction is used by the cooperative or passed-through to the patrons. If you sell product to a cooperative of which you are a member, and the cooperative further processes the commodity, it is likely that your gross receipts from the cooperative are not "domestic production gross receipts." As such, you will not earn a §199 deduction based upon those gross receipts. Instead, the Form 1099-PATR from the cooperative may reflect in Box 6 a §199 deduction available to you. This may be claimed on your tax return even if you don't have qualifying wages expense.

IRS regulations on Section 199 run over 200 pages. Consequently, full details of the Section 199 rules for farming are beyond the scope of this special study.

## Split-interest purchase of land

If you find that you have accumulated investment funds inside a corporation beyond the needs of the corporation, and you are itching to purchase more land, consider a "split interest" purchase. Here, the C corporation purchases a term interest in the land. The remainder interest is purchased by the individual who owns the stock of the corporation or, better yet, children or grandchildren of the stockholder. The corporation will not collect or pay rent during the term, in that the corporation "owns" the land for this period of time. At the end of the term, the individual owner(s) takes possession. The corporate farm will begin paying rent at that time.

The split interest purchase may also be appropriate when the older generation has substantial funds, but for estate planning, estate tax, or succession reasons does not want to own the permanent interest in the land. The younger generation pays for its share of the land purchase. The share of the purchase price to be paid by each party varies monthly, depending on published IRS interest rates. Each person's share also

depends on the number of years of the term interest. As the number of years of the term interest increases, the younger generation has a lesser purchase price.

Cash flow availability needs to be considered. The purchaser of the remainder interest needs to come up with his or her share of the purchase price. But the remainder interest holder won't receive any rent income (return on investment) until the expiration of the term interest (owned by the corporation or the older generation). This technique is more favorable when interest rates are high at the time of purchase.

### Development leases

It may be possible to structure a development lease. The corporation may be the farmer, with individuals owning the land. Under the development lease, the irrigation system, trellis for a vineyard, grain bins, or other leasehold improvements are constructed by the lessee (tenant). At the end of a reasonable lease term, the improvements revert to the landlord (individuals).

The development lease is beneficial when the tenant has the funds for building the improvements and can benefit from the depreciation deductions. The structure of the arrangement should make economic sense; that is, the tenant is able to earn his or her return on investment before the end of the lease term (when the assets revert to the landlord).

### Interest-charge DISC

No, this isn't a financing mechanism for a piece of tillage equipment. An IC-DISC is a Domestic International Sales Corporation, which is provided with a tax subsidy to encourage the exportation of products that are manufactured, produced, or grown within the United States. It is available only if the product can be traced to foreign commerce.

The IC-DISC allows for the deferral of income taxes on 4% of the foreign sales of the taxpayer. Sometimes, the deferral may be greater. Because of the complexity of the transactions, the IC-DISC tool is limited to taxpayers who have substantial income together with large export sales.

### Filing date, estimated taxes

Sole proprietor farmers and farmers who are partners in partnerships or shareholders of farm S corporations may qualify to be exempt from the requirement to pay estimated taxes. If more than two-thirds of gross income is from farming activities, estimated taxes need not be paid. However, in lieu of paying estimated taxes, the farmer is required to file the federal tax return on or

before March 1 (assuming a calendar year taxpayer). Failure to file by March 1 will subject the farmer to a penalty for underpayment of estimated taxes.

Many farmers have investments in S corporations or partnerships for which they do not receive Schedules K-1 in sufficient time prior to March 1 in order to prepare the Form 1040. Or, it just might not be possible due to the overall complexity of the tax return to finish by March 1. There is an alternative. A farmer (meeting the two-thirds gross receipts test) may pay an estimated tax payment by January 15. If the estimated tax paid is the lesser of 100% of the prior year's total tax liability, or two-thirds of the current year's liability, the tax return may be filed by April 15 and no penalty will be assessed if the balance due is paid with the return.



### TIP!

If you are a calendar year qualifying farmer (more than two-thirds of your gross income is from farming) and your tax liability is expected to dramatically increase for this year, consider paying a tax estimate on January 15, so that you have an extra 46 days to file and pay the balance of the tax liability.

C corporation farms are not provided with exceptions to the estimated tax rules.

### Other Forms of operations

Most farmers operate as sole proprietors. But farming the land you own may cause you to pay more self-employment tax than necessary. For example, much of the income associated with sole proprietor-owned real estate relates to the rental value of the land. Rent income from real estate is not subject to self-employment tax (although this issue is currently in dispute by the IRS). If you were able to pay yourself rental income for your real estate, your self-employment tax might be substantially reduced.

The remaining portion of this special study will summarize concepts to consider for other forms of operations. As with all tax planning, there is no "right" way to structure entities. The appropriate entity structure will depend on individual facts and circumstances, to include the type of farming, the ownership of real estate and by whom, whether non-farming family members have an interest, typical income level, available resources, and other variables. Consultation with knowledgeable advisers is a must.

### S Corporation Farms —

The C corporation farmer will have the same tax-planning issues as a sole proprietor, with some adjustments. Generally, it is best to target a federal taxable income of \$50,000. This level is not adjusted for inflation and has existed since 1981. The first \$50,000 of taxable income is taxed at 15%. The next \$25,000 of

taxable income is taxed at 25%. The income between \$75,000 and \$100,000 is taxed at 34%. Income between \$100,000 and \$335,000 is taxed at 39%. For this discussion, income above \$335,000 is taxed at 34%. There is no special capital gains tax rate for C corporations.

Operating as a C corporation creates a “double tax.” The income is first taxed in the corporation. Later, upon payment of a dividend or upon liquidation, a second tax occurs at the shareholder level. (An S corporation has a single tax, in that whatever income the corporation realizes is taxed directly to the shareholder, even if the shareholder receives no distributions from the corporation.) Let’s assume that the corporation has \$50,000 of taxable income and pays a federal tax of \$7,500. This leaves \$42,500 of remaining income in the corporation. If the shareholder wants that cash currently, a dividend is paid. At current dividend tax rates, the shareholder pays another \$6,375 of tax at 15%. The total tax paid on the \$50,000 is \$13,875, an effective rate of 27.75%. If the shareholder is otherwise in the 28% or higher tax bracket, a C corporation will save tax dollars. (State taxation must also be considered.)

Of course, this computation has been made using current tax rates and laws. The special maximum dividend tax rate of 15% is scheduled to expire after 2012. The effective double tax rate for C corporations will increase when the qualifying dividend tax rate expires and reverts to ordinary tax rates. Long-term planning on whether to incorporate must take into account the possibility that Congress will not extend the special dividend tax rate that has been in effect only since 2001.

Leaving more than \$75,000 of income in the corporation makes little sense for tax purposes because of the double tax issues. Unlike for individual taxpayers, there is no penalty of lost deductions if the corporation has a loss. The same net operating loss carryback rules apply to corporations with farm losses.

C corporations are provided with tax-free fringe benefit rules that do not apply to sole proprietors or S corporations. A C corporation may provide tax-free meals and lodging on the corporate premises, which includes housing the corporation owns or leases. In addition, the C corporation may provide medical insurance on a tax-free basis to a reasonable class of employees. Such a class may include management employees (who happen to be family members of the shareholders and their dependents). Medical expenses not covered by insurance may be reimbursed by the corporation, but if this plan is implemented, it must be done on a nondiscriminatory basis. (Certain part-time and underage employees may be excluded.)

The C corporation with excess income may push out income to the individual shareholder-landlords through the payment of reasonable rent. Reasonable wage payments for services rendered may also be

paid to shareholder-employees. Again, the targeted income of the C corporation should be \$50,000 or less, or certainly below \$75,000.

Wage payments to employees (including shareholder-employees) are subject to payroll taxes. Wages may be paid in the form of commodities, however, to avoid payroll taxes. Appropriate caution is necessary, as described earlier, to meet IRS rules in this regard. The year-end payment of a commodity wage will not reduce the corporate taxable income. This should be viewed only as a means of moving income out of the corporation. Year-end transfers of commodities in payment of wages are viewed as a sale of the commodity by the corporation with a related payment at fair market value as an expense. The employee receives the commodity with a tax basis equal to that fair market value. Form W-2 must be completed. Thus, the receipt of commodity wages does not provide the corporation with a net tax deduction, but the individual employee receives taxable income. The employee will receive a later deduction upon the sale of the commodity.

#### **Caution:**

Consider the Social Security implications of commodity wages. Since commodity wages are not subject to payroll taxes (if properly paid), no Social Security benefits will accrue to the employee’s account. For this reason, caution is warranted for paying wages to non-family members in the form of commodities.

The corporation should not accumulate earnings beyond what is needed for operations. After several years of accumulating taxable income, the corporation may find itself with excess investment assets. The accumulated earnings tax may be assessed by the IRS for an unreasonable accumulation. In addition, the corporation may be tempted to purchase land with these excess funds. This is strongly discouraged, in that you (nearly always) don’t want to own real estate within a corporation. Flexibility is limited and you lose the benefit of capital gains when appreciated property is owned by a C corporation. Since C corporations do not have special tax rates for capital gains, farming operations that generate substantial capital gain income—such as dairies, through the sale of cull cows—need to be structured in such a manner that the cows are not owned by the corporation.

Through 2012, if the individual shareholder finds himself in the 15% or lower tax bracket, it may be appropriate to declare a dividend from the corporation’s accumulated earnings. Dividends paid to a person in the 15% or lower bracket are subject to a zero percent rate. Only that portion of the dividend that would have been taxed at 15% or lower, if the special rate didn’t exist, would be subject to the zero percent tax rate.

After the corporation’s targeted taxable income is

achieved, review the individual's tax situation. Apply applicable techniques to reduce or increase the individual's level of income, if appropriate.

### **Regular (C) Corporate Farmers with Fiscal Year-End —**

A C corporation with a fiscal year-end has the same tax benefits as discussed immediately above, with one more benefit thrown in: The payments from the corporation to the individual are not immediately taxed at the individual level. An element of deferral exists, which allows the individual more flexibility and time to tax-plan further.

### **Corporate Row-Crop Farms with Livestock Farms Outside of Corporation —**

Livestock farmers who also raise row crops may find themselves with a C corporation for the row crops and another entity (perhaps a sole proprietorship or S corporation) for the livestock. Now there are two farms to work with in tax planning. The C corporation can plan its taxable income by paying rent and compensation to the shareholder-landlord-employee before its year-end. The livestock operation can reduce its taxable income by purchasing feed, which has been raised by the row crop C corporation, before its year-end.

All of the techniques discussed above are applicable to tax-planning both entities.

### **Family Partnership Owning Real Estate —**

Regardless of the form of the entity operating the farm, the ownership of the real estate should be considered. Depending on the family situation, forming a family partnership (or LLC) allows for the giving of ownership from the older generation to the younger generation. It is much easier to document and structure gifts of a partnership interest, versus giving undivided ownership in land.

The formation of a family real estate partnership may allow for interests in the operating entity to be given or bequeathed to the children who are active in the operations, while interests in the real estate are provided to children who aren't involved in farming. This may become problematic, however, in that the higher value may be in the long-term ownership in the real estate. Specific planning for gifts, who is to receive how much and of what, and the purchase of life insurance to provide "value" in the estate for the non-active family members, is beyond the scope of this discussion.

Often the older generation desires to continue to be in control of the land. After all, this generation built the farm to where it is today. Voting and nonvoting interests may be created to allow the older generation to continue to control all decisions. There is a limit, however, to how much control can be kept. The IRS continues to look at abusive family-estate and gift-planning arrangements, in which a "gift" to the children and grandchildren carries no real value.

### **Partnership as Operating Entity —**

Because of self-employment tax considerations, a general partnership does not provide the same tax advantages as operating in the corporate environment. The arrangement may be appropriate, however, for the parent-child operating entity, with the land being leased from the parent.

Be careful about changing your general partnership into a limited partnership or LLC. There may be problems with FSA payment limitations.

### **Limited liability company farms —**

Limited Liability Companies (LLCs), if properly structured, may create the best tax structure for a farm by combining the legal protection of a corporation with income tax flexibility of a partnership. To achieve the best tax effects, the LLC must be structured as a manager-managed LLC instead of the more common member-managed LLC. A member-managed LLC will always subject the operating income of the LLC subject to both income and self-employment taxes. However, a properly structured manager-managed LLC will exempt most of the non-manager's interest from self-employment tax. If a non-manager provides services to the LLC, usually only these services will be subject to self employment tax.

The estate tax benefits of step-up in basis for equipment and inventories will apply to assets held by the LLC. A C corporation will remain the only entity, however, that will have the advantage of certain tax free fringe benefits.

To properly create a LLC for optimum tax purposes is beyond the scope of this paper, however, it does appear to be one of the better organization options for farmers right now.

### **Other Recent Tax Law Changes**

Tax law is constantly changing. In addition to court cases which provide guidance on existing law, the IRS issues new rulings and procedures which also provide such guidance. New laws are enacted, and the effects on your operations from each new law need to be evaluated in order to ensure your tax goals and strategies are still viable and attainable.

It used to be that major changes in the tax law occurred every other year or so. In today's federal environment, Congress is constantly changing the tax law to provide funds for additional spending, to provide "stimulus," or to fulfill the desires of a favored constituency. Not all changes affect farmers in particular, but most changes have some affect on the overall tax liability.

The material presented herein is current through October 10, 2011.

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Paul Neiffer, CPA, is a Tax Principal in the AgriBusiness Group of LarsonAllen LLP. Paul owns a corn and bean farm in Missouri with a partner and looks forward to driving combine each fall. He also writes a column for Top Producer and a blog for Agweb.com. He speaks nationally on agricultural and other tax issues.

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