TAX GUIDE

FOR OWNERS AND OPERATORS OF SMALL AND MEDIUM SIZE FARMS

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Tax Guide
for
Owners and Operators
of
Small and Medium Sized Farms

Editors

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and

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Tax Guide for Owners and Operators of Small and Medium Sized Farms

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Warning and Disclaimer

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CHAPTER 1

OVERVIEW OF FARM MANAGEMENT

SYNPOSIS (click on section title to go directly there)

Introduction

Tax management is an integral part of *farm management*. For some production decisions such as whether to plant corn or soybeans this year, tax considerations have little or no impact. But tax considerations may have a major effect on the timing of income and deductions. (See Chapter 5 in this

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guide for an in-depth discussion of timing.) As a result, tax considerations can be a major factor in determining how some farm transactions, such as acquisition of new equipment, are structured.

For example, a producer may take advantage of the like-kind exchange provisions to trade in an old machine and acquire a replacement without recognizing gain for tax purposes. If the trade-in allowance exceeds the adjusted basis of the old machine (i.e., its initial cost minus the depreciation allowed or allowable), the gain realized on the trade is deferred in a qualified exchange.

Recognition of a loss is also postponed in a like-kind exchange. Therefore, if the adjusted basis of the old machine is more than the proposed trade-in allowance, the producer will generally have a lower tax and a higher after-tax income by selling the old machine and purchasing its replacement in separate transactions (rather than trading it in), because taking this path allows recognition of the loss.

Farm managers can make two types of mistakes with respect to taxes:

1. They can ignore the tax consequences of their decisions entirely, so that after-tax income is lost by not taking advantage of tax-reduction opportunities.
2. They can focus so much on reducing taxes that after-tax income is reduced. Producers must be aware of taxes and tax laws, but they should not let tax considerations overly influence their decisions.

This chapter reviews basic farm-management concepts and how they may be affected by tax considerations. It also illustrates how managing taxes can increase a farmer's after-tax income.

Budgeting

Budgeting is an analytical technique used to evaluate certain changes in the farm operation or to project farm income and cash flow. Budgeting can be done by hand or by computer. The three main types of budgets are partial budgets, total farm budgets, and cash-flow budgets. All of these budgets are based on estimates of future performance. Farmers should draw upon their own experiences and be as realistic as possible in this planning process. Tax considerations can be a part of any of these budgets, reflecting changes in the farmer's tax situation that would occur as a result of the alternatives being considered. (A number of tools are available at http://www.extension.iastate.edu/agdm/wdfinancial.html#analysis).

Partial Budgets

Partial budgets are used to make decisions involving only part of the farm business. Typically, the changes in receipts and costs of Alternative A are compared with the changes in receipts and costs of Alternative B, and the alternative with the higher net income is selected.

Example 1.1 Corn vs. Soybeans

A farmer is comparing production of an acre of corn vs. an acre of soybeans. The variable input costs (seed, fertilizer, chemicals, fuel, etc.) are about \$340 per acre for corn and \$180 per acre for soybeans. Each acre of corn is expected to produce about \$670 of revenue, compared to \$470 for soybeans. The per-acre return to the operator is \$330 (\$670 – \$340) for corn and \$290 (\$470 – \$180) for soybeans. A producer in this situation will tend to increase the acres planted in corn.

The expenses considered in Example 1.1 are ordinary current expenses, and the income for both crops is ordinary income. The tax treatment of expenses or receipts does not vary by crop. Thus, as noted in the introduction to this chapter, taxes have no effect on this decision.

In contrast, Example 1.2 looks at the tax impact of an equipment lease versus a purchase. An analysis tool to help with this comparison is accessible at http://www.farmdoc.illinois.edu/fasttools.

Example 1.2 Lease vs. Purchase of Machinery

A farmer can lease a \$100,000 tractor for 5 years for a tax-deductible lease payment of \$23,017 per year. Alternatively, the farmer could buy the tractor with a 30% down payment, signing a 5-year loan

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with a 6% interest rate with two payments due per year totaling $16,412. The interest and depreciation are tax deductible.

If farmer Anne's marginal income and self-employment tax rate is 42%, the after-tax net present value of the outflows (discussed later in the chapter) is $1,166 less with the lease than the purchase. In contrast, if farmer Ben's marginal income and self-employment tax is 15%, the after-tax net present value of the purchase is $1,214 less than the lease. Anne would generally prefer the lease, while Ben would generally prefer the purchase.

Cross Reference

For a discussion of whether a transaction is a lease or a purchase, see Chapter 4 of this guide.

Total Farm Budget

Total farm budgets are typically prepared for decisions having a major impact on the farm. Receipts, expenses, returns, and taxes should be budgeted for the current and the alternative situations. If farm income changes substantially, the associated change in taxes may determine which plan is best. Go to http://www.extension.iastate.edu/agdm/wdfinancial.html#analysis for a discussion of budgeting procedures.

Cash-Flow Budget

Partial and total farm budgets address the question, "Will it pay?" Without a positive answer to that question, a producer should not proceed. However, the answer to the "Can I pay for it?" question must also be positive. The cash flow associated with an investment is critical when loans are used to implement a decision. A tax-deductible expense does not necessarily generate the funds needed to make scheduled loan payments.

Example 1.3 Tax Savings and Loan Repayments

Cecile paid $100,000 for a piece of farm equipment and will deduct $10,710, $19,130, and $15,030 of depreciation for years 1, 2, and 3 respectively. If Cecile makes a 30% down payment and finances the $70,000 balance over 5 years at 6%, the loan is amortized with two payments per year totaling $16,412. If her marginal tax rate (including federal income and self-employment taxes and state income tax) is 35%, the tax savings from the depreciation deductions for the first 3 years will average $5,235 per year and therefore will not generate enough tax savings to make the loan payments.

Decision-Making Considerations

Farmers must evaluate alternatives to make management decisions. Marginal analysis is commonly used in evaluating alternatives. For example, how many pounds of nitrogen should be applied per acre to a specific field of corn? Do the savings on inputs from variable-rate application cover the added costs of variable-rate application?

Many alternatives considered by farmers involve investments that have costs and returns spread over a number of years. The costs and returns may occur at different points in time, and the lives of the investments are likely to be different. This difference in timing adds complexity to comparing the alternatives, because a dollar to be received 10 years from today is not worth the same amount as a dollar received today. Discounting the costs and returns of each alternative to their present value allows an appropriate comparison of the alternatives.

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Marginal Analysis

"Marginal cost equals marginal revenue" may bring back memories of Economics 101, but the message is an important one. Additional units of an input should be used as long as the additional cost is less than the additional revenue produced. Profit is maximized when marginal costs equal marginal revenue. If the producer's actions affect the prices of the product or costs of an input, the terms *marginal value product* and *marginal input costs* are typically used, but the underlying concept is unchanged.

The table in Figure 1.1 illustrates a classic example of marginal analysis with nitrogen applications on corn. If nitrogen application is increased from 200 to 240 pounds per acre at a marginal cost of $12, corn production increases by 7.2 (157.0 – 140.8) bushels per acre, which adds $28.80 of revenue for a $16.80 ($28.80 – $12) increase in profit. However, increasing the nitrogen application from 320 to 360 pounds, at a cost of $12, results in only $11.60 of additional income. Revenue from the last unit of nitrogen is less than the value of corn produced. Therefore, the last unit of nitrogen should not be applied.

Figure 1.1 Level of Nitrogen Fertilizer Application

Pounds of Nitrogen per Acre	Marginal Cost of Fertilizer	Bushels of Corn per Acre	Additional Bushels of Corn per Acre	Marginal Revenue from Corn
200	$60	149.8	149.8	$599.20
240	$12	157.0	7.2	$28.80
280	$12	163.4	6.4	$25.60
320	$12	167.2	3.8	$15.20
360	$12	170.1	2.9	$11.60

Time Value of Money

Farmers often postpone sales of raised commodities or use deferred-payment contracts to delay receipts into the year following the year of production. These techniques may be used to control the farmer's marginal tax rate.

Cross Reference

See Chapter 5 of this guide for a discussion of managing the timing of income and deductions.

A secondary effect of such strategies is deferring the payment of income and self-employment taxes, which allows the farmer to use the deferred taxes interest-free for a year. As shown in Figure 1.2, the present value of $1,000 payment deferred for a year with an 8% discount is $925.90, a savings of $74.10 ($1,000 – $925.90). If the deferral period is increased to 4 years, the net present value of $1,000 with a 6% discount rate is $792.10, a savings of almost $208. If the discount rate is 8%, the present value of a 4-year deferral is $735.

Figure 1.2 Time Value of Money

Year	Discount Rate	Present Value of $1,000			Amount of $1,000 at Compound Interest		
		4%	6%	8%	4%	6%	8%
1		961.50	943.47	925.90	1,040.00	1,060.00	1,080.00
2		924.60	890.00	857.30	1,081.60	1,123.60	1.166.40
3		889.00	839.60	772.20	1,124.86	1.191.01	1.259.71
4		854.80	792.10	735.00	1,169.85	1,262.47	1,360.48
5		821.90	747.30	680.60	1.216.65	1.338.22	1,469.32
10		675.60	558.40	463.20	1,480.34	1.709.84	2.158.92
20		456.40	311.80	214.50	2,191.11	3,207.12	4.660.94

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Compound interest increases the return on some investments.

Farm Financial Statements

Pencil and paper (the most commonly used record-keeping system in farm operations) document the farm's income and expenses, but they do not provide useful tools for analyzing the farm's operations.

The main reason most farmers keep records is for tax reporting— an after-the-fact method that does not provide any meaningful data by itself. Just tracking the figures needed to prepare a tax return typically does not allow analysis and decision-making throughout the year to handle the financial issues that transpire during the year. It also does not guarantee that all of the farm's income and expenses are captured because there is no checks-and-balances system.

Lenders and agricultural consultants often are concerned that a farmer lacks adequate records to monitor and analyze the farming business's financial health. Lack of financial data makes it difficult to determine the farm's actual cost of producing the end product, to ascertain the farmer's ability to service proper debt loads, and even to develop plans if the operation has major financial problems.

One result of the financial crisis of the 1980s was the formation of the Farm Financial Standards Task Force—a committee of farmers, lenders, educators, and others. This committee's efforts led to a set of guidelines for complete farm financial statements and guidance for analyzing them in a consistent manner. The recommended set of financial statements includes balance sheets, income statements, and cash flow statements for each farming operation. In addition, the committee provided 16 financial ratios (discussed later in this chapter) as a base guideline to measure the data and provide useful decision-making information for farmers.

Balance Sheet Shows Stability

A balance sheet has two parts that must equal each other or "balance" each other. This financial report provides indications about the farm's ability to support its ongoing operations, which helps determine how stable the farming operation is.

How the Balance Sheet Works

The following equation divides the balance sheet into its two parts, The totals of each of the two parts must be equal.

Assets = Liabilities + Owner's Equity

The balance sheet is presented as a snapshot of the operation's financial position at a single point in time, but it carries over from year to year as the farmer buys and sells assets or pays down debt. Figure 1.3 shows the organization of a balance sheet. The two main sections, Assets and Liabilities, are organized by timeframes. For assets, the gauge is liquidity, or how easily the asset can be converted to cash. For liabilities, the measure is the length of the loan, from the shortest to the longest.

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Figure 1.3 Balance Sheet

Balance Sheet for Family Dairy Farm
As of December 31, 201X

ASSETS		***LIABILITIES***	
Current Assets		**Current Liabilities**	
Cash in bank; farm checking account	5,316	Accounts payable (examples: suppliers and vendors)	4,321
Accounts receivable	2,544	Payroll taxes payable*	
Inventory (used only for some operations)		FICA tax payable	1,325
Total Current Assets	**7,860**	Federal withholding payable	222
		State withholding payable	151
Fixed Assets (at cost)		* owed to taxing authorities on behalf of employees	
Land	285,000	Notes payable (examples: <1 year bank loan; current portion of long-term debt)	30,500
Buildings and improvements	368,000	Credit accounts (examples: farm plan, credit cards, etc.)	3,025
Less accumulated depreciation on B & I	– 48,000	**Total Current Liabilities**	**39,544**
Equipment	163,000		
Less accumulated depreciation on equipment	– 32,000	**Long-Term Liabilities (> 1yr)**	
Vehicles	41,000	Mortgage loan	189,000
Less accumulated depreciation on vehicles	– 17,000	Equipment loan	242,000
Cattle	81,000	**Total Long-Term Liabilities**	**431,000**
Less accumulated depreciation on cattle	– 22,000		
Total Fixed Assets (at cost)	**819,000**	***Owners' Equity (also called Capital or Shareholders' Equity)***	
		Owners' contributions	4,500
Noncurrent/Other Assets		Owners' distributions	– 8,600
Cooperative stock (examples: milk plant, chemical provider, etc.)	5,689	Owners' equity/capital (retained earnings)	366,105
*Asset balance is the noncash portion kept or retained by the cooperative		**Total Owners' Equity**	**362,005**
Total Other Assets	**5,689**		
Total Assets	***832,549***	***Total Liabilities and Owners' Equity***	***832,549***

Assets

Assets are the items that help you operate the business and produce the farm’s income. They consist of cash (your checking account), inventories, fixed assets (land, equipment, etc.) and more. As you can see in Figure 1.3, assets are reported on the left side of the balance sheet and are classified as current, fixed, and noncurrent/other assets.

Current Assets

Current assets have a life of less than one year and are liquid, meaning they can be converted to cash relatively easily. The most typical current assets are the farm checking and savings accounts, inventories (for market-based balance sheets), and prepaid expenses.

Fixed Assets

Fixed assets are considered noncurrent assets, but they are shown as a separate category on the balance sheet from other noncurrent assets. Fixed assets are the tangible capital assets that farmers use to produce their end product or commodity. They include machine sheds, barns, tractors, fencing, tiling, cattle, land, and other assets. The amounts reported for these assets are their original costs reduced by accumulated depreciation (the sum of the depreciation deductions taken each year since an asset was acquired).

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Noncurrent/Other Assets

Noncurrent assets are those with lives extending beyond one year that are not considered easily convertible to cash. This category also includes other assets and is sort of a catch-all account for the asset side of the balance sheet.

Cooperative stock is the asset most often considered a noncurrent or other asset for farmers. Cooperative stock has both cash and noncash portions. The noncurrent/other asset portion of the stock is the noncash portion that is kept or retained by the cooperative. Therefore, receipt of cooperative stock impacts the balance sheet as well as the income statement (discussed later).

Liabilities and Owners' Equity

Liabilities and the owners' equity are reported on the right side of the balance sheet, and their total must equal the assets reported on the left side of the balance sheet. The most basic thought process in reporting transactions on the balance sheet is this: If the asset side is increased (for example, by purchasing a tractor), then the liabilities/owners' equity side must also increase (for example, by taking out a loan for the tractor). Note that if the tractor is not financed, there is no increase in total assets. Instead, there is a reduction of one class of assets and a corresponding increase in fixed assets.

The liabilities portion of the balance sheet is sorted into current liabilities and long-term liabilities. Long-term for the liabilities section is the same as noncurrent assets, defined as liabilities with due dates extending beyond one year.

Current liabilities are those that are due within one year. They include accounts payable (amounts due to suppliers, vendors, or agencies, such as the feed mill or repair shop) and the portion of long-term debt that is due in the current year (such as the principal and interest payment due on an operating note).

Another way to understand the liabilities section is to think about what liabilities truly are: the debts incurred to support or fund your assets to carry on the farming operations.

Owners' equity is just one name for the equity section of the balance sheet. It is also called net worth, shareholders' equity, or net assets, depending on the structure of your business and purpose for which you are creating the balance sheet. Owners' equity is calculated by subtracting total liabilities from total assets (assets minus liabilities equal owners' equity). It consists of the initial amount of money and property invested into the business plus the annual net profits (net earnings) of the business. If at the end of the business's accounting year, you decide to retain the profits within the business, they are transferred from the income statement (described next) onto the balance sheet into the owners' equity account as retained earnings. These funds can be held for future expansion, investment, debt servicing, or other uses.

Income Statement Shows Consumption

In a business setting, *consumption* is an expense incurred during the fiscal year for goods and services used to satisfy the needs of the business. To consume, you must have sales or income. One way to think about the income statement versus the balance is to think of a building and the daily operations happening inside. The building is emblematic of the balance sheet: It is the stable asset that allows the operations to continue. The daily operations happening inside the building (repairing equipment, for example) are the continual consumption phase.

The income statement has several different names that vary according to the structure of the entity and the resulting activity. It is also known as the profit and loss statement, statement of income, statement of operations, or statement of earnings. Figure 1.4 is an example of an income statement for a sole proprietorship.

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Figure 1.4 Income Statement

Income Statement for Family Dairy Farm
For the Year Ended December 31, 201X

Farm Income (also called Revenue/Sales)	
Milk income	332,000
Grain/crop income	112,000
Agricultural program payments (MILC, CCC, USDA, etc.)	18,000
Cattle	39,000
Cooperative distributions	3,500
(includes both cash and non-cash portions of coop distributions)	
Other income (examples: refunds, credits)	1,800
Cost of Goods Sold	
Cost of sales (purchased resale livestock)	– 18,000
Gross Farm Income	*488,300*
Expenses	
Advertising and marketing	4,730
Bank charges	365
Chemicals	25,400
Contract labor/Custom hire	6,675
Depreciation expense	71,000
Dues and subscriptions	5,705
Feed	42,000
Fertilizers/Lime	19,000
Freight/Trucking/Hauling	5,200
Gasoline, fuel, oil	9,500
Insurance	
Property	4,750
Liability	3,100
Interest expense	18,750
Payroll taxes	
FICA (employer share only)	4,131
Permits and licenses	2,800
Professional fees (legal and accounting)	750
Rent	9,800
Repairs and maintenance	21,600
Seeds	11,400
Taxes	
Real estate	7,500
Telephone (including cell)	1,350
Utilities	16,500
Vehicle expenses	7,500
Veterinarian, breeding, medicine	13,000
Wages and salaries	54,000
Total Expenses	366,506
Net Farm Operations Income (before taxes)	*121,794*
Other Income and Expenses	
Gain (loss) on sale of assets	3,485
(including purchased cattle, raised cattle, equipment, etc.)	
Interest income	122
Net Income	***125,401***

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The income statement is a picture of farm production (revenue/sales/income) over the year, reduced by what the production costs (expenses), to yield the net income.

Most farmers do a good job of tracking their income and expenses because this information can be retrieved from the farm checking account, operating line of credit, and long-term loans. However, they may not be accurately measuring the farm's economic performance or reporting their income or expenses correctly because they aren't using a checks-and-balances system.

A checks-and-balances system reconciles or balances accounts on a monthly basis to be sure each item is captured. Accounting software programs are often the most efficient means to achieve the checks and balances required to assure that the records are kept accurately. Further, preparing this information only for tax purposes does not offer any guidance in the decision-making process for the farm as a whole.

Most farm income statements are organized to match the operation's entity structure for tax purposes and are created for *book purposes*. Book purposes means that records are based on actual purchase and sales prices. Other types of income statements are created for management purposes. Different income statements, based on the fair market value of your operation, are used for lending purposes.

The following section describes the entries for the sole proprietorship income statement shown in Figure 1.4, The modifications required for other entity types are also discussed briefly.

Income

- Include total income received from the sales of both raised livestock and livestock purchased for resale. Also include the total cash receipts from the sales of breeding livestock.
- Do not include proceeds from outstanding loans in cash income (even if you report CCC loans as income for tax purposes).
- Both the cash and noncash portions of cooperative stock received are included in income. When amounts are moved to the balance sheet, the cash portion is included in your farm checking account (a current asset), and the noncash portion is included as a noncurrent/other asset.
- Report gross sales of cattle, milk, and other commodities, and enter the corresponding expenses. Even though the effect on income is the same if amounts are netted, entering both the income and expenses aids in determining the correct financial picture.
- Do not include sales of land, machinery, or other depreciable assets, loans received, or income from nonfarm sources in your gross farm income. Doing so overstates your farm operating income. These items are reported in the "Other income and expenses" section of the income statement.

Expenses

- Depreciation is a noncash expense that reduces the balance-sheet value of an asset over its life. Several accounting methods can be used to write off an asset's depreciable cost over its useful life. Depreciation frees up cash flow by reducing the company's reported income without a cash expenditure. Depreciation is discussed in Chapter 4 of this guide.
- Insurance costs for the owner's life and disability insurance are not tax deductible in most situations. Therefore, these costs should be paid from the personal checking account, taken as a distribution from the business, or added to the owner(s) Form W-2 income, depending on the entity structure.
- Do not include the death of purchased livestock as an expense; these costs are captured through the fixed assets section of the balance sheet. You must note these deaths, however, to be certain they are captured correctly.
- The owner's federal and state income taxes and self-employment taxes are personal expenses and should not be reported as a farm expense. If the entity structure is a corporation, the employer share of social security and Medicare taxes is reported as an expense.

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- Interest paid on all farm loans, land contracts, and farm-related charge cards is an expense on the income statement, but principal payments are not. The principal payments impact the balance sheet by decreasing the liability for the balance of the loan.
- Do not include the purchase of capital assets with a useful life longer than one year (such as machinery replacements) as a farm expense. The cost of these assets is accounted for on the balance sheet under fixed assets. It is expensed out via depreciation over the assets' designated useful lives. Land purchases do not depreciate but are included on the balance sheet as fixed assets.
- Family living costs (personal expenses such as college tuition and cable television) are shown as draws from the equity section if a sole proprietor farmer does not maintain separate business and personal checking accounts. However, the farming operation should have a separate account so that business and personal expenses are paid from different accounts.

Points to Remember

- You are creating your records for analysis. To achieve an accurate end result, you must enter accurate information.
- Schedule F (Form 1040), Profit or Loss From Farming, **is not** an income statement because it shows only part of your income for the year. For example, a dairy farmer includes only milk, crop, and feeder livestock sales are included on Schedule F (Form 1040). Sales of cull cows held longer than 24 months and of machinery, as well as various other transactions, are shown on different forms and schedules, including Form 4797, Sales of Business Assets, Schedule D (Form 1040), Capital Gains and Losses, and Form 6252, Installment Sales.

Statement of Cash Flows

The balance sheet and income statement provide valuable insights into your business, but one more statement—a statement of cash flows—is necessary to accurately determine if a farm is fiscally fit. The accounting events and transactions reported on the income statement do not necessarily coincide with the actual receipt and disbursement of cash: The income statement measures profitability, not cash flow.

A cash-flow statement is used to predict future cash flow, which helps with budgeting, expansion plans, debt pay-down decisions, and much more. For lenders, the cash flow reflects a farm's financial health and suggests areas to strategize with farmers.

The cash-flow statement is derived from the income statement. Its preparation starts with net income or earnings and then adds and subtracts changes in assets and liabilities from the beginning and ending balance sheets for the accounting period being analyzed. Cash flow leaves little room for manipulation by the owners or operations. Unless it is altered by outright fraud, this statement gives a true picture of cash ins and outs for the farm —either the farm has cash or it does not.

Figure 1.5 shows a cash-flow statement with a section for each of the three means by which cash enters and exits a business—*core operations*, *investing*, and *financing*. It makes adjustments to net income by adding or subtracting the differences in income, expense, and credit transactions that occur from one accounting period to the next. Not all transactions involve actual cash changing hands; therefore many items need to be analyzed for the proper treatment.

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Figure 1.5 Cash-Flow Statement

Cash-Flow Statement for Family Dairy Farm
For Year Ended December 31, 201X

Cash Flow From Operations	
Net Income	125,401
Additions to Cash	
Depreciation	71,000
Decrease in Accounts Receivable	1,000
Subtractions from Cash	
Decrease in Accounts Payable	– 13,000
Net Cash from Operations	***184,401***
Cash Flow From Investing	
Equipment	– 76,000
Cash Flow From Financing	
Notes Payable	– 43,000
Cash Flow for Year Ended December 31, 201X	***65,401***

Operations

The first section of the statement reflects how much cash is generated from the farm's products or services—the *normal operations* of the business, meaning the inflows and outflows of cash based on the day-to-day business dealings, Generally, changes between the beginning and ending balances in accounts receivable, depreciation, inventory, and accounts payable are reflected in cash from operations.

Depreciation is not a cash expense. It is deducted as an expense on the income statement and it adds to accumulated depreciation on the balance sheet. But because cash didn't change hands, the depreciation taken as an expense in the current accounting period is added back to cash flows. The only time an asset is accounted for in cash flows is when the asset is sold.

A decrease in accounts receivable implies that cash has been collected from customers who are paying amounts due on invoices. This difference is added to cash because the farm business has received cash. Accounts payable has the opposite effect. A decrease in accounts payable implies that cash has been taken out of the business to pay down bills. Thus, this difference is subtracted from cash.

Investing

The investing section typically consists of the purchase or sale of assets, such as changes in equipment, buildings, or investments (securities). Cash changes in this section are reductions when assets are purchased. When a farm sells an asset, the cash increases this section.

Financing

This section shows changes in debt or loans. It measures the flow of cash between the business and its owners and creditors. When principal is paid down on a loan, cash decreases because it is used to pay the liability. When additional funds are borrowed, cash increases.

The cash-flow statement in Figure 1.5 shows that the cash flow for the year 201X was $65,401. The positive cash flow is from the cash earned from operating the farm, which is a good sign. It means that the core operations of the farm are generating profits, which allows the farm to invest in expansion, future

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advancements or equipment, or pay down debt. Lenders will also be pleased because there is cash available to service debt.

Although all cash-flow statements do not show a positive cash position, a negative cash flow should not automatically be deemed to be a poor outcome without further analysis. Sometimes a negative cash flow is a result of a farm's decision to expand, which can take a considerable sum of cash and be good for the future of the operations. Analyzing cash flow and changes from one accounting period to the next gives the farmer, lender, and other decision-makers a better idea of how the business is performing and how it is being managed, as well as whether it may be on a successful path.

Points to Remember

- Cash flow is purely the cash coming in and the cash being spent .
- Cash flow does not include any amounts for *future* incoming or outgoing cash (credit transactions). It is like a checkbook register.
- Cash is not the same as net income. Net income is shown on the income and balance sheet, and includes both cash sales and sales made on credit.
- If all cash flows are accurately recorded, the total sources of cash equal the total uses of cash. If a significant difference exists, the records should be carefully reviewed for errors and omissions.

Conclusion

Each financial statement is just one piece of the financial puzzle. It is imperative to understand the interrelation among the reports to analyze the farm's financial position. To benefit even more from these financial statements, you can create a detailed analysis that provides additional information to gauge your performance.

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Appendix

Measures Used in Analysis

1. **Liquidity:** The ability of the farm to meet financial obligations as they come due
2. **Solvency:** The ability of the farm to pay all its debts if it were sold tomorrow
3. **Profitability:** The difference between sales and the expenses incurred to produce those sales (net profit)
4. **Repayment Capacity:** The ability to repay term debt from farm and non-farm income
5. **Financial Efficiency:** The effectiveness of assets used to generate income; the ability to use assets to their maximum potential

The Farm Financial Standards Council (http://www.ffsc.org/) recommends using sixteen financial ratios in those five general categories to analyze the financial efficiency of a farming operation. The desirable ranges and percentages vary significantly by the type of farm, entity structure, seasonal issues, and more. Trends demonstrated in a farm's operation are most important because they can identify areas that need improvement.

A key question in analyzing your own operation is, "How accurate are the financial statements used to develop the measures?" Unless the financial statements use accurate data, the financial ratios may have little validity. After accurately preparing the balance sheet, income statement, and cash-flow statement, it is a good exercise to apply the following standard financial ratios to your operation. Each accounting period can then be gauged on the prior period to determine the operation's progress. You will be well on your way to making better and more focused decisions.

Cross Reference

To obtain further information and definitions regarding the ratios, see http://www.ffsc.org/resources.htm, Farm Financial Ratios and Guidelines, by the Farm Financial Standards Council.

Liquidity

1. Current ratio = total current farm assets divided by total current farm liabilities
The desired range is 1.5 - 2.0.

2. Working capital = total current farm assets minus total current farm liabilities
The desired range is a positive figure that is stable. This ratio is calculated based on dollars and therefore is dependent on the farm's size.

Solvency

3. Debt/asset ratio = total farm liabilities divided by total farm assets
The desired range is less than 40%.

4. Equity/asset ratio = total farm equity divided by total farm assets
The desired range is greater than 60%.

5. Debt/equity ratio = total farm liabilities divided by total farm equity
The desired range is less than 65%.

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Profitability

6. Rate of return on farm assets = (net farm income from operations plus farm interest expense minus value of operator and unpaid family labor) divided by average total farm assets
The desired range is over 4%.

7. Rate of return on farm equity = (net farm income from operations minus value of operator and unpaid family labor) divided by average total farm equity
The desired range is greater than the rate of return on farm assets in item 6 and greater than 8%.

8. Operating profit margin = (net farm income from operations plus farm interest expense minus value of operator and unpaid family labor) divided by gross revenue
The desired range is at least 20% –35%.

9. Net farm income = anything left in your farm and not taken out for family living or taxes
The desired range is a positive net income and is dependent on the farm's size.

Repayment Capacity

10. Term Debt and Capital Lease Coverage Ratio = (net farm income from operations plus total non-farm income plus depreciation expense plus interest on term debt and capital leases minus total income tax expense minus family living withdrawal) divided by principal and interest payments on term debt and capital leases
The desired range is greater than 125%.

11. Capital replacement and term debt repayment margin = net farm income from operations plus total nonfarm income plus depreciation expense minus total income tax expense minus family living withdrawals (including total annual payments on personal liabilities) minus payments on prior unpaid operating debt minus principal payments on current portion of term debt and capital leases
The desired range is at least 25% more dollars than scheduled payments on debts and leases.

Financial Efficiency

12. Asset turnover ratio = gross revenue divided by average total farm assets
The desired range is greater than 25%–30%.

13. Operating expense ratio = (operating expense minus depreciation) divided by gross revenue
The desired range is less than 65%.

14. Depreciation expense ratio = depreciation expense divided by gross revenue
The desired range is less than 15%.

15. Interest expense ratio = interest expense divided by gross revenue
The desired range is less than 15%.

16. Net farm income from operations ratio = net farm income from operations divided by gross revenue
The desired range is greater than 15%.

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CHAPTER 2

OVERVIEW OF TAXES

SYNPOSIS (click on section title to go directly there)

Introduction

Farmers, as well as other taxpayers, pay a wide variety of taxes to federal, state and local governments. This chapter provides a brief overview of those taxes to help you understand the context of the tax planning discussed in the chapters that follow.

Property Taxes

Property taxes are imposed on the value of the property you own. The most common property tax is the real property tax imposed by local governments. This tax is generally the principal source of revenue for local governments. Some jurisdictions also impose a property tax on the value of certain personal property, such as motor vehicles licensed for use on public roads and equipment used in a business.

In most jurisdictions, property tax is computed annually by multiplying the assessed value of the property by that year's tax rate. The local government sends a tax bill to each property owner that details how the tax is calculated and when the payment or payments are due.

A failure to pay property taxes results in a tax lien on the property. The lien allows the local government to foreclose on the property, sell it at a public auction, and apply the sales proceeds to the unpaid taxes.

Local governments typically set the tax rate by dividing their approved budgets by the total assessed value of the real property subject to the tax. Therefore, the tax you pay depends on the assessed values of your property relative to the assessed values of all the other property in the local government's jurisdiction. If the assessed value of all property in a jurisdiction increases by 10% but the government's budget does not change, the amount of tax due on each property stays the same because the tax rate decreases by the same 10%.

In some states, land used for farming purposes is assessed at it use value rather than at its fair market value. The use value reflects the value of the property to a farming business rather than the amount a buyer would pay for it for an alternative use, such as recreation or development. The formula for computing the use value of farm land is typically based on commodity prices, farm land rental rates, or other measures of the ability of the land to produce income in a farming business. The threshold requirements for use valuation vary by state, but they generally involve evidence of agricultural use, such as planting crops or grazing livestock.

Planning Pointer

Satisfy Use-Value Requirements

In some cases, a small change in your use of land may make it eligible for use valuation and a reduction in property taxes. Changes that cost you less than the taxes you save increase your after-tax income.

Sales Taxes

Most state governments and many local governments impose a sales tax on purchases of goods and some services. The sales tax is collected at the point of purchase by the vendor, who then remits the taxes to the government.

A number of goods are exempt from sales taxes for a variety of reasons. The most common exemption is food purchased in grocery store. Goods purchased as an input for manufacturing are exempt because sales tax will be collected when the final product is sold. Most states have a sales tax exemption list of farm inputs, such as equipment, seeds, feed, fertilizer, lubricants, animal bedding, and livestock drugs. To qualify for a sales tax exemption that is based on the buyer's use of the good, the buyer generally must provide the seller an exemption certificate or other evidence that the purchase is sales tax-exempt.

In most states, farmers who regularly sell goods that are subject to sales tax must obtain a seller's permit and an identification number, and they must collect the sales tax at the point of sale. The collected sales taxes must be remitted to the government periodically with a tax return that reports the taxable sales.

Sellers are not required to collect sales tax on goods shipped to out-of-state buyers if the seller does not have a sufficient physical presence in the buyer's state to be treated as doing business in that state.

Use Taxes

Purchases that would be subject to a state or local sales tax if the seller had a physical presence in the buyer's state are subject to an equivalent tax called the use tax. Buyers are responsible for self-reporting and paying use tax, generally when they file their state income tax returns. Unlike sales tax, use tax is not collected at the point of sale, and unlike property tax, the government does not send a use-tax bill.

Example 2.1 Use Tax

Seth Shapiro bought a computer from an out-of-state seller that had no retail location in Seth's state. The seller was not required to collect—and did not collect—sales tax on Seth's purchase. If Seth purchased the computer from a seller in his own state, the seller would collect a 6% sales tax from Seth and remit it to the state government. Seth must report the purchase to his state government and pay a 6% use tax.

Excise Taxes

Like sales taxes, excise taxes are usually collected by the seller from the buyer at the point of sale. However, an excise tax differs from a sales tax in three ways:

1. An excise tax applies to a narrow range of products, such as tobacco products. A sales tax applies to most goods and some services.
2. An excise tax is based on the number of units purchased, such as cartons of cigarettes or gallons of gasoline. A sales tax is based on the amount paid.
3. An excise tax is usually a much greater proportion of the total sales price than a sales tax.

Fuels used in farming are not subject to the federal excise tax that is collected on fuels used in vehicles driven on public roads. Farmers can claim a credit on their federal income tax returns for the excise taxes they paid when they purchased the gasoline if they use the gasoline for a farming purpose. If farmers purchase diesel fuel and use it for a farming purpose, they can either claim a credit on their federal income tax returns or file a refund claim for the excise taxes paid on the diesel fuel.

Cross-Reference

See Chapter 14 of IRS Publication 225, *Farmer's Tax Guide (for 2010)*, for more details on the excise taxes on gasoline and diesel fuel.

Gift Taxes

A gift tax is imposed on the value of gifts made during the donor's life. The federal government and several states collect a gift tax. The amounts that can be given tax-free and the gift tax rates vary from state to state. This brief overview discusses only the federal gift tax.

✔ **Note**

Rules are More Complex

The rules for computing the gift tax are more complex than this summary indicates; this summary focuses on the effect of those tax rules. See IRS Publication 950, *Introduction to Estate and Gift Taxes*, and the instructions to IRS Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for more information on gift taxes.

Annual Exclusion

The federal gift tax rules include an annual exclusion. For 2011, donors may exclude from the gift tax the first $13,000 given to each of any number of individuals. The $13,000 amount is adjusted for inflation, so it may be a different amount in future years, but it will always be an even multiple of $1,000. In addition to the $13,000 (as adjusted for inflation), payments for the benefit of another individual are excluded from taxable gifts if they are made directly to an institution of higher learning or to a person or entity that provides medical care to the individual.

Example 2.2 Gift Tax Annual Exclusion

Guaming Yang gave $113,000 to each of her three children in 2011. Guaming's taxable gifts for 2011 total $300,000, because the first $13,000 transferred to each child is excluded from taxable gifts.

Gifts Between Spouses

Gifts of any amount to the donor's spouse are excluded from taxable gifts. Therefore, spouses can give as much as they want to give to each other and they will not be subject to the federal gift tax on those gifts.

Gifts to Charity

Gifts of any amount to qualified charities are excluded from taxable gifts. Therefore, an individual can reduce his or her taxable estate without paying any gift tax by making donations to qualified charities.

Federal Gift Tax Rate

The effective federal gift tax rate for taxable gifts in 2011 and 2012 is 35%. That rate is scheduled to increase for cumulative taxable gifts exceeding $500,000 in 2013 and later years. The rate is scheduled to be progressively higher for gifts in higher brackets until it reaches 55% for cumulative taxable gifts exceeding $3,000,000.

Applicable Exclusion Amount

An applicable credit amount offsets the federal gift tax on the first $5,000,000 of taxable gifts in 2011 and 2012. The applicable exclusion amount was $1,000,000 for gifts in 2002 through 2010 and it is scheduled to revert to the $1,000,000 amounts for gifts after 2012. Unlike the annual exclusion, each donor has only one applicable exclusion amount for cumulative taxable gifts made to all donees. The applicable exclusion amount for gifts in any tax year is reduced by the donor's prior taxable gifts that were tax-free because of the gift tax applicable exclusion amount in effect at the time of the prior gifts.

Example 2.3 Gift Tax Applicable Exclusion Amount

John James made no taxable gifts before 1999, when he gave each of his three children $210,000. The 1999 annual exclusion was $10,000, which reduced each taxable gift to $200,000, for a total of $600,000 of taxable gifts. The $650,000 gift tax applicable exclusion amount for 1999 resulted in no gift tax on the $600,000 taxable gifts.

In 2011, John gave his children another $500,000 in taxable gifts. The $1,000,000 gift tax applicable exclusion amount for 2011 is reduced by the $600,000 taxable gift that was tax-free in 1999. Therefore, only the first $400,000 ($1,000,000 – $600,000) of John's $500,000 taxable gifts in 2011 is tax-free. The gift tax on the remaining $100,000 is $35,000 (35% × $100,000).

If John's taxable gift in 1999 had been $700,000 (or any amount over $650,000), the 1999 $650,000 gift tax applicable exclusion amount would have allowed only the first $650,000 to pass tax-free. Therefore, the 2011 $1,000,000 gift tax applicable exclusion amount would be reduced by the $650,000 gift that was tax-free in 1999. Only $350,000 of John's $500,000 2011 taxable gift would then be tax-free. The gift tax on the remaining $150,000 would be $52,500 (35% × $150,000).

Planning Pointer

Opportunity in 2011 and 2012

Taxpayers may want to make gifts in 2011 and 2012 to take advantage of the $5,000,000 applicable exclusion amount. Congress could increase the applicable exclusion amount for 2013 and later years, but the increase, if any, might not raise the applicable exclusion amount to the current $5,000,000.

Estate Taxes

An estate tax is imposed on the value of a decedent's taxable estate. The federal government and several states collect an estate tax. The amounts that can be passed tax-free and the estate tax rates vary from state to state. This brief overview discusses only the federal estate tax.

✔ **Note**

Rules are More Complex

The rules for computing the estate tax are more complex than this summary indicates; but this summary explains the effect of those tax rules. See IRS Publication 950, *Introduction to Estate and Gift Taxes*, and IRS Publication 559, *Survivors, Executors, and Administrators*, for more information on estate taxes.

Gross Estate

For purposes of the federal estate tax, a decedent's gross estate includes the value of all property the decedent owned—directly or indirectly—at the time of death. In addition to the decedent's tangible assets (such as cash, bank accounts, personal property, and real estate), the gross estate includes intangible assets (such as life insurance owned by the decedent) and annuities payable to the decedent or the decedent's heirs.

✔ **Note**

Probate Estate Is Different

Some assets that are excluded from a decedent's probate estate are included in the decedent's federal estate tax gross estate. For example, if the decedent owned a life insurance policy on his or her life and the proceeds are payable to a beneficiary other than the decedent's estate, the policy is excluded from the probate estate but it is included in the federal estate tax gross estate.

Taxable Estate

A decedent's taxable estate is the gross estate reduced by deductions for debts owed by the decedent, funeral expenses, amounts that pass to the decedent's spouse, amounts going to a charity, and state death taxes.

Applicable Exclusion Amount

An applicable credit amount offsets the federal estate tax on the first $5,000,000 of the taxable estate for deaths in 2011 and 2012. The applicable exclusion amount is scheduled to be $1,000,000 for deaths after 2012. The applicable exclusion amount is reduced by the donor's taxable gifts that were tax-free because of the gift tax applicable exclusion amount in effect at the time of the gifts.

Example 2.4 Estate Tax Applicable Exclusion Amount

Rhonda Rodriguez made no taxable gifts before giving her children \$500,000 of taxable gifts in 2008. The \$1,000,000 gift tax applicable exclusion amount for 2008 resulted in no gift tax on the \$500,000. Rhonda died in 2011, leaving her entire \$6,000,000 estate to her children.

The 2011 estate tax \$5,000,000 applicable exclusion amount is reduced by the \$500,000 taxable gift that was tax-free in 2008 because of the 2008 gift tax applicable exclusion amount. Therefore, the first \$4,500,000 of Rhonda's estate is tax-free. The estate tax on the remaining \$1,500,000 is \$525,000 (35% of \$1,500,000).

If Rhonda's taxable gift in 2008 had been \$1,200,000 (or any amount over \$1,000,000), the \$1,000,000 gift tax applicable exclusion amount would have allowed \$1,000,000 to pass tax-free. Therefore, upon Rhonda's death in 2011, the 2011 \$5,000,000 estate tax applicable exclusion amount is reduced by the \$1,000,000 gift that was tax-free in 2008, and \$4,000,000 of Rhonda's estate is tax-free. The estate tax on the remaining \$2,000,000 is \$700,000 (35% of \$2,000,000).

Inheritance Taxes

An inheritance tax is imposed on a person who inherits property. There is no federal inheritance tax, but some states impose an inheritance tax on the value of money and other property that is inherited from a decedent.

Inheritance tax rules vary from state to state, but most states have an exemption amount that is not taxed and tax rates that increase as the amount that is inherited increases. Exemptions and rates often vary by the relationship of the heir or beneficiary to the decedent. An inheritance from a spouse might not be taxed, and an inheritance by a child might have a large exemption amount and low tax rates on the amount above the exemption amount. The exemption amount might decrease and the tax rates increase for inheritances from more distant relatives, with the lowest exemption amount and the highest tax rates applying to an inheritance from an unrelated decedent.

Income Taxes

An income tax imposes a tax on the taxpayer's income. The federal government, most state governments, and some local governments collect an income tax. Many state and local income taxes are based on the federal income tax rules, with varying adjustments. This brief overview discusses only the federal income tax.

Figure 2.1 summarizes the income tax computation by outlining the steps taxpayers follow on Form 1040, U.S. Individual Income Tax Return.

FIGURE 2.1 Outline of Federal Income Tax Calculation

Gross Income
– Above-the-line deductions
= Adjusted gross income
– Standard deduction or itemized deductions
– Personal and dependent exemptions deduction
= Taxable income
× Income tax rates
= Income tax
– Credits
+ Other taxes
= Total tax
– Tax payments during the tax year
= Tax due with return or tax refund

Gross Income

The Sixteenth Amendment to the United States Constitution gives Congress the power to collect taxes on income. Congress used that power by defining gross income as "all income from whatever source derived." Because of that broad definition, an increase in wealth is included in taxable income unless it is specifically excluded. For example, Congress excludes an increase in the value of property from gross income until there is a taxable event, such as a sale.

Form 1040 provides separate lines to report several categories of income, such as wages, interest, dividends, refunds, alimony, distributions from retirement plans, unemployment compensation, and social security benefits.

An individual's gross income from a sole proprietorship is reported on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship); Schedule E (Form 1040), Supplemental Income and Loss; or Schedule F (Form 1040), Profit or Loss From Farming. The related business expenses, which are some of the above-the-line deductions, are also reported on those forms. Only the net business income is reported on Form 1040.

Similarly, proceeds from selling assets that qualify for capital gain treatment are reported on Schedule D (Form 1040), Capital Gains and Losses. The income tax bases of those assets are also reported on Schedule D (Form 1040 and subtracted from the sale proceeds before the net amount is carried to Form 1040.

An individual's share of income from flow-through entities—such as partnerships, S corporations, and trusts—is reported first on Schedule E (Form 1040) and then carried to Form 1040.

Gross income that does not fall within any category on the itemized lines on Form 1040 is reported on a line called "Other income" (line 21 on the 2010 form).

Because deductions are subtracted from business income before it is reported on Form 1040, an individual's total gross income does not show up in any one place on the income tax return, and there is no line labeled "gross income." The sum of the income and losses that are reported in the income section of Form 1040 (line 22 of the 2010 form) is appropriately labeled "total income."

Adjusted Gross Income

Adjusted gross income (AGI) is an important number in the income tax calculation because it is used as a base for some other calculations. For example, medical expenses can be deducted only to the extent they exceed 7.5% of AGI. Most miscellaneous itemized deductions reduce taxable income only to the extent the total exceeds 2% of AGI.

AGI is calculated by subtracting any remaining above-the-line deductions from total income (business expenses and the bases of assets were already deducted on other schedules). The remaining above-the-line deductions include educator expenses, health savings account contributions, moving expenses, one-half of self-employment taxes, the cost of self-employed health insurance, certain retirement plan contributions, alimony, interest paid on student loans, deductible tuition and fees, and the domestic production activities deduction.

Including a deduction in the above-the-line category, rather than as an itemized deduction, has three effects on tax liability:

1. Above-the-line deductions can be claimed even if the taxpayer claims the standard deduction instead of itemizing deductions.
2. Above-the-line deductions are not subject to the floors that reduce some itemized deductions.
3. Above-the-line deductions reduce AGI, which affects other tax calculations as described earlier.

Standard Deduction

If a taxpayer does not elect to itemize deductions, he or she subtracts the standard deduction from AGI. Standard deductions vary by filing status, dependency status, and the taxpayer's age, and are increased for taxpayers who are legally blind.

Cross-Reference

See Figure 13.1 in Chapter 13 of this guide for a list of the 2011 standard deductions.

Itemized Deductions

Itemized deductions are personal expenses for which Congress specifically allows a deduction. They include medical and dental expenses (to the extent the total exceeds 7.5% of AGI); state and local taxes; interest on a home mortgage; gifts to charities; casualty and theft losses of property used for personal (rather than business) purposes; employee business expenses; investment expenses; and tax preparation expenses.

In most cases, taxpayers should elect to itemize their deductions if the total exceeds their standard deduction. However, a married person who files separately cannot itemize his or her deductions if his or her spouse claims the standard deduction.

Personal and Dependent Exemptions Deduction

Congress allows a set amount ($3,700 for 2011) to be deducted from AGI for each taxpayer filing the tax return and the dependents of those taxpayers. For example, a married couple with three children who file a joint income tax return can claim two personal exemptions and three dependent exemptions. For 2011, their personal and dependent exemptions deduction is $18,500 (5 × $3,700).

Taxable Income, Income Tax Rates, and Income Tax

Taxable income is the remainder after itemized deductions or the standard deduction and the personal and dependent exceptions deduction are subtracted from AGI. It is the base to which the tax rates are applied to compute income tax liability.

The income tax rates are graduated, which means that a higher tax rate applies to higher levels of income. The higher rates apply only to the income above the threshold for each rate and not to the income below that threshold.

Example 2.5 Income Tax Rates

Victor and Maria Gomez reported $50,000 of taxable income on their 2011 joint income tax return. For 2011, the joint return tax rate on the first $17,000 of taxable income is 10% and the tax rate for the next $52,000 is 15%. Therefore, the Gomezes' 2011 income tax is $6,650, as shown in Figure 2.2.

FIGURE 2.2 Gomez's 2011 Income Tax

Tax on first $17,000 of taxable income ($17,000 × 10%)		$1,700
Tax on amount over $17,000		
Amount over $17,000 ($50,000 – $17,000)	$33,000	
Tax rate	× .15	
Tax on $33,000		4,950
Total tax		$6,650

The federal income tax rate on long-term capital gains and qualified dividends is the lesser of the ordinary income tax rate or the tax rate for long-term capital gain. For 2011, the tax rate for most long-term capital gains is 0% for eligible gains and dividends included in total taxable income that does not exceed the 10% and 15% ordinary income tax brackets. It is 15% for eligible long-term capital gains and dividends included in income that would be taxed in the 25% or higher ordinary income tax brackets.

Example 2.6 Tax Rates for Capital Gain

Victor and Maria Gomez, from Example 2.5, have $25,000 of long-term capital gains in addition to their $50,000 of ordinary income. Because the 15% ordinary income tax bracket for married filing jointly ends at $69,000 for 2011, $19,000 ($69,000 – $50,000) of their $25,000 long-term capital gain falls within the 15% tax bracket when it is added to their ordinary income. That $19,000 of long-term capital gain is taxed at the 0% capital gain rate.

The remaining $6,000 ($25,000 – $19,000) of long-term capital gain falls within the 25% ordinary income tax bracket and is taxed at the 15% capital gains rate. With the addition of the $25,000 long-term capital gain, the Gomezes' 2011 income tax is $7,550, as shown in Figure 2.3.

FIGURE 2.3 Gomez's 2011 Income Tax

Tax on first $17,000 of ordinary taxable income ($17,000 × 10%)		$1,700
Tax on ordinary income over $17,000		
Amount over $17,000 ($50,000 – $17,000)	$33,000	
Tax rate	× .15	
Tax on $33,000		4,950
Tax on first $19,000 of capital gain ($19,000 × 0%)		0
Tax on capital gain over $19,000		
Amount over $19,000 ($25,000 – $19,000)	$ 6,000	
Tax rate	× .15	
Tax on $6,000		900
Total tax		$7,550

Credits

If the alternative minimum tax (see Chapter 9 of this guide) is owed, it is added to the income tax liability before nonrefundable credits are subtracted. These credits include the foreign tax credit; the credit for child and dependent care expenses; education credits, such as the Hope credit and the lifetime learning credit; the retirement savings contribution credit; the child tax credit; residential energy credits; and others.

The order in which credits are subtracted is important because some credits are refundable and some are not. If the amount of tax due before a refundable credit is applied is less than the refundable credit, the excess amount of the credit can be received as a refund. By contrast, if a nonrefundable credit exceeds the amount of tax due, the credit can be used only to reduce the tax to zero. The excess is not refundable.

✔ **Observation**

Benefit of Credits

Because tax credits offset tax liability, the benefit of a credit is the same for both high- and low-bracket taxpayers if there is a tax liability for the credit to offset or if the credit is refundable. By contrast, the benefit of a tax deduction depends on the tax bracket of the taxpayer. A $100 deductions from income in the 35% bracket saves the taxpayer $35 of taxes. A $100 deduction from income in the 15% bracket saves the taxpayer $15 of taxes.

Other Taxes

Taxes that cannot be reduced by nonrefundable credits are added to the net tax due after the credits are subtracted. These taxes include the self-employment tax; social security and Medicare taxes that were not already paid on tips and wages; and other taxes.

Total Tax, Tax Payments, and Tax Due

Payments include withholding and estimated payments and refundable credits. They are subtracted from the total tax liability to arrive at the tax balance that is due with the return or the tax refund that the IRS will send to the taxpayer.

Employment Taxes

Most wages paid to employees are subject to Federal Income Contributions Act (FICA) taxes and Federal Unemployment Tax Act (FUTA) taxes.

Cross-Reference

See Chapter 13 of IRS Publication 225, *Farmer's Tax Guide (for 2010)*, for more information on FICA and FUTA taxes.

FICA Taxes

Both the employer and the employee must pay FICA taxes on the employee's wages.

The FICA tax is comprised of two taxes. One is the social security tax (also called old-age, survivors, and disability insurance), which funds social security benefits, including disability, retirement, and survivor benefits. Since 1990, the social security tax rate has been 6.2% for both the employer and the employee. For wages paid in 2011, the social security tax rate for employees is temporarily reduced to 4.2%. The social security tax applies only up to an inflation-adjusted wage base, which is $106,800 for wages paid in 2011.

The second tax included in FICA taxes is the Medicare tax (also called hospital insurance), which funds Medicare payments. Since 1986, the Medicare tax rate has been 1.45% for both employers and employees. Unlike the social security tax, there is no wage limit for the Medicare tax. Employers and employees owe this tax on all wages.

Combined, the social security tax and the Medicare tax impose a 7.65% tax on both employers and employees (5.65% for employees on wages paid in 2011) for the first $106,800 (for 2011) of wages and a 1.45% tax on wages over $106,800 (for 2011).

Employers must withhold the employee's share of FICA taxes from wages and remit both the employee's share and the employer's share to the United States Treasury. Employers then report the wages and taxes on employment tax returns filed with the IRS.

FUTA Taxes

Famers must pay FUTA taxes if they meet either of the following tests:

1. They pay $20,000 or more to farmworkers in any calendar quarter during the current or preceding calendar year, or
2. They employ 10 or more farmworkers for some part of at least 1 day during any 20 or more different calendar weeks during the current or preceding calendar year.

Noncash Wages

Noncash wages paid to farmworkers are not subject to FICA or FUTA taxes. Noncash wages include food, lodging, clothing, transportation passes, commodities, and other goods and services.

Planning Pointer

Social Security Benefits

Paying noncash wages to farmworkers saves FICA taxes for both the employer and the employee and saves FUTA taxes for the employer. However, noncash wages are not counted as earned income for calculating social security benefits. Therefore, employers and employees should compare the FICA and FUTA taxes saved with the social security benefits lost by paying noncash wages.

Self-Employment Taxes

Instead of paying FICA taxes on wages, self-employed individuals pay self-employment tax on their self-employment income. Like the FICA tax, the self-employment tax is comprised of the social security tax and the Medicare tax. The social security and Medicare tax rates equal the sum of the rates paid by the employer and the employee on wages. Therefore, the self-employment tax rate is 12.4% (10.4% in 2011) and the Medicare tax rate is 2.9%.

The wage base that limits the social security tax to the first $106,800 (for 2011) of wages also limits the social security component of the self-employment tax to the first $106,800 (for 2011) of self-employment income. If a taxpayer receives both wages and self-employment income, the base for self-employment taxes is reduced by the wages he or she receives.

Cross-Reference

See Chapter 12 of IRS Publication 225, *Farmer's Tax Guide (for 2010)*, for more information on the self-employment tax.

Summary

Farmers must pay several different taxes that vary in their complexity and the way they are collected. Effective farm management includes minimizing taxes. However, some taxes are easier to manage than others.

Return to TOC

CHAPTER 3
FARM INCOME

SYNPOSIS (click on section title to go directly there)

Return to TOC

Introduction

In preparing their federal income tax returns, farmers are required not only to report all of their income but also to determine the income's character so that they can apply the proper tax rates. Some income is eligible for the more favorable tax rates on capital gains rather than the tax rates on ordinary income. Some income is subject to self-employment tax as well as to income tax.

Cross-Reference

For more information on where and when to report income, see Chapter 13, "Tax Reporting and Payment," in this guide.

Tax benefits that are available only to farmers include income averaging, postponed recognition of gain from weather-related sales of livestock, and carrying net operating losses to additional prior tax years. These provisions help farmers cope with the uncertainty of their income resulting from fluctuations in both yield and the price of commodities. Appendix A at the end of this chapter is a complete list of special federal tax provisions for farmers.

Defining Farm and Farming

Taxpayers must meet specified requirements to qualify as farmers. However, all of the special provisions do not use the same definitions of *farm, farmer*, and *farming*. The rules vary from one provision to another.

Definition of *Farm*

A definition of *farm* is contained in the estate tax valuation rules. It reads as follows:

> The term "farm" includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands.

This definition, with some variations, is also used in several other tax provisions.

Definition of *Farming*

In an IRS discussion of prepaid expenses, *farming* is defined as follows:

> The term "farming" means the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and management of animals. For purposes of the preceding sentence, trees (other than trees bearing fruit or nuts) shall not be treated as an agricultural or horticultural commodity.

This definition, with some variations, is also used in other tax provisions.

It is possible for a taxpayer to be considered a farmer for one tax provision and not for another. Taxpayers must determine whether an activity meets the definition of *farm*, *farming*, or *farmer* when deciding whether to report income and expenses on Schedule F (Form 1040), Profit or Loss From Farming, or on another tax form. Once that determination is made, the tax treatment for most items listed in Appendix A falls into place.

To help you determine whether to report income and expenses on Schedule F (Form 1040), the following discussion uses examples to illustrate the results of several court cases. In some cases, a small change in your facts may qualify you for one or more of the favorable tax provisions.

Illustrations and Examples

The Tax Court regards as a farmer any taxpayer who both participates to a significant degree in the farming process and bears a substantial risk of loss in the process. As a result, a taxpayer who operates a feed yard for profit is considered a farmer, as is a taxpayer who enters into a maintenance contract with a nursery to bud and cultivate the taxpayer's seedlings on the nursery's premises. A very liberal definition of a farmer was applied to a doctor who leased brood cows for the purpose of developing a herd and contracted the cattle-breeding and management responsibilities to an independent third party, with the taxpayer taking delivery of the calves once they were weaned. The court concluded that the manager acted at the doctor's discretion and the doctor bore the risk of loss.

Example 3.1 Farm Supply Outlet

Herb O'Sides operates a local company, Herb's Ag Products, which sells seeds, herbicides, fertilizers, pesticides, tools, and equipment to farmers. Local farmers, to whom Herb also provides many services, value his expertise. Herb visits customers' farms daily, inspects their soil and crops, takes leaf and soil samples, and advises them about fertilizers, herbicides, and pesticides. Herb does not charge for this advice. He often provides financial assistance to farmers, giving them credit and sometimes cosigning notes for them. Herb thinks that Herb's Ag Products qualifies as a farming business.

However, Herb's Ag Products is not a farming business. Even though Herb participates in the growing process (through farm visits and consultation) and bears a substantial risk of financial loss (by advancing credit and cosigning notes), his company did not cultivate, operate, or manage a farm for profit as an owner or tenant. The company's business is merchandise sales, not farming. Herb's Ag Products does not bear a substantial risk of loss from farming. Farmers have no recourse if their crops fail or the market for crops is poor. As a creditor, Herb has liens, collateral, security interests, and other rights and protections that farmers do not have.

This specific situation was addressed in court, and the court concluded a grain elevator or feed store that sells grains or feed to farmers and has no control or management of a farm operation does not qualify as a farm or farmer.

Example 3.2 Custom Harvester

Grim Reaper is a grain harvester who contracts with other individuals to cut their grain and haul it to sites designated by the individuals. Grim is paid an established amount per acre harvested. When Grim finishes cutting and hauling one individual's grain, he repeats the activity in another individual's fields. Grim has the equipment and work crews necessary to complete his work. Grim does not raise or grow the grain he cuts and hauls, and he does not own or lease the land on which the grain grows.

Grim is not engaged in a farming business. Some confusion can result, however, because Treasury regulations define a farming business as a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity, and examples include the raising or harvesting of crops. However, Grim is not using his equipment in a farming business. Grim's trade or business is not farming—he is not raising or growing the grain he harvests and hauls. Instead, Grim merely provides a service by cutting and hauling grain.

Example 3.3 Processing Commodities

Zoe Zinfandel started raising grapes years ago. She sold her grapes to a local winery and properly reported her income and expenses on Schedule F (Form 1040). A few years ago she not only sold grapes to the winery, but also began processing some of her grapes on her farm and selling grape juice and wine to a grocery store in the nearby town. She lets the wine age for 2 years before she sells it.

The grape juice and wine production is not part of her farming business because a farming business does not include the processing of commodities beyond the activities that are normally incident to the growing, raising, or harvesting of such products.

Zoe also raises beef cattle. Her husband, Merlot, has a full-time job as an engineer at a local manufacturing plant. They file a joint income tax return. Their income and expenses from various sources for a typical year are shown in Figure 3.1.

Figure 3.1. Zinfandels' Income and Expenses

	Gross	Basis or Expenses	Net
Merlot's Wages	$26,000	$0	$26,000
Calf Sales	6,000	4,800	1,200
Grape Sales to Winery	23,000	15,000	8,000
Juice and Wine	13,000	6,000*	7,000
Cull Beef Cows	5,000	1,000	4,000
Total	$73,000	$26,800	$46,200

*$2,000 of this amount is the wholesale value of the grapes used in juice and wine production.

Question 1

Where should the income and expenses be reported on Zoe and Merlot's joint tax return?

Answer 1

- Merlot's wage income is reported on the front of Form 1040.
- The calf sales and the grape sales are both reported on Schedule F (Form 1040).
- Zoe's sales of grapes to the local winery are also reported on Schedule F (Form 1040), because she has not processed those grapes.
- Zoe's juice sales are reported on Schedule C (Form 1040), Profit or Loss From Business, because she has processed them beyond the normal stage for preparing grapes for sale from the farm.
- The wholesale value of the grapes used for juice and wine ($2,000) is reported as an inventory purchase on Part III, Cost of Goods Sold, of Schedule C (Form 1040) and as income on Schedule F (Form 1040).
- The cull beef cow sales are reported on Form 4797, Sales of Business Property.

Question 2

Can Zoe use the cash method of accounting?

Answer 2

Yes. Subject to some exceptions, she is a farmer and can use the cash receipts and disbursements method of accounting that is included in the list of permissible methods that most taxpayers can use for computing taxable income. Zoe does not fall within any of the exceptions to this general rule and can therefore use cash accounting.

Question 3

Can Zoe pay commodity wages to her employees to avoid FICA tax liability on the wages?

Answer 3

Zoe and her employees can avoid FICA taxes (social security taxes and Medicare taxes) on wages paid as commodities for **agricultural labor**, which is defined as "services performed … in connection with raising or harvesting any agricultural or horticultural commodity." Therefore, the wages that Zoe properly deducts on her Schedule F (Form 1040) qualify for the exception to FICA taxes if they are paid in commodities. However, the wages that she properly deducts on her Schedule C (Form 1040) do not qualify for the exception to FICA taxes, even if she pays them in commodities.

Planning Pointer
Income Tax Withholding Exemption
Wages paid for agricultural labor that are not subject to FICA tax are also not subject to income tax withholding.

Observation
Activities Incident to Growing and Harvesting
Any processing that is incident to growing and harvesting a commodity is included in the term *farming business*. For example, the extraction of oil from mint plants occurs in conjunction with the harvest; therefore, the extraction process fits within the definition of *farming*. The processing of grapes into wine, however, is not necessary to place the grapes into their first marketable state. Thus, such processing does not fall within the definition of *farming*.

Contract Farming

Farm producers have entered into arrangements with seed companies, canneries, and packers of chickens and hogs that reduce some of the risk and result in a farmer making both fewer management decisions and no marketing decisions. Producers should be careful to retain as many characteristics of a farming business as possible to still qualify as a farmer and take advantage of favorable tax treatments.

Defining Farm Income

The Internal Revenue Code and Treasury regulations use "gross income from farming" and "farm income" as part of the threshold requirements for several income tax provisions. Those terms have slightly different definitions for some of the provisions. This section discusses and applies those definitions.

Separate definitions of *gross income from farming* are used for

- Relief from estimated tax penalties,
- Soil and water conservation expenditures, and
- The limit on deducting a charitable contribution for a conservation easement.

The term *farm income* is also used in the following provisions:

- Income averaging for farmers
- Deferral of weather-related sales of livestock
- Farm optional method for self-employment tax

Estimated Tax

The most commonly used income tax advantage for farmers is a special rule for estimated taxes. Instead of the generally required four estimated tax payments, farmers and fishermen have two options:

1. Make a single estimated payment of two-thirds of the tax due by January 15 of the following year.
2. Skip all estimated payments but file the annual income tax return and pay 100% of the tax due by March 1 of the following year.

The second option is used by most farmers, but choosing the first option in a low-income year when the amount of tax is low provides more time for filing the return.

To qualify as a farmer or fisherman, at least two-thirds of the taxpayer's *total gross income* for either the year of the estimated payment or the preceding tax year must come from farming or fishing. Total gross income is all income that is not exempt from income tax, whether received in the form of money, goods, property, or services. If a joint return is filed, total gross income includes the gross income of both spouses. Because total gross income is not reduced by losses (business, capital, or other), gross income for estimated tax purposes is **not** the same as the total income shown on line 22 of Form 1040, U.S. Individual Income Tax Return.

Gross income from farming includes gross farm income from Part I of Schedule F (Form 1040); line 7 of Form 4835, Farm Rental Income and Expenses; gross farm income from Parts II and III of Schedule E (Form 1040), Supplemental Income and Loss; and gains from the sale of livestock used for draft, breeding, dairy, and sporting purposes, reported on Form 4797. Gross farm income does not include wages received as a farm employee or gains from the sale or exchange of land or depreciable farm machinery.

Example 3.4 Gross Income from Farming

Ben and Sally Martinez are married and file a joint return. During a calendar tax year, Sally earned a $40,000 off-farm salary and the couple had $1,000 of interest income, a $3,000 capital loss on the sale of stock, $150,000 of gross farm income on line 11 of Schedule F (Form 1040), a $5,000 gain from the sale of raised breeding cows, and a $2,500 gain on the sale of a used tractor.

As shown in Figure 3.1, their gross income is not reduced by the $3,000 capital loss. The $2,500 gain on the sale of the used tractor is included in total gross income but not in gross income from farming. Ben and Sally's gross income from farming is $155,000, which is 78.1% of their $198,500 total gross income. Because more than two-thirds of their gross income in the current year is from farming, they are qualified farmers for estimated tax purposes.

FIGURE 3.1: Total Gross Income and Gross Income from Farming

Income Item	Tax Return Income	Total Gross Income	Gross Income from Farming
Sally's off-farm salary	$ 40,000	$ 40,000	
Interest income	1,000	1,000	
Capital loss on stock	– 3,000		
Gross farm income	150,000	150,000	$150,000
Gain of sale of breeding stock	5,000	5,000	5,000
Gain on sale of used tractor	2,500	2,500	
Total	$195,500	$198,500	$155,000

Planning Pointer

Retiring Farmers

When farmers retire or sell their businesses, the sale of land or depreciable farm machinery may prevent them from meeting the two-thirds of gross income from farming rule. However, because taxpayers qualify for the farm rule if two-thirds of their gross income is from farming in **either** the current year or the previous year, they often still meet the requirements for the farm exception to the underpayment of estimated tax penalty.

Soil and Water Conservation Expense

Congress limits the deduction of qualified soil and water conservation expenditures to 25% of gross income from farming. For this provision, *gross income from farming* is defined as income derived from the production of crops, fish, fruits, other agricultural products, or livestock. Gains from the sale of draft, breeding, and dairy livestock are included, but gains from the sale of assets such as farm machinery or the land are not included.

✔ **Observation**

Small Difference in Concept

The only difference between the definitions of *gross farm income* for the estimated tax provision and the soil and water conservation deduction is that gain from the disposition of sporting livestock is included for estimated tax purposes but not for soil and water conservation deductions. Thus, for the vast majority of taxpayers, gross farm income is the same for these two provisions.

Conservation Contribution Deduction

The deduction for charitable contributions is generally limited to 20%, 30%, or 50% of a taxpayer's adjusted gross income (AGI), depending on the type of contribution, with a 5-year carryover of excess amounts. Charitable contributions include the value of a contribution of a qualified interest in real property that is made exclusively for conservation purposes. A special rule for conservation contributions made before 2012 increases the deduction limit for qualified farmers and ranchers to 100% of their AGI.

Qualified farmers or ranchers for this provision must derive more than 50% of their total gross income for the year from the trade or business of farming. *Farming* is defined by reference to the definition in the estate tax special-use valuation rules. It includes cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm; handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than half of the commodity; and planting, cultivating, caring for, or cutting trees, or the preparation (other than milling) of trees for market.

Example 3.5 Expanded Definition of Gross Income from Farming

Jim and Betty Forester are married and filed a joint return. Betty earned a $40,000 off-farm salary; they have $1,000 of interest income, a $3,000 capital loss on the sale of stock, a $5,000 gain on the sale of breeding stock, and a $2,500 gain on the sale of a used tractor. Their farm income on line 11 of Schedule F (Form 1040) is $50,000, and they have a $75,000 sale of timber, as shown in Figure 3.2. If the sale of timber was not included as gross income from farming, Jim and Betty would have only $55,000 of gross farm income [$50,000 from Schedule F (Form 1040) and $5,000 from sale of breeding livestock], and less than 50% of their total gross income would be from farming. However, the sale of timber is included as farm income for the conservation contribution deduction. Therefore, more than 50% of their gross income is from farming, and they are qualified farmers for this expanded deduction limit.

FIGURE 3.2: Total Gross Income and Gross Income from Farming

Income Item	Tax Return Income	Total Gross Income	Gross Income from Farming
Betty's off-farm salary	$40,000	$40,000	
Interest income	1,000	1,000	
Capital loss	– 3,000		
Gross farm income	50,000	50,000	$50,000
Gain of sale of breeding stock	5,000	5,000	5,000
Gain on sale of used tractor	2,500	2,500	
Sale of timber	75,000	75,000	75,000
Total	$170,500	$173,500	$130,000

✔ **Note**

Estimated Tax Rule Is Different

Although Jim and Betty Forester in Example 3.5 qualify as farmers for the charitable deduction of a conservation easement this year, they do not qualify as farmers for estimated tax purposes based on this year's income. They might qualify based on their previous year's income.

Farm Income Averaging

Individuals engaged in a farming business may be able to average the tax rates that apply to some or all of their farm income by tapping their tax brackets from the 3 prior years (base years). There is no threshold requirement that the taxpayer is a *farmer*, but only *electible farm income* is eligible to be taxed in unused brackets from the 3 previous years.

For this provision, *farm income* includes items of income, deduction, gain, and loss attributable to the individual's farming business. Income from a farming business is the sum of any farm income or gains minus any expenses or losses allowed as deductions in computing taxable income. Gains from the sale or other disposition of farm property (other than land) that has been regularly used for a substantial period in a farming business are included. Gains from the sale of timber are excluded. The amount of farm income that the taxpayer elects to have taxed at the base years' rates is *elected farm income*. Any type of income (e.g., capital gain other than gain from the sale of land or timber) attributable to the farm business can be designated as elected farm income. The mechanics of farm income averaging are discussed in Chapter 7.

Weather-Related Sales of Livestock

Cash-basis taxpayers whose principal trade or business is farming may defer reporting the sale of animals in excess of their normal business practice if the sale results from drought or other weather-related conditions. To qualify, the taxpayer must show that the sale is related to weather conditions that caused an area to be declared eligible for federal assistance. *Farming* for this provision is defined in very broad terms similar to those discussed earlier: It is defined as activities by the owner, tenant, or operator in connection with cultivating the soil and raising or harvesting any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of livestock, bees, poultry, and fur-bearing animals and wildlife. Farming also includes handling, drying, packing, grading, or storing commodities in their unmanufactured state. Finally, farming also includes planting, cultivating, caring for, or cutting trees, or preparing (other than milling) trees for market, incidental to farming operations.

In one situation, a cattle rancher had a full-time job from which he earned an average salary of $65,000. The ranch generated $121,000 of average annual gross income. The taxpayer participated in the activity of raising livestock for 750–1,000 hours per year, and the taxpayer's spouse devoted 200–300 hours to the ranch during each tax year. Because the gross income generated by the cattle ranch was approximately two-thirds of the taxpayers' total annual gross income, and given the taxpayers' material participation, the taxpayer's principal trade or business was held to be farming and the couple was eligible to defer reporting some income because of weather conditions.

✔ **Observation**

Principal Business Activity

A taxpayer's principal business activity (PBA) is based on sources of gross receipts. The PBA is the activity from which the largest percentage of receipts is derived during the prior year or prior 3-year period.

Farm Operating Income

Farm accounting data serves three purposes.

First, farms using cash accounting should reconcile their cash flow and their bank records (i.e., reconcile the cash flow to zero). This means that the cash amount in the accounting records at the beginning and end of each month agrees with the bank amount after reconciling all cash inflows and outflows. A positive cash balance may mean that cash inflow was double counted, and a negative cash balance may mean that cash inflow was missed. The alternative is that some expenses have been missed or double counted.

A second purpose is to accurately reflect the taxable income upon which income taxes and self-employment taxes must be paid. Not all cash coming in is taxable, and some income is taxable with no cash coming into the accounting system, so that offsetting inflows and outflows must be entered into the accounting system to make this correct.

A third purpose uses information from the accounting system to analyze the profitability of the farm business. While money in a checking account may be an indication that the farm operation is making a profit, that is not necessarily the case. The cash may be a result of borrowing money or selling farm assets, rather than a result of operating profits. The following discussion concentrates on the second purpose, but the other purposes are also important.

Schedule F (Form 1040) Income

The income reportable on Schedule F (Form 1040) is used to compute net profit or loss. This profit is subject to income tax at ordinary tax rates, as well as to self-employment (SE) tax.

A checkbook represents a starting point for looking at income. Money coming into the checking account is cash flowing into the business. Much of it is taxable income, including proceeds from crop sales, livestock sales, culled breeding or dairy animals, agricultural program payments, crop insurance proceeds, rental income, and custom hire income. But some of the money coming into the checking account is not taxable or is not reported on the Schedule F (Form 1040). For example, borrowed funds may increase cash in the checking account but they are not taxable income. Consider the specific sources of money flowing into the checking account.

Raised Agricultural Products

Crops or agricultural products raised and sold by a farmer are the major cash source on most farms. This income, which is reported in Part I of Schedule F (Form 1040), includes sales of grains, vegetables, fruit, bedding plants, milk, calves, raised market livestock, eggs, and hay. Sales of farm products that were raised on the farm are offset in Part II of Schedule F (Form 1040) by the expenses of raising the products (covered in Chapter 4), so there are subtractions to arrive at net income.

Purchased for Resale

Sales of livestock or other items that were bought for resale are handled differently. When the item is sold, the full sales price is reported in Part I of Schedule F (Form 1040), but the original cost (or other basis) is also reported in Part I and subtracted from the sales price to arrive at gross income. The most common mistakes happen when animals are purchased in one tax year and sold during the next tax year.

Cooperative Distributions

Cooperative distributions—patronage dividends and per-unit retain allocations—are reported to the IRS on Form 1099-PATR. Some distributions may be in cash which is, of course, taxable. But some distributions may be noncash allocations that are currently taxable but are not immediately reflected in the checkbook. Although you are required to pay income tax on the allocations now, you do not receive any money until some point in the future. For accounting purposes, you are loaning the allocated funds back to your cooperative (which is partially owned by you). The cooperative then has working capital and does not have to borrow it from a bank or other lending institution. In the future, when your cooperative does send you the cash, the payment is not income because it has already been taxed. Don't count it as income a second time.

Agricultural Program Payments

Agricultural program payments are reported by the agency to you and to the IRS on Form 1099-G, Certain Government Payments. Most of these payments are taxable income to be reported on Schedule F (Form 1040). Expenses incurred for adopting an agricultural practice or undertaking a project often offset the income from the related payment. Payments for certain conservation projects or depreciable improvements (such as manure storage or chemical containment) may qualify for a cost-sharing exclusion from income.

Note that if a cost-sharing payment is not counted as income, the costs paid with that money cannot be deducted or depreciated. If the government payment is treated as income, you can deduct or depreciate the qualifying costs paid with those funds.

CCC Loans as Income

Farmers who receive Commodity Credit Corporation (CCC) loans on their crops can elect to report the loans as income rather than as loans. If you do not elect to report CCC loans as income, the loans are not included in income and repayments of the principal are not deductible. (However, interest payments are a deductible expense.) If you do not elect to report the loan as income and later forfeit the commodity instead of repaying the loan, you are treated as selling the commodity for the amount of the loan and must report that deemed sale on your Schedule F (Form 1040).

If you elect to report the loan as income, you acquire an income tax basis in the commodity that secures the loan. The basis is the amount of the loan that you reported as income. If you later sell the commodity, you subtract your basis in the commodity from the sales price and report any excess sales price as additional income or any deficit as a loss. If you forfeit the commodity instead of repaying the loan, there is no income or loss to report because your basis in the commodity equals the deemed sale price. If you feed the commodity to livestock, you can deduct your basis in the commodity as a farm expense.

Crop Insurance and Disaster Payments

Crop insurance and disaster payments are normally income when the check is received. Under some circumstances, the crop payment inclusion as income may be deferred to the following year if the later year is when the crop is normally sold. Payments from revenue insurance that covers the combination of yield risk (poor crop yields) and price risk (low prices) can be postponed only to the extent they are paid for yield risk.

Custom-Hire Income

Custom-hire income includes machine work done for someone else. It might be just harvesting, or it could be an agreement to perform all of the work of tillage, planting, pest control, harvesting, and hauling. It is not entirely clear when custom work becomes a separate business that is reported on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship). If custom work is a small part of the total farm operation, then the income is reported on Schedule F (Form 1040).

Although the tax rules do not include a clear threshold, if more than half of a farmer's income comes from custom hire, the farm and nonfarm businesses should be reported separately on Schedules F and C (Form 1040). Be aware that reporting income and expenses on Schedule C (Form 1040) sacrifices some tax advantages of being a farmer and causes different employment rules to apply to employees of the nonfarm business.

Other Income

Other income reported on Schedule F (Form 1040) includes farm operating income that is not specifically listed on Schedule F (Form 1040), such as state and federal fuel or gasoline credits. These may be received as a check or as a credit that reduce taxes. The fuel credit is income because it is a refund of fuel taxes already paid and deducted as an expense, even though the credit may never go through the checkbook.

Other income reportable on Schedule F (Form 1040) does not include the following items that are reportable elsewhere on the tax return:

- Gain or loss from selling breeding livestock, equipment, land improvements, or land used in a farming business
- Investment income, such as timber sales
- Rental income
- Wages received for working for someone else

Barter Income

Other income reportable on Schedule F (Form 1040) includes farm barter income if it is not already included as the sale of agricultural products. Barter income results from trading farm products or your labor for other farm products, property, or someone else's labor. If you receive farm products or labor, you must include the fair market value (FMV) of the products or labor you received in income.

Although barter income and expenses often offset each other and do not change taxable income, reporting them is not only a tax law requirement, but it is often beneficial to you.

Example 3.6 Corn Exchanged for Hay

Derry Aire traded $10,000 of his corn for $10,000 of his neighbor's hay. If Derry does not report the deemed sale of the corn and the deemed purchase of the hay, his net farm profit on Schedule F (Form 1040) does not change because the omitted income and deduction offset each other.

However, not reporting the corn sale reduces Derry's gross income from farming by $10,000. This reduces the amount of soil and water conservation expenses he can deduct, and it may disqualify him for the exception to the underpayment of estimated tax penalty because it reduces the income included in the numerator of the two-thirds test by $10,000.

In some cases, barter income is not offset by a barter deduction, and failing to report the barter transaction incorrectly reports income. For example, if you trade a bull for some hay, the income from the deemed sale of the bull is not subject to SE tax, while the deemed cost of the hay is deducted from income that is subject to SE tax. Failing to report the barter transaction would incorrectly report too much SE income and too little income that is not subject to SE tax.

Not reporting barter income and expense can also lead to an incorrect business analysis because it underreports income from one enterprise and expenses for another enterprise. Be sure to include barter income in both your accounting and tax records.

Cancellation of Debt Income

Generally, if a debt is forgiven or canceled the debtor has taxable income equal to the amount of debt that is canceled. Although it seems counterintuitive to treat a canceled debt as income, the logic for this rule is as follows: When a taxpayer receives a loan, the amount received is not included in income because there is an obligation to repay the loan. If the loan is canceled without being paid, the taxpayer's wealth increases by the amount of the canceled debt.

Several exception to the general rule that canceled debt must be included in income are discussed and illustrated in Chapter 12 of this guide.

Refunds or Reimbursements

Taxpayers who receive refunds or reimbursements for expenses they deducted on their income tax returns for a prior year must generally include the refund or reimbursement in income. For example, if you paid $400 for a load of hay in December, but $50 was refunded in January because the cost was supposed to be only $350, you must report the $50 as income for the tax year that includes January. If the $50 refund were paid in the same tax year as the $400 payment, the deduction for the hay expense is reduced from $400 to $350.

Insurance Received

Taxpayers who receive insurance payments for casualties, thefts, and losses generally have to report the insurance payments as income to the extent it exceeds their income tax basis in the property that was damaged or destroyed. This rule and the exceptions to it are discussed in Chapter 9 of this guide.

Disposition of Property Used in Farming

When farmers sell assets they use in the course of their business (such as equipment, breeding livestock, land, and buildings), the gain or loss is not subject to self-employment tax. Consequently, the sale is reported on Form 4797, Sales of Business Property, instead of on Schedule F (Form 1040).

Gains or losses from assets that do not meet a required holding period are ordinary gains or losses. The required holding period is more than one year for all assets except livestock. The required holding period for livestock other than cattle or horses is 12 months, which is one day less than the required holding period for other assets. For cattle and horses, the required holding period is 24 months.

Gains and losses from assets held for the required holding period are netted for each tax year. If there is a net loss from these assets, the net loss is deducted from ordinary income. If there is a net gain from these assets, the gain generally is treated as long-term capital gain, which is subject to a lower tax rate than ordinary income. However, if the taxpayer deducted net losses from these assets in the previous 5 years, the gain is treated as ordinary income to the extent of those losses.

If the asset was depreciated, part or all of the gain may have to be reported as ordinary income under the depreciation recapture rules. For buildings, gain equal to the depreciation claimed in excess of straight-line depreciation is treated as ordinary income. For other depreciable assets (such as equipment and draft, breeding, dairy, or sporting livestock), gain equal to all of the depreciation claimed is treated as ordinary income.

The following examples illustrate these rules.

Example 3.7 Bare Land

Sandy Beach sold an 80-acre parcel of land with no improvements for $320,000 ($4,000 per acre). Her income tax basis in the land is her $80,000 ($1,000 per acre) purchase price 20 years ago. Her gain from the sale is $240,000 ($320,000 – $80,000)

Sandy reports the sale in Part I of Form 4797 because the land was held longer than one year. The $240,000 gain is netted with the gains and losses from the sales of other assets that meet the holding period.

Example 3.8 Raised Cow

Marjorie Lucero culled a raised dairy cow during her fourth lactation. Marjorie held the cow almost 6 years, so she met the 24-month or more holding period for cattle and horses. The cow was sold for $400, and Marjorie's basis was zero because she had deducted all the costs of raising the cow as feed, labor and other costs. Therefore, Marjorie must report $400 of income in Part I of the Form 4797.

Example 3.9 Purchased Bull

Joe Running Bear purchased a yearling bull for $1,500 in year 1 and sold him in year 2 for $2,000. Direct expensing and depreciation reduced Joe's basis in the bull to $500 at the time the bull was sold. Because the bull was held fewer than 24 months, Joe reports the sale in Part II of Form 4797 and the $1,500 ($2,000-$500) gain is taxed as ordinary income.

Example 3.10 Machinery

Ben Yang purchased a new haybine for $25,000 5 years ago and sold it this year for $12,000. Direct expensing and depreciation reduced the basis from $25,000 to $10,000. Pete reports his $2,000 ($12,000 – $10,000) gain in Part III of Form 4797. Because the $2,000 gain is less than the $15,000 depreciation Ben deducted, all of the gain is depreciation recapture that is taxed as ordinary income.

Investment Income

Some gains or losses, such as gain or loss from the sale of standing timber, qualifies as capital gains or losses and are reported on Schedule D (Form 1040), Capital Gains and Losses. If the asset was held more than one year, the gain or loss is long term. If the asset was held one year or less, the gain or loss is short-term.

Summary

Farmers can save income taxes by taking advantage of tax law provisions that give them favorable tax treatment. Savings can result from avoiding self-employment taxes and from taking advantage of the rules that allow income to be taxed as capital gain.

To qualify for the special tax advantages, farmers must meet certain requirements. However, the qualifying requirements differ among the various tax provisions. Therefore, an individual farmer may be eligible for some of the tax benefits but not others.

Appendix A: Special Tax Provisions for Farmers

The special federal income tax provisions for farmers include the following items:

- Exclusion of income from discharge of indebtedness [I.R.C. §§ 108(a)(1)(C) and 1017(b)(4)]
- Limit on deducting charitable contribution of a conservation easement [I.R.C. § 170(b)(1)(E)(iv)]
- Carryback of net operating losses [I.R.C. § 172(b)(1)(G)]
- Soil and water conservation expenditures [I.R.C. §§ 175 and 1252]
- Expenditures for fertilizer, lime, and other materials to enrich, condition or neutralize soil [I.R.C. § 180]
- Domestic production activity deduction [Treas. Reg. § 1.199-4]
- Uniform capitalization of reproductive expenses [I.R.C. § 263A]
- Record keeping for business use of vehicles [Treas. Reg. § 1.274-6T(b)]
- Method of accounting for corporations engaged in farming [I.R.C. § 447]
- Cash method of accounting [I.R.C. § 448 and Treas. Reg. § 1.471-6(a)]
- Material participation for purposes of the passive loss rules [I.R.C. § 469(h)(3)]
- Crop insurance or disaster payments [I.R.C. § 451(d)]
- Weather-related sales of livestock [I.R.C. §§ 451(e) and 1033(e)]
- Deduction of prepaid expenses [I.R.C. § 464(f)]
- Application of the at-risk rules [Temp. Treas. Reg. § 1.465-1T and Prop. Reg. § 1.465-43]
- Livestock destroyed by disease [I.R.C. § 1033(d)]
- Disposition of converted wetlands or highly erodible croplands [I.R.C. § 1257(c)(1)(B)]
- Imputed interest rules [I.R.C. § 1274(c)(3)(A)]
- Farm income averaging [I.R.C. § 1301]
- Self-employment tax on rent [I.R.C. § 1402(a)]
- Special use valuation of real estate for estate tax purposes [I.R.C. § 2032A]
- FICA taxes on commodity wages [I.R.C. § 3121(a)(8)(A)]
- FUTA taxes [I.R.C. §§ 3306(b)(11) and 3306(k)]
- Excise tax on gasoline and diesel fuel used on farms [I.R.C. §§ 6420 and 6427(c)]
- Relief from estimated tax penalties [I.R.C. § 6654(i)]

CHAPTER 4

FARM DEDUCTIONS

SYNPOSIS (click on section title to go directly there)

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Introduction

Some income tax deductions, although available to all business taxpayers, have special rules for farmers. Other deductions, such as soil and water conservation expenses, are available only to farmers and ranchers. This discussion is intended to help operators of farms and ranches optimize deductions to reduce their tax liability.

Some deductions discussed in this chapter are not claimed on Schedule F (Form 1040), Profit or Loss from Farming. However, farmers need to be familiar with these possible deductions, such as the Domestic Production Activities Deduction (DPAD).

Ordinary and Necessary Business Expenses

The Internal Revenue Code allows taxpayers to deduct "ordinary and necessary expenses paid . . . in carrying on any trade or business." These ordinary and necessary expenses include fertilizer, pesticides, lime, seeds, repairs to equipment, and other costs of operating a farm business. This chapter explains how you determine whether an expense is "ordinary and necessary" and therefore deductible from gross farm income.

The portion of Schedule F (Form 1040) shown in Figure 4.1 itemizes most of the deductible expenses that are likely to be incurred in a farming business. Farmers can use line 34, "Other expenses," to claim deductions that are not listed on lines 12 through 33.

Figure 4.1: Part II of Schedule F (Form 1040)

Part II **Farm Expenses—Cash and Accrual Method.**
Do not include personal or living expenses such as taxes, insurance, or repairs on your home.

12	Car and truck expenses (see instructions). Also attach **Form 4562**	12			25	Pension and profit-sharing plans	25	
					26	Rent or lease (see instructions):		
13	Chemicals	13			a	Vehicles, machinery, and equipment	26a	
14	Conservation expenses (see instructions)	14						
15	Custom hire (machine work) .	15			b	Other (land, animals, etc.) . .	26b	
16	Depreciation and section 179 expense deduction not claimed elsewhere (see instructions) .	16			27	Repairs and maintenance . .	27	
					28	Seeds and plants	28	
					29	Storage and warehousing . .	29	
17	Employee benefit programs other than on line 25	17			30	Supplies	30	
					31	Taxes	31	
18	Feed	18			32	Utilities	32	
19	Fertilizers and lime . . .	19			33	Veterinary, breeding, and medicine	33	
20	Freight and trucking . . .	20			34	Other expenses (specify):		
21	Gasoline, fuel, and oil . . .	21			a		34a	
22	Insurance (other than health)	22			b		34b	
23	Interest:				c		34c	
a	Mortgage (paid to banks, etc.)	23a			d		34d	
b	Other	23b			e		34e	
24	Labor hired (less employment credits)	24			f		34f	

Reporting all farm income and expenses on the proper lines allows you to compare line entries from one year to the next to ensure that you have not missed a deduction and to make management decisions about optimizing your expenses.

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Some farm expenses, such as interest paid, are reported in subcategories on Schedule F (Form 1040). The mortgage interest that banks, farm credit associations, and other financial institutions report to you and the IRS on Form 1098, Mortgage Interest Statement, is entered on line 23a so that the IRS can match the Form 1098 amount with the amount you report on your tax return. Line 23b records other interest paid in your farming business that is not reported on a Form 1098, such as interest paid on a note held by the financing arm of your local implement dealer.

Rent expenses are split between machinery and equipment leases reported on line 26a and land rents reported on line 26b. Labor expenses are reported on line 24, and employee benefits and pension and profit-sharing expenses are reported on lines 17 and 25, respectively.

Repairs and Maintenance

Equipment maintenance expenses are deductible in the year they are paid if they are repairs but they must be capitalized and depreciated (as discussed later in this chapter) if they are improvements. This determination can be challenging.

Deductible repairs are expenditures that keep the property in efficient operating condition, restoring it to its previous operating condition. On the other hand, capital expenditures do one or more of the following:

1. Add to the property's value
2. Substantially prolong its useful life
3. Adapt the property to a new or different use

Example 4.1 Fence Expenses

Rusty Nail paid Juan Mendes $500 to tighten the wire and replace five of the forty fence posts on the east side of his pasture. Rusty also paid Juan $2,000 to build a new fence on the south side of his pasture.

Rusty can deduct as an ordinary business expense the $500 he paid to repair the fence on the east side of the pasture. The $2,000 he paid for the fence on the south side of the pasture is a capital expenditure, which is depreciable rather than currently deductible.

Separating Business and Personal Expenses

Some expenses, such as property insurance, utilities, and real estate taxes, may be incurred for both business and personal reasons. If you receive a single bill for this type of expense, you must allocate the expense between your business use and your personal use.

Example 4.2 Business and Personal Expenses

The $4,000 premium for your property casualty insurance covers all of the buildings on your farm property, including your house. The cost of casualty insurance for your home is $800. You can deduct $3,200 ($4,000 – $800) as a business insurance expense. None of the $800 is deductible unless you qualify to deduct part of the cost of the home as a business expense, as discussed in the next section of this chapter.

Business Use of the Home

Generally, expenses incurred to purchase or maintain a home are not tax-deductible because they are personal expenses. However, if you use part of your home for business (such as for office space), you may be able to deduct some of the costs. To prevent abuse, the tax rules for a business use of home deduction are complicated. Therefore, you should compare the tax benefits with the administrative and other costs before claiming part of your home expenses as a business deduction.

Exclusive and Regular Use

To qualify for a business-use deduction, part of the home must be used **exclusively** and **regularly** for business purposes. The portion of the home used for business does not have to be a separate room; an area of a room qualifies if it meets the exclusive and regular use requirements. However, any personal use, such as for personal recordkeeping or using the computer to access the Internet for nonbusiness reasons or play games, disqualifies the area as being used exclusively for business.

Planning Pointer

Duplicated Costs

Home office expenses may include the cost of a separate computer, printer, desk, filing cabinet, and other office equipment just for business use. Taxpayers who forgo the business deduction can use the same equipment for both business and personal purposes.

Deduction Limit

The deduction for business use of a home is limited to net income from the business before that deduction. Otherwise deductible expenses in excess of the income limit are carried forward to future tax years and can be deducted subject to the net income limit in each succeeding year. If the carryforward has not been used up by the time the business is terminated, the remaining amount can never be deducted.

Example 4.3 Deduction Limit

Apple Blossom had a loss from her farm business this year before deducting her $2,400 of home business office expenses. She cannot increase her farm loss by deducting the $2,400, but she can carry the $2,400 forward and deduct it in a future profitable year.

Depreciation of Home

You can deduct depreciation for the portion of your home that is used for a business purpose. However, when you sell your home, gain equal to the total amount of depreciation that was allowable after May 6, 1997, does not qualify for the rule that allows you to exclude from income your gain from the sale of a principal residence.

Example 4.4 Depreciation of a Home

Beginning in 2000, Apple Blossom used a portion of her home as a business office. She deducted a total of $15,000 of depreciation before she sold her home for a gain. Apple must report $15,000 of that gain as capital gain that is taxed at a rate equal to the lesser of 25% or her marginal ordinary income tax rate. The remainder of her gain is excluded from her income because she met the rules for excluding gain from the sale of a home.

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Planning Pointer

Forgoing the Depreciation Deduction

Forgoing allowable depreciation to avoid reporting part of the gain on sale of the home is not good planning for two reasons.

First, gain equal to the amount of depreciation that could have been deducted is not eligible for the exclusion whether the depreciation was deducted or not. Therefore, not deducting the depreciation does not increase the amount of gain that can be excluded from income.

Second, the tax advantage of the depreciation deduction is greater than the tax cost of not excluding the gain in most cases. The deduction reduces farm income that is subject to both income tax at the ordinary income tax rates and self-employment tax. The gain that is not excluded is subject to a maximum 25% tax rate and is not subject to self-employment tax. The gain is also taxed in a later year.

Truck and Car Expenses

Farmers often use trucks and cars for both business and personal reasons. The business use costs can be deducted from taxable income if adequate records of that use are kept. To reduce the record-keeping burden, taxpayers can use a standard mileage rate for the business miles driven in a car, van, pickup, or panel truck. Alternatively, they can deduct the actual costs of the business use, such as gas, oil, repairs, insurance, and depreciation expenses.

Standard Mileage Rate

The standard mileage rate (SMR) is adjusted at least annually for changes in most of the fixed and variable costs of operating a vehicle. Self-employed taxpayers who use the standard mileage rate can also deduct the costs of parking, tolls, state and local taxes on the vehicle, and interest on loans to buy the vehicle because those costs are not included in the standard mileage rate.

For 2011, the SMR is 51¢ per mile for miles driven in January–June and 55.5¢ per mile for miles driven in July–December.

Although the SMR reduces the record-keeping burden, it results in a lower income tax deduction if the actual costs of operating a vehicle are greater than the SMR.

Example 4.5 SMR vs. Actual Costs

In 2011, Red Durham drove his pickup truck 10,000 miles for his farming business (4,000 miles before July and 6,000 miles after June) and 5,000 miles for personal use. If he kept adequate records of his business miles, he can deduct $5,371 [(4,000 × 51¢) + (6,000 × 55.5¢)] for vehicle expense on his 2011 Schedule F (Form 1040).

If Red kept adequate records of all of the costs of driving his pickup and the total cost for 2011 is $9,000, he can deduct $6,000 [$9,000 × (10,000 business miles ÷ 15,000 total miles)] of vehicle expense.

The ability to switch annually between deducting the SMR and actual expenses is restricted. If you claim actual expenses the first year a vehicle is used for business, you cannot use the SMR for that vehicle in later years. If you deduct the SMR for the first year you use a vehicle for business, you can deduct actual expenses in later years, but you are limited to using straight-line depreciation for the vehicle. Electing the SMR in the first year can allow you to deduct actual expenses for later years in which you have high repair bills and use the SMR in other years.

If you use more than four cars and trucks at the same time in your farming business, you cannot use the SMR; your only option is to deduct actual expenses. You are not using five or more cars or trucks for business at the same time if you alternate using them for business (that is, use them at different times).

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Depreciation and I.R.C. § 179 Expensing Limits

Cars and trucks that have a gross vehicle weight of 6,000 pounds or less are subject to annual ceilings on the amount of allowable depreciation and I.R.C. § 179 expensing deductions. The so-called *luxury car limits* are imposed to prevent taxpayers from deducting large amounts of these expenses from taxable income. These limits affects the choice of using the SMR or actual expenses because they restrict the depreciation and I.R.C. § 179 expensing that can be included in actual costs.

The ceiling varies depending on the type of vehicle, the year it is placed in service, whether additional first-year depreciation (AFYD) is deducted, and the number of years the vehicle has been in use. The ceiling must be prorated if business use of the vehicle is less than 100%. Figure 4.2 shows the limits for vehicles first placed in service in 2011. The limits do not apply to vehicles with a gross weight exceeding 6,000 pounds.

Figure 4.2: Depreciation and I.R.C. § 179 Expense Limits for Vehicles Placed in Service in 2011

Tax Year	Cars		Trucks and Vans	
	No AFYD	AFYD	No AFYD	AFYD
2011	$3,060	$11,060	$3,260	$11,260
2012	4,900	4,900	5,200	5,200
2013	2,950	2,950	3,150	3,150
After 2013	1,775	1,775	1,875	1,875

Cross Reference

Cost-recovery rules, including depreciation, I.R.C. § 179 expensing, and AFYD, are discussed later in this chapter and in Chapter 5 of this guide.

Example 4.6 Comparison of Vehicle Deduction Options

In 2011, Olga Petrov paid $62,000 for a new Cadillac. Her actual operating costs for the car were $5,000, and she drove it 15,000 miles for her farming business (7,000 miles before July and 8,000 miles after June) and 5,000 miles for personal use.

Olga can deduct $12,045 of actual expenses or the $8,010 standard mileage deduction, as shown in Figure 4.3.

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Figure 4.3: Olga Petrov's 2011 Car Deduction Options

Actual Expenses		
Costs other than depreciation		$ 5,000
AFYD limit for cars		11,060
Total costs		$16,060
Business use percentage (15,000 ÷ 20,000)		× .75
Business deduction		$12,045
Standard Mileage Rate		
Miles before July	7,000	
SMR for January–June	51¢	
Standard mileage deduction		$ 3,570
Miles after June	8,000	
SMR for July–December	× 55.5¢	
Standard mileage deduction		4,440
Total standard mileage deduction		$ 8,010

If Olga deducts the $12,045 of actual expenses for 2011, she cannot use the SMR for later years. As shown in Figure 4.4, Olga's actual cost deduction in 2012 will be $7,425 and her 2012 standard mileage deduction will be $8,325, assuming the same costs and usage as in 2011 and a 55.5¢ SMR for 2012.

Figure 4.4: Olga Petrov's 2012 Car Deduction Options

Actual Expenses	
Costs other than depreciation	$ 5,000
AFYD limit for cars	4,900
Total costs	$ 9,900
Business use percentage (15,000 ÷ 20,000)	× .75
Business deduction	$ 7,425
Standard Mileage Rate	
Business miles	15,000
SMR (assumed)	× 55.5¢
Standard mileage deduction	$ 8,325

Before choosing a method for deducting vehicle expense, you should consider the discounted value of the deductions you can claim over the life of the car under each method.

Example 4.7 Comparison over the Life of Vehicle

Olga, from Example 4.6, plans to keep the Cadillac she purchased in 2011 for 5 years. To compare the discounted value of the tax deductions over that period, assume that her costs, business use, personal use, and the SMR are the same in 2012 through 2015 as they were in 2011. Also assume that her marginal tax rate is 35% and that the appropriate discount rate is 5%. The present value of the tax savings from deducting actual costs is $11,541, and the present value from deducting the SMR is $13,073. Therefore, based on the assumptions used to make these calculations, Olga should choose the SMR in 2011 rather than deducting her actual costs.

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Relief from Recordkeeping

A special rule for farmers allows them to deduct 75% of the cost of operating a vehicle without business mileage records if the vehicle is used during most of the normal business day directly in connection with the business of farming. Farmers must choose this method of substantiating expenses for a vehicle in the first year it is placed in service. If this method is chosen, the farmer cannot use another substantiation method for that vehicle in late years.

Lease vs. Purchase of Equipment

Leasing is an alternative method of financing the acquisition of equipment. Instead of paying principal and interest on a loan to purchase the equipment, farmers can make lease payments for the right to use the equipment for a stated term. Both tax and nontax factors affect the decision to lease or buy. The nontax issue is whether the total cost of the lease payments is greater or less than the total cost of ownership, including interest on the loan and the decrease in value of the equipment. The tax issue is whether deductions for lease payments or deductions for interest and depreciation provide a greater tax advantage. Leasing may provide a tax advantage by increasing tax deductions in the early years of the lease.

The tax issue is further complicated by rules that may treat a lease as a disguised installment purchase for income tax purposes. These rules kick in if the terms of a contract look more like an installment purchase arrangement than a lease. If the lease contract is treated as a disguised sale, the farmer cannot deduct the required payments as rent. Instead, the payments are treated as payments on a loan. The farmer can deduct the deemed interest portion of the payments and depreciate the deemed purchase price.

After-Tax Comparison of Leasing and Purchasing

Example 4.8 Lease vs. Purchase of Tractor

Mary Farmer is considering acquiring a tractor for $100,000. She can purchase the tractor for a $30,000 down payment and a $70,000 loan amortized over 5 years at a 7% rate of interest, taking a tax deduction for the interest paid on the loan and for depreciation. Alternatively, Mary can lease the tractor for 5 years by paying $19,353 at the time of signing and making four additional $19,353 lease payments, taking a tax deduction for each lease payment. If Mary wishes, she can acquire the tractor at the end of the 5-year lease for $20,000 and depreciate that $20,000 cost using MACRS depreciation over a 7-year recovery period.

The remainder of this example analyzes Mary's after-tax cost of a purchase or a lease. In both situations, Mary's total tax rate is 31.07%, including a 3% state income tax, 15% federal income tax, and net 13.07% self-employment tax (considering the income tax savings from deducting half of the self-employment tax, which is explained in Chapter 6 of this guide). This tax rate is assumed to be constant over the 10-year period of analysis. In both cases, it is also assumed that the tractor is sold at the end of the 10-year period for $15,000. Mary's after-tax discount rate for both the lease and purchase is 8%.

Purchase of Tractor

Figure 4.5 shows the calculation of the present value of the after-tax cost of purchasing the $100,000 tractor. The second column shows Mary's $30,000 down payment when she purchased the tractor (year 0) and her $17,072 loan payments in years 1 through 5. Mary deducts the interest portion of the loan payments listed in column 3 and the allowable depreciation listed in column 4. The adjustments for taxes (tax savings) presented in column 5 are computed using Mary's 31.07% tax rate. The sale of the fully depreciated tractor in year 10 for $15,000 results in depreciation recapture that is taxed as ordinary income but is not subject to self-employment tax, and it yields $12,300 of after-tax income. Finally, the net after-tax inflows (positive numbers) and outflows (negative numbers) from column 6 are discounted in column 8 using Mary's after-tax discount rate of 8% (column 7) and summed over the 10-year

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planning period. **The after-tax net present value of the cost of acquiring the $100,000 tractor by purchase is $65,556.**

FIGURE 4.5: PURCHASE OF $100,000 TRACTOR
5-Year Fully Amortized Loan with 30% Down and 7% Interest; Sale in Year 10 for $15,000

Year (1)	Payments (2)	Interest Expense (3)	150% DB Depreciation (4)	Adjustment for Taxes (5)	Net After-Tax Cash Flow (6)	After-Tax Discount Factor (7)	Present Value Net Cash Flow (8)
0	– 30,000				– 30,000	1.0000	– 30,000
1	– 17,072	4,900	10,714	4,851	– 12,221	0.9259	– 11,316
2	– 17,072	4,048	19,133	7,202	– 9,870	0.8573	– 8,462
3	– 17,072	3,136	15,033	5,645	– 11,427	0.7938	– 9,071
4	– 17,072	2,161	12,249	4,477	– 12,595	0.7350	– 9,258
5	– 17,072	1,117	12,249	4,153	– 12,919	0.6806	– 8,793
6			12,249	3,806	3,806	0.6302	2,398
7			12,249	3,806	3,806	0.5835	2,221
8			6,124	1,903	1,903	0.5403	1,028
9						0.5002	
10					12,300*	0.4632	5,697
			100,000				– 65,556

*After-tax proceeds from sale of tractor $15,000 – ($15,000 x 0.18) = $12,300

Lease of Tractor

Figure 4.6 presents similar information for leasing the $100,000 tractor. Mary made the initial $19,353 lease payment at the time of signing (year 0) and four more $19,353 tax-deductible payments at the end of years 1 through 4. She purchased the tractor at the end of year 5 and depreciated the $20,000 purchase price using 7-year MACRS. As in the outright purchase alternative, she sold the tractor for $15,000 in year 10. This results in an $8,281 net after-tax gain that is reported as ordinary income not subject to self-employment tax because of the I.R.C. § 1245 recapture rule. **The after-tax net present value of the cost of acquiring the tractor by lease is $64,583.** In this example, Mary would save $973 by leasing rather than making an outright initial purchase of the tractor.

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FIGURE 4.6: LEASE OF $100,000 TRACTOR
Purchase for $20,000 in Year 5 and Sale for $15,000 in Year 10

Year (1)	Lease Payment (2)	Purchase/Sale (3)	150% DB Depreciation (4)	Adjustment for Taxes (5)	Net After-Tax Cash Flow (6)	After-Tax Discount Factor (7)	Present Value Net Cash Flow (8)
0	– 19,353			6,013	– 13,340	1.000	– 13,340
1	– 19,353			6,013	– 13,340	0.9259	– 12,352
2	– 19,353			6,013	– 13,340	0.8573	– 11,436
3	– 19,353			6,013	– 13,340	0.7938	– 10,589
4	– 19,353			6,013	– 13,346	0.7350	– 9,805
5		– 20,000	2,142	666	– 19,334	0.6806	– 13,159
6			3,826	1,189	1,189	0.6302	749
7			3,006	934	934	0.5835	545
8			2,450	761	761	0.5403	411
9			2,450	761	761	0.5002	381
10		8,281*	1,225	381	8,662	0.4632	4,012
			15,099		I		– 64,583-

*After-tax value of sale for $15,000 in year 10
$20,000 purchase price - $15,099 depreciation = $4,901 adjusted basis
$15,000 sales price - $4,901 = $10,099 depreciation recapture
$10,099 x (1 - 0.18) = $8,281 net after-tax sale proceeds

Planning Pointer

Rapid Cost-Recovery Rules

In 2011 and 2012, leasing may not provide a tax advantage because the additional first-year depreciation and I.R.C. § 179 expensing rules in effect for both years will allow farmers to deduct most or all of the cost of equipment they purchase and place in service in those years.

Disguised Sale Rules

Most short-term leases of equipment are not disguised sales because the farmer does not have the right to buy the equipment at the end of the lease. The lease payments can be deducted because they are ordinary and necessary business expense as discussed earlier in this chapter.

Example 4.9 Short-term Lease

Dusty Trail operates a cattle ranch and rents a hay baler on a per bale basis. At the end of the haying season, Dusty returns the hay baler to the rental company and pays his rental costs. Rusty can deduct the rent payment on his income tax return.

A multiyear lease of equipment is more likely to be treated as a disguised sale than a short-term rental arrangement. IRS Publication 225, *Farmer's Tax Guide (for 2010 returns),* lists the following factors as indications that the arrangement is a conditional sales contract:

- The agreement applies part of each payment toward an equity interest you will receive.
- You get title to the property after you make a stated amount of required payments.

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- The amount you must pay to use the property for a short time is a large part of the amount you would pay to get title to the property.
- You pay much more than the current fair rental value of the property.
- You have an option to buy the property at a nominal price compared to the value of the property when you may exercise the option. (This value is determined when you make the agreement.)
- You have an option to buy the property at a nominal price compared to the total amount you have to pay under the agreement.
- The agreement designates part of the payments as interest, or part of the payments can be easily recognized as interest.

Planning Pointer

Aggressive Leasing Arrangements

An aggressive leasing arrangement that requires large lease payments in the earlier years so that the farmer can accelerate the income tax deductions is more likely to be treated as a conditional sale. This is true because the lease payment is both more likely to exceed the current fair rental value and more likely to be a large part of the amount you would pay to get title to the property.

Example 4.10 Conditional Sales Contract

Bird O'Paradise leased a walk-in cooler to store freshly harvested flowers for her cut-flower farm business. The agreement requires Bird to pay $11,500 annually for 2 years—$10,000 as a lease payment and $1,500 as a capital charge (interest). At the end of the 2 years, the agreement allows Bird to purchase the cooler for $500.

For tax purposes, the agreement is a sale and not a lease. Bird cannot deduct the $11,500 annual payments as rent. She can deduct $1,500 each year as interest and begin depreciating the $20,000 cost of the cooler. If she pays the additional $500 at the end of the lease, it adds to her basis for depreciation.

Travel Expenses

Ordinary and necessary business expenses include the costs of traveling for business. However, if the travel is for both personal and business purposes, only the cost of the business portion of the trip is deductible. To maximize the tax benefits of travel deductions, keep the following rules in mind when planning a business trip that includes some personal objectives.

Meals and Lodging

Meal and lodging costs must be allocated between the business and personal portions of a trip when it includes days that are spent primarily on personal activities.

Example 4.11 Allocation of Meal and Lodging Expenses

Paige Turner left home Wednesday afternoon for a business meeting in San Antonio. The business meeting ended Saturday morning, so that Paige could have returned home before her evening meal on Saturday. Instead, she stayed over Saturday night to do some sightseeing and returned home on Sunday.

Paige can deduct her lodging costs for Wednesday through Friday nights and her meals through Saturday noon. She cannot deduct the cost of her lodging Saturday night or the meals after her noon meal on Saturday.

Two rules may further limit the deduction for meal expenses incurred while traveling.

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1. Only 50% of the cost of the meal can be deducted.
2. A travel meal expense is not deductible unless the traveler must stop for substantial sleep or rest to properly perform his or her business duties.

✔ **Note**

Business-Related Entertainment

If a meal is business-related entertainment (such as taking a client or customer to dinner), the cost of the meal is deductible, subject to the 50% limit, even though there is no need for substantial sleep or rest.

Example 4.12 Sleep Not Required

Redd Angus attended a breeding cattle sale in a neighboring county. He left after breakfast, bought his noon meal at the sale, and returned home in time for his evening meal. Redd can deduct his transportation expenses because the purpose of the trip was business. He cannot deduct the cost of his noon meal because the trip did not require substantial sleep or rest.

Transportation

The cost of transportation for travel within the United States is subject to an all-or-nothing rule. If the primary purpose of your trip is business, you can deduct all of your transportation expense. If the primary purpose of your trip is personal, you cannot deduct any of your transportation expense.

Example 4.13 Transportation Costs

Paige Turner, from Example 4.11, returned from San Antonio on Sunday after her business meeting ended on Saturday. Because she spent 3 days at her business meeting and 1 day sightseeing, she can deduct all of her transportation expense.

Companion's Expenses

The travel expenses of a companion who joins you on a business trip are deductible only if there is a business purpose for your companion's travel. If there is no business purpose for your companion's travel, the extra costs for your companion's travel are personal expenses that cannot be deducted. This includes your companion's meal expenses and bus, train, or air fare. If there is a difference in lodging rates for more than one person staying in a room, the deductible lodging expense is the single rate. Rental car expenses incurred with a companion are fully deductible if there is no difference in the rental rate for one or two persons in the car.

Summary

Combining personal travel with business trips may allow you to deduct part of those costs as a business expense.

Soil and Water Conservation Expenses

Taxpayers engaged in the business of farming may elect to deduct the cost of certain improvements to land that otherwise must be added to the land's basis. This election is a significant tax advantage because land cannot be depreciated and costs that are added to the basis of land provide a tax benefit only when the land is transferred in a taxable transaction. At that time, the basis reduces the gain or increases the loss from the transfer. In most cases, gain from the transfer of land is treated as capital gain rather than as ordinary income.

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The election to deduct the cost of qualifying improvements not only allows farmers to obtain a tax benefit in the year of the improvements are purchased, rather than in the year the land is sold, but it also allows the expenses to reduce ordinary income and self-employment income rather than income that is taxed at the lower rate for capital gains.

Cross Reference

Chapter 5 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* explains the special rules for deducting soil and water conservation expenses.

To be deductible, the conservation expenses must be consistent with a plan approved by the Natural Resources Conservation Service or a soil conservation plan approved by a comparable state entity. The land must be land that the landowner or the landowner's tenant is using for farming or has used in the past for farming. **Expenditures on land that has not been used in farming are not deductible under I.R.C. § 175.**

Eligible Expenses

Deductible conservation expenses include (but are not limited to) the following items:

1. Treatment or movement of earth, such as leveling, conditioning, grading, terracing, contour furrowing, or restoration of soil fertility
2. Construction, control, and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, watercourses, outlets, and ponds
3. Eradication of brush
4. Planting of windbreaks
5. Expenses such as cleaning ditches and periodic brush removal

Expenses for improvements that can be depreciated cannot be claimed as a deduction under this special rule.

Eligible Taxpayers

Taxpayers must be engaged in the business of farming to elect to deduct soil and water conservation expenses. Taxpayers are engaged in the business of farming if they cultivate, operate, or manage a farm for gain or profit, either as an owner or as a tenant.

- A person engaged only in forestry or the growing of timber is not engaged in the business of farming.
- Landowners who rent their land and receive farm rental payments based on farm production, either in shares or in cash, are in the business of farming for this purpose.
- Landowners who receive a fixed cash rent are in the business of farming only if they materially participate in the farming business.

Cross Reference

See the discussion of material participation for landlords on page 74 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* for a definition of *material participation*.

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Planning Pointer

Shift to a Share Lease

A cash-rent landowner could shift to a share lease for a year in which conservation expenditures will be incurred. This makes the landowner a farmer for the election to deduct soil and water conservation expenses, without regard to material participation.

Gross Farm Income Limit

The deduction for soil and water conservation expenses is limited to 25% of the taxpayer's gross income from farming. Qualifying expenses in excess of this limit can be carried forward to future tax years and deducted to the extent of 25% of gross farming income for each year. If the taxpayer ceases to farm before the carryforward is used up, the excess can never be deducted and it cannot be added to the basis of the land.

The election to deduct soil and water conservation expenses applies to all tax years after the year you make the election unless you receive permission from the IRS to change your election. When the affected land is sold, any unused carryforward cannot be added to its basis. However, if the taxpayer continues in a farming business after selling the land, the carryover can still be deducted to the extent of 25% of gross farm income.

To avoid losing the tax benefits from deducting soil and water conservation expenses, you should plan to use them up before you quit farming. As you near the end of your farming career, you may want to seek permission from the IRS to change your election so that you can add newly incurred soil and water conservation costs to the basis of your land rather than increase a carryover that you cannot deduct because of the gross farm income limit.

An alternative for a farmer who plans to retire is to postpone planned soil and water conservation improvements until after the farmer quits farming. If you then lease the land on a cash lease without material participation, you will not be eligible to deduct new soil and water conservation expenses and must add them to the basis of your land.

Recapture

If you deduct soil and water conservation expenses and later sell the affected land, you may have to treat part of the gain realized on the sale as ordinary income rather than as capital gain. If you held the land for 5 years or less, all of the gain is treated as ordinary income up to the amount previously deducted for soil and water conservation expenses. If you held the land for more than 5 years but less than 10 years, the ordinary income recapture amount is reduced by 20% for each year you held the land beyond 5 years.

In most cases, the tax benefit of the soil and water conservation expense deduction exceeds the tax cost of the recapture because the deduction reduces both ordinary income and self-employment income and the recapture adds only to ordinary income. The deduction also reduces tax liability in an earlier tax year than the recapture adds to tax liability. However, if the deduction falls in a year with little or no farm income, and the recapture falls in a year of high income, the tax cost of the recapture may exceed the tax benefit of the deduction.

Fertilizer and Lime

Because fertilizer and lime often benefit the land for longer than a year, their cost must generally be capitalized and deducted over the period their benefits last. However, farmers can elect to deduct expenses for fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming in the year the expenses are paid. This includes both the cost of the materials and the cost of applying them to the land

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Cross Reference

See the discussion of fertilizer and lime on page 21 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* for further information about deducting or capitalizing the cost of fertilizer and lime.

Most farmers elect to deduct these expenses in full in the year they are paid. However, you may want to spread the deduction over the years the fertilizer, lime, or other materials benefit the soil if you expect to be in a higher tax bracket in those later years.

Depreciation and I.R.C. § 179 Expensing

The cost of assets (such as buildings, equipment, and breeding livestock) that farmers use to produce income generally cannot be deducted as an expense in the year the asset is purchased. Instead, the cost is deducted over the useful life of the asset. The cost-recovery rules give taxpayers several options for deducting the basis of assets. Assets used in a farming business are eligible for one or more of the following cost-recovery methods:

1. I.R.C. § 179 expensing allows taxpayers to elect to deduct part or all of the cost of qualifying assets in the year the assets are placed in service. The deduction is limited to the taxpayer's income from all businesses and is also limited to a set dollar amount that varies by tax year. Under current law, the dollar limit is $500,000 for tax years beginning in 2011, $125,000 for tax years beginning in 2012, and $25,000 for tax years beginning after 2012.
2. The additional first-year depreciation (AFYD) rules allow taxpayers to deduct on their 2011 income tax returns 100% of the cost of qualifying assets that they purchase in 2011. In 2012, taxpayers can deduct 50% of the cost of qualifying assets purchased in 2012. Under current law, there is no AFYD provision for most assets purchased after 2012.
3. The depreciation rules establish a recovery period for each type of asset. For example, the recovery period for breeding hogs is 3 years; for cars and trucks, it is 5 years; for farm machinery and equipment, it is 7 years; and for farm buildings, it is 20 years. Farmers can choose a longer recovery period and a slower method of depreciation for assets if they want to save more of the total depreciation deduction for later years.

Cross Reference

See Chapter 7 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* for further information about the cost-recovery rules.

The cost-recovery rules result in a dizzying array of options for deducting the cost of the assets you buy to use in your farming business. Because some of your assets qualify for only some of the options, you must carefully choose the cost-recovery method you use for each asset. Managing your cost-recovery options to minimize your income tax liability is discussed in Chapter 5 of this guide.

Domestic Production Activities Deduction (DPAD)

In 2004, Congress added the domestic production activities deduction (DPAD) to the Internal Revenue Code. The DPAD allows taxpayers to reduce their taxable income by up to 9% of their net income from most production activities in the United States, including production of commodities in a farming business. (Under a phase-in provision, the deduction rate was 3% in 2005 and 2006 and 6% in 2007, 2008, and 2009.)

For 2010 and later years, the DPAD is limited to the least of three amounts:

1. 9% of the net income from qualifying production,
2. 9% of modified adjusted gross income (9% of taxable income for a business entity), or

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3. 50% of the qualifying wages paid by the taxpayer for qualifying production during the year.

Cross Reference
See page 24 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* for further information on the DPAD.

50% of Wages Paid Limit

The DPAD limit of 50% of qualifying wages paid reduces your DPAD to zero if you have no paid labor, and it severely limits the DPAD if you have very little paid labor. Therefore, you may save taxes by paying wages to family members who are working on the farm.

Example 4.14 Wages for Spouse

Carlos and Virginia Little Otter operate a farming business as Carlos's sole proprietorship. Before 2011, they reported all of the farm income as Carlos's self-employment on Carlos's Schedule F (Form 1040), Profit or Loss From Farming. Virginia was not paid a wage, so Carlos had no deduction for wages paid. Because Carlos had no qualifying wages, his DPAD was limited to 50% of zero, even though his net income from production and his modified adjusted gross income both exceed $40,000.

Beginning in 2011, Carlos decided to pay Virginia $15,000 per year (a reasonable wage for her work in the farming business). The wages are subject to FICA tax, which increases their taxes by $1,682 but the wages reduce Carlos's self-employment tax which saves $1,704. Paying the wages also allows Carlos to claim a $7,500 DPAD, decreasing their tax by $1,125. Therefore, the net savings from paying wages to Virginia is $1,147.

Wages that are not subject to withholding are not qualifying wages for the DPAD limit. Consequently, the following farm wages are not included:

1. Wages paid in commodities
2. Wages paid for agricultural labor to a child under age 18
3. Compensation paid in nontaxable fringe benefits

Further, only wages that are paid for qualifying production count as part of the limit. For example, wages paid for custom-hire work do not count because custom hire is not a production activity that qualifies for the DPAD.

Example 4.15 Non-Qualifying Wages

If Carlos from Example 4.14 avoids FICA taxes by paying Virginia in commodities, her commodity wages will not qualify as wages for the DPAD limit. Similarly, if Carlos pays cash wages to their children under age 18 for their work in the farming business, the wages will not be qualifying wages for the DPAD limit.

Members of Cooperatives

Members of cooperatives can claim their share of the cooperative's DPAD if the cooperative elects to pass the DPAD through to its patrons. Marketing commodities through a cooperative that passes its DPAD through to its members results in a greater DPAD deduction for most farmers for one or both of two reasons:

1. The member's share of the cooperative's DPAD is often greater than the DPAD the member could claim if he or she sold the commodity to a buyer that is not a cooperative.

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2. The member's DPAD is not limited by his or her modified adjusted gross income or qualifying wages.

Example 4.16 DPAD from a Cooperative

In 2011, Maggie O'Malley sold $120,000 of corn to the local elevator (which is not a cooperative). Her total cost of producing the corn was $90,000, including $6,000 of wages. Her 2011 modified adjusted gross income was $40,000.

Maggie's DPAD is $2,700, which is the least of

1. $2,700 (9% of her $30,000 profit on the corn),
2. $3,600 (9% of her $40,000 modified adjusted gross income), or
3. $3,000 (50% of her $6,000 of qualifying wages).

If Maggie marketed her corn through a cooperative that elected to pass its DPAD through to its members and incurred expenses equal to 5% of its gross grain sales, Maggie's share of the cooperative's DPAD would be $10,260. Because Maggie's DPAD is not limited by her own table income qualifying wages, she can claim the entire $10,260 DPAD on her income tax return.

Hobby Farms

Taxpayers who engage in an activity (such as raising horses) without an intent to make a profit can deduct the expenses of the activity only to the extent of income from the activity. Furthermore, the expenses can be deducted only as an itemized deduction that is subject to a 2% of adjusted gross income reduction, which means many taxpayers do not get the full benefit of the deduction.

The purpose of this *hobby loss* rule is to prevent taxpayers from deducting the cost of their personal activities from their taxable income from other sources.

Cross Reference

See pages 6 and 27 of IRS Publication 225, *Farmer's Tax Guide (for 2010),* for further information about the not-for-profit activity rules.

Presumption of Profit Motive

An activity is presumed to be *engaged in for profit* if it produces a profit (gross income exceeding deductions) in 3 of 5 consecutive tax years. Horse breeding, training, showing, or racing activities meet the presumption if they show a profit in 2 of 7 consecutive tax years. If the taxpayer meets the threshold for the presumption, the IRS has the burden of proving the lack of a profit motive.

Factors in Determining Profit Motive

If a taxpayer does not meet the 3- of 5-year (or 2- of 7-year) profit test, the burden of showing that a profit motive exists is borne by the taxpayer. The following nine factors help determine whether a taxpayer is engaged in an activity for profit:

1. The manner in which the taxpayer carries on the activity
2. The expertise of the taxpayer or the taxpayer's advisers
3. The time and effort expended by the taxpayer in carrying on the activity
4. The expectation that assets used in the activity will appreciate in value
5. The taxpayer's success in carrying on other similar (or dissimilar) activities

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6. The taxpayer’s history of income or losses with respect to the activity
7. The amount of occasional profits that are earned
8. The taxpayer’s financial status
9. The elements of personal pleasure or recreation

Other facts and circumstance may also be considered, and no one factor is conclusive of a profit objective. A simple comparison of the number of factors indicating a profit motive with the number of factors indicating there is not a profit motive is **not** decisive.

Satisfying the For-Profit Requirement

The IRS does not impose the not-for-profit limit on farmers whose only source of income is their farming business, because it is clear that the farmer is engaged in the farming activity with a profit motive.

Example 4.17 Full-time Farmer

Juan de Herrera began raising pistachios in 2011. Juan works 60 hours a week in his farming business and has no other income. His bank gave him a line a credit that allows him to pay his business and personal living expenses until his pistachio orchard is productive enough to make a profit.

The IRS will not limit Juan’s expense deduction to his pistachio income even if he does not make a profit in 3 of 5 years because he is not raising pistachios for personal pleasure or recreation. Therefore, Juan does not need to postpone deductions or accelerate income in an attempt to show a profit in 3 of 5 years.

If you have substantial off-farm income and do not work full time in your farming activity, you may want to avoid more than 2 consecutive years (5 consecutive years for the specified horse activities) of losses so that you satisfy the 3- of 5-year (or 2- of 7-year) profit test each year and thus shift the burden of proving the lack of a profit motive to the IRS.

Postponing the For-Profit Test

You can postpone IRS’s application of the for-profit test by filing Form 5213, Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit.

Filing this form prevents the IRS from imposing the not-for-profit limit on your deductions until the close of the sixth tax year after you start a horse activity and the close of the fourth tax year after you start any other activity. However, filing the form also keeps all of those tax years open so that the IRS can limit your deductions for those years if it finds that you did not have a profit motive.

If you do not file Form 5213, the IRS generally has only 3 years after you file a return to challenge your deductions on that return. Therefore, you should not file Form 5213 unless the IRS applies the not-for-profit limit to your deductions. If the IRS applies the limit, you can then file Form 5213 to postpone the application until the fifth year (seventh year for horse activities) of the activity.

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CHAPTER 5

MANAGING THE TIMING OF INCOME AND DEDUCTIONS

SYNPOSIS (click on section title to go directly there)

Introduction

Tax management is essential in ensuring that a farm operator pays no more than the legally required amount of tax. Several factors produce the opportunity or necessity for tax planning. Farm businesses are subject to all of the general economic market factors that affect non-farm businesses. In addition, farm businesses also see wide fluctuations in income due to weather, disease, and other natural phenomena. Because marginal tax rates increase as income increases, the additional tax paid in a high income year may not be offset by the taxes saved in a low income year. Fortunately, most farm businesses calculate their income on a cash basis of accounting, which allows great flexibility in managing the ups and downs of farm income. A primary goal of tax management is to avoid wide fluctuations in annual income in order to avoid swings in marginal tax rates.

Marginal Federal Income Tax Rate

A taxpayer's *marginal federal income tax rate* is the rate that applies to the taxpayer's last dollar of taxable income. Each year the IRS publishes rate schedules for each filing status, adjusting the taxable income brackets for inflation. Figure 5.1 shows the 2011 tax rate brackets for a married taxpayer filing a joint return.

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FIGURE 5.1 2011 Federal Income Tax Rates Joint Returns

Married filing jointly or Qualifying widow(er)			
If taxable income is over	but not over	the tax is	of the amount over
$0	$17,000	10%	$0
17,000	69,000	$1,700.00 + 15%	17,000
69,000	139,350	9,500.00 + 25%	69,000
139,350	212,300	27,087.50 + 28%	139,350
212,300	379,150	47,513.50 + 33%	212,300
379,150	-----------	102,574.00 + 35%	379,150

Example 5.1 — Marginal Federal Income Tax Rate

Bob is a married farmer who has $44,238 of taxable income in 2011. Applying the 2011 tax rate schedule in Figure 5.1, the first $17,000 of income is taxed at a 10% rate. The remaining $27,238 ($44,238 – $17,000) is taxed at a 15% rate. Bob's marginal federal income tax rate is 15%.

Because the federal income tax rate brackets are indexed for inflation, a taxpayer with the same amount of income this year as last year might find more of that income being taxed at the lower rates this year.

Effective Marginal Tax Rate

The marginal federal income tax rate is not the only consideration in tax planning. You should also consider the *effective marginal tax rate* that results from applying all of the tax rules. This concept looks at the total increase in tax as a percentage of increased income, taking into consideration the numerous tax benefits that are phased out as income increases (for example, the child tax credits, the education credits, and the deduction for student loan interest).

Furthermore, the effective marginal tax rate includes the impact of self-employment (SE) tax, alternative minimum tax (AMT), and state and local income taxes. SE tax is a significant component of a farmer's total tax liability. It is comprised of two components, a 12.4% tax for social security (retirement, survivor, and disability) benefits and a 2.9% tax for Medicare benefits, for a total 15.3% rate. The 12.4% social security tax rate is reduced to 10.4% for SE income earned in the tax year beginning in 2011. For tax years beginning in 2012 and thereafter, the rate is scheduled to go back to 12.4%.

Taxpayers can deduct one-half of the SE tax (calculated without regard to the 2011 rate reduction), which reduces the effective tax rate for SE tax to 13.07% (11.36% for tax years beginning in 2011), for taxpayers in the 15% federal income tax bracket with no state or local income tax.

Example 5.2 Marginal Federal Income and SE Tax Rate

Consider Bob from Example 5.1. Each additional dollar of farm income will cost him 11.36¢ in net SE tax because he is allowed to deduct one-half of the unreduced SE tax from his taxable income before computing his income tax liability. Bob's effective combined marginal federal income and SE tax rate is 26.36% (15% income tax plus 11.36% net SE tax).

The *net earnings from self-employment* that are subject to the social security component of the SE tax are capped at $106,800 for 2011 (a limit that is adjusted for inflation each year.) Because self-employment income is reduced by 7.65% (half of the unreduced total SE tax rate) when computing the SE tax, net earnings from self-employment are calculated at 92.35% (100% – 7.65%) of SE income. Therefore, in 2011, taxpayers are subject to the 10.4% social security component of the SE tax on a maximum of $115,647 ($106,800 ÷ 0.9235) of SE profits.

Because the $106,800 cap applies only to the social security component of the SE tax, the marginal SE tax rate decreases to 2.9% (the Medicare tax rate) on net earnings from self-employment above this cap.

Example 5.3 Reduction of SE Tax Rate

Guadalupe is a married farmer who has $115,647 of net farm income in 2011. Her SE tax is computed as shown in Figure 5.2.

FIGURE 5.2 Guadalupe's SE Tax on $115,647 of Net Farm Income

Net farm income	$115,647
Deduction (7.65% × $115,647)	– 8,847
Net earnings from self-employment	$106,800
SE tax rate for 2011 (10.4% + 2.9%)	× 13.3%
Guadalupe's SE tax for 2011	$ 14,204

If Guadalupe's net farm income increases by $100, her net earnings from self-employment increase by $92.35 and her SE tax rate on the additional $92.35 is 2.9%. Therefore, the $100 increase in net earnings from farming increases her SE tax by only $2.68 (2.9% × $92.35).

✔ **Observation**

No Itemized or Personal Exemption Deductions for SE Tax

Farmers often pay more SE tax than federal income tax because neither itemized deductions (or the standard deduction) nor personal exemption deductions are allowed when computing SE tax. For example, a married farmer with two children whose only income is a $50,000 net profit from farming will pay a $6,141 ($50,000 × 0.9235 × 13.3%) SE tax in 2011. For federal income tax purposes, the farmer's taxable income is reduced to $20,529 after subtracting an $11,600 standard deduction, a $14,800 (4 × $3,700) personal and dependent exemptions deduction, and the $3,071 deduction for 50% of the SE tax, and the farmer will pay only $2,229 of federal income tax (before any available credits).

An important point concerning marginal tax brackets is that a taxpayer does not get a dollar for dollar tax benefit for each dollar of deductions. Bob, in Example 5.2, reduces his federal tax by26.36¢ for each $1 of tax deduction. If Bob spends $1 to acquire that tax deduction, he will save 26.36¢ in tax. However, his out-of-pocket cost is 73.64¢ (the $1 spent minus the 26.36¢ saved in taxes).

Because a taxpayer incurs a personal out-of-pocket cost for a portion of each dollar spent, it is unwise to spend money just to get tax deductions. The taxpayer must gain something of value, in addition to tax savings, to justify additional expenses. This may seem obvious, but there are many taxpayers who want to spend money just to avoid tax.

It is also important to recognize that marginal tax brackets are just that—marginal. The marginal tax bracket applies only to each incremental dollar of income.

Example 5.4 Application of Marginal Tax Rate

If Bob (in Example 5.1) increases his taxable income above $69,000, he will move into a 25% marginal federal income tax bracket (see Figure 5.1). Therefore, if Bob's income rises from $69,000 to $69,001, the federal income tax is 25¢ of that last dollar, **but only of the last dollar**. Moving into a 25% marginal bracket does not mean that the government will take 25¢ of **every** dollar. All of the income up to $69,000 is still taxed in the lower brackets.

Observation

Tax Rates Change

It is important to remember that tax rates have changed over the years and could change again at any time. It is important to factor these changes into t farm management decisions.

Tax-planning strategies for a cash basis taxpayer often involve delaying income or prepaying expenses to move income from a higher effective marginal tax rate to a lower one. A farmer may get a tax benefit by prepaying supplies, but even though the farmer can ultimately use the supplies, the additional cost of pre-purchasing must be recognized. This cost typically includes the time value of money—interest expense on money borrowed or lost interest income on money taken from savings to make the prepayments. Therefore, a taxpayer gains the most by prepaying expenses that will be used early in the next year. A taxpayer must consider whether his or her marginal bracket is high enough that the tax savings justify taking on a current cost that could have been delayed.

Deferring Income

Deferral is the concept that underlies most year-to-year tax planning. The goal is to delay reporting taxable income as long as possible, provided that the income will be taxed at the same or a lower marginal tax bracket when it is reported in a later year.

Cross-Reference

Constructive Receipt of Income

See page 5 of the 2010 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of when income has to be reported because it is available to you.

Deferring taxable income can be accomplished in one or both of two ways:

1. Delaying the receipt of income to a later year, or
2. Accelerating tax deductions to an earlier year.

A deduction taken this year is not available for a later year. Similarly, if income is not reported this year, it must be reported in a later year. **Therefore, deferral does not affect the total amount of income reported over a period of years.**

If deferral does not ultimately change the amount of taxable income reported, what does it accomplish? Potentially, it should accomplish two things. First, it can defer the payment of tax for a period of time, as Example 5.5 illustrates.

Example 5.5 Income Deferral

Jane has a choice of selling $10,000 of crops on December 31, 2011, or waiting until January 1, 2012.

Jane is in a 28% effective marginal tax bracket each year, so the tax on these sales will be $2,800 in either event. However, if Jane takes the $10,000 on December 31, 2010, she will pay that $2,800 on March 1, 2012. If she waits until January 1, 2012, she will not have to pay that $2,800 in tax (plus the SE tax on the additional income) until March 1, 2013—a full year later.

Jane should analyze this deferral by deciding whether the loss of the use of $10,000 for one day (December 31, 2011, to January 1, 2012) is more than made up by gaining the use of $2,800 (plus the SE tax) for one year (March 1, 2012, to March 1, 2013). Clearly, it would benefit Jane to defer the sale of her crops by one day if her investment return on the deferred tax exceeds the savings from the 2% SE tax rate reduction for 2011.

The second benefit that deferral can sometimes accomplish is taxing the deferred income at a lower marginal tax bracket when it is reported. If this happens, the taxpayer not only delays the payment of tax but pays less tax as well.

Example 5.6 Income Deferral and Tax Reduction

Suppose Jane (from Example 5.5) is in a 28% effective marginal bracket in 2011 and will be in a 25% effective marginal bracket in 2012. Pushing $10,000 of crop sales from 2011 to 2012 not only delays the payment of tax by one year, it also reduces Jane's tax on this $10,000 from $2,800 to $2,500. Jane would save $300 due to the lower 2012 tax rate.

There are two strong cautions to consider when deciding to use the deferral concept. The first is that marginal tax brackets can cut both ways. In the above example, Jane saved $300 due to the lower 2012 marginal tax rate. However, suppose Jane focuses only on delaying the tax and forgets that the marginal tax bracket could go up?

Example 5.7 Income Deferral and Tax Increase

Suppose Jane (from Example 5.5) pushed $10,000 of sales from 2011 to 2010, is in a 25% effective marginal bracket in 2011, and is in a 28% effective marginal bracket in 2012. Jane has delayed paying $2,500 of tax from March 1, 2012, to March 1, 2013. However, on March 1, 2013, she owes $2,800, not $2,500, which is $300 more. Unless Jane can earn $300 on $2,500 between March 1, 2012, and March 1, 2013 (a 12% rate of return), her tax planning was a mistake.

The second caution in using the deferral concept is that it may entail risks beyond taxes. For instance, delaying sales to defer income may subject the taxpayer to price fluctuations.

Example 5.8 Income Deferral and Loss of Income

Suppose Jane (from Example 5.5) delayed $10,000 of sales from 2011 to 2012. Further assume that Jane is in a 28% effective marginal bracket in 2011 and a 25% effective marginal bracket in 2012. However, suppose that after delaying her sale into 2012, Jane received only $7,000 instead of the $10,000 she would have received in 2011. Figure 5.3 shows a comparison of Jane’s after-tax positions.

FIGURE 5.3 After-Tax Effect of Delayed Sale

	2011 Sale	2012 Sale
Cash received	$10,000	$ 7,000
Tax paid	– 2,800	– 1,750
Net cash	$ 7,200	$ 5,250

Taxes were deferred, as well as reduced. However, Jane ended up with less after-tax income because of the lower sales price.

Installment Sale Reporting

If a sale qualifies for installment reporting, the gain is included in gross income in future years as payments are received from the buyer. Such a sale avoids the risk of price changes discussed earlier under deferring income, but it does not eliminate the risk that the buyer might default on payment. The seller eliminates market risk but takes on the risks of being the creditor.

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Cross-Reference

Installment Sale Tax Rules

See Chapter 10 of the 2010 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the installment sale reporting rules.

Installment reporting may be especially useful when a significant dollar amount of farm assets is being liquidated (including sales to family members) because it can spread the income over future years in which the seller's effective marginal tax rate may be lower.

All three of the following requirements must be met for a sale to qualify for installment reporting.

1. There is a gain on the sale. (Losses are reported in full in the year of sale.)
2. At least one payment is received in a tax year after the tax year of sale.
3. The gain is not ordinary income from depreciation recapture arising from the sale of depreciable property, such as purchased breeding livestock, equipment, and certain farm buildings.

Farm producers who report on a cash basis and who are not required to account for inventory on their tax returns can report the sale of crops and market livestock on the installment method. (Accrual-basis taxpayers and those required to account for inventory on their tax returns cannot report the sale of their products on the installment method, although they can use it for qualifying asset sales.)

If the installment sale contract does not include an interest charge, or if it includes an interest charge that is lower than a required rate, the IRS will treat part of the sales price as interest that is taxed as ordinary income. The minimum rate of interest that must be charged to avoid the adjustment is called the Applicable Federal Rate (AFR). The AFRs are published monthly by the IRS for short-term (not more than 3 years), mid-term (more than 3 years but not more than 9 years) and long-term (more than 9 years) contracts. There are two notable exceptions to the requirement that the AFR be charged:

1. The total sales price is $3,000 or less.
2. All payments under the contract are to be made within 1 year of the sale date.

In addition, no interest needs to be charged on any payment made within 6 months of the sale date, regardless of the total length of the contract.

✔**Note**

Related-Party Farmland Rate

A special rule allows sellers to charge the lesser of the AFR or a 6% rate compounded semi-annually for the sale of farm land (not buildings) between family members. This rule applies only to a total of $500,000 of land sales in any given tax year. (With the currently low AFRs, this provision is irrelevant but it has been useful with historically higher AFRs.)

Example 5.8 Installment Sale of Crops

Samantha expects to be in the 25% tax bracket this year due to an exceptionally good apple crop. She is normally in the 15% tax bracket. Sam is concerned that the market price may drop, so she is reluctant to defer income by keeping her crop in storage and selling it next year. She trusts the creditworthiness of the company that has been buying her apples for the last 12 years. Therefore, Sam entered into an installment sale with the buyer. She sold $50,000 of apples in November (based on the current market price at that time) and agreed to take payment the following January. Even though the AFR rules do not apply (because all contract payments will be made in less than 1 year), Sam convinced the buyer to pay 4.45% interest on the unpaid balance.

Sam reports the $50,000 of apple income next year as ordinary income from the sale of her crop when she receives the payment. She also reports the interest income that accrues through the date of payment.

The sale of farm land can be reported in much the same way. The computations are somewhat more complex because gain must be calculated by subtracting the taxpayer's cost basis and any expenses of sale from the sales price. This gain is then prorated and reported by the seller as payments are received.

Generally the terms of payment extend beyond 1 year, and an amortization schedule is required to determine the amount of principal and interest included in each payment received.

Example 5.9 Installment Sale of Land

Maurice sold land for $1,000,000. He had acquired the land 30 years ago for $200,000. He paid his real estate agent, attorney, appraiser, and surveyor $75,000 in closing costs. Maurice agreed to accept a $100,000 cash down payment plus $100,000 each year for 9 years, with interest of 6% on the unpaid balance. Maurice's gain on the sale is calculated as follows:

Sale price	$1,000,000
Less: basis	– 200,000
Less: expenses	– 75,000
Gain	$ 725,000

Maurice's gross profit percentage is 72.5% ($725,000 gain ÷ $1,000,000 sale price), so 72.5¢ of each dollar of principal received on the sale is taxable. In the year of sale Maurice must pay tax on $72,500 (72.5% × the $100,000 down payment). Taxation of the balance of the gain is deferred until Maurice receives each payment during the next 9 years.

Caution

Property Sold Subject to Debt

The property sold may be subject to debt that is assumed by the buyer. Such sales require complex calculations and may trigger unexpected tax results for the seller. Taxpayers should seek competent tax advice in such situations.

As stated previously, depreciation recapture from the sale of purchased breeding livestock, equipment, and certain buildings cannot be reported on the installment method. This may result in a surprise to the taxpayer who sells on a deferred-payment basis and expects to pay no tax until the cash is actually received.

Example 5.10 Sale of Equipment

Amiyah sold some equipment for $100,000. The equipment originally cost her $125,000 but she had deducted a total of $80,000 of depreciation by the time of the sale. Therefore, her adjusted basis in the equipment is $45,000 ($125,000 – $80,000). Amiyah incurred no expenses on the sale so her gain is calculated as:

Sale price	$100,000
Less: basis	– 45,000
Gain	$ 55,000

Amiyah agreed to allow the buyer pay $20,000 down and $20,000 annually for the next 4 years, plus interest of 6% on the unpaid balance. Amiyah's gain is 55% ($55,000 ÷ $100,000) of her sale price so she expects to pay tax in the year of sale on $11,000 (55% × $20,000 down payment). However, all of the gain arose from depreciation recapture, which results in the full $55,000 being taxable to Amiyah in the year of sale.

Accelerating Expenses

In addition to deferring income, taxpayers may reduce taxable income in the current year by accelerating expenses. Cash-basis taxpayers can accelerate the deduction of expenses by prepaying farm expenses for the coming year. Three rules must be met in order to deduct such prepaid expenses.

1. The expenditure must be a payment and not merely a deposit.
2. The payment must be made for a legitimate business purpose, such as securing a lower price.
3. The deduction must not materially distort income.

Taxpayers who are not farmers (and in some rare cases those who are farmers) can deduct prepaid expenses only to the extent that the expenses do not exceed 50% of the total of non-prepaid expenses.

Cross-Reference

Prepaid Expenses

See pages 19–22 of the 2010 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the prepaid expense rules.

The deduction of certain expenses cannot be accelerated even if they are prepaid. These generally include interest, rent, insurance, and real estate taxes. Taxpayers may pay and deduct the interest accrued on loans up to year end, but they cannot deduct advance payments of next year's interest until next year. Payments for rent and insurance cannot be currently deducted to the extent that the rental or insurance coverage period exceeds 12 months. If the payment provides a benefit for more than 12 months, the taxpayer must prorate the payment and deduct only the portion with current year benefit.

Example 5.11 Prepaid Rent

Guadalupe rented land from her neighbor for $12,000 under a 12-month lease agreement. The term of the lease runs from December 1 to November 30. When Guadalupe makes her $12,000 lease payment in November, she is able to deduct the full amount in the year of payment.

However, if Guadalupe's lease is for a 24-month term ($24,000) and Guadalupe paid the full lease amount at signing in November, her deduction in the year she made the payment is limited. Guadalupe can deduct only $1,000 ($24,000 ÷ 24 months) in the year she made the payment. She can deduct $12,000 in the next tax year and the remaining $11,000 in the year after that year. If she paid only $12,000 at signing, she could deduct the full $12,000 in the year she made the payment because the benefit of the payment does not exceed 12 months.

A common year-end tax-savings tactic for cash-basis taxpayers is to pay off open accounts because these taxpayers can claim expense deductions only when the amounts actually paid. Before making advance payments on other items, farmers should consider clearing their open accounts.

Another tactic to accelerate expenses is to move needed repairs and maintenance up to the current year. For instance, painting a barn or repairing machinery could be moved from the following spring to the current year.

Managing Depreciation Expense

Deductions can also be accelerated by maximizing the expense deductions available for depreciable property. (See Chapter 4 for more information about depreciation.) Taxpayers can manage the tax effect of depreciation by choosing the depreciation method and the timing of acquisitions. As noted in Chapter 4, taxpayers can deduct 100% additional first-year depreciation (AFYD) for the cost of new equipment, livestock, and buildings purchased and placed in service in 2011. For 2012 purchases, the AFYD deduction is 50% of the purchase price of eligible assets. In addition, there is the direct expense election under Internal Revenue Code Section 179 (referred to as § 179). Even for the cash-basis taxpayer, equipment is depreciable when it is placed in service. This can generate a deduction without paying any cash if equipment is purchased on a deferred payment plan.

The fundamental way to maximize deductions for depreciable property is to use accelerated depreciation, AFYD, and the § 179 deduction, if allowed, rather than slower depreciation methods.

The timing of acquisitions can also affect the amount of depreciation that is allowed. For example, taxpayers must use a mid-quarter convention rather than the half-year convention if the depreciable basis of property purchased in the last quarter of the tax year is more than 40% of the depreciable basis of all property purchased during the year. Many farmers want to move a planned purchase from the following year to the current year to gain depreciation deductions on the new item. However, accelerating the purchase may trigger the mid-quarter convention, which can result in not only little depreciation gained on the accelerated purchase, but also a reduced total of depreciation deductions for the year.

Example 5.12 Less Depreciation

Don's only equipment purchases were $40,000 in September. The equipment is 7-Year MACRS property, and Don is eligible to use rapid depreciation. With the half-year convention, Don could deduct $4,284 of depreciation.

In a tax-planning attempt, Don moved $27,000 of equipment purchases scheduled for next year up to December. This triggers the mid-quarter convention ($27,000 ÷ $67,000 = 40.3%). Don's total allowable depreciation on the entire $67,000 of equipment is reduced to $3,940. Don tax-planned himself into less depreciation by triggering the mid-quarter convention.

This example demonstrates that you must be very cautious in accelerating depreciable asset purchases as a tax-planning move. The mid-quarter convention is a wrinkle that must be considered.

As a corollary, however, if the original purchases were made early in the year, year-end purchases that trigger the mid-quarter convention may increase the allowable depreciation deduction.

Example 5.13 More Depreciation

Suppose Don (from Example 5.12) purchased $40,000 of equipment in March and $27,000 in December. The mid-quarter convention is triggered and his total depreciation on the purchases is $8,224. If the timing of his purchases had not triggered the mid-quarter convention, his allowable depreciation on the $67,000 under the half-year convention would be $7,176.

The AFYD deduction and the § 179 direct expense election were ignored in Examples 5.12 and 5.13, but they can be significant tax planning tools when available. There are some additional considerations regarding AFYD and § 179.

1. The full deduction is allowed even if property is purchased on the last day of the year.
2. To maximize the acceleration of deductions, § 179 should be taken on property in the class with the longest life. This will increase the deductions in the earlier years of the properties' useful lives.
3. A taxpayer may benefit from delaying purchases into later years to take greater advantage of § 179 each year.

Example 5.14 Maximizing § 179

Jazlyn purchased $600,000 of used equipment in October 2011 and made no purchases in 2012. In 2011, she expensed $500,000 under § 179 and depreciated the other $100,000 of her cost using rapid depreciation and the mid-quarter convention. She can deduct $503,750 of depreciation and § 179 expenses in 2011 and $28,880 of depreciation in 2012.

If Jazlyn delayed $100,000 of her purchases until 2012, she could claim a $500,000 § 179 deduction in 2011 and a $100,000 § 179 deduction in 2012. She could not claim any depreciation because her entire purchase price would be recovered through § 179 deductions.

Lease vs. Purchase of Equipment

Leasing is often considered to be a way of reducing taxable income because deductible lease payments can be greater than deductible depreciation and interest. However, taxpayers need to carefully analyze the after-tax cost of a lease versus purchase. If the total cost of leasing is greater than the total cost of owning, the tax savings have to exceed that difference to make leasing the better after-tax alternative.

If leasing is the better option, taxpayers must be sure the transaction will be treated as a true lease rather than as an installment purchase contract. Over the years, IRS rulings and court decisions have indicated that the following factors result in a transaction being treated as a purchase rather than a lease.

1. The agreement applies part of each payment toward an equity ownership interest.
2. The lessee receives title to the property upon payment of a stated amount under the contract, in contrast to an *option* to purchase at reasonable market value.
3. The amount the lessee pays for a short period of time is nearly the amount that would be paid to buy the property.
4. The lessee pays much more than the current fair rental value of the property.
5. The lessee can purchase the property at a nominal price compared to the value of the property at the time of purchase (for example, $1).
6. The lessee has the option to buy the property at a nominal price compared to the total amount the lessee has to pay under the lease.
7. The lease designates part of the payments as interest, or a part of the payments is easy to recognize as interest.
8. The lessee has an equity interest in the leased item during the lease period.

Trade-ins and Leasing

Trade-ins on leased items can create tax problems. If the lessee has an equity interest in the equipment as a result of the trade-in, the transaction does not qualify as a lease. To preserve lease treatment, the transaction must be structured as a sale of the old equipment. This is a taxable sale for which the gain is generally reportable on IRS Form 4797, Sale of Business Property, as ordinary income that is not subject to self-employment (SE) tax. This ordinary income can then be offset by deducting the lease payment on the new equipment.

Example 5.15 Trade-In Resulting in Installment Purchase

Brenda traded her old tractor for what she thought was a lease of a new tractor. However, the dealer applied the $25,000 trade-in value of the old tractor to the purchase price of the new tractor and figured the subsequent payments on the balance of the purchase price.

Because Brenda has an equity interest in the new tractor, she is treated as making an installment purchase of the new tractor. Her "lease" payments are treated as installment payments. She cannot deduct the payments as lease payments, but she can deduct the new tractor's cost through § 179 expensing and/or depreciation. She can also deduct the interest portion of her installment payments.

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✔ **Observation**

As discussed earlier in this chapter (see Example 5.11) prepaid lease payments can be deducted in full currently only if the benefit does not exceed 12 months. If a trade-in credit covers lease payments that extend beyond 12 months, only the portion attributed to months in the current tax year can be deducted currently.

Example 5.16 Trade-In Treated as a Sale

If Brenda from Example 5.15 sold her old tractor to the dealer for $25,000, she must report her gain from that sale on Form 4797 as ordinary income that is not subject to SE tax. If her adjusted basis in the old tractor after depreciation is zero, she has a $25,000 gain to report.

If the dealer applies the $25,000 sale price to true lease payments, the $25,000 can be deducted as a lease payment subject to the 12-month rule discussed earlier in this chapter. If the annual lease payments are $25,000 or more, Brenda can deduct the $25,000 credit as a lease expense in the year she entered into the lease. However, if the annual lease payment is less than $25,000, she can deduct currently only the portion of the credit that is prorated to the tax year of the transaction.

Depreciation vs. Lease Expense

If the transaction qualifies as a lease for tax purposes, the next step is to consider whether a lease payment deduction is more beneficial than a depreciation deduction. If the asset qualifies for the §179 deduction ($500,000 for 2011 and $125,000 for 2012), the taxpayer can get a bigger first-year deduction by purchasing rather than leasing the asset. (The details of qualifying property and other considerations are discussed in Chapter 4.) Leasing may provide a larger first-year deduction for assets that do not qualify for the § 179 deduction, such as general-purpose farm buildings.

Furthermore, leasing may also be a useful tool for the taxpayer whose purchases are great enough to cause the phase-out of the § 179 deduction. (In 2011, the deduction is reduced dollar for dollar for total qualifying purchases over $2,000,000.)

Example 5.17 Leasing to Maximize § 179 deduction

George plans to purchase $2,200,000 of equipment in 2011. Because this exceeds the $2,000,000 limit on qualifying property by $200,000, his § 179 deduction is reduced by $200,000 from $500,000 to $300,000. If he leases the $200,000 of excess equipment, he could claim the full $500,000 § 179 expense deduction. The leasing company told George that his first-year lease payment would be $40,000.

The total deductions available to George for the two alternatives are shown in Figure 5.3

FIGURE 5.3 Deduction Alternatives

	Purchase Only	Purchase and Lease
§ 179 deduction	$300,000	$500,000
Lease payment	0	40,000
First-year depreciation*	203,490	160,650
Total first-year deductions	$503,490	$700,650

* 10.71% of cost of purchases reduced by § 179 deduction

George can increase his first-year deduction by $197,160 if he leases the excess equipment that would reduce his maximum § 179 deduction.

Non-Tax and Other Considerations

Example 5.17 illustrates that using a lease may generate significant first-year tax deductions. Note that the lease payment in the example is $40,000, whereas the depreciation expense on $200,000 of equipment would be only $21,420. However, the producer needs to consider the total cost of leasing versus purchase over the life of the asset. A lease may include a different interest component than the financing available for purchase. The purchase option amount must be factored in. The lease term may also be shorter than the loan term, making it necessary to consider the time value of money. In making the decision, the farm producer should consider a cash-flow analysis that takes into account all of these factors.

State income taxes, such as incentives for capital purchases, also influence the decision, and there may be non-tax considerations favoring the lease such as:

1. The lease obligation not being included as a financial statement liability,
2. No lost capital on the financial statement for the leased item, and
3. The ease of replacing leased equipment if it becomes obsolete or is no longer needed.

Summary

Because the federal income tax rates are graduated (a higher tax rate applies to income in the higher brackets than in the lower brackets) farmers who use cash-basis accounting can manage their tax liability by shifting income away from the high-income years and deductions away from low-income years. However, the tax rules impose some limits on making these shifts and there are some non-tax factors to include in the analysis of the costs and benefits of the shifts.

CHAPTER 6

MANAGING THE CHARACTER OF INCOME AND DEDUCTIONS

SYNPOSIS (click on section title to go directly there)

Introduction

Taxable income from farming falls into three categories:

1. Ordinary income **subject to** self-employment (SE) tax
2. Ordinary income **not subject** to SE tax
3. Gain on disposition that is taxed as long-term capital gain

A farmer's effective tax rate is highest for ordinary income that is subject to SE tax and is the lowest for long-term capital gain. By knowing the rules, taxpayers may have opportunities to shift income to a lower tax category.

Self-Employment Income

Self-employment income is subject to ordinary income tax rates ranging from 10% to 35% (in 2011) and is also subject to a 13.3% (in 2011) SE tax. (The SE tax rate is effectively 11.36% for taxpayers in the 15% federal income tax bracket, as discussed in Chapter 5).

Generally, any income generated by an individual's own work is self-employment income, except for wages reported on a Form W-2, Wage and Tax Statement. (These wages are subject to a Federal Insurance Contributions Act (FICA) tax of 7.65% on the employer and 7.65% on the employee for a total of 15.3%. For wages earned in 2011, employees pay only 5.65% in FICA taxes.) Therefore, ordinary farm income reported on Schedule F (Form 1040), Profit or Loss from Farming, as well as director's fees, are ordinary income subject to SE tax.

Net rental income from land used in farming **is subject** to SE tax if the land owner materially participates in the farming activity. Net rental income from buildings **is not subject** to SE tax. Net rental income from machinery and equipment **is subject** to SE tax unless it is rented with farm land and the land

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owner does not materially participate in the farming activity or it is rented with land that is not used in farming or with buildings.

Cross-Reference

Self-Employment Tax

See Chapter 12 of the 2010 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the SE tax rules.

Some income from farm operations is not subject to SE tax. The most notable exclusion is gain from the sale of assets used in a farming business to produce other products. Such assets include land, buildings, machinery, and draft, breeding, dairy, and sporting livestock. Reporting the sale of cull cows, ewes, sows, and mares on Schedule F (Form 1040) is a costly error because it erroneously includes gain from those sales in the self-employment income that is reported on Schedule SE (Form 1040), Self-Employment Tax.

Example 6.1 Livestock Sales

Carlos operates a hog operation. His principal income is from the sale of market hogs. Carlos reports his hog sales on Schedule F (Form 1040). The net income from these market hogs is ordinary income subject to SE tax. Carlos raises some of the female hogs born on the farm to become part of his breeding stock. When these sows are no longer fit for producing more litters of pigs, he sells them. The income from the sale of these sows is reported on Form 4797, Sales of Business Property, and is not subject to SE tax.

Timber sales can also be exempt from SE tax and therefore are reported on Form 4797. To qualify for Form 4797 reporting, the taxpayer must sell standing timber rather than participate in the harvest or any further processing. Christmas trees are treated as timber is they are more than 6 years old when they are severed from their roots.

Cross-Reference

Timber Tax Rules

See pages 53 and 54 of the 2010 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the tax rules for timber.

Material Participation and Rental Income

Rent received for the use of real estate is generally not subject to SE tax. Therefore income and expenses from the rental of farm real estate are generally not reported on Schedule F (Form 1040). However, rent received for land used in agricultural production **is** subject to SE tax **if** the owner materially participates in the farming operation. A materially participating farm owner must report the rental proceeds (whether received as cash or as a share of the crop) and related deductions on Schedule F (Form 1040). The net Schedule F (Form 1040) profit is subject to SE tax.

The material participation tests for including net rental income as self-employment income apply only to *land* used in agricultural production. The net rent from *buildings* used in agricultural production and from any real estate that is not used in agricultural production is generally **not subject to SE tax** even if the owner materially participates in the activity. However, if the owner or the owner's employees provide additional services (such as in the rental of hotel or motel rooms) or the rent is received by a real estate dealer in the course of his or her real estate business, the net rent **is subject to SE tax**.

Material participation is not an issue for rental income and expenses from property other than land and buildings (e.g., farm equipment). Net rent from that property **is subject to SE tax** unless renting it is a one-time event. The rental income and expenses must be reported on Schedule C (Form 1040), Profit or Loss from Business.

A land owner materially participates in a farming activity if he or she meets any one of the following four tests.

Test #1: The land owner performs any three of the following activities:

(a) advances, pays, or stands good for at least half the direct costs of producing the commodities;

(b) furnishes at least half the tools, equipment, and livestock used in producing the commodities;

(c) advises and consults with the tenant periodically; and

(d) inspects the production activities periodically.

Test #2: The land owner regularly and frequently makes, or takes an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.

Test #3: The land owner works 100 hours or more over a period of 5 weeks or more in activities connected with producing the farm commodities.

Test #4: The land owner takes actions that, considered in their total effect, show that he or she is materially and significantly involved in the production of the farm commodities.

If the land owner does not materially participate in the farming activity, then the tax reporting depends on the form in which rental payments are received.

- For a *cash rental arrangement*, the income and expenses are reported on Schedule E (Form 1040), Supplemental Income and Loss, which is used to report most rentals.
- For a *crop share rental arrangement*, the income and expenses are reported on Form 4835, Farm Rental Income and Expense.

In either case, the income is ordinary income, but it is not subject to SE tax because the land owner does not materially participate.

This provision of the tax law provides a tax planning opportunity. If the taxpayer operates the farm, but the taxpayer's spouse owns the real estate (and does not materially participate in the farming operation), the farm operator can pay rent to the land owner and reduce the couple's overall tax liability. The farm operator and landowner should enter into a bona fide lease arrangement (preferably in writing), with rent set at the prevailing market rate.

Example 6.2 Rent to Spouse

Mary operates a tobacco farm on land owned by her husband, Joe. On average over the last 5 years, the farm generated a $75,000 profit. When non-farm income and their deductions are factored in, their usual taxable income is $62,000. Based on the prevailing tobacco land rental rates in their area, the fair rental value of the land is $20,000 per year. The property taxes are $8,000. As shown in Figure 6.1, Mary and Joe could reduce their overall joint tax liability by $1,568 each year if Mary paid $20,000 of rent to Joe.

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FIGURE 6.1 Tax Comparison With and Without Rent Payments

	Without Rent Payments	With Rent Payments
Farm income	$75,000	$63,000[*]
Deduction for ½ S/E tax	– 5,299	– 4,451
Net rental income		12,000
Other non-farm net income	– 7,701	– 7,701
Taxable income	$62,000	$62,848[**]
Income tax	8,462	8,590
SE tax	10,598	8,902
Total tax	$19,060	$ 17,492

[*] Reduced by $20,000 rent expense but increased by $8,000 property tax which becomes Joe's expense.

[*] Net taxable income is unchanged except for the reduced deduction for ½ of the SE tax paid.

Other Tools for Reducing Self-employment Income

Wages paid to the children of a farm operator are exempt from FICA taxes until the child reaches age 18. Thus, the family can reduce their contribution to the social security and Medicare systems by employing their children. The farmer must abide by all applicable labor laws and enter into a bona fide employer-employee relationship, preferably in writing. The child must have specific job responsibilities and be paid a wage commensurate with those duties.

Wages paid to a spouse are subject to FICA taxes, so that hiring a spouse does not provide the same tax savings as hiring the farmer's children. However, as an employee, a spouse is eligible for fringe benefits that are tax deductible by the farmer and tax-free to the spouse. Such fringe benefits include term life insurance with a benefit of up to $50,000, qualifying meals and lodging, and participation in the farm's retirement program. The farmer could also provide health insurance to his or her spouse who is a bona fide employee. This allows the farmer to deduct the premium as a farm expense, thereby reducing SE tax while not increasing FICA tax. The health insurance policy may provide family coverage, thus indirectly insuring the farmer. Without this strategy, the farm operator may qualify to deduct the health insurance premium as an adjustment to gross income, which still reduces taxable income but does not reduce self-employment income.

Maximizing Capital Gain Treatment

As mentioned previously in this chapter, not all sales from farm operations are reportable on Schedule F (Form 1040) as ordinary farm income subject to SE tax. Most notably, the sale of livestock held for dairy, breeding, sport, and draft purposes is reported on Form 4797. This same reporting rule applies to the sale of standing timber.

Cross-Reference

Sale of Assets Used in a Farming Business

See Chapter 9 of the 2010 IRS Publication 225, *Farmer's Tax Guide*, for an explanation of the tax treatment of gains and losses from the sale of assets used in a farming business.

Draft, breeding, dairy, or sporting livestock must be held for a minimum period of time called the *required holding period* before gain on their sale is eligible for long-term capital gain treatment. Such treatment currently means a 0% rate of tax to the extent the taxpayer's taxable income does not exceed the 15% federal income tax bracket for ordinary income. The income tax rate is 15% on long-term capital gain that, when added to ordinary taxable income, exceeds the top end of the 15% federal income tax bracket. The required holding period is more than 1 year for assets other than livestock. It is 24 months or longer for cattle and horses and 12 months or longer for other livestock, such as hogs, sheep, goats, and alpacas.

Example 6.3 Maximizing the Capital Gain Advantage

George sold $40,000 of heifers. He raised these animals to add to his dairy herd but decided against putting them in the herd due to a change in economic conditions. George's total taxable income is in the 15% federal income tax bracket. Because he sold the heifers when they were 23 months old, his tax on the sale is $6,000 ($40,000 × 15%). Because the heifers were held for dairy purposes, the sale is reported on Form 4797 as ordinary income and George is not subject to SE tax on the gain.

If George held the heifers one more month, the gain would qualify for long-term capital gain treatment and George would pay no tax (a 0% capital gain rate) on the sale. George incurred a $6,000 tax cost for selling one month too soon.

✔ **Observation**

Purchased Livestock

Gain from the sale of *purchased* dairy, breeding, sport, and draft livestock is eligible for long-term capital gain treatment only if the livestock is held for the required holding period **and** only to the extent the animals are sold for more than their original cost. Any gain due to depreciation of the original cost basis is ordinary gain from the recapture of depreciation, as discussed in Chapter 5 for equipment sales.

Effect of Losses from the Sale of Business Assets

Taxpayers may deduct losses from the sale of business assets from ordinary income whether or not they are held the required holding period. However, losses incurred during the tax year on the sale of assets that were held for the required holding period must first be netted against gains during the tax year from the sale of assets held for the required holding period. Ordinary income is reduced only if the result of netting the gains and losses is a net loss for the tax year.

✔ **Observation**

Gains and Losses in the Same Year

Having both gains and losses in the same year from business assets held for the required holding period reduces the benefit of long-term capital gain treatment.

Example 6.4 Sale of Gain and Loss Assets

Camille plans to sell land that will generate a $40,000 gain and equipment that will generate a $10,000 loss. Both assets have been held for the required holding period. Camille's taxable income is in the 25% tax bracket.

If Camille sells both the land and the equipment in the same year, she will have a $30,000 net gain ($40,000 gain on land minus $10,000 loss on equipment) eligible for long-term capital gain treatment. The preferential 15% capital gain rate applies because Camille's taxable income is in the 25% federal income tax bracket. Camille owes $4,500 of tax.

If Camille sells only the land this year, her tax will increase by $6,000 ($40,000 gain × 15%). She could then sell her equipment next year at a $10,000 loss. Even though the equipment has been held for the required holding period, the loss becomes a fully deductible ordinary loss because she has no assets sold that year at a gain. Therefore, the loss reduces Camille's tax liability next year by $2,500 ($10,000 × 25%). Over the 2-year period, Camille has paid $3,500 under this plan – saving $1,000 over the initial plan to sell both assets in the same year.

Planning Pointer

"Look Back" Rule

It appears that Camille would be better off by selling the loss asset in the first year to accelerate the deduction and then selling the land the following year to delay the income. However, Congress decided to disallow this by enacting what is called "1231 loss recapture." This provision requires taxpayers who generate a gain eligible for capital gains treatment on the sale of a business asset, to "look back" at the last 5 years. To the extent there is a net loss from that period, the current year's gain is taxed as ordinary income.

Example 6.5 Sale of Loss Asset in First Year

If Camille sells only the equipment the first year, the $10,000 loss reduces her income tax by $2,500. If she then sells the land in the second year, $10,000 of the gain is taxed at her 25% ordinary income rate and the remaining $30,000 is taxed at the 15% capital gain rate. Therefore her total tax increase in the second year is $7,000 [($10,000 × 25%) + ($30,000 × 15%)]. The net tax increase for the 2 years is $4,500 ($7,000 – $2,500), which is the same amount as if she had sold the two assets in the same year.

Unharvested Crop Sales

Crop sales are generally subject both ordinary and SE tax and are reported on Schedule F (Form 1040). However, if unharvested crops are sold with land to the same buyer, the crop value can be reported as part of the land sale. If the land was held for the required holding period (more than 1 year), the entire gain on the sale qualifies for long-term capital gain treatment. When the crop is sold with the land, the costs of raising the crop cannot be deducted as farm expenses, but they are added to the basis of the crop to determine the gain or loss from the sale.

Example 6.6 Sale of Unharvested Crops

Billy Bob's taxable income is in the 25% federal income tax bracket and he plans to sell 50 acres of cropland. The growing crop has a $34,000 fair market value; the cost of raising and harvesting the crop is $10,000. If Billy Bob harvests and sells the crop, he will incur an $8,580 tax on his $24,000 net income from the crop, as shown in Figure 6.2.

FIGURE 6.2 Tax on Harvested Crop

Net income from crop sale	$ 24,000
Less: 1/2 SE tax	– 1,474
Net ordinary income	$ 22,526
Income tax	$ 5,632
SE tax*	2,948
Total tax	$ 8,580

* In 2011, the SE tax rate is 13.3% of the net earnings from self-employment, which is 92.35% of the self-employment income ($24,000 × 92.35% × 13.3% = $2,948).

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If the unharvested crop is sold with the land, the net income from the crop qualifies for long-term capital gain treatment and results in a $3,600 ($24,000 × 15%) federal income tax. There is no SE tax and Billy Bob therefore saves $4,980 ($8,580 – $3,600) of taxes.

Cross-Reference

See Chapter 12 for a discussion of maximizing the capital gain advantage when selling a farm.

Summary

The tax rate for a farmer's income varies by the type of income. Some income is subject to both ordinary income tax rates and self-employment taxes; some is subject only to ordinary income tax rates; and some is subject only to capital gains rates. Farmers can use a few planning opportunities to move income to the most favorable tax rates.

CHAPTER 7

OTHER TOOLS TO MANAGE TAX LIABILITY

SYNPOSIS (click on section title to go directly there)

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Introduction

Chapter 5 presented timing techniques that can be useful in leveling out the peaks and valleys of farm income to avoid higher tax brackets. Chapter 6 explained the ways that various types of income are taxed and strategies for maximizing the income that is taxed at the lowest rates. This chapter describes additional tax law provisions that help farm producers manage or reduce their overall tax liability.

Either market or growing conditions may cause fluctuations in farm income. Legal restrictions may cap a deduction for expenses that are prepaid. Market considerations may promote either making such pre-purchases or delaying the sale of products. In such cases, farm producers may need to rely on additional tools provided in the tax law.

Farm Income Averaging

Individual taxpayers with certain farm income may elect a 4-year method of income averaging. The tax on the election year taxable income is calculated by borrowing unused tax brackets from the 3 prior years (referred to as *base years*). The taxpayer chooses the amount (called *elected farm income* or EFI) of the current year farm income that will be taxed at base-year rates. This allows a farm producer with higher than usual income another technique for keeping income out of higher marginal tax rate brackets.

C corporations, estates, and trusts may not use the election. The IRS reports that this tax-saving method of calculating tax is being underutilized by taxpayers.

Elected Farm Income (EFI)

EFI is limited to the lesser of the taxpayer's total taxable income [after subtracting any net operating loss (NOL) deductions] or the taxable income attributed to any farming business (called *electible farm income*). Electible farm income includes not only net farm profits from Schedule F (Form 1040), Profit or Loss from Farming, but also an owner's share of net farm income from an S corporation (including wages), partnership, or LLC. It does not include wages from a C corporation. Gains from the sale of farm business property (excluding land and timber) regularly used in farming for a substantial period are included in electible farm income.

A farming business includes nursery production, sod farming, and the production of ornamental trees and plants, as well as the production of livestock, fruit, nuts, vegetables, horticultural products, and field crops. However, gain from the sale of trees that are more than 6 years old when cut is not electible farm income, because these trees are no longer classified as ornamental trees. The income, gain, or loss from the sale of grazing and development rights or other similar rights classified as attributable to a farming business is not electible farm income.

The terms *regularly used* and *substantial period* are not defined in the Internal Revenue Code or congressional committee reports. However, Treasury regulations state that if a taxpayer ceases farming and later sells farm business property (other than land) within a reasonable time after the cessation of farming, gains or losses from the sale are farm income. A sale within 1 year is deemed to be within a reasonable time. Taxpayers must consider all of the facts and circumstances of sales beyond 1 year from the cessation of the farm business to determine if the asset was still regularly used in the farm business.

Example 7.1 Facts and Circumstances

At the time Allie Gator quit farming in 2009, she sold her land, buildings, and most of her farm equipment. She did not sell her pickup truck at that time because she used it in her new construction business. She did not find a buyer for her combine until June 2011. She also sold her pickup in 2011.

Gain on the combine is electible farm income because Allie's only reason for holding it was to find a buyer after terminating her farm business. Gain on the pickup is not electible farm income because it was realized more than a year after Allie terminated her farm business and she kept the pickup to use it in a non-farm business.

Income-Averaging Tax

To calculate the income-averaging tax for the election year, taxpayers subtract EFI from the current year's taxable income and calculate the tax on the remaining income using the current-year income tax rates. The tax on the EFI is calculated by

1. adding one-third of the EFI to the taxable income of each base year,
2. computing the tax on the total from step 1 for each base year using the tax rates for each base year, and
3. subtracting the tax paid for each base year from the tax computed in step 2 for each base year.

The total tax for the election year is the sum of the tax on the election year income reduced by the EFI and the amount from step 3 for each of the base year calculations

Farm income averaging does not affect self-employment (SE) tax for either the election year or the base years. It also does not increase the alternative minimum tax.

Taxpayers report their income-averaging election and compute their income-averaging tax on Schedule J (Form 1040), Income Averaging for Farmers and Fishermen. The relevant lower tax rates for capital gains apply in the election year as well as in the base-year calculations.

Example 7.2 Income Averaging

Fruit growers Mr. and Mrs. B & B Goodyear had a substantial increase in farm income in 2011. Receipts were up and costs were down. Mrs. Goodyear works off-farm. Their $58,000 Schedule F (Form 1040) profits, combined with their nonfarm income and deductions, result in a $93,000 taxable income. They file a joint return. Their taxable incomes for 2011 and the previous 3 years are shown in Figure 7.1.

FIGURE 7.1: Goodyears' Taxable Income

Year	Taxable Income
2011	$93,000
2010	30,900
2009	60,550
2008	28,200

The Goodyears elected to income average in 2011. Their maximum EFI is $58,000 (the amount of taxable income attributed to farming). Their optimum EFI may be the taxable income that exceeds their 15% tax bracket or $24,000 ($92,000 – 68,000). They decided to designate $24,000 of their Schedule F (Form 1040) profit as EFI and tax $8,000 per year at the tax rates borrowed from each of the 3 base years.

Question 1. Will all of the EFI be taxed at 15%?

Answer 1. In 2009 their 15% tax bracket ended at $67,900, and their taxable income was $60,550, leaving $7,350 of the 15% rate bracket available for EFI from the election year. This $7,350 is taxed at the 15% tax rate. However, the remaining $650 ($8,000 – $7,350) added to the 2009 base-year income is taxed at the 25% rate from the 2009 tax brackets. For 2008 and 2010, all $8,000 will be taxed at the lower rate.

Question 2. Should the Goodyears reduce EFI to avoid the 25% tax bracket from 2009?

Answer 2. For each $1 of EFI subject to the 25% tax rate from 2009, $2 is taxed at the 15% rate from the other 2 base years. Therefore, the marginal tax rate for the Goodyear's EFI is 18.33% [(15 + 15 + 25) ÷ 3]. If they put less than $24,000 in their EFI for 2011, their income taxed at their 2011 tax rates will exceed $69,000, and their marginal tax rate on the income taken out of the EFI will be 25%.

Question 3. How much income tax will the Goodyears save by income averaging in 2011?

Answer 3. They will save $2,205 [10% (25% rate – 15% rate) on the first $22,050 (3 × $7,350)], and $130 [6.67% (25% – 18.33%) on the remaining $1,950 of EFI], for a $2,335 total tax reduction.

Base Year Losses

The IRS allows the use of negative taxable incomes in the base years when performing the income-averaging calculation. This, in effect, allows such taxpayers to borrow 0% tax rates from the base years with eligible losses. However, there can be no double benefit from the negative taxable incomes already reflected in any net operating loss (NOL) arising from that year (see Chapter 10).

Example 7.3 Income Averaging and Net Operating Losses

Abdul had a $45,000 Schedule F (Form 1040) loss in 2010. He and his wife filed a joint return and claimed five personal and dependent exemption deductions (including three children). Their taxable income is a negative $74,650, as shown in Figure 7.2.

FIGURE 7.2: 2010Taxable Income

Schedule F	$ – 45,000
Standard deduction	– 11,400
Exemptions	– 18,250
Taxable income	$ – 74,650

Abdul's NOL for 2010 is $45,000. This NOL must be removed from taxable income, leaving a negative $29,650 to be used as base-year income for 2010 on Abdul's Schedule J (Form 1040), Income Averaging for Farmers and Fishermen, when he files his 2011 tax return.

Questions and Answers

Question 1. Which taxpayers qualify for farm income tax averaging?

Answer 1. The Internal Revenue Code says that "individuals engaged in a farming business" qualify, and it specifically excludes estates and trusts. The IRS instructions indicate that individual owners of partnerships, LLCs, and S corporations qualify (farm income flows through the business and retains its character in the hands of the individual owner taxpayer). C corporations do not qualify for farm income averaging. Wages and dividends from a C corporation are not qualified farm income.

Question 2. Does the EFI retain its character as unused brackets are carried forward, and may the taxpayer select the type of income to include in EFI?

Answer 2. Taxpayers are allowed to carry forward the unused lower brackets as ordinary farm income and keep capital gains in current-year taxable income, or select the best combination of ordinary farm income and qualified capital gains to meet their tax management objectives. When a combination of ordinary farm income and capital gains is included in EFI, the IRS indicates that an equal portion of each type of income must be taxed at each base-year rate. The taxpayer cannot tax all of the capital gains at just one prior-year's rate.

Any capital gain that is taxed at a base-year rate is taxed at the capital gains tax rate in effect for that prior year. Therefore, 2011 farm business capital gains of a taxpayer in a 25% income tax bracket could be eligible for a 0% rate for capital gains if the taxpayer has a base year with taxable income in the 15% income tax bracket and those gains are included in EFI.

Question 3. Do farm owners who rent their farm or land for agricultural production qualify?

Answer 3. If the farm owner materially participates in the farming activity and properly reports the income on Schedule F (Form 1040), this income qualifies for income averaging. Final regulations allow farm owners who do not materially participate but who receive crop-share rental income (properly reported on Form 4835, Farm Rental Income and Expenses) to also use the farm income-averaging rules. For crop-share rents, the lessor must have a written crop-share lease agreement. Cash rental income reported on Schedule E (Form 1040), Supplemental Income and Loss, is not income attributable to a farming business.

Question 4. How much farm use is required to meet the "regularly used in farming" rule that applies to gains from the sale of farm business property?

Answer 4. All sales reported on Schedule F (Form 1040) are qualified. Sales of raised dairy and breeding livestock reported on Form 4797, Sales of Business Property, qualify. Sales of farm property for which depreciation and I.R.C. § 179 deductions were claimed also qualify. Therefore, it appears as if all sales of farm machinery, buildings, and livestock qualify as being "regularly used."

Question 5. Can taxpayers make the election to income average on an amended return?

Answer 5. Yes.

Question 6. If an NOL was carried to a base year, does the income-averaging election affect how much of that NOL is used in the base year?

Answer 6. No, the amount of the NOL used in the base year is not refigured as a result of taxing one-third of the EFI at that base year's rate. Similarly, the base-year's income, deductions, and credits are not affected by the additional income taxed at that year's rates (for example, the taxable portion of social security benefits and the allowable deductions on Schedule A (Form 1040), Itemized Deductions, are not recalculated). The income-averaging computation on Schedule J (Form 1040) simply uses the tax brackets of the base years without altering the tax returns originally filed for those base years.

Question 7. Must a taxpayer use the same filing status in each year?

Answer 7. No, the tax is computed based on the filing status in effect for each base year and the election year.

Question 8. Can a taxpayer use income averaging even though it provides no current-year tax savings?

Answer 8. Yes, this technique may be used to shift income to the oldest base-period year, which drops out of the calculations for the following year. This may also allow the base-period incomes (and marginal tax rates) to be leveled out in anticipation of income averaging in future years. Use caution when including capital gains in the income-averaging computation because of the 0% rate of tax on adjusted net capital gain for 2008 through 2012 (but not for earlier or later years).

Planning Guidelines

Generally it is better to implement economically sound income tax management practices throughout the year rather than use income averaging as the only tax management strategy. Use tax management practices that reduce taxable income and then elect income averaging as needed. Income averaging provides an opportunity for reducing only the regular income tax rates applied to the current year taxable income. Farm income averaging does nothing to reduce gross income or its impact on the many phase-outs of deductions and credits that are triggered by higher gross income.

An exception to this general rule may make income averaging a better option than reducing current year taxable income by using the techniques described in Chapter 5. The exception arises when net earnings from self-employment exceed the base for the social security component of the SE tax ($106,800 of net earnings for 2011). Realizing high income that is exempted from this component of SE tax but that is eligible to be taxed at lower base year rates due to farm income averaging may be advantageous.

Income averaging should be used to transfer as much high-bracket income as possible from the election year to low tax brackets in the base years. There will be cases in which the EFI used in a base year is not taxed in the lowest bracket, but income averaging still saves taxes. A farm taxpayer needs the following information to determine whether and how much 2011 farm income should be averaged:

- Taxable income for 2011 as well as ordinary income and capital gain attributed to farming
- Taxable income from his or her 2008, 2009, and 2010 tax returns
- Income tax brackets for 2011 and the 3 prior years (see Figure 7.3)

FIGURE 7.3: Top End of Taxable Income Tax Brackets

Bracket	Single	Married Filing Jointly	Head of Household	Married Filing Separately
2011				
10%	$ 8,500	$ 17,000	$ 12,150	$ 8,500
15%	34,500	69,000	46,250	34,500
25%	83,600	139,350	119,400	69,675
28%	174,400	212,300	193,350	106,150
33%	379,150	379,150	379,150	189,575
2010				
10%	$ 8,375	$ 16,750	$ 11,950	$ 8,375
15%	34,000	68,000	45,550	34,000
25%	82,400	137,300	117,650	68,650
28%	171,850	209,250	190,550	104,625
33%	373,650	373,650	373,650	186,825
2009				
10%	$ 8,350	$ 16,700	$ 11,950	$ 8,350
15%	33,950	67,900	45,500	33,950
25%	82,250	137,050	117,450	68,525
28%	171,550	208,850	190,200	104,425
33%	372,950	372,950	372,950	186,475
2008				
10%	$ 8,025	$ 16,050	$ 11,450	$ 8,025
15%	32,550	65,100	43,650	32,550
25%	78,850	131,450	112,650	65,725
28%	164,550	200,300	182,400	100,150
33%	357,700	357,700	357,700	178,850

Priority of Goals

1. Elect farm income until the marginal rate of the election year is not greater than the average of the marginal rates that are borrowed from the base years. Be sure to consider the effective rate if there are capital gains in the base year or in EFI.
2. Load the oldest base year followed by an equal amount in the other base years to the extent this can be done without increasing tax.
3. Elect additional income attempting to level the income of the current and prior 2 base years to prepare these years to be base years for next year's income averaging (again, only to the extent that this can be done without increasing tax).

CCC Commodity Loans And Loan Deficiency Payments

When the market price of a commodity falls below the marketing assistance loan rate offered by the Commodity Credit Corporation (CCC), producers may realize more income by taking advantage of one or more of the government program options. Those options and the income tax consequences of each option are discussed in this section. This allows the farm producer to maximize the use of lower tax brackets while selling the crop at the most favorable market price and avoiding the accumulation of income that might be pushed into higher marginal tax rates.

CCC Nonrecourse Marketing Assistance Loan

Instead of selling a commodity, producers can use the commodity as collateral for a nonrecourse loan from the CCC. This alternative puts cash in the producer's pocket at the time of harvest and lets the producer wait to see whether market prices improve.

The Internal Revenue Code allows taxpayers to elect to treat these loans as income in the year received. They make the election on Schedule F (Form 1040), Profit or Loss from Farming. If the producer has not made this election, the CCC loan is treated the same way as any other loan. The IRS provides procedures for an automatic change in accounting method in the event that a taxpayer wants to stop reporting loans as income.

Example 7.4 Using CCC Commodity Loans under Election to Manage Taxable Income

Isabella is a crop farmer whose commodity is currently selling for 75% of the amount Isabella expects the market price to be next spring. She would like to wait until then to sell her crop, but her taxable income is currently projected to be only $20,000 without any additional sales. It was a great crop year and Isabella expects her commodity to ultimately sell for $60,000. She files a joint tax return with her husband and they are normally able to keep their taxable income near the top of the 15% federal income tax bracket and out of the 25% federal income tax bracket. If Isabella is unable to increase her current-year income, they will waste much of their 15% tax bracket this year and will also push $60,000 of income into the 25% tax bracket next year. Farm income averaging could be used to obtain tax savings on some but not all of this income.

Isabella should consider obtaining a $40,000 CCC commodity loan and electing to treat the loan as current year income. The $40,000 loan will be taxed at a 15% tax rate.

If market prices subsequently rise above the loan rate*,* producers can repay the loan, with interest, and then sell the commodity for more than the loan amount.

The income tax consequences of the sale depend upon whether or not the taxpayer made the election to treat the loan as income. In any event, the interest expense is deductible on Schedule F (Form 1040).

- Typically, the producer did not make the election to treat the loan as income, so he or she has no basis in the commodity. Therefore, the full sale price is reported as Schedule F (Form 1040) income.
- If the producer made the election to report the loan as income, he or she has basis in the commodity equal to the amount of the loan. That basis is subtracted from the sale price to determine the gain on the sale, which is reported in the resale section of Schedule F (Form 1040). (This treatment is the same as if the farm producer had purchased the crop for resale. Such resale crops have a basis equal to their original cost because that amount is not deductible at the time of purchase. Therefore, only the amount of sale price in excess of that original cost is taxable at the time of sale.)

Example 7.5 Subsequent Sale of Commodity with Loan Under Election

The following year, Isabella, from Example 7.4, sold her carryover commodity for $60,000. However, because the crop was collateral for a CCC loan and Isabella had elected to report the loan as income, she recognizes only $20,000 of income from the sale ($60,000 sale proceeds minus $40,000 of basis from the CCC loan under election). This increase in income may be much easier to tax-manage through the tax-planning techniques discussed in Chapter 5. In addition, Isabella and her husband were able to take advantage of the 15% bracket in the previous year by including the $40,000 loan in their income.

If market prices do not rise above the loan rate, producers should choose to redeem the commodity by paying the posted county price (PCP) to the CCC. By making that payment, the producer is no longer obligated on the loan and can keep the difference between the original loan rate and the PCP. This replaces the previous option of forfeiting the grain to the CCC.

A producer who redeems the commodity by paying the PCP will receive a Form CCC-1099-G from the CCC for the difference between the loan rate and the PCP (market gain). That amount must generally be reported as an agricultural program payment on Schedule F (Form 1040).

However, if the producer elected to treat the loan as income, the difference between the loan rate and the PCP is not reported as taxable income because the full loan amount was already reported in taxable income in the year it was received. Instead, the difference is subtracted from the producer's basis in the commodity so that the producer now has basis in the commodity equal to the PCP. The producer should still report the market gain on line 6a (agricultural program payments) on Schedule F (Form 1040) but not include it as taxable on line 6b.

Loan Deficiency Payment

If the market price of a commodity is below the loan rate, producers can choose not to borrow from the CCC but to instead claim a loan deficiency payment (LDP) for the crop. This presents another opportunity to increase taxable income when market prices are down at year end. The loan deficiency payment is equal to the difference between the loan rate and the PCP on the date the LDP is claimed. Producers obtain the same result as if they had taken the loan and paid the PCP rate on the date they claimed the LDP. The LDP is reported as an agricultural program payment on lines 6a and 6b of Schedule F (Form 1040).

✔ **Observation**

Note that reconciling taxpayer records to the amounts reported on Form CCC-1099-G can be challenging:

- CCC loan activity is not reported on the Form 1099. Borrowings and program payments may be commingled in taxpayer records.
- Often, advance government payments are made. If market conditions later are better than expected, these advances must be repaid. Sometimes these payments are simply netted from subsequent government payments; at other times they are paid by taxpayer check and can be confused with PCP "purchase" payments or repayments of CCC loans.
- Program payments are typically direct-deposited to the producer's bank account. Sometimes these payments are applied directly to CCC loan balances.
- Interest paid to the CCC on loans is not reported to the taxpayer on a Form 1099.

Like-Kind Exchanges

A cardinal rule of taxation is that all income, from whatever source derived, whether received in cash or property, is taxable unless specifically excluded by law. Therefore, if a farm operator plows a neighbor's field and receives a steer in exchange, the farm operator must report custom work income equal to the market value of the steer. If a farmer trades five steers for a used plow, the farmer must report steer sales on Schedule F (Form 1040) equal to the value of the plow received.

The Internal Revenue Code (I.R.C.) provides an exception to this general rule for like-kind exchanges. These exchanges are often referred to as § 1031 exchanges after the I.R.C. section that describes them. I.R.C. § 1031 allows the gain in such exchanges to be deferred rather than recognized at the time of the exchange. When a taxpayer disposes of property, gain is *realized* to the extent that the value of whatever is received exceeds the total of the taxpayer's income tax basis in the property given up and any expenses of sale. Under the like-kind exchange rules, the realized gain is *recognized* (or reported as taxable on the taxpayer's tax return) only to the extent of cash and other unlike property received. The difference between the realized gain and the recognized gain is deferred. This deferral is accomplished by reducing the basis of the like-kind property received by the amount of the deferred gain.

Example 7.6 Like-kind Exchange Concepts

Pablo exchanged property that qualifies as like-kind. His basis in the property given up is $4,000. He received like-kind property with a $10,000 value. Pablo therefore realizes a $6,000 gain ($10,000 value of property received minus his $4,000 tax basis). However, Pablo recognizes gain only to the extent of unlike property received (none). Therefore, he defers the entire $6,000 gain. His $4,000 basis in the property he received is the $10,000 price of the property received, reduced by the $6,000 gain deferred on the exchange. If Pablo later sells the property received for its $10,000 market value, he will then be taxed on the $6,000 gain that was deferred at the time of the exchange.

Rules and Requirements

A § 1031 transaction must actually be an exchange of qualifying property. A sale of property, followed by a purchase of like-kind property, does not qualify for non-recognition of gain as a like-kind exchange unless the sales proceeds are held by a qualified intermediary and stringent timeframes regarding the replacement property are met. Gain or loss is recognized if the taxpayer actually or constructively receives money or non-like-kind property before the taxpayer actually receives the like-kind replacement property. Both the relinquished property and the acquired property must be used in a trade or business or held for investment.

- For real property, *like-kind* is interpreted very broadly. Any real estate can be exchanged for any other real estate as long as the relinquished property was, and the acquired property is, used in a trade or business or held for investment. Consequently, a farm can be exchanged for city real estate, and improved real estate can be exchanged for unimproved real estate. However, care must be exercised to ensure that any property subject to recapture rules (such as the depreciation recapture rules) that is included as part of the real estate given up is replaced with an equal amount of such recapture property in the replacement real estate received. The depreciation recapture rules apply to single-purpose livestock and horticultural facilities, silos, grain bins, and drainage tile. If this requirement is not met, the taxpayer must recognize ordinary income.
- *Like-kind* is interpreted to mean *like class* for personal property. Under Treasury regulations, *like class* means that both the relinquished and replacement properties are in the same product class under the North American Industry Classification System (NAICS). Most equipment used in a farm business is contained within product class 333111, which includes such items as combines, planters, tractors, plows, haying equipment, and milking machines. Farmers generally qualify for like-kind treatment when they exchange farm equipment for farm equipment. However,

automobiles, general-purpose trucks, heavy general-purpose trucks, information systems, and other office equipment are all assigned to separate product classes. Livestock of different sexes are not property of a like kind, whereas exchanges of same-sex livestock have qualified as tax-free exchanges.

Farm taxpayers generally enter into like-kind exchanges every time they trade in a piece of equipment on another piece of equipment. Such treatment allows gain to be deferred by reducing the basis of the equipment received by the gain not recognized. The cost basis that the taxpayer depreciates is not the list price, nor is it just the cash paid to boot: it also includes the adjusted tax basis (often referred to as remaining book value) of the traded-in equipment. This approach to determining basis results in the same answer as reducing the purchase price by the gain deferred under the § 1031 rules.

Example 7.7 Equipment Trade-in as Like-Kind Exchange

Christy Chang had a planter with a $6,000 depreciated basis. On March 15, 2011, she acquired a newer planter that the dealer had listed for $12,000. Christy traded in her old planter and paid the dealer $4,000 in cash. That trade is a like-kind exchange. The $8,000 trade-in allowance ($12,000 list price minus $4,000 cash paid) was the dealer's opinion of the value of Christy's old planter. This becomes the sales price of the old planter. Christy therefore realized a $2,000 gain, but she does not have to recognize any gain because she received no cash or other unlike property. Christy defers the $2,000 realized gain by reducing the basis in the newer planter. Christy's basis in the newer planter is:

Cost	$12,000
Less: Deferred gain	– 2,000
Basis	$10,000

Note that this is the same result as calculating the basis by adding the $6,000 adjusted tax basis of trade-in to the $4,000 cash paid to boot.

Other Rules and Reporting Requirements for Like-Kind Exchanges

Taxpayers must use IRS Form 8824, Like Kind Exchanges, as a supporting statement for like-kind exchanges that either generate no taxable gain or gain that is reported on other forms [including Form 4797, Sale of Business Property, and Schedule D (Form 1040), Capital Gains and Losses]. A separate Form 8824 should be attached to Form 1040, U.S. Individual Income Tax Return, for *each* exchange. Form 8824 should be filed for the tax year in which the seller (exchanger) transferred property to the other party in the exchange.

If the relinquished property is subject to depreciation recapture or other recapture rules, part or all of the recapture must be recognized in the year of the like-kind exchange if the like-kind property received is not also property subject to the same recapture rules. Furthermore, any recapture potential not recognized in the year of the exchange carries over as an attribute of the asset received in the exchange, and it may trigger ordinary income recapture upon any subsequent sale of the property received.

✔**Observation**

Related Parties

Like-kind exchanges between related parties can result in recognition of gain if either party disposes of the received property within 2 years after the exchange.

Tax Planning Opportunities with the Like-Kind Exchange Rules

In many cases, a taxpayer benefits from deferring gain on an asset that is sold by using the like-kind exchange rules to roll the gain into a replacement asset. In some situations, however, it is better to recognize the gain at the time the asset is sold. The key to a successful tax plan is to analyze whether the cost of recognizing gain at the time the asset is sold is offset by the benefit of having additional basis in the property later. This question brings together many of the tax-planning issues discussed in Chapters 5 and 6.

- If gain is recognized, will it be ordinary income or income eligible for the reduced rate for capital gains?
- Will the property received in the exchange be depreciable? If so, how quickly?
- What is the income tax rate for the year of the exchange compared to years when depreciation will be claimed or the property received in the exchange might be sold?
- What impact does the self-employment tax have on the choice?
- Are there any state tax considerations that may favor recognizing gain and therefore having a higher basis in the property received?

The gain deferral under § 1031 is mandatory for all qualifying transactions. Therefore, a taxpayer who wants to recognize gain must carefully plan the transaction so that it is not a like-kind exchange.

Example 7.8 Sale versus Like-Kind Exchange

John is considering buying a $60,000 tractor. His current tractor has a $20,000 adjusted tax basis, but the dealer will give John a $25,000 trade-in allowance. John's neighbor offered to buy the old tractor for $25,000. Should John trade or sell?

Assume that John is in the 25% federal income tax bracket, has a $100,000 Schedule F (Form 1040) profit, and has purchased no other depreciable property this year. Also assume that the self-employment tax rate is 15.3% rather than the 13.3% that applies only in 2011.

With a like-kind exchange (trade-in), John would have no gain. His basis in the new tractor would be the $35,000 cash paid plus the $20,000 basis of the tractor he traded. John wants to maximize his deductions, so he claims the maximum $35,000 § 179 deduction (limited to cash paid) and continues to claim the $8,000 current-year depreciation on the trade basis. Therefore, his purchase generates $35,000 of increased tax deductions. This reduces John's self-employment tax by $4,945 ($35,000 × 0.9235 × 0.153). The deduction for one-half of the self-employment tax is therefore reduced by $2,472, resulting in a $32,528 ($35,000 – $2,472) net decrease in taxable income. At John's 25% income tax rate, he will save $8,132 of federal income tax. The total federal tax savings of the purchase using a like-kind exchange are $13,077 ($4,945 + $8,132).

If John sells his old tractor to the neighbor, he will recognize the $5,000 gain. All of this gain is ordinary income because of the depreciation recapture rules, but it is not subject to self-employment tax. Without a trade-in, John will pay the dealer the full $60,000 purchase price and can elect a $60,000 § 179 deduction. He no longer receives the $8,000 current-year depreciation on the old tractor, so the net reduction in his current-year Schedule F net income is $52,000. This reduces John's self-employment tax by $7,347 ($52,000 × 0.9235 × 0.153). The deduction for one-half of the self-employment tax is therefore reduced by $3,674, resulting in a $48,326 ($52,000 – $3,674) net decrease in taxable income. At John's 25% federal income tax rate, he will save $12,082 of federal income tax. The total tax savings of the sale followed by a purchase that is not a like-kind exchange are $19,429 ($7,347 + $12,082).

In the year of acquisition, John can reduce his tax liability by $6,352 ($19,429 – $13,077) by selling rather than exchanging his old tractor. However, tax planning is seldom a one-year proposition. With the trade, John will continue to depreciate the carry-over basis from the old tractor because he has deducted only $8,000 of basis in the current year. He will deduct the remaining $12,000 of basis in future years. If he continues in the same rate bracket, these future deductions will save John $1,696 in self-employment tax and $2,788 in income tax for a total of $4,484. In this case, John is still better off structuring the transaction as a sale ($6,352 savings in the exchange year, reduced by $4,484 future taxes, for a net saving of $1,868).

Shifting Income to Another Taxpayer

Chapter 5 discussed reducing self-employment tax by paying wages to the taxpayer's children under the age of 18. There are additional tax benefits to having other family members as bona fide employees, paying them for the use of farm assets they may own, or giving assets to them for them to sell.

Each taxpayer is entitled to his or her own standard deduction. In addition, if a taxpayer is not claimed as a dependent of another taxpayer, he or she is eligible for his or her own personal exemption deduction. Each taxpayer also has his or her own tax rate brackets to fill (unless subject to the so-called *kiddie tax*). These provisions of the tax law provide tax-planning possibilities for the farm family.

Example 7.9 Employing Family Members

Sven is in the 25% tax bracket and on average has a $100,000 Schedule F (Form 1040) profit. His 20-year-old daughter, Mary, is in college but spends many weekends, most school breaks, and summers working on the farm. She and Sven determine that $7,000 is reasonable compensation for the work she does on the farm. Mary still qualifies as Sven's dependent.

Because Mary is not under age 18, she and Sven must pay FICA tax on her $7,000 wage. Therefore, there will be no significant net savings from the reduction in Sven's self-employment tax. Because Mary is a dependent, she is ineligible for any deduction for a personal exemption. However, she is eligible for a standard deduction ($5,800 in 2011). Mary has no other income, so her taxable income is $1,200 ($7,000 wages minus $5,800 standard deduction). This leaves Mary in the 10% tax bracket, so she pays $180 of income tax.

Sven reduces his taxable income by $7,000 which saves $1,750 of income taxes. The net federal income tax savings to the family is $1,570 ($1,750 – $180) and the cash stays in the family.

This approach could also be considered in paying wages to parents who have retired from the farm and find themselves in a lower tax bracket than the family members currently operating the farm.

✔**Observation**

There may be non-tax considerations that enter into payments to others. College financial aid may be impacted by the student having increased earnings. Social security benefits may be reduced for a retired parent who has not yet reached full retirement age. In addition, increased earnings for those collecting social security benefits could result in more of those benefits being subject to income tax.

Example 7.10 Gift of Farm Asset

Gail, a dairy farmer, would like to give her daughter Beth $10,000 in 2011. Because this is Gail's only gift to Beth this year and it is under the $13,000 annual gift tax exclusion for 2011, she can make the gift without any gift tax consequences. However, Gail is in the 25% income tax bracket and Beth is in the 15% bracket. Gail normally sells $10,000 of raised cows each year that qualify for capital gain treatment. Instead of gifting cash to Beth, she could gift $10,000 of cows that Beth could then sell. If Gail sells the cows, the gain will be taxed at a 15% tax rate on capital gains. Beth is in the 0% tax bracket for capital gains, so the family can save $1,500 in income tax.

Non-farm Tax Planning

The majority of annual tax planning is likely to be driven by the income and expenses of the farm operation and how these items are managed using the techniques presented in this chapter as well as in Chapters 5 and 6. However, farmers and non-farmers alike may benefit from the following tax-planning considerations.

"Bunching" Itemized Deductions

Taxpayers often find that their itemized deductions fall just short of the amount of their standard deduction, and therefore they claim the standard deduction each year. The "bunching" strategy involves shifting itemized deductions into alternate years, so that the taxpayer is eligible for itemizing in those years. In the intervening years, the taxpayer claims the standard deduction.

Example 7.11 Managing Itemized Deductions

Barney and Betty normally have about $9,000 of itemized deductions. Therefore, they plan to claim the $11,600 standard deduction for 2011 instead of itemizing deductions. Assuming the standard deduction is also $11,600 for 2012, they will deduct $23,200 over the 2-year period.

If Barney and Betty accelerate $5,000 of itemized deductions from 2012 to 2011, they can deduct $14,000 in itemized deductions in 2011. In 2012, they will have only $4,000 of itemized deductions, so they will use the $11,600 standard deduction. They now claim $25,600 ($14,000 + $11,600) of tax deductions over the 2-year period and gain $2,400 ($25,600 – $23,200) in deductions.

Itemized deductions can be bunched by techniques such as

1. Making all planned charitable contributions in one year;
2. Grouping planned medical expenses (Junior's braces, wisdom teeth, etc.);
3. Making an estimated state income tax payment by December 31 to cover the full amount of state tax that will be due at the time of filing. [This will not benefit the taxpayer who is subject to the alternative minimum tax (AMT), because taxes are not a deduction for the AMT.]

Retirement Accounts

Contributions to retirement accounts also provide a tax-deferral opportunity. Such contributions can reduce the taxpayer's overall tax if the taxpayers are in a lower tax bracket in the years when they withdraw funds than in the years when they contribute the funds. Traditional Individual Retirement Accounts (IRAs) are a common vehicle for both farm and non-farm taxpayers. Not only are the contributions tax deductible, but the earnings are also tax deferred.

Example 7.12 Traditional Individual Retirement Account

Hose is in the 25% tax bracket and has a $75,000 farm profit. He expects to be in the 15% tax bracket when he withdraws the funds in retirement 10 years from now. He contributes and deducts $5,000 this year, which saves him $1,250 ($5,000 × 25%) of taxes. When he withdraws this $5,000 in retirement, his tax will be only $750 ($5,000 × 15%). Hose not only reduced his total tax by $500 but also delayed the tax by 10 years. In addition, the account generates earnings that are not taxed until Hose withdraws them.

Retirement accounts should be considered when taxpayers encounter a low-income year. Contributions to Roth IRAs may be a good option for those years. The disadvantage of Roth contributions compared to a traditional IRA is that the Roth contributions are not deductible, but that disadvantage is relatively small for a year in which the taxpayer is in a low tax bracket. The advantage of Roth IRAs is that the earnings are not simply tax deferred, as with traditional IRAs; qualified withdrawals from Roth IRAs are not subject to tax. This means that the earnings are **not taxed at all**. Taxpayers who are currently in a lower tax bracket than they expect to be when they retire should consider a Roth IRA. For some A taxpayers with a balance in a traditional IRA, it may be appropriate to convert the account to a Roth IRA. A conversion triggers taxable income currently but the taxpayer may take advantage of operating losses (see Chapter 10) or simply a lower than usual tax bracket.

Retirement accounts may also be used to maximize the benefits of having the taxpayer's children on the farm payroll, as discussed earlier in this chapter. Because IRA contributions are limited in amount (generally $5,000 in 2011) and are limited to earned income (wages and net earnings from self-employment), the family can increase tax-deductible and tax-deferred contributions by paying wages to children.

Example 7.13 IRAs for Taxpayer's Children Working on the Farm

Fred and Wilma file a tax return showing a $30,000 farm profit. They each contribute $5,000 to their IRAs. They could hire their son Dale for $5,000. Dale would then also be able to make a $5,000 contribution to his IRA. In addition, Fred and Wilma will receive the tax benefits discussed previously from hiring their son.

Health Plans

Health and accident insurance provided to employees can be claimed as a deduction by the employer on Schedule F (Form 1040) and does not have to be included in the employee's income.

Example 7.14 Health Insurance

Ariana Land owns and operates a farm. Ariana has a health plan that provides health insurance for employees. In 2011, Ariana paid $15,000 for health insurance premiums under the plan. Ariana can deduct $15,000 on her Schedule F (Form 1040), and her employees do not have to include that $15,000 in their income. If the employees' marginal tax rate (including income and employment taxes) is 35%, providing health insurance rather than paying $15,000 more in wages reduces the employees' taxes by $5,250 (35% × $15,000).

A health plan can also reimburse employees for the cost of health insurance and for health care costs that are not covered by health insurance.

Example 7.15 Reimbursement of Health Care Costs

The insurance that Ariana (from Example 7.14) provides for her employees requires the employees to pay 100% of the first $1,000 of health care costs and 20% of the next $5,000 of health care costs. In 2011, Ariana's employee John Tiller paid $1,200 for health care that was not covered by the health insurance.

If Ariana's health plan also provides for reimbursing employees for their out-of-pocket costs, Ariana can deduct her reimbursement of John's $1,200 expense. John does not have to include the $1,200 in income. If John's marginal tax rate is 35%, reimbursing his health care costs instead of paying him another $1,200 in wages reduces his taxes by $420 (35% of $1,200).

Similarly, if Ariana's health plan provided reimbursements for the cost of health insurance rather than providing health insurance, Ariana could deduct those reimbursements and her employees would not have to include them in income.

Family Members

A health plan can include health insurance for family members of employees and reimbursement of health care costs for family members of employees. If the business owner employs his or her spouse, the business owner can be included in the health plan as a member of the employee's family.

Example 7.16 Husband is an Employee

If Ariana's health plan (from Examples 7.14 and 7.15) includes members of employee's families, and her husband, Levi, is an employee of her business, then Ariana's business can pay for health insurance that includes coverage for both Levi and Ariana and her business can reimburse Levi for out-of-pocket health care costs for bothhimself and Ariana.

Self-employed individuals who are not eligible to participate in an employer-subsidized health plan can deduct the cost of health insurance for themselves and members of their family from income subject to federal income tax, but that deduction does not provide the same tax benefit as a health plan that includes the self-employed individual's spouse as an employee. Partners in a partnership, members of an LLC that is taxed as a partnership, and shareholders of S corporations can also claim the self-employed health insurance deduction. The advantages of an employee health plan, as compared to the self-employed health insurance deduction, are:

1. It allows the cost of health insurance to be deducted from income subject to the self-employment tax, as well as from income subject to federal income tax.
2. It allows reimbursements for out-of-pocket health care costs to be deducted, as well as the cost of health insurance.

Example 7.17 Husband is not an Employee

If Levi (from Example 7.16) is not an employee of Ariana's business, Ariana's cost of health insurance for her family can be deducted from income subject to federal income tax, but the out-of-pocket health care costs can be deducted only as itemized deductions, and none of the costs can be deducted from Ariana's self-employment income.

To illustrate, assume that the cost of health insurance for Levi and Ariana is $8,000 per year and their out-of pocket expenses for health care are $3,000. Also assume that Levi and Ariana's taxable income is in the 15% federal income tax bracket.

If Levi is not Ariana's employee, Ariana can deduct the $8,000 cost of their health insurance from their joint income subject to income tax, which reduces their federal income tax by $1,200 (15% ×$8,000).

If Levi is Ariana's employee and is included in her health plan for employees, Ariana can deduct both the $8,000 cost of the health insurance and the $3,000 reimbursement from her business income. That reduces her self-employment tax by $1,554 ($11,000 × 0.9235 ×15.3%) (for years other than 2011) and their joint income tax by $1,533 [$11,000 – (50% × $1,554) × 15%]. The $3,087 ($1,554 + $1,533) total savings from the health plan is $1,887 ($3,087 – $1,200) greater than the tax savings without the health plan.

Ariana must file all tax forms applicable to her employment of Levi. Therefore, she must file Forms W–2, W–3, and 943, but she should not include the cost of Levi's health insurance as taxable compensation because it is not subject to income tax or FICA tax.

Nondiscrimination

For 2011 and later years, most employers who provide either group health or accident insurance or a medical reimbursement plan are subject to certain nondiscrimination rules. A plan generally may not discriminate in favor of highly compensated individuals in either eligibility or benefits. A highly compensated employee is any of the following individuals:

1. one of the five highest paid officers,
2. an employee who owns (directly or indirectly) more than 10% in value of the business, and
3. an employee who is among the highest paid 25% of all employees (other than those who can be excluded from the plan).

The following employees may be excluded from the plan:

1. employees who have not completed 3 years of service,
2. employees who have not attained age 25,
3. part-time or seasonal employees,
4. employees represented by a collective bargaining agreement in which health benefits were the subject of good faith bargaining, and
5. employees who are nonresident aliens and who receive no earned income from the employer that constitutes income from a source within the United States.

Part-time is defined as under 25 hours per week, but if other employees with similar work have substantially more hours, then a part-time employee may work up to (but not including) 35 hours per week. *Seasonal* is defined as under 7 months per year, but if other employees with similar work have substantially more months, then a seasonal employee may work up to (but not including) 9 months per year.

If a plan favors highly compensated individuals, you must include all or part of the health benefits you provide to these employees in their wages subject to federal income tax withholding. However, you can exclude these amounts from the employee's wages subject to social security, Medicare, and FUTA taxes. The benefits provided to employees who are not highly compensated individuals are still tax-free.

The term *officer* generally means an executive with administrative authority in the business. Unincorporated entities such as sole proprietorships and partnerships may have officers for this purpose. The indirect (constructive) ownership rules deem an employee to hold the ownership interest of his or her spouse, parents, children, and grandchildren. Therefore, a plan must be nondiscriminatory before an employee-spouse can received fully excludable benefits.

SUMMARY

In addition to managing the timing of deductions and income, farmers can use income averaging, special tax rules for CCC commodity loans and loan deficiency payments, like-kind exchanges, shifting income to another taxpayer, bunching itemized deductions, retirement accounts, and health plans to manage their income tax liability to keep it as low as possible.

CHAPTER 8

DAMAGED, DESTROYED, OR STOLEN PROPERTY

SYNPOSIS (click on section title to go directly there)

Introduction

After their property is damaged, destroyed, or stolen, many taxpayers are surprised to learn that their economic loss is not a tax-deductible loss. This occurs in either of the following circumstances:

- The taxpayer does not have an income tax basis in the property, or
- The taxpayer is reimbursed for the loss (by insurance or other compensation) in an amount that is equal to or greater than the taxpayer's income tax basis in the property.

If a reimbursement exceeds the property's income tax basis, the taxpayer has a gain that must be reported on the income tax return.

The tax rules for these gains and losses are explained thoroughly in the publications listed in the following cross-reference. This chapter explains some of the basic rules and some planning opportunities for taxpayers whose property is damaged, destroyed, or stolen, but it does not provide a detailed explanation of these complex rules.

In cooperation with the participating land-grant universities, this project is funded in part by USDA-Risk Management Agency under a cooperative agreement. The information reflects the views of the author(s) and not USDA-RMA.

Cross-Reference

IRS publications that explain the tax rules for damaged, destroyed, and stolen property are:

- IRS Publication 547, *Casualties , Disasters, and Thefts*
- IRS Publication 584, *Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)*
- IRS Publication 584-B, *Business Casualty, Disaster, and Theft Loss Workbook*
- IRS Publication 225, *Farmer's Tax Guide* (Chapter 11 in the 2010 edition)

IRS Form 4684, Casualties and Thefts, and its instructions are also very helpful in calculating the tax consequences for damaged, destroyed, and stolen property.

General Rules

When property is damaged, destroyed, or stolen, the owner suffers an economic loss unless the loss is fully reimbursed by insurance or other compensation. The damage, destruction, or theft may result in a tax loss or a tax gain, depending on whether the compensation is less than or greater than the property owner's income tax basis in the property.

Example 8.1 Casualty Gain or Loss

Rose Petal's cow was struck by lightning and killed. The cow was worth $700, and Rose's insurance company compensated her for $500 of the loss. Therefore, Rose's economic loss is $200 ($700 – $500). However, Rose had deducted all the costs of raising the cow, so she had a zero income tax basis in it. Consequently, Rose had a $500 ($500 – $0) tax gain.

Casualty and Theft Losses

The Internal Revenue Code gives taxpayers more favorable treatment of casualty and theft losses than of other losses.

Personal-Use Property

If the property's use is for **personal purposes**, one favorable treatment is allowing part of the loss to be included as an itemized deduction on Schedule A (Form 1040), Itemized Deductions. By contrast, losses of personal use property that are **not** due to a casualty or theft are not deductible. Two reductions apply to personal casualty or theft losses—$100 per loss event and a 10% of adjusted gross income (AGI) subtraction from the total of all such losses.

Example 8.2 Loss on Personal-Use Property

Pedro Gonzales' exotic pet bird was killed by a cat. The bird was worth $10,000 and Pedro's insurance company compensated him for $7,000 of the loss. Pedro paid $12,000 when he purchased the bird and therefore realized a $5,000 ($12,000 – $7,000) loss for income tax purposes. Because the bird's death was a casualty (it was sudden and unexpected), the loss may be included as an itemized deduction on Pedro's income tax return after subtracting $100 and 10% of his AGI from the $5,000. If the bird had died from natural causes, Pedro could not deduct any of his loss.

The acceleration of a disaster-area casualty loss deduction that is explained in the next section also applies to disaster losses incurred on personal-use property.

Business-Use Property

If the property's use is for **business purposes** and the loss occurred in a federally declared disaster area, the taxpayer may elect to deduct the loss in the tax year preceding the disaster. By contrast, losses that are **not** due to a federally declared disaster must be deducted in the year the loss occurred unless there is a reasonable likelihood the loss will be reimbursed. If there is a reasonable likelihood that part or all of the loss will be reimbursed, the deduction is deferred (to the extent of the likely reimbursement) until the tax year it becomes reasonably unlikely that it will be reimbursed.

The $100 and 10% of AGI reductions do not apply to business property losses.

Casualty

For federal income tax purposes, a **casualty** is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. For example, damage to shingles caused by a hailstorm is a casualty loss, but gradual damage to shingles by the sun over several years is not a casualty.

Loss of property due to progressive deterioration is not deductible as a casualty loss because the damage results from a steadily operating cause or normal process, rather than from a sudden event. The following are examples of damage due to progressive deterioration rather than from a sudden, unexpected, or unusual event:

- Gradual weakening of a building due to normal wind and weather conditions.
- Deterioration and damage to a water heater that has burst. However, rust and water damage to rugs and drapes caused by the bursting of a water heater does qualify as a casualty.
- Most losses of property caused by a drought. To be deductible, a drought-related loss must be incurred in a trade or business or in a transaction entered into for profit.
- Damage or destruction of trees, shrubs, or other plants by fungus, disease, insects, worms, or similar pests. However, a sudden destruction due to an unexpected or unusual infestation of beetles or other insects may result in a casualty loss.

Theft

A **theft** is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the law of the state where it occurred, and it must have been done with criminal intent.

Theft losses are calculated in the same manner as casualty losses, but the loss is reported in the year that the taxpayer discovers the theft.

Example 8.3 Theft Loss

Thieves removed irrigation pipe from Lemon Lime's orchard. The fair market value of the missing pipe was $5,000 and Lemon's income tax basis in the missing pipe was $3,000. Lemon did not have any insurance coverage.

Lemon's casualty loss for tax purposes is limited to the $3,000 income tax basis in the asset.

Casualty and Theft Gains

The tax law also treats gains that result from a casualty or theft favorably by treating them as resulting from an involuntary conversion of the property. This allows the taxpayer to avoid recognizing the gain if he or she reinvests the insurance proceeds or other compensation in replacement property. The unrecognized gain is deferred by reducing the taxpayer's basis in the replacement property. Therefore, a subsequent taxable transfer of the property causes the taxpayer to recognize the gain.

Cross-Reference

See the discussion of postponing gain on pages 69-71 of IRS Publication 225, *Farmer's Tax Guide (2010),* for more information on involuntary conversions.

Example 8.4 Deferring Casualty Gain

Rose Petal, from Example 8.1, may elect to defer the $500 gain from her cow that was killed by lightning if she buys a replacement cow that costs $500 or more by the end of the second tax year following the year the cow was killed. The entire insurance payment must be reinvested to postpone all of the gain.

Tax Management of Damaged, Destroyed, or Stolen Property

Although the tax benefits are often less than a taxpayer anticipates, there are tax-planning opportunities when property is damaged, destroyed, or stolen.

Deferring Recognition of Gain

As noted in the previous section, property that is damaged, destroyed, or stolen is eligible for the involuntary conversion rules. An involuntary conversion does not have to result from a casualty. Therefore, the destruction could be due to progressive deterioration. If the taxpayer receives compensation for the damaged or destroyed property that results in a gain, the taxpayer may elect to defer recognition of the gain if he or she reinvests the compensation in similar property by the end of the second tax year after the damage, destruction or theft.

✔ **Observation**

Rules Less Restrictive than Like-kind Exchange Rules

Although the involuntary conversion rules are similar to the like-kind exchange rules, some differences make the involuntary conversion rules more taxpayer-friendly. A broader range of property often qualifies as replacement property in an involuntary conversion than under the like-kind exchange rules. (However, for some involuntary conversions, a narrower range of property qualifies as replacement property than under the like-kind exchange rules.) A second difference is that a taxpayer may take possession of the compensation for the converted property under the involuntary conversion rules before acquiring the replacement property. By contrast, a taxpayer can defer gain under the like-kind exchange rules only if the proceeds from the relinquished property are held by a qualified intermediary until they are used to acquire the replacement property.

Example 8.5 Deferred Gain

Amanda Reckonwith owns farmland by a river that floods regularly. Amanda paid $1,000 per acre for the land in 1975. In 2011, a flood washed out a levee, and 10 acres of her land are now under water. Instead of rebuilding the levee, the government bought the 10 acres from Amanda for $3,000 per acre.

Amanda has realized a $2,000 ($3,000 – $1,000) per acre gain from this involuntary conversion of her land. If she does not replace the land, she must recognize $20,000 ($2,000 × 10 acres) of long-term capital gain in 2011. The federal income tax rate on her long-term capital gain is 15%, and her state income tax marginal rate on her long-term capital gain is 5%. Therefore, Amanda must pay $4,000 ($20,000 × 20%) income tax on the gain if she does not acquire replacement property timely.

If Amanda pays at least $30,000 for replacement land, regardless of total acreage, she can defer recognition of the gain by rolling it into the replacement land. For example, she can defer the gain if she buys 25 acres of land for $50,000 ($2,000 per acre). Her basis in the replacement 25 acres will be her $10,000 ($1,000 × 10 acres) basis in the flooded land, plus the $20,000 excess she paid for the replacement land over the $30,000 she received for the flooded land. Therefore, her basis in the replacement land is $30,000 ($10,000 + $20,000). If she later sells the replacement land for $50,000, she will then recognize the $20,000 gain that was deferred from the 10 acres the government bought from her.

Depreciable Replacement Property

If replacement property is depreciable, it is often more advantageous to **not** defer gain from involuntarily converted property. By not deferring the gain, the taxpayer acquires a higher income tax basis in the replacement property. The depreciation or I.R.C. § 179 deduction for that higher basis reduces not only ordinary income but also self-employment income. By contrast, the gain that is recognized increases only ordinary income or capital gains and does not increase self-employment income.

> **Cross-Reference**
> See the discussion of self-employment tax in Chapter 6 of this guide.

Example 8.6 Depreciable Replacement Property

Allen Rentch's tractor caught on fire in 2011 and was damaged beyond repair. The loss was insured, and his insurance company paid him the tractor's $5,000 fair market value. Allen had depreciated his original $12,000 basis of the tractor down to zero, so he realized a $5,000 tax gain from the tractor's loss.

- If Allen does not elect to defer the gain he must report $5,000 of ordinary income (depreciation recapture) on his 2011 income tax return. Allen is in the 15% federal marginal income tax bracket and a 5% state marginal income tax bracket. Therefore, recognizing the gain adds $1,000 ($5,000 × 20%) to his 2011 income tax liability.
- If Allen pays $5,000 for a used replacement tractor and elects to defer the gain on the destroyed tractor, he has no gain to report in 2011 and has a zero basis in the replacement tractor. If he sells the replacement tractor in 2015 for $5,000, he must report $5,000 of ordinary income in 2015. If his marginal tax rates are the same as in 2011, he will pay an additional $1,000 of income tax for 2015 due to the sale of the tractor. Therefore, his tax liability is the same, but he has postponed paying the $1,000 of taxes for 5 years.
- If Allen pays $5,000 for a used replacement tractor and **does not** elect to defer the gain on the destroyed tractor, he must report the $5,000 of gain in 2011. However, if he has not used up his $500,000 I.R.C. § 179 deduction for 2011 on other property, he can elect to deduct the entire $5,000 cost of the replacement tractor in 2011. That deduction offsets his entire $5,000 gain from the destroyed tractor. It also reduces his self-employment income for 2011, which saves him $614 ($5,000 × 92.35% × 13.3%) of self-employment tax. The self-employment tax savings reduces his self-employment tax deduction from ordinary income by $307 ($614 × 50%), which adds $46 ($307 × 20%) to his income taxes. Therefore, the net tax savings is $568 ($614 – $46).

  If Allen has used his I.R.C. § 179 deduction on other property, he can depreciate the $5,000 he paid for the used replacement tractor over 8 tax years (7-year property with a half-year convention). The used tractor does not qualify for additional first-year depreciation because its original use did not begin with Allen. The depreciation deductions will reduce his ordinary income and self-employment income by a total of $5,000 over the 8 years. Therefore, by not electing to defer the gain on his destroyed tractor, Allen has accelerated $1,000 of taxes into 2011 but will save $1,635 of taxes over the 8 years. Using a 6% discount rate, the present value of the $1,635 of tax savings over the 8 years is $1,374. Therefore, the net value of Allen's tax savings over the 8 years is $374 ($1,374 – $1,000) and even without the I.R.C. § 179 deduction, Allen is better off **not** electing to defer the gain from the destroyed tractor.

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Planning Pointer

Capital Gain on Converted Property

If the gain on the converted property is capital gain and the replacement property can be depreciated, it is even more advantageous to include the gain in income rather than deferring it. For example, if in Example 8.6, Allen lost five raised cows held for more than a 24 months and realized the same $5,000 gain, the gain would be long-term capital gain, and the federal income tax rate on that gain is zero in 2011. Assuming a 5% state income tax rate on long-term capital gain, Allen would owe only $250 ($5,000 × 5%) of income tax on the realized gain if he did not defer that gain. His $5,000 basis in replacement cows would reduce his income and self-employment taxes by the same $1,635 as in Example 8.6.

Effect on Netting of Gains and Losses

The tax rules allow taxpayers to deduct a net loss from certain property they use in a trade or business from ordinary income but to treat a net gain from that property as a capital gain. For example, if a farmer has a $10,000 gain from selling cull cows and a $12,000 loss from selling machinery in 2011, the net $2,000 loss is deducted from ordinary income. If the loss on the machinery is only $7,000, the $3,000 net gain is taxed as capital gain.

If a taxpayer has a net gain from damaged, destroyed, or stolen property during a tax year, that net gain is included in the netting of gains and losses from property used in a trade or business. However, if a taxpayer has a net loss from damaged, destroyed, or stolen property, that net loss is deducted from ordinary income without netting it with the gains and losses from property used in a trade or business.The effect of these rules is the following. If a taxpayer has a net gain from damaged, destroyed, and stolen property and also has a net gain from assets used in the trade or business, the losses from damaged, destroyed, or stolen property just reduce gain that is taxed as capital gain. By contrast, if a taxpayer has a net loss from damaged, destroyed, or stolen property, that net loss reduces ordinary income.

Electing to defer gain from damaged, destroyed, or stolen property preserves the benefits of deducting a loss from other property in the same tax year.

Example 8.7 Preserving Ordinary Deduction

A tornado completely destroyed Braxton Bovine's barn on August 29, 2011, killing the 20 dairy cows that were in the barn. Figure 8.1 shows information from Braxton's records regarding the barn and the cows.

Figure 8.1 Braxton Bovine's Records

Item	Barn	20 Dairy Cows
Purchase date	May 15, 1990	August 20, 2007
Cost	$35,000	$20,000
Depreciation claimed	– 35,000[1]	– 13,336[2]
Adjusted basis	$0	$6,664
FMV before casualty	$ 35,000	$ 17,000
Insurance payment	$ 30,000	0
Gain or loss	$ 30,000	- $6,664

[1] 150% declining balance for 20-year property

[2] 150% declining balance for 5-year property, half-year convention

If Braxton does not elect to roll the gain from the barn into a replacement barn, the $6,664 loss from the cows reduces the $30,000 gain from the barn, so that Braxton reports only the $23,336 ($30,000 – $6,664) remaining gain as long-term capital gain. His other ordinary income is not reduced by the loss.

If Braxton elects to roll the gain from the barn into a replacement barn, the $6,664 loss from the cows offsets ordinary income in 2011 rather than capital gain on the barn.

Accelerating a Loss Deduction

If a disaster caused your area to be eligible for federal assistance, you can elect to deduct the loss on your original or amended return for the tax year immediately preceding the tax year in which the disaster occurred. There are two potential advantages of making this election:

1. Accelerating the deduction may allow you to realize the tax savings earlier.
2. Accelerating the deduction may offset income in a higher tax bracket.

Example 8.8 Earlier Tax Savings

The roof on Paige Turner's barn collapsed under the weight of ice from a January 2011 ice storm that caused her county to be declared a federal disaster area. Paige files her income tax return on a calendar-year basis. Because she qualifies as a farmer, she avoids the penalty for not making estimated tax payments by filing her return and paying her taxes before March 1 each year. The barn was not insured, and her income tax basis in it was $10,000. Therefore, Paige realized a $10,000 loss that she can deduct on her 2011 income tax return.

Paige can elect to accelerate the deduction by claiming the $10,000 loss on her 2010 tax return. If she is in the same income tax brackets in 2010 and 2011, she will realize the same tax benefit on either income tax return. However, by claiming the deduction on her 2010 income tax return, Paige will realize the tax savings when she files the 2010 income tax return and pays her taxes in February 2011 rather than when she files her 2011income tax return and pays her taxes in February 2012.

In many cases, the disaster that caused the tax loss also reduces income for the tax year. Consequently, taxable income in the year preceding the loss year may be in a higher tax bracket than in the year of the disaster. If that is the case, accelerating the tax deduction results in a larger tax savings from the deduction.

Example 8.9 Greater Tax Savings

The ice storm in Example 8.8 also suffocated most of Paige's alfalfa crop, which reduced her 2011 income substantially. As a result, her taxable income for 2011 is in the 15% federal income tax bracket. In 2010, her taxable income was in the 25% federal income tax bracket.

By electing to deduct the $10,000 loss on her 2010 income tax return, Paige increased the income tax savings from the deduction from $1,500 (15% of $10,000) to $2,500 (25% of $10,000).

Summary

Many taxpayers are surprised to learn that losing property in casualties, thefts, or disasters often does not result in the deductible income tax loss they expected. However, special income tax provisions provide some tax advantages. These provisions may allow taxpayers to postpone reporting taxable gain or to accelerate reporting tax losses. Making optimal use of these special provisions can take some of the economic sting out the unexpected loss of property.

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CHAPTER 9

ALTERNATIVE MINIMUM TAX

SYNPOSIS (click on section title to go directly there)

Introduction

Congress imposed the alternative minimum tax (AMT) to prevent taxpayers with significant income from combining specified tax exclusions, deductions, and credits so as to pay very little or no federal income tax. When it was first enacted in 1969, the AMT affected only a few very high-income taxpayers. But since it was first imposed, changes to the regular tax rules have caused many more taxpayers to pay the AMT. This chapter gives a basic explanation of the AMT, some examples of situations that cause taxpayers to pay it, and some planning techniques to minimize the AMT's impact.

Cross-Reference

More detailed information

For more detailed information about the AMT for individual taxpayers, see the 2-page Form 6251, Alternative Minimum Tax--Individuals, and the 12 pages of instructions for it. Form 6251 and its instructions can be accessed at www.irs.gov. Enter "Form 6251" in the search box in the upper right hand corner.

The terminology of the AMT tax is a little confusing because the tax is technically an add-on tax (added on to the regular tax liability) rather than an alternative to the regular income tax. Therefore, taxpayers report their regular income tax on their income tax return and then add on the AMT to find their total income tax liability.

But while the AMT is technically an add-on tax, it has the effect of an alternative tax because taxpayers calculate their AMT by subtracting regular tax liability from a *tentative minimum tax*. If the taxpayer's tentative minimum tax is less than the regular tax, there is no AMT. If the tentative minimum tax is greater than the regular tax, the AMT is the difference between the tentative minimum tax and the regular tax. The effect of these rules is that taxpayers must pay the higher of the regular tax or the tentative minimum tax.

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This chapter focuses on the AMT imposed on individual taxpayers. The individual AMT is the only AMT imposed on income from most partnerships, S corporations, and limited liability companies (LLCs) that are taxed as disregarded entities, because the income of those entities is taxed at the ownership (partner, shareholder, or member) level—the entities themselves do not pay tax on the income. The AMT imposed on C corporations is discussed briefly at the end of the chapter.

Basic AMT Calculation

Taxpayers compute their tentative minimum tax by first computing their alternative minimum taxable income (AMTI), which is their taxable income for regular tax purposes adjusted by the difference between deductions that are allowed for the regular tax and those that are allowed for the AMT. The AMTI is then reduced by an exemption amount. The resulting income is multiplied by 26% for the first $175,000 ($87,500 for married filing separately) and 28% for the amount over $175,000 ($87,500.

AMT Adjustments

To calculate AMTI, taxpayers start with their taxable income and then add back some of the deductions they claimed to compute their taxable income. They also make some adjustments that reduce their taxable income. These adjustments account for the differences between the deductions that are allowed for the regular income tax and those that are allowed for the AMT.

Example 9.1 AMT adjustments

Andy and Mary Thompson are married and have four children. In calculating their $65,000 taxable income for 2011, they included the following deductions that affect AMTI:

1. $28,876 depreciation on a farm building (built in 2010 for $400,000; depreciated over 20 years using the 150% declining balance method)
2. $5,000 state income tax
3. $10,000 real property taxes on their home
4. $22,200 personal and dependent exemptions deduction (Andy, Mary, and four children)

The AMT rules require Andy and Mary to add the following amounts to their taxable income to compute their AMTI:

1. $8,876 of the farm building depreciation (this is the excess over the $20,000 of depreciation that could be claimed using the straight-line depreciation method over 20 years)
2. $5,000 state income tax (the entire amount)
3. $10,000 real property taxes on their home (the entire amount)
4. $22,200 personal and dependent exemptions deduction (the entire amount)

Adding the $46,076 total of these adjustments to their $65,000 taxable income results in an $111,076 AMTI.

AMT Exemption Amounts

Figure 9.1 shows the maximum AMT exemption amounts provided in the Internal Revenue Code (I.R.C.) for any year that the Congress does not temporarily increase them. However, each year beginning in 2001 Congress has temporarily increased these exemption amounts for individual returns, and it is likely to continue to increase them or otherwise change the AMT rules to reduce the impact of the AMT. Figure 9.1 also shows the temporary increase in the exemption amounts for 2011. The examples in this chapter use the amounts shown in Figure 9.1 for 2011. If Congress does not temporarily increase the AMT exemption amounts for a year after 2011, AMT liability will dramatically increase for some taxpayers.

Figure 9.1 AMT Exemption Amounts

Filing Status	I.R.C. Exemption Amount	2011 Exemption Amount
Married individuals filing jointly	$45,000	$74,450
Surviving spouses	45,000	74,450
Head of household	33,750	48,450
Single individuals	33,750	48,450
Married individuals filing separately	22,500	36,225
Estates and trusts	22,500	22,500
Corporations	40,000	40,000

Example 9.2 Basic AMT Calculation

Andy and Mary Thompson from Example 9.1 compute their AMT as shown in Figure 9.2.

FIGURE 9.2 AMT Calculation

AMTI	$111,076
Exemption	– 74,450
AMT tax base	$ 36,626
AMT tax rate on first $175,000 of AMTI	× 0.26
Tentative minimum tax	$ 9,523
Regular tax on $65,000	– 8,904
AMT	$ 619

Note that Andy and Mary pay the $8,904 regular tax plus the $619 AMT for a total tax of $9,523, which is equal to the tentative minimum tax. Therefore, the effect of the AMT is to make taxpayers pay the higher of their regular tax liability or their tentative minimum tax.

✔ **Observation**

Exemption Amount Stated in I.R.C. Would Increase AMT

If Congress had not increased the AMT exemptions for 2011, Andy and Mary would owe $8,276 of AMT for 2011. Subtracting the $45,000 exemption from their $111,076 AMTI leaves $66,076. When $66,076 is multiplied by the 26% AMT rate, the tentative minimum tax is $17,180, which exceeds their $8,904 regular tax by $8,276.

AMT Credit

The AMT caused by some adjustments can create a credit that reduces regular income tax liability in subsequent tax years. In effect, these adjustments do not increase a taxpayer's total tax liability; they simply accelerate income tax liability by imposing the AMT in one year and reducing income taxes in a later year. Because taxpayers must pay the higher of their regular tax or their tentative minimum tax each year, a subsequent-year reduction of AMTI does not in itself produce the offsetting benefit that the credit provides.

Adjustments That Create an AMT Credit

The adjustments that can create an AMT credit are those that defer deductions rather than permanently prohibit them. For example, some assets can be depreciated at a faster rate for regular tax purposes than for AMT purposes. In the early years of depreciating those assets, the regular tax depreciation exceeds the AMT depreciation, and the excess is an addition to AMTI that can cause an AMT liability. In the later years of depreciating those assets, the regular tax depreciation is less than the AMT depreciation, and the deficit is subtracted in calculating AMTI. By the end of the assets' recovery period, the total regular tax depreciation and the AMT depreciation are the same. Therefore, the AMT rules simply deferred the depreciation deduction—they did not reduce the total depreciation deduction.

AMT adjustments that cause a permanent difference in regular taxable income and AMTI **do not** create an AMT credit. These adjustments include

- itemized deductions, including any investment interest expense reported on Schedule E,
- the standard deduction, and
- the personal and dependent exemptions deduction.

Example 9.3 AMT Credit

In Example 9.2, Andy and Mary Thompson's AMT for 2011 was $619. Three of their four AMT adjustments—the $5,000 of state income tax, $10,000 of real property taxes, and $22,200 of personal and dependent exemptions deduction—**are not** deferral adjustments. The AMT caused by those permanent adjustments does not create an AMT credit.

However, their $8,876 depreciation adjustment **is** a deferral adjustment that creates a $619 AMT credit. (Without the $8,876 depreciation adjustment, their 2011 AMT would be zero). The credit can be subtracted from their regular tax liability in 2012, but a limit applies: It can reduce their regular tax liability only to their tentative minimum tax for 2012. Any excess is carried forward to reduce regular income taxes in future years, subject to each year's tentative minimum tax limit.

✓ **Observation**

AMT on Deferral Items Only Accelerates Tax Liability

Because Andy and Mary receive a $619 credit in 2012 for the $619 AMT they paid in 2011, the AMT did not permanently increase their income tax. The AMT only accelerated the $619 liability from 2012 to 2011.

AMT Management and Planning Issues

The examples in this section show how the AMT affects taxpayers with large capital gains or itemized deductions that are limited for the AMT calculation.

Taxpayers with Large Capital Gains

The same capital gains tax rates that are used for regular tax liability apply in calculating the AMT. Although these rates do not trigger the AMT, taxpayers with large capital gains nevertheless may be subject to the AMT as a result of a reduction or loss of the AMT exemption. The AMT exemption amounts shown in Figure 9.1are maximums; the exemption is phased out for higher income taxpayers. (The phase-out begins when AMTI exceeds $112,500 for taxpayers filing as single or head of household, $150,000 for joint returns and surviving spouses, and $75,000 for married taxpayers filing separate returns.) Thus, while the tax rate on capital gains is still capped at 15%, the tentative minimum tax increases because the reduced AMT exemption increases the total income that is subject to the AMT rates.

Example 9.4 Taxpayer with Large Capital Gains

Tommy Hawk is single with no dependents. In 2011, Tommy decided to quit farming, He sold his 70 acres of farmland but kept his home, outbuildings, and machinery. He had $25,000 of farm income for 2011 and $35,000 of wages from a new job. He sold the 70 acres for $260,000. His income tax basis in the land was $30,000, so he had a $230,000 capital gain from its sale.

Tommy claims the $5,800 standard deduction, and his personal exemption deduction is $3,700. If Tommy had not sold the land, he would not owe any AMT. His AMTI would be $58,234 ($25,000 farm income – $1,766 SE tax deduction + $35,000 wages). His income subject to the AMT after subtracting his $48,450 AMT exemption would be $9,784, and he would have a $2,544 tentative minimum tax ($9,784 × 26% = $2,544), which is less than the $8,769 regular tax on his $50,500 taxable income.

However, the capital gain from the farmland sale increases his taxable income to $278,734 and his regular tax to $42,815. The capital gain is still taxed at the 15% rate, but its inclusion in his AMTI reduces his $48,450 AMT exemption to $6,892 and his AMT increases to $5,652.

Planning Pointer

Spread Capital Gains to More Than One Year

If large capital gains would cause the AMT, spreading them over more than one year can reduce or eliminate the additional liability. Spreading the gains can keep AMTI below the threshold for reducing the AMT exemption amount.

The current income tax rates on long-term capital gains are as low as they have been for many years. They will increase in 2013 under current law. The risk of paying a higher income tax on long-term capital gains in future years should be factored into a decision to postpone capital gains.

Capital gains can be spread out by making an installment sale or by selling part of the assets in each of two or more years. Be sure to compare the tax savings with the risk of not being paid on an installment contract or the risk of a price decrease if you delay selling part of the assets.

Example 9.5 Spreading Capital Gains

Tommy Hawk from Example 9.4 sold his farmland for $260,000, but he entered into an installment contract that required the buyer to pay $130,000 in 2011 and $130,000 plus interest in 2012. After subtracting $15,000 of basis from each of those payments, Tommy has $115,000 of long-term capital gain to report in each year. He has $58,234 of ordinary income and claims the standard deduction and one personal exemption deduction for 2011. Tommy's AMT for 2011 is zero.

If his income is similar in 2012, and the AMT exemption amounts, tax rates, standard deduction, and personal exemption deduction are the same for 2012 as they are for 2011, Tommy also will owe no AMT for 2012. Spreading the capital gain over the two years reduces his total AMT from $5,652 to zero.

Itemized Deduction Limitations

The AMT calculation eliminates or limits several of the Schedule A (Form 1040) itemized deductions. They include the following four common itemized deductions.

1. State and local taxes (including property taxes, income taxes, and sales taxes) are not deductible at all in calculating AMT. Taxpayers with high state and local taxes are more likely to have an AMT liability.
2. Miscellaneous itemized deductions subject to the 2%-of-adjusted-gross-income (AGI) floor are not allowed for the AMT.

- Hobby activity deductions are allowed for regular tax purposes as a 2%-of-AGI-floor miscellaneous deduction to the extent of the income from the hobby activity, but they are not deductible for the AMT. Therefore, taxpayers with significant hobby expense deductions for regular tax purposes may have an AMT liability.
- Employee business expenses are allowed as a 2%-of-AGI-floor miscellaneous deduction, but they are not deductible for AMT. Therefore, taxpayers with significant employee business expenses may have an AMT liability.

3. Home mortgage interest on indebtedness that is **not** used to acquire, construct, or substantially improve the taxpayer's main home or second home is not deductible for AMT.
4. Medical and dental expense deductions are limited to a 10%-of-AGI floor instead of the 7.5%-of-AGI floor that applies to the regular tax liability calculation.

Example 9.6 Hobby Expenses

Mia Bombardini, a single taxpayer with no dependents, has $45,000 of wages for 2011. She raises horses, and the IRS treats her horse activities as a hobby because she has not made a profit in the first seven years of raising horses. In 2011, Mia had $40,000 of revenue and $48,000 of expenses from her horse activity. The hobby loss rules limit her expense deduction for regular tax purposes to her $40,000 of revenue from the activity. The deduction is further reduced by 2% of her AGI. As a result, her taxable income is $27,000 and her regular income tax is $3,629.

Mia cannot deduct the $40,000 of horse expenses and certain other deductions when she computes her AMT. Consequently, Mia owes $1,604 of AMT in addition to her $3,629 regular tax.

Planning Pointer

Prepayment of Taxes

Taxpayers who prepay property taxes or state income taxes for the following year (doubling the current-year deduction) to maximize the use of the standard deduction the following year may find themselves with an AMT liability that reduces or eliminates the intended tax benefit.

AMT for Corporations

The AMT for corporations is similar to the AMT for individuals with a few important differences. The first important difference is that small C corporations are exempt from the AMT. For this purpose, a small corporation is one whose average annual gross receipts for all prior 3-tax-year periods do not exceed $7,500,000. (If the C corporation had only one prior tax year, the average annual gross receipts limit is $5,000,000.) Therefore, most small- and medium-sized farms that are operated as C corporations are not subject to the AMT.

Differences for C corporations that are subject to the AMT include the following:

1. Some preferences and adjustments taken into account in computing AMTI are different.
2. The AMT exemption is $40,000.
3. The tax rate used to compute the tentative minimum tax is 20%.

The Future of the AMT

AMT has become a growing concern for more and more taxpayers. It affects more taxpayers because Congress has reduced regular income tax rates without changing the AMT rates. Regular tax rate brackets are also indexed for inflation, but the AMT brackets are not.

Congress has temporarily increased the AMT exemption amounts each year since 2001 and may temporarily increase them or make other changes to the AMT in future years. It has considered permanently increasing the AMT exemption amount and indexing it for inflation. Other potential solutions are increasing the AMTI threshold for phasing out the AMT exemption and repealing the AMT.

Taxpayers should take these potential changes into consideration when planning their business activities to minimize federal income taxes.

CHAPTER 10

NET OPERATING LOSSES

SYNPOSIS (click on section title to go directly there)

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Introduction

Weather, disease, and variable prices for inputs and commodities often cause farmers' incomes to fluctuate from one year to the next. As discussed in Chapter 5, "Managing Timing of Income and Deductions," farmers can minimize their income tax liability by timing income and deductions to keep their taxable income level. In some cases, leveling techniques are not enough to avoid a spike or a dip in taxable income. The tax effect of spikes can be minimized with the income-averaging rules discussed in Chapter 7, "Other Tools to Manage Income Tax Liability." If taxable income dips below zero, the tax effect can be managed with the net operating loss (NOL) rules discussed in this chapter.

The concept of the NOL rules is quite simple: Taxpayers are allowed to carry business losses from the loss year to offset taxable income in other tax years. A loss can be carried back and/or forward.

Planning Pointer

NOL Rules Are Last Planning Resort

The NOL rules **do not** make the best use of business deductions. Therefore, farmers should first try to smooth their taxable income with the leveling techniques discussed in Chapter 5 of this guide. When those techniques do not fully succeed in avoiding negative taxable income, the NOL rules make the best of an unfortunate situation.

Most NOLs have a 2-year carryback limitation, but a farm NOL is carried back 5 years unless the taxpayer elects to forgo the 5-year carryback. If the NOL is not fully absorbed (used up) in the fifth tax year that precedes the loss year, the excess is carried to the fourth prior year and so on until the NOL is fully absorbed. If all or part of the NOL is unused after it has been carried to the first year before the loss year, the balance is carried forward to the year after the loss year and then to subsequent years until it is fully absorbed. However, an NOL can be carried forward only 20 years.

Caution

Income Absorbing the NOL

As discussed later in this chapter, if the NOL exceeds taxable income in a carryback or carryforward year, the amount of the NOL that is absorbed will be more than the taxable income for the carryback or carryforward year.

Example 11.1 Absorption of NOL Carryover

Pete Moss started his horticulture farm in 2005 as a sole proprietor. His business blossomed in several good years before 2011. In 2011, a late frost followed by a June hailstorm and an August drought caused an $80,000 farm loss. Pete had no other income or losses that year, and he carried his $80,000 farm NOL back to 2006, which absorbed $15,000 of it. The remaining $65,000 was carried to 2007 and subsequent years as shown in Figure 11.1.

If the $10,000 NOL carryforward remaining after 2012 is not fully absorbed by 2031 (20 years after the 2011 NOL year), any remaining NOL is lost and can never be deducted.

FIGURE 11.1 Absorption of Pete Moss's 2011 NOL

Carryback or Carryforward Year	Year	NOL Carryback or Carryforward	NOL Absorbed	NOL Remaining
Fifth year before loss year	2006	$80,000	$15,000	$65,000
Fourth year before loss year	2007	65,000	12,000	53,000
Third year before loss year	2008	53,000	11,000	42,000
Second year before loss year	2009	42,000	17,000	25,000
First year before loss year	2010	25,000	7,000	18,000
First year after loss year	2012	18,000	8,000	10,000

Although the principle of NOLs is simple, actual computation of NOL deductions can be complex. Complexity arises because the NOL is limited to business losses that are not carried to other years under other tax rules, such as the capital loss carryover rules. These limitations require taxpayers to add back some expenses and losses that were deducted to compute taxable income. The computations are further complicated by required modifications to taxable income in the years to which the NOL is carried.

Cross Reference

For more information on NOLs, see IRS Publication 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*. It can be accessed from the IRS website, www.irs.gov.

Computing the NOL

One way to compute an NOL is to start with the year's negative taxable income and add back the deductions that are not allowed to be included in the NOL.

Observation

Taxable Income Must Be Negative to Have an NOL

If you have positive taxable income for a tax year, you do not have an NOL for that year even if your business has a net loss. Positive taxable income indicates that you have income from other sources (such as wages, nonbusiness income, or income from other businesses) that offsets the business loss, so there is no net loss left to carry to another tax year.

Items Not Included in NOL

Several deductions included in the calculation of taxable income are not included in NOL calculations. These usually are excluded from the NOL computation for one of the following two reasons:

1. Generally, only **business** losses can be carried to another year; therefore, with a few exceptions, nonbusiness deductions in excess of business income are not included in the NOL.
2. Items that carry to another tax year under another carryover rule—such as capital loss carryovers—are excluded from the NOL calculation to avoid duplication.

The following items are examples of deductions that are removed from the NOL by adding them back to the taxpayer's negative taxable income:

1. Dependent and personal exemptions deduction

Computation Note

Schedule A (Form 1045) Calculation

Instead of beginning with negative taxable income and then adding back the personal and dependent exemptions deduction, Schedule A (Form 1045), Application for Tentative Refund, begins with the taxpayer's income before the personal and dependent exemptions deduction is subtracted. Consequently, if you use Schedule A (Form 1041) to compute your NOL, you do not add back your personal and dependent exemptions deduction to compute your NOL.

2. Nonbusiness deductions (such as itemized deductions, the standard deduction, and the deductions for contributions to retirement plans) in excess of nonbusiness income (such as interest, dividends, and taxable social security benefits)
3. Capital losses in excess of capital gains
4. An NOL deduction carried from another year

Example 11.2 Adding Back Nonbusiness Deductions

Paige Turner's taxable income for 2011 before deducting personal and dependent exemptions is a negative $10,000 that results from both business losses and nonbusiness deductions. Her nonbusiness deductions exceed her nonbusiness income by $6,000, so she must add that $6,000 back to her negative $10,000 taxable income, which reduces her NOL to $4,000.

If Paige's nonbusiness deductions exceeded her nonbusiness income by more than her $10,000 negative taxable income, she would not have an NOL.

Business Income and Deductions

Business income and deductions are defined broadly for purposes of the NOL calculation. They include not only the ordinary income and deductions from a trade or business but also gain or loss from the disposition of both real property used in a trade or business and depreciable property used in a trade or business. Being employed is treated as a trade or business, which means wages are business income and deductible employee expenses are business deductions.

An exception to the business-connection requirement is that deductions attributable to casualty and theft losses from property held for personal use or for investment are treated as business losses for the NOL calculation even though they are not connected with a trade or business.

Observation

Effect of Business or Nonbusiness Classification

Classifying **ordinary income and capital gain as nonbusiness income** is advantageous to a taxpayer because it reduces the amount of nonbusiness deductions that must be added back to compute an NOL. Similarly, classifying **deductions and capital losses as business** deductions is advantageous to the taxpayer.

Example 11.3 Business and Nonbusiness Income and Deductions

Neil Down, who is not married and does not itemize deductions, realized a $10,000 loss from his sole-proprietor farming business in 2011. After considering his other income and deductions (as shown in Figure 11.2), his taxable income for 2011is a negative $13,000.

Return to TOC

FIGURE 11.2 Neil Down's 2011 Taxable Income

Income or Deduction	Amount
Business loss	–$10,000
Wage income	6,000
Investment income	500
Adjusted gross income	–$3,500
Personal exemption deduction	–3,700
Standard deduction	–5,800
Taxable income	–$13,000

In calculating his NOL, Neil is not allowed to deduct his personal exemption deduction. He can deduct $500 of his standard deduction because he has $500 of nonbusiness (investment) income. Consequently, Neil adds back his $3,700 personal exemption deduction and $5,300 ($5,800 – $500) of his standard deduction to his negative $13,000 taxable income to compute his $4,000 ($13,000 – $3,700 – $5,300) NOL.

✔ **Observation**

Other Ways to Look at the NOL

Note that the $4,000 NOL equals the sum of Neil's negative $3,500 AGI and the $500 portion of his standard deduction that is allowed by his $500 investment income. His NOL could also be viewed as his $10,000 business loss reduced by his $6,000 of wage income.

Carrying the NOL Back or Forward

Most NOLs are carried back 2 years unless the taxpayer elects to forgo the carryback and carries the NOL forward only. However, some NOLs qualify for different carryback periods. By default, NOLs from a farming business are carried back 5 years. Farmers can elect to forgo the 5-year carryback and carry farm NOLs back 2 years, or they elect to forgo the carryback altogether and carry the NOLs forward only.

Default Carryback Period (2 Years)

Generally, an NOL can be carried back to the 2 tax years immediately before the loss year. If the NOL is not fully absorbed in those 2 years, the excess is carried forward for up to 20 years after the loss year.

✔ **Observation**

Excess NOL at End of 20-Year Carryforward Period

Any NOL that is not absorbed in the carryback and carryforward periods is lost. It cannot be deducted in any other tax year.

Farming Loss (5 Years)

Taxpayers who have an NOL from a farming business can carry that NOL back 5 years and then forward up to 20 years. A farming business is a trade or business involving cultivation of land, raising or harvesting any agricultural or horticultural commodity, operating a nursery or sod farm, and raising or harvesting trees bearing fruit, nuts, or other crops, or ornamental trees. Raising, shearing, feeding, caring for, training, and management of animals are also farming businesses. A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by someone else, or a business in which the taxpayer merely buys or sells plants or animals grown or raised by someone else.

Farmers can elect to waive the 5-year carryback. The carryback period then reverts to 2 years.

Election to Forgo Any Carryback

Taxpayers who decide to forgo the carryback periods must include a statement with the original return filed for the loss year declaring that they are waiving the carryback period. The original return must be filed by its due date (including extensions). If the original return is filed by its unextended due date without the election, the taxpayer can make the election on an amended return filed within 6 months of the unextended due date.

Caution

NOL Absorbed by Carryback Years

If a taxpayer does not elect out of the carryback, **the NOL is treated as absorbed by the carryback years,** to the extent there is income in those years to absorb it, **whether or not the NOL deduction is claimed for those years.**

Note

Recordkeeping

The taxpayer bears the burden of proving the amount of NOL that is available to deduct in a carryforward year. If a taxpayer did not deduct an NOL in a closed year, the taxpayer must still keep records of the NOL absorption to verify the NOL carried to each tax year.

Absorbing the NOL

The amount of an NOL that is absorbed (used up) by a year to which it is carried is equal to that year's *modified taxable income.* Modified taxable income is taxable income increased by some of the deductions that are taken in calculating taxable income. For example, the personal and dependent exemptions deduction and the net capital loss deduction must be added back to taxable income.

The NOL amount that is carried to the second eligible carryback or carryforward year is the beginning NOL minus the first eligible year's modified taxable income. The NOL carried to the third eligible year is the amount carried to the second year minus the second year's modified taxable income. This process is repeated until the NOL is fully absorbed or until it is carried to the last eligible year.

Because modified taxable income is always greater than taxable income, more of an NOL is absorbed in each year than the amount of taxable income offset by the NOL. Therefore, some of the NOL deduction is wasted by each intervening year to which the NOL is carried if the NOL is greater than the taxable income for that intervening year.

Planning Pointer

Avoiding Lost Deductions

Two planning techniques can reduce or eliminate the lost deductions:

1. Choose the first carryback or carryforward year so that the NOL is absorbed in as few intervening years as possible.
2. Avoid the NOL by spreading income evenly over several tax years.

Calculating Taxes in Carryback and Carryforward Years

If an NOL is carried back, it is claimed as a deduction that reduces taxable income and tax for the carryback year. The recalculation of tax in a carryback year is complicated because the NOL deduction reduces AGI, and that reduction in AGI may affect itemized deductions and personal and dependent exemption deductions. Consequently, the affected deductions must be recalculated.

Taxpayers can claim a quick refund of taxes paid in prior years by filing Form 1045, Application for Tentative Refund, no later than the end of the tax year following the year the NOL occurred. For example, a farmer who has an NOL in 2011 has until December 31, 2012, to file a Form 1045 claiming a refund from carrying the NOL back to 2006 and any other carryback years that are affected.

Taxpayers can also claim a refund from carrying an NOL back by filing a Form 1040X, Amended U.S. Individual Income Tax Return, for each of the carryback years. Form 1040X must be filed within 3 years of the due date (including extensions) for the loss year's tax return. For example, a farmer who has an NOL in 2011 has until April 15, 2015 (3 years after the April 15, 2012, due date of the 2011 return) to file amended returns for 2006 and any other carryback years to claim refunds from carrying back the 2011 NOL. If the farmer received a 6-month extension of time to file that extended the due date of the 2011 return to October 15, 2012, he or she has until October 15, 2015, to amend the 2006 and other tax returns.

✔ **Note**

Election to Forgo the Carryback

As noted earlier in this chapter, the election to forgo the carryback must be made on the tax return for the year the NOL occurred or on an amended return for that year filed within 6 months (excluding extensions) of the due date for the original return. A calendar year taxpayer has until October 15, 2012, to elect on an amended return to forgo the carryback of a 2011 NOL. If this deadline is not met, the taxpayer cannot forgo the carryback.

NOL Carried Between Joint and Separate Returns

If the taxpayer's filing status is not the same in the loss year and in all of the carryback or carryforward years, allocations may be required.

Taxpayers who file a joint return for at least one of the years involved in an NOL calculation and its carryback or carryforward period, and file a separate return or file a return as a person who is not married for at least one of those years, may need to allocate the NOL, income and deductions, or the modified taxable income between the spouses. However, income and deductions on a married filing jointly return do not have to be allocated when an NOL from a year the same couple filed separately is carried to the joint return.

Separate Returns May Reduce Tax Liability

If one spouse has an NOL and their joint income without the loss is lower than their average annual income, it may be advantageous to file separate returns in the NOL year. By filing separate returns, the NOL can be carried to another tax year to reduce income in a tax bracket higher than the joint income bracket of the NOL year.

Example 11.4 Separate Returns

Tom and Mary Katt have no children, do not itemize deductions, and are both under age 65. Figure 11.3 shows their AGI for 2011 (the loss year) and 2006 (the first carryback year for their farm NOL). Mary's income is from wages.

FIGURE 11.3 Tom and Mary Katt's AGI

	2011	2006
Tom	–$20,000	$30,000
Mary	21,500	40,000
Total	$ 1,500	$70,000

If Tom files a separate 2011 return, his NOL is $20,000.

If Tom and Mary file a joint return for 2011, their income tax is zero, but there is no NOL to carry back. Therefore, their AGI for 2006 (the carryback year) is still $70,000. After deducting the $16,900 total of their $10,300 standard deduction and $6,600 personal exemptions deduction for 2006, their taxable income for 2006 was $53,100 and their income tax was $7,214.

If Tom and Mary file separate returns for the loss year (2011), Mary's federal income tax is $1,375and Tom has a $20,000 NOL to carry back. The NOL deduction reduces their 2006 joint AGI to $50,000, their taxable income to $33,100, and their income tax due to $4,214. Therefore, the total tax liability for the 2 years if separate returns are filed in 2011 is reduced to $5,589 ($1,375 + $4,214)—a savings of $1,625 ($7,214 – $5,589).

Making Optimal Use of an NOL Deduction

The tax benefit of an NOL can be squandered if other tax benefits are used in the loss year or in a year the NOL deduction is claimed. Other tax benefits may waste NOLs in two ways.

1. They may reduce an NOL in a loss year, even though they do not reduce taxable income in that or any other year.
2. In the years that an NOL deduction is claimed (the carryback and carryforward years), other tax benefits may reduce the NOL to be carried to subsequent years even though they do not reduce taxable income in that year or any other year.

Because some of those tax benefits could be shifted to another tax year, it is useful to know which ones waste NOLs.

Excess Nonbusiness Deductions and Losses

If nonbusiness deductions exceed the total of nonbusiness ordinary income plus excess nonbusiness capital gains in an NOL year, **the excess nonbusiness deductions will never provide a tax benefit**.

Shifting Nonbusiness Deductions Away from Loss Year

One way to benefit from the excess nonbusiness deductions is to shift them to another tax year.

If those deductions are shifted to a year that has no NOL, they will offset taxable income in that year.

If they are shifted to a year when there is an NOL, but nonbusiness ordinary income plus net nonbusiness capital gains exceed nonbusiness deductions, they will increase the NOL.

Shifting excess nonbusiness deductions involves the same kind of tax planning as bunching itemized deductions every other year and claiming the standard deduction in the alternate years. Therefore, deductions you may be able to shift away from the NOL year include medical expenses, taxes, interest expenses, charitable contributions, and miscellaneous deductions. Shifting other nonbusiness deductions such as alimony payments away from the NOL year can also help reduce nonbusiness deductions down to nonbusiness income. If you are making less than the maximum retirement plan contributions each year, contributions could be bunched in the years where they would offset taxable income or add to the NOL.

Example 11.5 Shifting Nonbusiness Deductions

Guy and Barb Wire's tax adviser projects that they will have a $20,000 NOL for 2011. Included in that projection are $16,000 of itemized deductions, which include $3,500 in real estate taxes that can be paid in 2011 or postponed until 2012. Their only nonbusiness income is $2,000 of interest income.

The $14,000 of itemized deductions in excess of their $2,000 of interest income provide no tax benefit—they do not increase the Wires' 2011 NOL and they do not reduce taxable income in 2011. If Guy and Barb postpone paying the $3,500 of real estate taxes until 2012 and have $3,500 or more taxable income in 2012, they can preserve the tax benefit of deducting the payment of those taxes. Shifting the $3,500 payment to 2012 does not affect their 2011 NOL (it is still $20,000) but it allows them to deduct the $3,500 from their 2012 taxable income. If they are in the 15% federal income tax bracket in 2012, the deduction will save them $525 ($3,500 × 15%) of federal income taxes.

Barb and Guy could further reduce their 2012 taxable income without decreasing their 2011 NOL by shifting up to $11,500 of other nonbusiness deductions to 2012.

Shifting Nonbusiness Income to Loss Year

The problem of losing the benefits of a deduction because nonbusiness deductions exceed non-business income and net nonbusiness capital gains can also be alleviated by increasing the total amount of nonbusiness ordinary income and nonbusiness capital gains in the loss year. Such an increase will be effectively tax-free until the sum of nonbusiness ordinary income and excess nonbusiness capital gains equals nonbusiness deductions.

If nonbusiness ordinary income or nonbusiness capital gains are shifted from a year without an NOL to an NOL year in which nonbusiness deductions exceed the total of nonbusiness ordinary income and net nonbusiness capital gains, the shifted income is tax-free. The same result occurs if nonbusiness ordinary income is shifted from an NOL year with an excess of nonbusiness ordinary income and net nonbusiness capital gains over nonbusiness deductions.

Example 11.6 Shifting Nonbusiness Capital Gain

Guy and Barb Wire from Example 11.5 have 100 shares of XYZ stock that has a $45,000 income tax basis and is currently worth $50,000. If they sell that stock in 2011, the $5,000 capital gain ($50,000 – $45,000) does not increase their income taxes for 2011 and does not reduce their 2011 NOL. Therefore, the $5,000 gain is effectively tax-free.

Guy and Barb could repurchase $50,000 of XYZ stock or make another investment. In either case, they would have a $50,000 income tax basis in the new investment. If they later sell the new investment for $50,000 or more, their gain is $5,000 less than it would have been if they kept the original XYZ stock with a $45,000 income tax basis and subsequently sold it for the same amount as the new investment.

Shifting Nonbusiness Capital Losses

Nonbusiness capital losses in excess of nonbusiness capital gains provide no tax benefit in an NOL year because they are not allowed as part of the NOL computation. If those capital losses are shifted to a year when there is no NOL, or to an NOL year that has excess nonbusiness capital gains, the losses will provide a tax benefit.

Example 11.7 Shifting Nonbusiness Capital Losses

The projected $20,000 NOL for Guy and Barb Wire in Example 11.5 includes a planned sale of RST stock for a $900 capital loss. Guy and Barb will get no tax benefit from that capital loss in 2011. It does not increase their 2011 NOL, and it is not carried over as a capital loss carryover because Guy and Barb have business capital gains in 2011 that give them a net capital gain for 2011. Because they have the NOL, it does not reduce taxable income in 2010.

If Guy and Barb postpone the sale of the RST stock until 2012, they still have a $20,000 NOL for 2011, and the $900 capital loss in 2012 will reduce their taxable income.

Waiving Carryback May Reduce Tax Liability

In some cases, an NOL deduction is more useful to the taxpayer in the years following the NOL year than in the carryback years because of the higher tax rates imposed in higher income years. If the carryback years have low income compared to the income expected in the carryforward years, forgoing the carryback is advantageous as long as the 20 carryforward years will use up most or all of the NOL.

Capital losses in carryback or carryforward years may keep a taxpayer from realizing the full benefit of the NOL deduction in those years. Similarly, the NOL deduction may cause the loss of a tax credit that cannot be carried beyond its carryback or carryforward year. (For example, an investment tax credit may be wasted if an NOL is carried to the final year the credit can be claimed and the NOL reduces taxable income to zero for that year.) In these cases, the election can be used to minimize the loss of the NOL deduction or credit.

In some cases, the taxpayer may not expect to realize enough taxable income in the carryforward years to absorb the NOL. In those cases, the NOL should be carried back to the low-income years to reduce low-bracket income rather than be completely wasted.

Because the timing of the tax savings differs between carrying an NOL back and carrying it forward, the present value of the tax savings should be computed to properly compare the options. If the NOL is carried back, the tax savings will be received shortly after the refund claim is filed. If the NOL is carried forward, the tax savings are realized when taxes would otherwise be paid in the carryforward years. The NOL deduction can be used to reduce quarterly estimated tax payments, or it can be used to reduce the tax paid or increase the refund received when the carryforward year return is filed. In either case, the present value is less than the face amount of the tax savings.

To compare the value of future tax savings with the value of refunds from previous years, you or your tax adviser should calculate the present value of future tax savings as of April 15 of the year following the NOL year.

Control Timing of NOL

If you have some choice in determining the tax year that an NOL is realized, it should occur in the year that results in deductions that will generate the greatest tax benefit. The years in which an NOL deduction generates the greatest benefit are those that have the highest taxable income (and are therefore in the highest marginal bracket) and those with little long-term capital gain or tax credits that will waste the NOL. For example, if a farmer's marginal tax rate was higher in 2006 than in 2007, accelerating an NOL into 2011 instead of delaying it to 2012 will cause the loss to offset the higher bracket 2006 income instead of the lower bracket 2007 income.

Use NOL Before It Expires

If the time period for using an NOL carryforward is about to expire, accelerating income to absorb the full loss will reduce total taxes. Shifting income to make use of an NOL that would otherwise expire makes the shifted income effectively tax-free.

Farm Corporations and NOLs

A farm corporation generally figures and deducts an NOL in the same way an individual, estate, or trust does. The same 5-year or 2-year carryback and up to 20-year carryforward periods apply, and the same sequence applies when the corporation carries two or more NOLs to the same year.

A corporation's NOL differs from individual, estate, and trust NOLs in the following ways:

1. A corporation can take different deductions when figuring an NOL.
2. A corporation must make different modifications to its taxable income in the carryback or carryforward year when figuring how much of the NOL is used and how much is carried over to the next year.
3. A corporation uses different forms when claiming an NOL deduction.

Figuring the NOL

A corporation figures an NOL in the same way it figures taxable income, starting with its gross income and subtracting its deductions. If its deductions exceed its gross income, the corporation has an NOL. However, the following rules for figuring the NOL apply:

1. A corporation cannot increase its current year NOL by carrybacks or carryovers from other years.
2. A corporation cannot use the domestic production activities deduction to create or increase its current year NOL, including any carryback or carryover.
3. A corporation can take the deduction for dividends received, explained later, without regard to the aggregate limits based on taxable income that normally apply to this deduction.
4. A corporation that is a public utility can figure its deduction for dividends paid on certain preferred stock without limiting it to its taxable income for the year.

Dividends-Received Deduction

A corporation's deduction for dividends received from domestic corporations is generally subject to an aggregate limit of either 70% or 80% of taxable income. However, if a corporation has an NOL for a tax year, the limit based on taxable income does not apply. In determining if a corporation has an NOL, the corporation figures the dividends-received deduction without regard to the otherwise applicable taxable income limit.

Claiming the NOL Deduction

If a corporation carries an NOL back, it can file Form 1139, Corporation Application for Tentative Refund, or Form 1120X, Amended U.S. Corporation Income Tax Return. If a corporation expects to have an NOL in its current year, it can automatically extend the time for paying all or part of its income tax for the immediately preceding year. It does this by filing Form 1138, Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback.

Figuring the NOL Carryover

If an NOL available for a carryback or carryforward year is greater than the taxable income for that year, the corporation must modify its taxable income to figure how much of the NOL it will use up in that year and how much it can carry over to the next tax year. Its carryover is the excess of the available NOL over its modified taxable income for the carryback or carryforward year.

Modified Taxable Income

A corporation figures its modified taxable income the same way it figures its taxable income, with the following exceptions:

It can deduct NOLs only from years before the NOL year whose carryover is being figured.

The corporation figures its deduction for charitable contributions without considering any NOL carrybacks.

Modified taxable income for any year cannot be less than zero. Modified taxable income is used only to figure how much of an NOL the corporation uses up in the carryback or carryforward year and how much it carries to the next year. It is not used to fill out the corporation's tax return or figure its tax.

Ownership Change

A loss corporation (one with cumulative losses) that has an ownership change is limited on the taxable income it can offset by NOL carryforwards arising before the date of the ownership change. This limit applies to any year ending after the change of ownership.

Summary

Planning the timing of income, deductions, gains, and losses can maximize the benefit of the NOL rules.

Certain tax benefits are removed to determine the NOL that is carried to the first eligible year and the NOL that is carried to each subsequent year. Whether the NOL is expressed as a positive number (i.e., as a deduction) or a negative number (i.e., as the taxable loss), removal of the other tax benefits decreases the NOL.

The NOL deduction claimed in any carryback or carryforward year is not necessarily the amount of the NOL that is absorbed that year. A year to which the NOL is carried can use up more of the NOL than that year's taxable income before modifications.

CHAPTER 11
INCOME TAX CONSEQUENCES OF FARM FINANCIAL DISTRESS

SYNPOSIS (click on section title to go directly there)

Introduction

Farmers often face significant income tax consequences from financial distress transactions. The two most common income tax consequences from these transactions are

1. the recognition of gain or loss from transfer of assets, and
2. discharge of indebtedness income.

Recognition of Gain or Loss From Transfer of Assets

The rules that require the recognition of gain or loss as a result of transferring assets in financial distress are the same as those that apply to transfers outside of financial distress.

Example 11.1 Transfer of Assets

Danica Distress previously weathered financial setbacks by tapping her secured line of credit with her local bank. However, she has reached the limit of that credit and now wants to know the income tax consequences of selling her assets to pay her debts. She has $500,000 of secured debt. Her assets are shown in Figure 11.1.

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Figure 11.1: Danica's Assets

Asset	Fair Market Value	Basis
Stored grain	$20,000	$0
Raised herd	90,000	0
Machinery	75,000	20,000
Land	300,000	80,000
Total	$485,000	$100,000

Danica is married and files a joint federal income tax return with her husband, Dillon, who earns $30,000 a year from an off-farm job. He has enough federal income tax withheld from his paycheck to pay the federal income tax on all of their income, the FICA taxes on his wages, and the self-employment tax on Danica's $10,000 of farm income. They have two children.

If Danica sells all of her assets for their $485,000 fair market value, she and Dillon will owe an additional $68,747 of federal taxes on the $385,000 ($485,000 – $100,000 basis) gain. However, all $485,000 of the sales proceeds will go to her secured creditors to reduce the debt owed to them from $500,000 to $15,000. After paying $485,000 of debt with the sale proceeds, Danica will still owe $83,747 ($68,747 + $15,000) in taxes and lender debt.

Tax Planning for Gain on Transfer of Assets

Tax planning for the gain on the sale of assets because of financial distress is the same as planning for the sale of assets outside of financial distress. Two particularly useful strategies are income averaging and timing of income.

Income Averaging

The income-averaging rules allow farmers to use tax brackets from the 3 prior years to compute taxes on some or all of the current-year farm income. Therefore, income in the high brackets of the current year can be taxed at lower rates.

Cross-Reference
See Chapter 7 of this book for an explanation of the income-averaging rules.

Timing of Income

If farmers can control the timing of asset sales, they may delay selling some assets until the following tax year to save both income taxes and self-employment (SE) taxes.

Bunching up SE income in one year can push some of that income above the social security wage base, which is $106,800 for 2011. Earned income above the wage base is subject to a 2.9% SE tax rate instead of the 15.3% (13.3% for 2011) tax rate that applies to earned income up to $106,800 (for 2011). The income-averaging rules can then be used to reduce the income tax rate on the income that is pushed into a higher tax bracket by the bunching of income.

Example 11.2 Bunching Self-Employment Income

Sven Olssen potentially has $106,800 of net earnings from self-employment in Year 1 and $100,000 of net earnings from self-employment in Year 2. If the tax rate is 15.3% in both years, his SE tax would be $16,340 ($106,800 × 15.3%) in Year 1 and $15,300 ($100,000 × 15.3%) in Year 2, for a total of $31,640.

If he can bunch the net earnings from self-employment into one tax year, his SE tax would be $19,240 ($16,340 on the first $106,800, plus $2,900 on the remaining $100,000). That is a $12,400 ($31,640 – $19,240) reduction in his SE tax.

Bunching up ordinary income has the added advantage of emptying the 15% regular income tax bracket for the following year so that long-term capital gains in the following year qualify for the lower tax rate for capital gains, which is 0% in 2011 and 2012.

Example 11.3 Tax Rate on Capital Gain

Carlos and Virginia Little Otter have $100,000 of taxable income in 2011, of which $30,000 is ordinary income and $70,000 is long-term capital gain. The ordinary income fills up their entire 10% income tax bracket ($17,000) and fills up $13,000 ($30,000 – $17,000) of their 15% bracket. The top end of their 15% bracket is $69,000, which means $39,000 ($69,000 – $30,000) of their capital gain is taxed at 0%. The remaining $41,000 ($70,000 – $39,000) is taxed at their 15% rate for capital gain.

Discharge of Debt

Creditors sometimes forgive some or all of a financially distressed taxpayer's debt because the taxpayer is unable to pay or because the cost of collecting the debt is more than the debt. For income tax purposes, if a creditor forgives debt for any reason other than for the purpose of making a gift to the debtor, the discharged debt is potentially included in taxable income as cancellation of debt income (CODI).

Example 11.4 Cancellation of Debt Income

Pete Bogg had $100,000 of debt and $150,000 of assets when he borrowed another $25,000. Before he spends the $25,000, it increases both his debt and his assets, but it does not change his $50,000 net worth and is not taxable income. If Pete pays off the debt, his assets and debt both decrease by $25,000, but his net worth does not change and he cannot claim an income tax deduction for the $25,000 debt payment.

However, if Pete's lender forgives $25,000 of his debt, his debt goes down by $25,000 but his assets do not decrease. Therefore, his net worth increases by $25,000, which is CODI that may have to be included in taxable income.

Repossession of assets can also result in a taxable gain on disposition.

Example 11.5 Repossession of Assets

Paige Turner borrowed $100,000 from her bank to buy a $120,000 tractor in 2007. In 2011, she was unable to make the payments on the loan and the bank repossessed the tractor. At the time of repossession, the remaining debt was $75,000 and the tractor's fair market value (FMV) was $50,000. The bank decided to not pursue a claim for payment of the rest of the debt because Paige was insolvent.

For income tax purposes, Paige is treated as selling the tractor to the bank for its $50,000 FMV and then using the $50,000 to pay that much of her $75,000 debt. The remaining $25,000 of debt is potentially CODI.

Paige had claimed $68,544 of depreciation on the tractor before 2011, and she can claim $7,350 of depreciation for 2011 (half-year convention and the fifth year of 7-year property). Her adjusted basis in the tractor then is $44,106 ($120,000 –$68,544 – $7,350), and she has a $5,894 ($50,000 – $44,106) gain on the deemed sale. The depreciation recapture rules treat all of that gain as ordinary income.

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Exceptions to Recognition of CODI

If any of the following exceptions applies, the debtor does not have to include CODI in income.

1. A deduction for the amount paid would be allowable if the taxpayer paid the debt that was discharged. Examples include feed or other farm inputs purchased on credit from the seller and interest on a loan.
2. The debt was discharged in bankruptcy.
3. The debt discharged was *qualified principal residence debt* that was discharged before January 1, 2013.
4. The debtor was insolvent at the time the debt was discharged.
5. The seller of property under an installment contract discharged the debt, and the original purchaser under the contract owed the debt that was discharged.
6. The debt discharged is *qualified farm indebtedness*.
7. The debtor is not a C corporation, and the debt discharged is *qualified real property business indebtedness*.

If discharged debt qualifies for more than one of these exceptions, the first applicable exception in the list is applied to the discharged debt.

Example 11.6 Qualified Farm Debt

Because the $25,000 of debt that was discharged in Example 11.5 was discharged while Paige was insolvent, Paige does not have to include the $25,000 CODI in her gross income, although she must record it on her federal income tax return.

Paying the Price

In most cases, the taxpayer must pay a price for not recognizing CODI. The price is a reduction of the taxpayer's following tax attributes:

1. Net operating loss (NOL): Any NOL for the tax year of the discharge, and any NOL carryover to such year.
2. General business credit: Any carryover to or from the tax year of debt discharge of an amount includable in determining the amount allowable as a general business credit.
3. Minimum tax credit: The amount of the minimum tax credit available at the beginning of the tax year immediately following the tax year of the discharge.
4. Capital loss carryovers: Any net capital loss for the tax year of the discharge, and any capital loss carryover to such year.
5. Basis reduction: The basis of the taxpayer's property.
6. Passive activity loss and credit carryovers: Any passive activity loss or credit carryover of the taxpayer from the taxyear of the discharge.
7. Foreign tax credit carryovers: Any carryover to or from the tax year of the discharge for determining the amount allowable as a foreign tax credit.

Credits are reduced $1 for every $3 of CODI that is excluded from income. The other tax attributes are reduced $1 for every $1 of CODI that is excluded from income. The CODI exclusion and tax attribute reductions are reported on IRS Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness.

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Order

The general rule is that the tax attributes are reduced in the order listed. However, a taxpayer can elect to reduce the basis in depreciable property first.

Example 11.7 Attribute Reduction

Paige from Example 11.5 must reduce her tax attributes to pay the price for not including the $25,000 discharged debt in her gross income. If she has no NOL, general business credit, minimum tax credit, or capital loss carryovers, she must reduce the basis in her farm assets by $25,000.

Limit on Basis Reduction

If the debt discharge is excluded from income under the bankruptcy or insolvency exceptions, a limit applies to the reduction of basis in assets. The aggregate basis in the taxpayer's assets is reduced only down to the remaining debt after the discharge, so that the taxpayer's assets may equal his or her remaining liabilities.

Timing

The attribute reduction occurs after taxes are computed for the year of the debt discharge. Therefore, the attributes are used on the tax return before they are subject to reduction under the CODI rules.

Example 11.8 Timing of Attribute Reduction

Paige from Example 11.7 must reduce the basis in her assets after she has claimed depreciation for 2011 and calculated gain on sale of assets in 2011. Assume that she had only one asset after the tractor was repossessed—land with a $60,000 basis and a $100,000 FMV.

If Paige sells the land in 2011 (the same year the tractor was repossessed), she must recognize $40,000 ($100,000 – $60,000) of gain on the land. She then has no basis in assets to reduce and therefore does not have to pay a price for not recognizing the $25,000 of CODI.

If she waits until 2012 to sell the land, she must reduce its basis by $25,000 at the end of 2011 (to pay the price of excluding the CODI from her taxable income). She will then have a $65,000 ($100,000 – $35,000 reduced basis) gain to report on her 2012 income tax return.

Summary

Farmers in financial distress face income tax consequences from transferring their assets as well as from cancellation of debt. Those taxes can be minimized by planning the timing of the transfers and the cancellation of debt, as well as by electing income tax options that reduce taxes. To make the best use of the tax-planning opportunities, it is important for farmers to consult their tax advisers before they enter into transactions to restructure their debt..

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CHAPTER 12
BUYING AND SELLING A FARM

SYNPOSIS (click on section title to go directly there)

Introduction

The purchase and/or sale of a farm are major economic events for most producers and have significant tax consequences for both the buyer and seller.

This chapter provides an introduction to the issues buyers and sellers face when they buy or sell a farm. An article with the same title as this chapter that is posted on the www.ruraltax.com website includes more details.

Allocation of Purchase Price

The buyer and the seller of a group of farm assets must each allocate the purchase price among the assets involved. The seller must know the sales price of the individual assets to separately calculate the gain or loss on each asset. The buyer must know the purchase price of each asset to determine its basis.

If the buyer and the seller are unrelated parties, they generally have divergent economic interests. The seller would like to allocate the sales price, to the extent possible, to assets from which gains are taxed as long-term capital gains, such as buildings that have been fully depreciated and land. In contrast, the purchaser would like to allocate the purchase price, to the extent possible, to assets for which cost-recovery deductions can be claimed as quickly as possible, such as machinery and equipment.

Generally, the buyer and seller can use any reasonable method of allocating the price. Ideally, they will agree on an allocation at the time of the sale and include that allocation in the sales agreement. If they agree in writing to an allocation, both parties must use that allocation for income tax purposes unless the IRS successfully challenges the allocation or one of the parties can show a mistake, undue influence, fraud, or duress.

However, the parties often do not discuss allocation of the overall price at the time of the sale. They then must allocate it when they report the sale or purchase on their income tax returns. The tax rules do

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not explicitly require the seller and the buyer to use the same allocation, but the IRS can compare the two parties' allocations and use a disparity to challenge either or both of the allocations.

Installment Sales

The seller may finance the buyer's purchase by entering into a land contract that requires the buyer to make a down payment and periodic payments of principal and interest. When the buyer has made most or all of the payments, the seller gives the buyer a deed for the farm. Alternatively, seller financing can be documented with a deed from the seller to the buyer at the time of the sale and a promissory note from the buyer to the seller to pay the balance due with interest. The buyer also gives the seller a mortgage to secure the buyer's obligation to pay the promissory note.

The income tax treatment of a land contract and a deed with a promissory note and mortgage are identical. For income tax purposes, these sales are treated as *installment sales* if one or more payments are due in tax years following the year of the sale.

Cross-Reference

See Chapter 10 of IRS Publication 225, *Farmer's Tax Guide* (for 2010), for an explanation of the installment sale rules. Chapter 5 of this book also discusses installment sales.

Tax Consequences for Seller

Generally, a seller reports gain as he or she receives principal payments. However, the gain from the sale of assets that have been depreciated (such as buildings, fences, grain bins and other improvements) that is treated as ordinary income under the depreciation recapture rules must be reported in the year of the sale.

Cross-Reference

See Chapter 9 of IRS Publication 225, *Farmer's Tax Guide* (for 2010), for an explanation of the depreciation recapture rules.

A seller can elect out of installment reporting by reporting all gain from the sale on the return for the year of the sale. Sellers who report all gain in the year of the sale have no gain to report as they receive each principal payment, but they must report interest as income when it is received.

Example 12.1 Installment Sale

Gabriella Muccio sold 180 acres of land to Liam Syed for $900,000 in 2011. Gabriella and Liam agreed to allocate $15,000 of the purchase price to fences that were included in the sale. Gabriella paid $30,000 for the fences and had fully depreciated that cost. Gabriella's income tax basis in the land was $200,000.

If Liam gets financing from a bank and pays Gabriella the full $900,000 purchase price, Gabriella must report the full $685,000 ($885,000 – $200,000) capital gain from sale of the land and $15,000 ordinary income from sale of the fences on her income tax return for 2011. Most of the capital gain will be taxed at the higher rate (15% rather than 0%) even if she has no other income.

If Gabriella financed Liam's purchase of the farm, she could spread her gain from the sale of the land over the years she receives payments from Liam. (The gain from the sale of the fences must all be reported in the year of sale even if Liam pays for them over several years.) That may allow her to take advantage of a lower tax rate on the capital gains.

For example, if she spread the capital gain over enough years to keep all of her income for those years within her 10% and 15% income tax brackets, she would pay the lower tax rate for capital gains in all of those years. Under current law, the lower rate will be 0% in 2011 and 2012 and 5% for 2013 and thereafter. The higher tax rate on capital gains will be 15% for 2011 and 2012 and 20% for 2013 and thereafter. Gabriella could reduce the tax on her capital gains by up to $102,750 (15% of $685,000) by financing Liam's purchase.

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Caution

By financing the buyer's purchase, you run the risk of the buyer defaulting on the payments.

Tax Consequences for Buyer

For the buyer, an installment purchase is treated in the same way as a purchase that is financed by a third party. The buyer of business or investment property can begin depreciating assets in the year of the purchase and can deduct the interest paid to the seller as a business or investment expense.

Example 12.2 Installment Sale

Liam from Example 12.1 can begin depreciating the $15,000 cost of the fence in 2011, whether the purchase is financed by Gabriella or by a third party such as a bank. He can deduct the interest he pays to Gabriella if she finances the purchase or to the bank if it finances the purchase.

Sale of Farm with Principal Residence

A special provision in the Internal Revenue Code for the sale of principal residences allows taxpayers to exclude up to $250,000 ($500,000 on some joint returns) of gain on the sale or exchange of a principal residence. To qualify, the taxpayers must have owned the residence and used it as their main home for at least 2 of the 5 years before the sale. This exclusion from income increases the incentive for owners of farms to claim that land around the personal residence is a part of the residence rather than being used in the farming operation. By claiming more of the land as part of the personal residence, more gain can be attributed to the personal residence and therefore excluded from income up to the $250,000 or $500,000 limit.

Cross-Reference

See IRS Publication 523, *Selling Your Home,* for an explanation of the exclusion of gain on sale of a principal residence.

Growing Crops Sold with Land

If a growing crop is included in the sale of land, part of the purchase price must be allocated to the growing crop. That allocation must be reflected in the income tax reporting of both the buyer and the seller.

Tax Consequences for Seller

Taxpayers who sell a growing crop with the land on which it is growing can treat the gain on the growing crop as long-term capital gain if the land has been held for more than a year. The growing crop must be sold, exchanged, or involuntarily converted at the same time and to the same individual as the land.

In calculating the gain from sale of the growing crop, the seller must allocate part of the purchase price to the growing crop and treat the costs of raising the crop as its income tax basis. The costs allocated to the basis of the growing crop cannot be deducted as a business expense.

Example 12.3 Sale of Growing Crop with Land

In 2011, Red Durham sold 240 acres of land with a growing winter wheat crop to his neighbor, Buck Wheat, for $1,575 per acre. Based on the value of the winter wheat crop, Red and Buck agreed in writing to allocate $125 of the per acre price (a total of $30,000) to the growing wheat crop.

Red incurred $8,400 ($35 per acre) of direct costs (seed, fertilizer, chemicals, etc.) and indirect costs (e.g., depreciation) of growing the winter wheat in 2010, and he deducted that $8,400 on his 2010

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Schedule F (Form 1040). Now that Red has sold the growing crop in a transaction that qualifies for long-term capital gain treatment, he must remove the $8,400 from his deductions by amending his 2010 tax return. The $8,400 is included in his income tax basis in the growing crop.

Red also paid $4,800 ($20 per acre) for fertilizer and fungicide in 2011 for the growing wheat crop. Because Red sold the growing crop, he cannot deduct that $4,800. Instead, he adds it to the basis of his growing crop, which gives him a $13,200 ($8,400 + $4,800) income tax basis in the crop.

Red calculates his $16,800 gain on the sale of the growing crop by subtracting his $13,200 income tax basis from the $30,000 purchase price allocated to the growing crop. He nets that gain with the gains and losses from other sales of property used in the farming business (including the gain from the sale of the land). A net gain is treated as long-term capital gain to the extent it exceeds losses reported from sales of property used in the farming business in the previous 5 years. A net loss is treated as an ordinary loss.

Tax Consequences for Buyer

The buyer of land with a growing crop has a basis in the growing crop equal to the portion of the purchase price that is allocated to the growing crop. If the buyer of the land sells the crop, the basis reduces the income he or she must report from that sale. If the buyer of the land feeds the crop to livestock, he or she can deduct the allocable cost as an expense of raising the livestock.

Example 12.4 Purchase of Growing Crop with Land

Buck Wheat (the buyer in Example 12.3) has a $30,000 basis (the price he and Red agreed to allocate to the growing crop) in the wheat. When Buck harvested the winter wheat, he sold it for $72,000. He must report the $72,000 sale price on line 1, his $30,000 basis on line 2, and the resulting $42,000 gain on line 3 of Schedule F (Form 1040).

If Buck fed the wheat to his livestock in 2011 (the same year he purchased the land and growing crop), he can deduct the $30,000 income tax basis in the wheat on his 2011 income tax return.

If Buck fed part or all of the wheat to his livestock in 2012 (the year after he purchased the land and the growing crop), it is not clear when he can claim the deduction. Buck could take the position that he can deduct the entire basis in 2011 (the year he purchased the crop with the intent to feed it to livestock), but the IRS may allow him to deduct the basis only in 2012 (the year he uses the wheat as feed).

Like-kind Exchange of Real Property

Taxpayers who do not need or want immediate cash from the sale of a farm can delay recognizing the gain by rolling the sales price into *like-kind* property. The deferred gain is rolled over by carrying the basis of the relinquished property into the basis of the replacement property. If the taxpayer never disposes of the replacement property, the taxpayer's heirs can avoid recognizing the deferred gain through the tax law provision for a basis adjustment to date-of-death fair market value.

The tax rules that allow the gain to be rolled to replacement property have a variety of labels, including tax-free exchange, like-kind exchange, and 1031 exchange (after § 1031 of the Internal Revenue Code). More complex 1031 exchanges are called deferred like-kind exchanges, Starker exchanges, or reverse deferred exchanges.

> Cross-Reference
>
> See pages 11 through 19 of IRS Publication 544, *Sales and Other Dispositions of Assets* (for 2010), for an explanation of the like-kind exchange rules. Also see Chapter 7 of this book.

For real property, the term *like-kind* is interpreted very broadly. Any real estate can be exchanged for any other real estate as long as both the relinquished property and the replacement property are used in a trade or business or held for investment. Consequently, a farm can be exchanged for city real estate and improved real estate can be exchanged for unimproved real estate.

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Example 12.5 Exchange of Real Property

Alva Babcock plans to sell bare farmland that has a $100,000 income tax basis and is worth $500,000. She wants to invest the proceeds in an apartment building. The farmland and apartment building are like-kind property. Therefore, if she exchanges the farmland for an apartment building that is worth $500,000, she does not have to recognize the $400,000 gain on her farmland. Her income tax basis in the apartment building is $100,000.

Requirements

A transaction does not qualify as a like-kind exchange to the extent the taxpayer receives cash or unlike property. One way to avoid receiving cash or unlike property is to engage in a direct exchange, such as transferring an old tractor and some cash to an implement dealer in exchange for a new tractor. In some transactions, a direct exchange is not practical because the buyer of the taxpayer's property does not have property the seller will accept in exchange.

For example, Alva Babcock's son Amos may want to buy Alva's bare farmland, but he does not own the replacement apartment building that Alva wants to acquire. Amos could purchase the apartment building and then trade it for the farmland, but the deferred like-kind exchange rules allow the same result without the need for Amos to purchase the apartment building. Under those rules, Alva could transfer the farmland to a third party and Amos could purchase the farmland from that third party. The third party then uses the proceeds from sale of the farmland to buy the apartment building and transfer it to Alva to complete Alva's 1031 exchange.

To qualify as a deferred like-kind exchange, the taxpayer must carefully comply with detailed rules that require the services of a knowledgeable professional. In general, those rules require the taxpayer to identify the replacement property within 45 days and to acquire ownership of the replacement property within 180 days of selling the relinquished property.

Caution

Taxpayer Cannot Possess Sale Proceeds

It is imperative that the taxpayer never have possession of the sale proceeds. If a taxpayer sells a farm and receives the sales proceeds, he or she cannot defer gain recognition by using the proceeds to purchase replacement property. Therefore, taxpayers should seek the counsel of a qualified professional before entering into any agreement to sell a farm if they plan to roll the gain into replacement property under the like-kind exchange rules.

Summary

Income tax planning is as important in buying and selling a farm as it is in operating a farm. Sellers can **defer** recognizing their gain by making an installment sale, **avoid** recognizing their gain on the sale of their principal residence, or **roll** their gain on business or investment property into replacement property through a like-kind exchange.

Buyers can reduce their taxable income after the purchase by depreciating the portion of their purchase price that is properly allocated to the depreciable property included in the purchase.

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CHAPTER 13

TAX REPORTING AND PAYMENT

SYNPOSIS (click on section title to go directly there)

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Introduction

This chapter explains a farmer's income and self-employment tax reporting obligations, including estimated taxes, entity returns, and information returns.

Cross Reference
For more information see the sample income tax return at www.ruraltax.org.

Filing Requirements for Individual Income Tax Returns

Filing Threshold

Taxpayers are required to file federal income tax returns if their gross income is equal to or greater than a filing threshold. In general terms, a farmer's gross income is the total proceeds from the sale of commodities plus gain on the sale of breeding livestock, equipment, land, and buildings. If you meet the gross income requirement, you must file a federal income tax return even if your deductions reduce your income and self-employment taxes to zero.

Filing thresholds are equal to the sum of the personal exemptions deduction and the standard deduction (except for taxpayers who are married and file separate returns) Therefore, they vary by filing status and are adjusted each year. Figure 13.1 shows filing thresholds for 2011 based on filing status.

Figure 13.1 Components of Filing Thresholds

Filing Status	Personal Exemption(s) Deduction	Standard Deduction	Additional Standard Deduction	Total
Married individual, separate return	$ 3,700	$ 0	$ 0	$ 3,700
Single individual	3,700	5,800	0	9,500
Single individual, 65 or older	3,700	5,800	1,450	10,950
Head of household	3,700	8,500	0	12,200
Head of household, 65 or older	3,700	8,500	1,450	13,650
Qualifying widow (er)	3,700	11,600	0	15,300
Qualifying widow (er), 65 or older	3,700	11,600	1,150	16,450
Married couple, joint return	7,400	11,600	0	19,000
Married couple, joint return, one spouse 65 or older	7,400	11,600	1,150	20,150
Married couple, joint return, both spouses 65 or older	7,400	11,600	2,300	22,300

Example 13.1 No Net Farm Income

Red Durum is a single taxpayer who has $70,000 of gross farm income and $70,000 of farm expenses in 2011. He has no other income. Even though he has no taxable income in 2011, he is required to file a federal income tax return because his gross income exceeds $9,500.

You must file a federal income tax return even though your gross income is below the filing threshold in certain situations. The most common situation for farmers is having $400 or more of net earnings from self-employment.

Example 13.2 No Taxable Income

Assume that Red, from Example 13.1, had only $9,000 of gross farm income and $6,000 of farm expenses, for a $3,000 net farm income. Red's $5,800 standard deduction and $3,700 personal exemption

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deduction reduce his taxable income below zero. However, Red is still required to file a tax return because he has more than $400 of earnings from self-employment.

You should file a return even though you do not meet the filing requirements if you qualify for a tax refund due to tax withholding or a refundable credit, such as a refundable child tax credit, earned income credit, or refundable education credit.

Cross-Reference

For more information on filing requirements, see the instructions for Form 1040, U.S. Individual Income Tax Return, which are available at www.irs.gov.

Due Dates

Individual income tax returns are due on the fifteenth day of the fourth month after the end of the individual's tax year. The tax year for most individuals is the calendar year, which means that the tax return is due on April 15th of the following year. An exception applies if the taxpayer has filed bankruptcy and is filing two short tax years in the same calendar year.

Most farmers are aware of an option to file tax returns by March 1. This option exempts them from the penalty for not paying estimated taxes and is discussed later in this chapter.

Every individual taxpayer can receive an automatic extension of time to file a tax return by filing Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return, by the original due date of the return. The total tax due still must be paid by the original due date, even though the exact amount due has not been calculated. Any underpayments are subject to interest and a penalty on the remaining balance that is paid when the Form 1040, U.S. Individual Income Tax Return, is filed. The penalty is not charged, however, if at least 90% of the tax was paid by the due date and the remaining amount is paid when the return is filed by the extended due date.

The extension period is six months after the original due date. For individual taxpayers with a calendar tax year, the extended return must be filed by October 15th to avoid late filing penalties. The only requirement for receiving the extension is filing the application.

Penalties

There are penalties for both filing a return late and paying a balance due late.

The failure to file penalty is 5% of the unpaid tax for each month or fraction of each month the return is filed after the due date (original or extended), up to a maximum that is 25% of the unpaid tax. If the return is not filed within 60 days of the due date (original or extended), the minimum penalty is the lesser of $135 or 100% of the tax due.

The failure to pay tax penalty is one-half of 1% of the unpaid tax for each month or fraction of a month the payment is late, up to a maximum of 25% of the unpaid tax. For taxpayers who have entered into an installment agreement with the IRS, the failure to pay penalty is reduced to one-fourth of 1% for each month or fraction of a month the tax payment is late.

Observation

No Late Penalty if No Tax Due

If there is no tax due with the return because the tax is covered by estimated payments, tax withholding from wages or other payments, or tax credits, there are no penalties for failure to file pay tax.

If the taxpayer both files late and pays late, the combined failure to file and failure to pay penalties are limited to 5% per month.

Example 13.3 Late Filing

Red Durum, a single farmer, filed his 2011 tax return on June 16, 2012. He had not filed an application for an automatic extension. Red had a $10,000 balance due on his 2011 return, which he paid on June 30, 2012. His late filing penalty is $1,500, which is 5% of the balance due for each month or fraction of a month his return was late (3 × 5% × $10,000). Red also has a $150 late payment penalty, which is one-half of 1% for each month or fraction of a month he was late (3 × 0.5% × $10,000). The late payment penalty partially offsets the late filing penalty, so Red's total penalty is $1,500.

Statute of Limitations

The statute of limitations for the IRS to assess additional taxes after an original return is filed is generally 3 years from the original or extended due date. A return filed before the due date is treated as filed on the due date.

There is no time limit for assessing additional tax if the return was fraudulent or false, no return was filed for the year, or there was a willful attempt to evade taxes.

If a taxpayer omits an amount in excess of 25% of gross income, the assessment statute of limitations is extended to 6 years.

Filing Requirements for Entity Returns

Several entities besides a sole proprietorship can be used to conduct a farm business. These include C corporations, S corporations, partnerships, trusts, and estates. [Limited liability companies (LLCs) are another option but for federal income tax purposes, they are taxed as sole proprietorships, partnerships, S corporations, or C corporations.] Each of these entities has its own filing requirements, return due dates, and penalties for late filing and late payment. The statutes of limitations for assessment, however, are the same for entities as it is for individuals.

Filing Threshold

C corporations must file Form 1120, U.S. Corporation Income Tax Return, and S corporations must file Form 1120S, U.S. Income Tax Return for an S Corporation. Corporations must file tax returns even if they have no income or have no income tax due. Corporations that are inactive should attach a statement stating that there was no activity for the tax period.

Partnerships must file Form 1065, U.S. Return of Partnership Income, regardless of the amount of partnership taxable income.

Estates with income must file Form 1041, U.S. Income Tax Return for Estates and Trusts, if they have $600 or more of gross income. Trusts must file if they have $600 or more of gross income or any amount of taxable income. Both estates and trusts must file tax returns if any beneficiary is a nonresident alien.

Bankruptcy estates must file Form 1041 if their gross income is equal to or greater than the sum of the exemption deduction and the basic standard deduction, which is $9,500 for 2011.

Due Dates

The due date for filing a corporation tax return is the fifteenth day of the third month after the close of the tax year. For corporations that use a calendar year, this due date is March 15th. Corporations often have fiscal years that are different than the calendar year. For example, the due date of the return for a corporation with a fiscal year that ends on February 28 is May 15th.

Both C and S corporations may obtain an automatic 6-month extension by filing Form 7004, Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns, by the original due date of the return. As with individuals, the corporation must pay any tax due by the return's due date. Any remaining balance due calculated at the time the return is filed is subject to interest and penalty, but as with individuals, the penalty is not charged if the corporation has an extension of time to file its tax return, pays 90% of the tax due by the regular due date of the return, and pays the remaining tax by the extended due date of the return.

The due date for filing a partnership return is the 15th day of the fourth month following the close of the tax year. Most partnerships are on a calendar year, for which the due date of the partnership return is

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April 15th. Partnerships may receive an automatic 5-month extension of time to file by filing Form 7004 by the due date of the partnership return. Partnership returns are informational returns, with each partner paying taxes on his or her prorated share of income. This information is reported to each partner on Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc.

Trusts and estates with income must file Form 1041 by the 15th day of the fourth month following the close of the tax year. Estates and trusts may obtain an automatic 5-month extension by filing Form 7004 by the due date.

Penalties

The late filing penalty for C corporations is 5% of the unpaid tax for each month or fraction of a month the return is filed after the due date (including any extension), up to a maximum of 25%. The minimum penalty for a return that is filed late fee is the smaller of the tax due or $135. The late payment penalty is one-half of 1% of the unpaid balance for each month or fraction of a month after the return due date, up to a maximum of 25%. If the return is filed late and the tax is paid late, the late payment penalty partially offsets the late filing penalty, so that the combined penalty is limited to 5% of the unpaid balance per month or part of a month.

Partnership and S corporations face late filing penalties of $195 per partner or shareholder per month for a maximum of 12 months for taxable years beginning after December 31, 2009. An additional penalty of $100 per shareholder or partner can be imposed for each failure to timely furnish a correct and complete Schedule K-1 (Form 1120S or Forms 1065) to a shareholder or partner. If an S corporation has a corporate level tax due on a late return, the C corporation penalties for late filing and payment are also assessed.

Trusts and estates are subject to the same late filing and late payment penalties that apply to individuals and C corporations.

Where to Report Income and Expenses

Farmers generally report their income and expenses on Schedule F (Form 1040), Profit or Loss From Farming. However, there are several exceptions that are discussed in this section. Reporting income and expenses on the proper tax form is important because the tax rules differ for the various forms.

Schedule F (Form 1040), Profit or Loss From Farming

Farmers report the income received and the expenses incurred in the ordinary course of a farming business on Schedule F (Form 1040). The types of income reportable on Schedule F (Form 1040) include revenue from the sale of livestock and commodities that were raised to be sold in the ordinary course of the farming business, government payments, and patronage dividends and per-unit retains from cooperatives.

Farmers should **not** report the proceeds from selling assets used in the farming business on Schedule F (Form 1040). Those proceeds are reported on Form 4797, Sales of Business Property. Assets used in the farming business include breeding, dairy, and draft livestock; machinery; and real property (land and improvements on the land, such as buildings, fences, tile lines, and grain bins).

Expenses reportable on Schedule F (Form 1040) include the costs of raising the livestock and commodities that are raised to be sold in the ordinary course of the farming business and the costs of raising and maintaining draft, breeding, or dairy animals. Depreciation of buildings, machinery, and other assets used in the farming business is deducted on Schedule F (Form 1040), as is the cost of repairing those assets.

Schedule C (Form 1040), Profit or Loss From Business

If a farmer engages in a business activity that is not farming, the income and expenses for that activity are reported on Schedule C (Form 1040). Any processing of a commodity that was raised on the farm beyond the stage required to make it marketable as a commodity is a non-farming business. For example,

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if you raise grapes and use them to make wine, you should report the income and expenses from the grape growing on Schedule F (Form 1040 and the income and expenses from making wine on Schedule C (Form 1040).

Form 4797, Sales of Business Property

The proceeds from selling assets used in the farming business—including breeding, dairy, and draft livestock, machinery, and real property (land and improvements on the land such as buildings, fences, tile lines and grain bins)—are reported on Form 4797. The gain or loss from each sale is computed by subtracting the basis of the asset from its sales proceeds.

Schedule SE (Form 1040) Self-Employment Tax

Some income from farming is subject to self-employment tax as well as income tax and must be reported on Schedule SE (Form 1040). Self-employment income includes the net profit from farming from line 36 of Schedule F (Form 1040), a partner's share of farm income from a partnership, and a member's share of income from a limited liability company (LLC) that is taxed as a partnership.

Information Returns

Like all business operators, farmers must prepare information returns for some of the payments that they make, and they must send copies of the information return to the taxpayers they paid as well as filing the returns with the IRS. The IRS matches the amounts on these returns with the amounts reported on the recipients' income tax returns to determine if the income was reported. Farmers who fail to file required information returns are subject to penalties.

Farmers must file Form 1099-MISC, Miscellaneous Income, to report several types of business expenses paid to other taxpayers. Lenders are required to file Form 1098, Mortgage Interest Statement, to report mortgage interest received in the conduct of a trade or business. Employers, including farmers who have employees, must file Form W-2, Wage and Tax Statement, to report wages paid to their employees.

The amounts reported on information returns reflect payments made during the calendar year, whether the payer reports income taxes on a fiscal year or on a calendar year.

Forms 1098 and 1099

The due dates for filing all types of Forms 1098 and 1099 are February 28 of the year following the year the payments were made if the returns are filed on paper or March 31 if they are filed electronically.

Each type of Form 1099 must be grouped and filed with a separate Form 1096, Annual Summary and Transmittal of U.S. Information Returns, if paper returns are filed. For example, all Forms 1099-MISC, Miscellaneous Income, must be grouped together and filed with a Form 1096. All Forms 1099-INT, Interest Income, must be grouped together and filed with a separate Form 1096.

A copy of each Form 1098 or 1099 must be furnished to the recipient of the payment by January 31 of the year following the year of the payments.

The recipient of the payments must provide the payer with a completed Form W-9, Request for Taxpayer Identification Number and Certification, to report his or her taxpayer identification number (TIN). If the recipient does not provide the TIN in the required manner, the payer must impose backup withholding at a 28% rate.

Penalties for failure to file correct information returns with the IRS are time-sensitive. If a return is correctly filed within 30 days of its due date, the penalty is $15 per information return. If the returns are filed more than 30 days late but before August 1, the penalty is $30 per information return. If the forms are not filed by August 1, the late filing penalty is $50 per information return.

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Form 1099-MISC, Miscellaneous Income

Form 1099-MISC is used to report several types of payments of $600 or more made in the course of a trade or business. It is not filed when personal expenses are paid. Generally, it is issued only for payments made to noncorporate businesses, but there are exceptions for legal services furnished by law firms that are incorporated and for medical and health care payments made to corporations by the farming business.

Form 1099-MISC is used by farmers to report nonemployee compensation (payments for services made to independent contractors). Generally these payments are for machine hire, but they also include amounts paid for professional services provided by attorneys, accountants, and crop consultants. Payments for nonemployee compensation are almost always reported as self-employment income by the recipients.

Form 1099-MISC is also used to report rents for real estate (including farmland, pasture, buildings, and grain storage) and equipment. Generally, payments reported as rent for real estate are not included as self-employment income by recipients.

Form 1099-INT, Interest Income

Form 1099-INT is filed to report interest payments of $600 or more made to individuals or noncorporate entities in the course of a trade or business. Taxpayers are not required to file Form 1099-INT for nonbusiness loans.

Form 1099-DIV, Dividends and Distributions

Corporations file Form 1099-DIV to report the dividends they pay to a shareholder. Dividends are commonly used to reduce capital in a closely held farming corporation and to make cash available to the shareholder.

Dividends paid by U.S. corporations are generally *qualified dividends* if the recipient has held the stock for at least 61 days (91 days for preferred stock). Qualified dividends presently receive preferential tax treatment. Qualified dividends that are in the recipient's 10% or 15% ordinary income tax brackets are subject to a 0% tax rate. Qualified dividends received by individuals who are in the higher tax brackets for ordinary income are subject to a 15% tax rate

Form 1098, Mortgage Interest Statement

Lenders use Form 1098 to report mortgage interest received in the course of a trade or business from an individual who has paid $600 or more of interest. Lenders do not have to file Form 1098 if they are not in the business of lending money. A mortgage is defined as a loan secured by real property, which includes land and anything built on it.

Form 1098 is not required for interest received on loans made to a partnership, corporation, trust, or estate.

Form W-2, Wage and Tax Statement

An employer must file a Form W-2 for each employee, no matter how small the amount of wages that were paid during the calendar year. If paper Forms W-2, along with a Form W-3, Transmittal of Wage and Tax Statements, are submitted, they must be filed with the Social Security Administration by the following February 28. If the Forms W-2 are filed electronically, they must be filed by March 31.

Form W-2 must be provided to each employee by January 31, and employers must file a copy with the state tax agency as well.

Cross Reference

For more information, see the instructions for Forms 1096, 1099-MISC, 1099-INT, 1099-DIV, W-2, and W-3, which are available at www.irs.gov.

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Estimated Taxes

Most taxpayers who owe a tax of $1,000 or more after subtracting withholding and refundable credits are required to pay quarterly estimates of their taxes. Penalties apply to late payments of the estimates. Qualified farmers are not subject to the penalties if they meet certain requirements.

Special Rules for Farmers

If a farmer files his or her tax return using a calendar year and pays the tax in full by March 1, the penalty for not paying estimated taxes does not apply.

A qualified farmer who wants to file on April 15 can avoid the penalty for underpayment of estimated taxes by making a single estimated payment by January 15th. This payment must equal or exceed the lesser of two-thirds of the tax due on April 15th for the current year, including self-employment tax, or 100% of the tax due for the previous year, including self-employment tax.

Example 13.4 Payment of January Estimate

For 2010, Red Durham paid $3,756 of federal income tax and $5,652 of self-employment tax, for a total of $9,408. He expects to owe $15,000 of federal income tax and self-employment tax for the 2011 tax year and will not be able to file by March 1. Because 100% of his 2010 tax is less than two-thirds of his $15,000 projected tax for 2011, the lowest amount Red can pay by January 15, 2012, to avoid the estimated tax penalty is $9,408.

Qualified Farmer for Estimated Tax Purposes

To qualify as a farmer for estimated tax purposes, a farmer must receive two-thirds of his or her gross income from farming for the current or previous year. The calculation is made in three steps.

First, the taxpayer must calculate his or her gross income from all sources. The following income items tare combined for this calculation:

- Wages
- Taxable interest
- Ordinary dividends
- Taxable refunds from state income tax
- Alimony received
- Gross income from business reported on Schedule C
- Capital gain income (before netting against losses)
- Gains on the sale of business property
- Taxable individual retirement account distributions, pension distributions, and social security benefits
- Gross rental and royalty income
- Taxable income from estates and trusts
- Gross farm income from Schedule F (Form 1040) and Form 4835
- Shares of gross income from partnerships, LLCs, and S corporations
- Unemployment compensation
- Other income

Next, the taxpayer must calculate gross farm income. The following income items are combined for this calculation:

- Gross income from Schedule F (Form 1040), Profit or Loss From Farming
- Gross income from Form 4835, Farm Rental Income and Expenses

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- Gross farm income from partnerships, LLCs, S corporations, and trusts and estates engaged in farming
- Gains from the sale of livestock

Gains from the sale of farm equipment or land, wages received as a farm employee, and income from custom grain harvesting or hauling are **not** included in gross farm income.

The final step is dividing gross farm income by gross income. If this calculation results in a fraction of at least two-thirds, the taxpayer is considered a qualified farmer and is exempt from the penalty for not paying quarterly estimated taxes if he or she follows the special rules discussed in the previous section.

Example 13.5 Calculation of Qualified Farmer Status

Red Durum's gross income includes $40,000 of gross income from his Schedule F (Form 1040) and $10,000 from sales of raised breeding stock that he reported on Form 4797, Sales of Business Property. In addition, he has $4,000 of interest on his savings accounts and $3,000 in wages. His gross farm income is $50,000 ($40,000 + $10,000) and his total gross income is $57,000 ($40,000 + $10,000 + $4,000 +3,000).

Red is a qualified farmer for estimated tax purposes because his gross farm income is 88% ($50,000 ÷ $57,000) of his total gross income, which exceeds the two-thirds requirement.

Estimated Tax Penalty

Qualified farmers who do not make quarterly estimated tax payments but file and pay all taxes due by March 1st do not owe estimated tax penalties. Qualified farmers who do not file by March 1st but who make a single estimated tax payment by January 15th owe a penalty only if the payment is less than the lesser of two-thirds of the tax due for the current year or 100% of the tax for the previous year.

The penalty is calculated on Form 2210F, Underpayment of Estimated Tax by Farmers and Fishermen. It is equal to interest from January 15th to the date the balance due is paid, calculated using the amount by which the estimated payment, if any, was less than the amount required to be paid to avoid the penalty. This usually results in fairly small penalties.

Example 13.6 Estimated Tax Penalty

Red Durum is a qualified farmer who paid $7,235 of federal income tax and self-employment tax on his 2010 income. He made a $3,000 estimated federal tax payment for his 2011 taxes on January 15, 2012. On April 15, 2012, he filed his 2011 return and paid his remaining balance due of $6,008.

The lesser of the $7,235 of taxes Red paid for 2010 and two-thirds of his $9,008 taxes for 2011 is $6,005 (two-thirds of $9,008). Therefore, his underpayment was $3,005 ($6,005 – $3,000). Assuming a penalty rate of 4%, he owes an additional $30 ($3,005 × 4% × 90 days ÷ 365 days).

Cross Reference

For more information see Chapter 15, "Estimated Tax," of IRS Publication 225, *Farmer's Tax Guide* (2010).

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