Income Tax Management for Farmers in 2011

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Reference Materials

“Income Tax Management for Farmers in 2011”
available on-line at:

www.agecon.purdue.edu/extension/programs/tax_planning.asp
‘11 Tax Planning is Critical

- Year-end review is essential
  Where are you?
  Income and expenses
  Where do you want to be?
- Keep your flexibility in managing taxes
‘11 Tax Planning is Critical

1. Take action by Dec. 31, 2011 income and expense items
2. After-year-end planning with depreciation and Sec. 179
3. Special circumstances – adjusting to new conditions
Topics to be covered

• Depreciation and Expensing
  – Depreciation and Sec. 179
  – Additional First Year Depreciation (AFYD)
  – Planning Cost Recovery in 2011
  – Some Planning Considerations
Topics (continued)

• Social security tax reduction
• Limitations on farm losses
• Repeal of expanded Form 1099 reporting
• Schedule F changes
• Payroll tax incentives
Other topics to be covered

- Deferred income from sales
- Prepaid expenses
- Farm income averaging
- Crop insurance
- Disaster sale of livestock
- Casualty losses
- Self-employment tax update
- Tax management
• Increased §179 expensing election/deduction
  - ’10/’11 limit of $500,000
• Qualifying investment limit increased to $2,000,000
• Both extended through 2011
Depreciation and §179 Expensing

- §179 election limit increased to $500,000 and an $2,000,000 investment limit for ’10 and ’11
- Decisions can be made when completing the tax forms
- Farmers have considerable flexibility for their tax planning
What is §179 Property?

p. 2-3

1. Tangible personal property used in a trade or business
   Excludes machine sheds and general purpose barns, but includes single purpose structures and field tile
   Qualified real property – but no farm assets qualify
   Landowners usually do NOT qualify as a trade or business
2. Purchased new or used property.
Inherited property is not eligible.
Property purchased from a related party does not qualify.
(siblings are not a related party)
3. Only “boot” paid is eligible for expensing on a like-kind exchange (swap or trade)

Ex. 1, Sara trades for used tractor and pays $50,000 boot

Only the $50,000 boot is eligible for Sec. 179 election and deduction
4. §179 expensing election is phased out on $ for $ basis if qualifying property placed in service exceeds $2,000,000.

Ex. 2, Luc buys $2,025,000, his §179 election limited to $475,000.

- If Luc had purchased $2,100,000 of qualifying – election limit is $400,000.
5. Deduction is limited to taxable income from all active trades and businesses of farmer and spouse if filing as MFJ. Off-farm job, business, other farm income (Form 4797) are included. Active taxable income before Sec. 179 deduction.
Use of §179 Election  

- From $0 up to the $500,000 election can be used (deduction is subject to income limit)
- Can be all on one item or divided up on several items – make notations in your records
- Flexibility in its use
Election is limited to:

1. Qualifying property acquired up to $500,000 in ’10 and ‘11

2. Phase-out $1 for $1 above $2,000,000 (only boot portion counts) of purchases qualifying for the election
Deduction is limited to:

1. Amount elected plus any carry over from prior years
   (max is $500,000 in ’10 and ‘11)

2. Taxable income from active trades or businesses
   (farm and non-farm income)
Sec. 179 changes

Can make, change or revoke a §179 election made after ’07 on an amended return

Limits on property elected for Sec. 179

Notations on records

Fine tune tax planning
50 - 100% Additional First-Year Depreciation (AFYD)

- Intended to stimulate economy - investment in new assets only
- Applies to assets placed in service in 2008-12 only
- Comes after § 179 deduction, if any, is taken
50 - 100% Additional First-Year Depreciation (AFYD) p. 4

Requirements to qualify

1. Original use must start with the taxpayer (must be new)
2. Must be MACRS property with a class life of no more than 20 years: includes farm buildings
3. Generally must be placed in service before Jan. 1, 2013
4. Taxpayer is not required to use the Alternative Depreciation System (ADS)
Ex. 4, Able trades tractor with $35,000 adj. basis and pays $80,000 boot ($115,000 total). Takes $57,500 with 50% AFYD plus 10.71% X $57,500 for $6,158 for a total of $63,658.
“All or Nothing” AFYD

IMPORTANT!!!

• 100% AFYD is standard for ’11
• 100% AFYD: all qualifying assets
• Taxpayer can ELECT NOT to take AFYD – election includes all assets in a MACRS class
“All or Nothing” AFYD  p. 5

- Ex. 5 new tractor $80,000
  new planter $30,000
Both are 7-year MACRS assets

‘11 AFYD
Take $110,000 or elect $0
Ex. 5 new tractor $80,000 (7-yr MACRS)
new computer $30,000 (5-yr MACRS)

‘11 AFYD

1. Both $110,000
2. Just tractor 80,000
3. Just computer 30,000
4. Neither 0
### Sec. 179 Expensing and AFYD by Year

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<td>50%</td>
<td>50%</td>
<td>50% before 9/9/10</td>
<td>100%</td>
<td>50%</td>
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<td></td>
<td></td>
<td></td>
<td>100% After 9/8/10</td>
<td></td>
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</tr>
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</table>
§ 179 vs. AFYD

- Both are accelerated cost recovery
  - typically use for longer-life assets
- AFYD – new assets only
  - entire basis of trades
  - general purpose barns/shop
  - “all or nothing”
§ 179 vs. AFYD

• § 179 – both new or used assets are eligible
  - boot only on trades
  - flexibility in amount of deduction
  - recapture in year of conversion to less than 50% business
§ 179 vs. AFYD

• § 179 is limited by income and any excess is carried forward
• AFYD can create a loss which can be carried back or can carry forward
• Generally want to avoid both
Examples p. 6-7

• Ex. 6 – Elect out of AFYD and use § 179 in tax management
• Ex. 7 – Depreciation of shop and shed ($3,000 vs. $41,500)
Landowners

• Cash rent and share lease landowners are generally not in the trade or business of farming
• Get depreciation but not § 179
• AFYD in ‘11 and ‘12 is a unique opportunity for rapid write-off of investments
State Reactions - Two sets of books?

- Some states (Indiana) have not accepted increased Sec. 179 and AFYD deductions
- Add-back for Indiana taxes
- Check your state procedures
- Differences among states
What’s ahead for Sec. 179?

- Sec. 179 limits have never been reduced
- Concern about the deficit
- Currently ‘12 limit on deduction is $125,000 (adj. to $139,000)
Future Directions?

• § 179 Expensing
• Likely to continue, but at a reduced level of qualified investment
• Investment limit focuses effects on "small businesses"
Future Directions - AFYD

- AFYD is potentially expensive
  - Write off 100% of qualified investment
  - No limit on the size of potential deduction – large firms are eligible on all their investments

Unlikely to continue
Other changes

Limitations of Farm Losses for Taxes
Began in ’10
Farmers getting gov’t payments
Loss limited to greater of:
1. $300,000 or
2. Total net farm income over last 5 years
Social Security Tax Reduced

- Social security and self-employment (SE) tax rate decreases 2 percent
  - SE tax rate drops from 12.4% to 10.4%
- Medicare tax rate of 2.9% is unchanged
- Complicated computations
- Individual’s benefits are not reduced
- Future ?
• Broadened – to be effective after 2011
• Taxpayer in a trade or business would have reported ALL payments totaling $600 or more for property and services during the tax year
Schedule F (Form 1040) p. 8

- A number of lines were added to account for various types of payments for sales
- Most of the new lines will not be used for 2011
- IRS is updating instructions
• REPEALED
• Continues for compensation, interest and rent of $600 or more to unincorporated taxpayer
• Ex. 9 – Dan Fixit $575 for services vs $625 for parts and services (No 1099 vs required 1099)
• Hire an unemployed individual and qualify for 6.2% incentive - equal to employer’s share of social security tax
• Lesser of $1,000 or 6.2% of wages if employed 52 weeks
Tax Management
– before 12/31/11

• Defer income
• Prepay expenses
Deferring Income

• Defer receipt of income on ’11 sales until ‘12 tax year
• Cash basis farmers can use installment sales because they are not required to inventory raised commodities
Deferring Income

“Constructive receipt”

Written contract must be in place before commodity is delivered

Contract should specify that farmer has no right to payment until specific date in ‘12
Deferring Income

• Livestock contracts must waive time limit on payment
• Increased risk for producer
• Farmer must own commodity and be paid for personal property, not just services
Deferring Income

- Cost of items purchased for resale is deducted when income is reported
- Installment reporting cannot be used for losses or depreciation recapture
Prepaying Expenses

• Cash basis farmers can deduct cost of supplies purchased this year although they will not be delivered or used until next year

• Various sets of rules must be met
1. Purchase not just a deposit
   - Specific quantities indicated
   - No right to a refund
   - Seller does not treat as a deposit (no interest paid)
   - No right to substitute
2. Business purpose other than just reducing taxes
   - discount for early purchase
   - assure supply
   - secure preferential treatment
3. Not distort income
   - Subjective tests of distortion
   - Objective standards
     - 12 month rule on intangibles
     - 1 year rule on supplies
Ex.10 and 11
12-month test

• **Ex. 10** Herbicide purchase in Dec. 2011 and used by June 2012.
• Actual purchase/business reasons
• Uses herbicide in less than year
• All the physical links feels quite right
• Ex. 11 – Insurance

Policy 7/1/11 to 6/30/12 benefit does not extend more than 12 months beyond initial benefit

Entire premium of $1,200 is deductible in ‘11
12 month test

• Ex. 11 – Insurance
  Policy 7/1/11 to 6/30/13 benefit does extend more than 12 months beyond initial benefit
  Only premium of $600 for ‘11 is deductible in ‘11
Payment and Deduction  p.11

• To be deductible we need to have an actual payment of expenditure:
  – Payment by farmer
  – Charge to credit card or 3rd party
  – Paying on the web to 3rd party
  – Charging to supplier or signing a seller’s note is NOT payment
50% Rule

• Limits prepayment to 50% of total deductible expenses, other than prepaid expenses

• NOT by category – TOTAL

• Seed, fertilizer, chemicals, labor, depreciation, rent etc.
50% Rule

Test over three year period

- Rule does NOT apply to qualified farm-related taxpayer
  1. Lives on a farm
  2. Principal occupation-farming
  3. Family member meets 1 or 2

- Test over three year period
Farming Syndicate Rules
No prepaid expenses  p. 12

• Entity other than a regular (C) corporation
• More than 35% of losses go to limited partners/entrepreneurs
• Cousins are not considered family members
Farm Income Averaging

- Relatively new after the end of the year tax planning tool
- Election can be made on an amended return
- Does not create or increase the AMT
Farm Income Averaging

Farmers can elect to have part or all of their farm income taxed at tax rates of prior 3 years.

Does not affect self-employment tax for this year or prior years or income tax of prior years.
Includes Schedule F income, gains on machinery and livestock, but not land or timber.

Flow-through from partnerships or S corporations.

Salary from a farm S corporation.
“Elected” farm income is divided by 3 and added to prior years’ income and taxed at that year’s tax rates of the individual. Does not affect income or SE tax for those years.
• Ex. 14 Danica’s Sch. F $150,000
  tax of $32,957 (28% bracket)
  $13,000 unused in 15% brackets
  Saves 13% on $39,000=$5,850
• Ex. 15 Optimal Averaging
  Average marginal tax rate
Farmer can select the type of income for averaging. Ordinary income, capital gain income or a combination. Once elected, 1/3 of each type of income goes to each base year.
Farm Income Averaging Possibilities  p. 15

Farmers with substantially higher than normal income and limited §179 or 50% AFYD

Retiring farmers with depreciation recapture (taxed as ordinary income) on machinery and other farm assets
Families with significant increase in income from non-farm sources, but only farm income can be averaged

Situations in which normal tax planning does not apply
Crop Insurance Indemnities

• Cash basis farmer normally reports income when received
• If crop is normally sold in a year following the year of production, can elect to defer reporting of indemnity for physical loss
• One election covers all crop insurance indemnities of a farm
• Sell one crop in year of production and carry one over
  – Notice 1985 –
Support for two or more positions
Crop Insurance Indemnities

• Revenue insurance – need to divide between physical loss and loss due to price decline
• One procedure is illustrated to determine deferrable amount in 2007’s paper
Crop Insurance Proceeds

- Cannot accelerate reporting of crop insurance proceeds
- Group Risk Plan and GRIP are not tied to specific loss

Will be reported after county yields are determined
• ‘10 indemnities deferred from reporting in ‘10, must be reported on 2011 return

• Indemnities from ‘10 crops paid in ’11 must be reported on 2011 return
Casualty Losses

- Casualty loss - result of sudden, unexpected or unusual event
- Business assets have basis
  Totally destroyed – adj. basis is measure of loss
  Partially destroyed – repair cost
Weather-Related Sale of Livestock

- 2 provisions in tax law
- Sale with expected replacement with 2 years (may be extended because of continued drought)
- Sale in excess of normal sales reporting is deferred a year
Sale with replacement

• Gain is not reported as income if replacements are purchased within allowable period.
• Must replace with similar animals
• Basis is cost of new animals minus sale proceeds
• Statement – p 17-18
Sale with Replacement

p. 17-18

- Statement is attached to Sch. F
  Gives facts of situation
- May have a gain to report
- If not replaced, amend ‘11 return
Sale without Replacement

- Allows postponement of reporting until the usual time of sale
- Must be declared a disaster area
- Statement is attached to return
- Show calculation of income being deferred
Casualty Losses

- $0 basis assets – no loss
- Insurance payment > basis results in a gain unless proceeds are reinvested
- Insurance payment < basis results in a loss
Self-Employment Tax Update

• Earnings subject to 12.4% SE tax was $106,800 in ‘09 and ’10. Goes to $110,100 in ‘12
• All earnings subject to 2.9% Medicare
• 3.6% increase in benefits
• Optional SE tax methods
  increase quarters of coverage
  Indexed to avoid future problem
• Land rented to an entity
  No new developments
• Conservation Reserve Program Area of confusion – IRS proposed all CRP payments be earnings for SE tax

• Taxpayers receiving social security benefits have rent exception, not earnings for SE tax purposes
• CPR participants not getting social security benefits
• Farm bill does not clarify these situations
• Continues to be a gray area
Soil and Water Conservation

• See 2007’s materials
• www.agecon.purdue.edu/exten
  sion/pubs/taxplanning2007.asp
• Cost sharing deduction - § 175
• Income exclusion - § 126
Gifts of Commodities – Cash Basis Farmers

- Gifts to family or others
  1. If gift is made in the year of production, donor’s expenses should be reduced by cost of production

Recipient family member has a basis equal to cost of production
Recipient sells and reports gain on Schedule D
Not earnings for SE taxes
Donor saves SE tax on gain not reported and gain is taxed at recipient’s (lower) income tax rate
2. Gift is made of a commodity in the year following year of production
Deduct expenses on Sch. F to reduce SE and income tax
Donor and donee’s tax basis is $0
Greater income tax savings too
Family Gifts

- IRS looks for economic significance other than tax avoidance
- Caution if recipient is involved in the farm operation
- Must convey control of commodity
- Be aware of kiddie tax
Charitable Donations  p. 23

Donation can be of current or prior year’s commodities

Expenses are deducted on Sch. F
– Reduces income for both income and SE tax
– No charitable contribution is claimed as tax basis is $0
Charitable Donations p. 23-24

– But, no income is reported for either income or SE tax purposes
– Savings of about 1/3 the value of the contribution at 15% income tax rate and about 40% at 25% income tax rate

Example 19 on p. 23-24
Charitable Donations  p. 24

Let the charity make the sale
Write a letter to the charity
• X bushels of corn
• Will deliver for charity
• Request written instructions
Cash basis farmer

- Income when constructively received by taxpayer (deferred payment contracts)
- Expense when paid (can borrow from 3rd party to pay)

Year to date review, file by March 1
Long-Run Tax Planning

• Structure farm to take advantage of tax laws
  – Medical expenses
  – Retirement contributions
  – Control SE earnings
  – Other fringe benefits
  – Transfer of ownership
Plan for the longer term, not just this tax year

“Income tax free” amount

Keep taxable income stable from year to year

Think SE tax too – often more difficult to manage
Year-End Purchases of Inputs/Machinery  p. 25

- Must be purchase, not just a deposit
- Delivery of inputs is not necessary, but depreciable items must be placed in service
- Use inputs up within 12 months
• Think taxes on major decisions, but economics are more important: Uncle only pays part!
• Consider taxes before, rather than after, the deal is finalized
• Consult a tax specialist
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