INCOME TAX MANAGEMENT

FOR FARMERS IN 2010

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Effective income tax planning and management seeks to maximize after-tax wealth, and typically involves consideration of receipts and expenditures for multiple years. Increased volatility of both input and output prices has made farm income more difficult to predict. Planning is especially difficult in 2010 because Congress has enacted a number of short-term tax laws intended to stimulate the economy that affect only the current tax year. A number of "Bush tax-cut" provisions are currently scheduled to expire at the end of 2010 and would generally increase taxes. Concerns about both weak economic growth and deficit spending continue to impact policy discussions of future taxes.

The 2008 incomes of many farmers were at record levels, and receipts were deferred into 2009. However, increases in rent and input prices cut into margins and, with sharp declines in 2009 commodity prices, affected 2009 taxable income levels. Because of the wide range of variability of 2010 commodity prices, year-end tax planning is critical in 2010. Determining year-to-date receipts and expenses, including depreciation, is essential for effective tax planning. Actions can be taken before the end of the tax year to manage taxable income for 2010. Additional first-year depreciation, Section 179 expensing, and farm income averaging provide opportunities for tax planning after the end of the tax year. Good tax planning should also consider the self-employment tax as well as income tax.

The Indiana state and local income tax rates are nearly flat-rate taxes, but a number of the federal deductions are not allowed for state and local tax purposes. This adds additional complications to tax preparation.

The first section of this publication briefly discusses a number of recent changes in the health insurance area and how these affect most producers. The second section discusses recent changes affecting businesses and individuals. The changes in depreciation and Section 179 expensing are emphasized as part of a broader review of this area. Third is a discussion of planning with respect to a net operating loss. Procedures for the deferral of income from sales of commodities in 2010 and procedures to ensure the deductibility of prepaid expenses are reviewed. Farm income averaging is discussed in the fifth section. Crop insurance and casualty losses are reviewed. Developments with respect to self-employment taxes, including the Conservation Reserve Program (CRP) payments, are discussed in the eighth section. The ninth section summarizes other recent tax developments affecting farmers and landowners. The publication closes with a brief discussion of tax management.

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* This publication is intended for general educational purposes only. For information on specific tax situations, consult a competent tax advisor. For helpful comments on earlier versions of this publication, appreciation is expressed to Purdue colleagues Freddie Barnard, Craig Dobbins, Howard Doster, Gerry Harrison, Laura Hoelscher, Jess Lowenberg-DeBoer, Alan Miller, Bob Taylor, and Luc Valentin; and to Linda Curry, IUPUI; Charles Cuykendall, Cornell University; David Frette, CPA, Washington, IN, and David Miller, Ohio State University. For a more discussion of income taxes and agriculture, go to www.RuralTax.org .

HEALTH INSURANCE LAW CHANGES

There are a number of new tax laws relating to health care. These laws often have different effective dates.

Small Business Health Care Credit

The small business health care tax credit, effective for 2010, is intended to encourage small employers to begin or continue offering health insurance to employees. For 2010, qualifying small employers must pay at least half the cost of single coverage (individual, not family coverage) for its employees. The maximum tax credit of 35 percent is for employers with 10 or fewer full-time employees whose average annual wages do not exceed $25,000. The credit is fully phased out for employers with the equivalent of at least 25 full-time employees or who pay an average annual wage of at least $50,000.

The maximum credit is scheduled to increase to 50 percent for 2014 and later years. The small business health care credit reduces the employer's tax liability dollar-for-dollar. The remaining premium is deductible as a business expense.

Example 1. Deductibility

Jack Employer pays premiums of $20,000 for health insurance for qualified employees which generate a 35 percent tax credit of $7,000. In addition, Jack can deduct the remaining $13,000 of insurance premiums as a business expense.

Relatively few agricultural producers will qualify for the small business health care credit because of the eligible employee restriction. Self-employed individuals (sole proprietors or partners); more-than-2 percent-shareholder-employees of S corporations; and other employees who own more than 5 percent of the employer's business, their family members, and domestic employees are not eligible employees for the health care credit. The hours worked by disqualified employees are not included in determining the number of equivalent full-time employees.

Coverage of Children Under Age 27

Health insurance coverage provided for an employee's children under age 27 is generally tax-free to the employee after March 10, 2010. Furthermore, health insurance plans that cover dependent children are required to make coverage available for an adult child until the child's 27^{th} birthday for insurance plan years beginning on or after September 23, 2010. The child does not need to be the parent's dependent to be covered by the insurance. However, the child cannot be eligible for his or her own employer-provided health plan coverage.

This expanded coverage applies to both employer-provided plans and self-employed individuals who qualify for the self-employed health insurance deduction on Form 1040.

Example 2: Coverage for Adult Child

Betty is a self-employed farmer with a 23-year old daughter, Anne. Anne earns $25,000, is not Betty's dependent, and is not eligible for an employer-provided health plan. For 2011, Betty pays a $7,000 premium for health insurance, $5,000 for coverage for herself and $2,000 for coverage for Anne.

During 2011, Anne is in an accident and incurs $14,000 in medical expenses. After the deductible and co-pay, Betty receives $10,800 in insurance benefits. Betty can claim $7,000 for the self-employed health insurance deduction and neither Betty nor Anne reports the $10,800 insurance benefits as income.

Self-Employed Health Insurance Deduction

For tax years beginning in 2010, a self-employed individual may generally deduct the premiums for self-employed health insurance in computing adjusted gross income. This is in addition to the prior deduction for self-employment tax purposes. This puts the employee with an employer-provided health plan and the self-employed individual on a similar after-tax basis.

The self-employed individual cannot claim the deduction for any month in which he or she was eligible for a subsidized health plan maintained by an employer of either the taxpayer or the taxpayer's spouse. The deduction is limited to the insurance premiums and does not cover out-of-pocket medical costs.

The self-employed health insurance deduction is also limited to the earned income in the trade or business that established the health insurance plan.

Example 3: Premium Deductibility

Danny is a self-employed farmer who paid premiums of $8,000 in 2010 for health insurance for himself, spouse and children. In 2010, Danny had earned income from farming (net Schedule F income) of $45,000 so Danny may deduct the 2010 expenditure of $8,000 from gross income and from earnings for self-employment taxes.

Example 4: Limited Deduction

Danny from the previous example has net Schedule F income of $3,000 and $25,000 from the sale of livestock held for breeding or dairy purposes. Gains or losses on investment property; depreciable property or other fixed assets used in a trade or business; and livestock held for draft, breeding, sport, or dairy purposes are not earnings from self-employment. Thus, Danny's 2010 deduction of self-employed health insurance premiums is limited to $3,000. The $5,000 of remaining insurance premiums can be treated as medical expenses subject to the 7.5-percent of adjusted gross income limitation.

This provision currently applies only to a taxpayer's first tax year beginning after December 31, 2009.

Other Health-Related Provisions

For tax years beginning after December 31, 2010, over-the counter drugs will not be a qualifying expense for health plan reimbursements and withdrawals from health savings accounts. This will be consistent with the treatment of nonprescription drugs for itemized deduction purposes on Schedule A, Form 1040.

The penalty tax for the non-qualified distributions from health savings accounts (HSA) increases from 10 percent to 20 percent for years after December 31, 2010.

Employers must disclose the cost of employer-sponsored health insurance coverage on the Form W-2 for each employee; however, the value of the employer-provided insurance continues to be excluded from the employee's gross income.

For tax years beginning in 2013, qualifying medical expenses will be deductible as itemized deductions only to the extent that they exceed 10 percent, rather than the current 7.5 percent, of adjusted gross income. For taxpayers who have reached age 65 by the end of 2012, the increase to 10 percent will not occur until January 1, 2017.

Reimbursements under flexible spending accounts (FSA) will be limited to $2,500 per year for years beginning after December 31, 2012.

Effective for tax years beginning after December 31, 2013, most U.S. citizens and legal residents will be required to maintain minimal essential health coverage. Essential health benefits will be defined by the Department of Health and Human Services (HHS). Low income taxpayers will receive a refundable tax credit. Penalties will apply to individuals who fail to maintain minimum coverage.

Effective for years beginning after December 31, 2012, the unearned income of higher-income individuals, estates and trusts will be subject to the 3.8 percent Medicare tax on their net investment income. The income limits are $250,000 for a married couple, filing jointly; and $200,000 for a single individual or head of household. There will also be an additional tax of 0.9 percent on wages of over $250,000 for a married couple, filing jointly, and $200,000 for single individuals or head of household.

Effective for tax years ending after December 31, 2013, individuals who were not covered through an employer plan will be eligible for a refundable tax credit to help pay the premiums for insurance purchased on a state establish exchange. These exchanges will include four levels of coverage, called bronze, silver, gold and platinum. The bronze plan must provide benefits which are actuarially equivalent to 60 percent of the full actuarial value of the benefits offered by the plan. The requirement increases to 70 percent for silver, 80 percent for gold and 90 percent for platinum plans.

For further information on health law and taxes see Harris, Curry, and Collum (eds.) ***2010 Income Tax Workbook.***

RECENT TAX LAW CHANGES AFFECTING BUSINESS AND INDIVIDUALS

The I.R.C. Section 179 expensing has been increased almost annually by Congress. Most recently, the Creating Small Business Jobs Act of 2010 increased the Section 179 expensing limit to $500,000 for tax years beginning in 2010 and 2011. The Jobs Act also extended the 50-percent additional first-year depreciation of new property placed in service during calendar year 2010.

Other topics in this section deal with the proposed extension of the 5-year recovery period for new agricultural machinery and equipment placed in service in 2010. The limitations on farm losses, expanded Form 1099 reporting and payroll tax incentives are also discussed.

Depreciation and Section 179 Expensing

Taxpayers can recover the cost of assets that last more than a year through depreciation. The basics of the Modified Cost Recovery System (MACRS) of depreciation and the recovery rates are discussed in the Appendix of this publication.

Farmers and others in an active trade or business can elect to treat the cost of up to $500,000 of qualifying property purchased during 2010 and 2011 as an expense (rather than as a depreciable capital expenditure). Congress has aggressively increased and extended the Section 179 deduction in recent years. Under current legislation, the Section 179 limit is scheduled to drop back to $125,000 (with indexing) for 2012.

The Jobs Act expanded the definition of Section 179 property to include qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property. The deduction for qualified real property cannot exceed $250,000 annually. Farm property does not qualify for the expanded definition of qualified Section 179 property.

The Section 179 expensing election can be made after the close of the tax year when completing the return or on an amended return. Because of the expanded Section 179 expensing, farmers have greater flexibility in managing their deductions and taxable income after the close of the tax year.
To qualify for Section 179 expensing, all of the following requirements must be met.

1. The property generally must be tangible personal property used in a trade or business. Farm machinery and equipment; livestock used for draft, breeding, or dairy purposes; grain storage; single purpose livestock or horticultural structures; and field tile all qualify for Section 179 expensing. General-purpose farm buildings, such as machinery sheds or hay barns, are not eligible for Section 179 expensing. Real property is generally not eligible for Section 179 expensing.

2. The property must be purchased, but new or used property can be expensed under Section 179. Inherited property or property acquired from a related party (spouse, ancestors, or lineal descendants) is <u>not</u> eligible for Section 179 expensing.

3. For property acquired in like-kind exchanges (swaps or trades), only the boot portion paid is eligible for expensing.

<u>Example 5:</u> Trades and Section 179

Sara Farmer trades an old tractor with an adjusted basis of $35,000 for another used tractor and $50,000 boot. Only the $50,000 is eligible for Section 179 expensing.

4. The Section 179 expensing election is phased out on a dollar-for-dollar basis if over $2,000,000 of qualified property is placed in service during 2010 or 2011.

<u>Example 6:</u> Investment Limit

Luc Farmer buys $2,025,000 of machinery in 2010. Luc's maximum Section 179 expensing allowed would be reduced by $25,000 ($2,025,000 - $2,000,000), making Luc's Section 179 election limit $475,000 ($500,000 – $25,000). An individual is not allowed to elect the full $500,000 and carry over the $25,000 excess.

Only the boot portion on like-kind trades is considered in determining the $2,000,000 limit. Thus, if the $2,025,000 purchase in

Example 2 was a like-kind exchange and the boot portion was $25,000 or more, then the full $250,000 Section 179 expensing could be elected.

5. The expensing deduction is limited to the taxable income from any active trade or business before any Section 179 expensing. A farmer's and/or spouse's off-farm wage or business income can be combined with Form 1040 Schedule F for aggregate taxable income. This could permit a Section 179 expense for an asset acquired by a farm business with a loss on Schedule F. Gains or losses from the sale of livestock, machinery, and other business assets reported on Form 4797 are also included in taxable income for purposes of applying this taxable income limitation.

6. The entire Section 179 expensing election can be taken on one large item, reducing the basis for cost recovery. Alternatively, several small items can be completely written off in the year of purchase. Less than the full $500,000 expensing election can also be claimed. The amounts expensed are treated the same as depreciation when the property is sold or traded and for depreciation recapture purposes.

If a Section 179 expensing election is made, notations regarding the specific allocations should be made on the depreciation schedule. If no allocations are specified, IRS prorates the expensing election among all eligible assets. Generally, it will be more advantageous to allocate the expensing deduction to longer-lived assets and to assets that are likely to be kept in the business for their entire depreciable life.

The American Jobs Creation Act provides greater flexibility with respect to late Section 179 elections and changes in Section 179 elections. Initially, Section 179 elections could be made only on the original return for the year and could not be changed on an amended return. Thus, if a return was audited and a change proposed, the taxpayer could not make or change the Section 179 election. Rev. Proc. 2008-54 2008-38 IRB allows a taxpayer to make, change, or revoke a Section 179 election by the extended due date of the return or by filing an amended return for tax years beginning after 2007. If a Section 179 election is revoked, that revocation is irrevocable for that property.

Example 7: Revocation of Section 179

Assume a farmer elected to expense $25,000, the entire cost of a used planter in 2009, and then revoked that election in 2010. The farmer could no longer elect to expense any of the cost of the planter for 2009, but other qualifying assets acquired in 200 could be expensed for 2009.

Extension of 5-Year Recovery Period for New Farm Machinery?

One of the tax acts of 2008 required that new farm machinery placed in service in 2009 be depreciated over a 5-year period. Grain bins, fences, other land improvements, and cotton-ginning assets were not eligible. Used farm machinery placed in service in 2009 continued to 7-year property. This provision applied only to 2009, but may be extended to 2010.

One cannot elect to use a 7-year recovery period for machinery and equipment that qualifies as 5-year property. If desired, slower depreciation deductions can be obtained by using straight-line depreciation over a 5- or 10-year recovery period.

Additional First-Year Depreciation

The Economic Stabilization Act of 2008 provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis, after Section 179 expensing, if any, of qualifying property placed in service after December 31, 2007 and before January 1, 2009. This provision has been extended to before January 1, 2011. This additional first-year or bonus depreciation is allowed for both regular and AMT tax purposes.

To qualify for the additional first-year depreciation, the property must meet all five of the following requirements.

1. The original use of the property must start with the taxpayer (property must be new).

2. The property must be MACRS property with a recovery period of not more than 20 years.

3. The property generally must be placed in service before January 1, 2011. The deadline is extended for some property with a recovery period of 10 years or more, but only the portion of the basis attributable to expenditures in 2010 qualifies.

4. The taxpayer is not required to use the Alternative Depreciation System (ADS) for the property. A producer with orchards, vineyards, or groves who elected not to capitalize pre-production expenses is generally required to use ADS.

<u>Example 8:</u> Total Depreciation

In July 2010, Able Farmer trades his old tractor with an adjusted basis of $35,000 for a new tractor, pays $80,000 boot, and uses the tractor during harvest. The tractor is new farm equipment, purchased and placed in service in 2010. It is assumed that the tractor will not be depreciated over 5-year recovery period. The new tractor is eligible for the additional first-year depreciation. This deduction is 50 percent of the $115,000 initial basis of the tractor, or $57,500. Able also takes the 7-year MACRS deduction of 10.71 percent of the remaining $57,500 basis in the new tractor, or an additional $6,158. Total new tractor depreciation in 2010 would be $63,658.

An election not to take the 50-percent additional first-year depreciation can be made by a taxpayer by MACRS classes. A statement is attached to the tax return identifying the classes of property for which the election is made and indicating that the taxpayer is electing not to take the additional first-year depreciation on all of the qualifying assets in these MACRS classes.

Note that the election is “all or nothing” by MACRS class of assets. Unlike the Section 179 deduction, a taxpayer cannot claim only a portion of the additional first-year depreciation on an asset.

Planning 2010 Cost Recovery

For assets acquired before 2010 the method of cost recovery and amount of Section 179 expensing, if any, would generally have been determined in the year when the assets were placed in service. Cost recovery in 2010 on these assets would be determined by multiplying the appropriate cost recovery percentage from Table 1 in the Appendix by the depreciable basis of the asset. Thus, there are essentially no tax management options with existing assets.

Because the provisions of the Section 179 and additional first-year depreciation are different, taxpayers can manage their 2010 deductions by choosing which provisions to use with specific assets. For example, as discussed previously, the 50-percent additional first-year depreciation applies only to new assets whose original use starts with the taxpayer. Because of the "all or nothing" aspect of the additional first-year depreciation, a taxpayer may use Section 179 expensing and make the election not to take the additional depreciation.

Example 9: "All or Nothing"

Harry Farmer purchased a new tractor for $80,000 and traded a planter with an adjusted basis of $10,000 and $20,000 boot for a new planter in 2010. Both the new tractor and new planter would be eligible for additional first-year depreciation of $40,000 and $15,000, respectively. The $80,000 tractor and $20,000 boot on the planter would also be eligible for Section 179 expensing. Depending on his income, Harry might elect to forgo the additional first-year depreciation on the tractor, Harry would also have to forgo the additional first-year depreciation on the planter. However, Harry could take up to $100,000 in Section 179 expensing on the tractor and planter to manage his taxable income for 2010.

Both additional first-year depreciation and Section 179 expensing represent an acceleration of cost recovery. Taking these deductions on assets with longer recovery periods would generally increase the present value of the tax savings compared to assets with shorter recovery periods. At a 6-percent discount rate, the present value of $100 received in 5 years is $74.40 and $55.80 if received in 10 years.

Some assets, such as machinery sheds, shops, and general purpose barns, are eligible for the additional first-year depreciation, but do not qualify for Section 179. For like-kind exchanges, only the boot portion is eligible for Section 179 expensing, but the entire basis of the new asset is eligible for the additional first year depreciation.

Example 10: Depreciation Eligibility

Sally Farmer has a machinery shed and shop built for $80,000 in 2010. The machinery shed is not eligible for Section 179 expensing, but, as 20-year MACRS property, is eligible for $40,000 of additional first-year depreciation and $1,500 ($40,000 X 3.75 percent) of MACRS depreciation, for a total of $41,500 in cost recovery for 2010.

Section 179 expensing deduction is limited to the income from active trades or businesses. If the expensing election exceeds the income limitation, the excess election amount is carried forward and can be deducted, subject to the Section 179 dollar and taxable income limitation. In contrast, an additional first-year depreciation deduction in excess of taxable income creates a net operating loss (NOL). A farmer can carry the NOL back 2 years or 5 years, and then carry the NOL forward up to 20 years. Alternatively, the farmer can elect to forgo the carry back period. Good tax management will generally avoid carry forward and NOL situations.

Farmers do have a number of options with respect to cost recovery through MACRS, additional first-year depreciation, and Section 179 expensing in 2010. There are trade-offs among options between the value of tax-savings of deductions for income and self-employment tax purposes in one year versus those deductions being spread over several future years.

For 2009, agricultural machinery and equipment were shifted from the 7-year MACRS class to the 5-year MACRS class. This results in 4.29 percent additional cost recovery in the year of purchase. The additional depreciation for 2010 is small relative to the 50-percent additional first-year depreciation. Furthermore, the maximum Section 179 deduction has been increased to $500,000 for 2010.

Limitations on Farm Losses

Beginning in 2010, the 2008 Farm Bill limits the amount of farm losses that can be used to offset nonfarm income for tax purposes. The amount is the greater of:

1. $300,000 ($150,000 if married, filing separately) or

2. Total net farm income received over the last five years.

Individuals with no prior farm income because this is their first year farming or they have negative total farm income for the 5 years may still deduct $300,000 of farm losses. Losses that are limited in a specific year are carried forward and treated as a deduction as attributable to farming businesses.

The limitation on loss deductions applies only to taxpayers, other than C corporations, who receive Commodity Credit Corporation loans, direct or countercyclical payments, or ACRE payments through the 2008 Farm Bill.

Form 1099 Reporting Expanded

Effective for payments after December 31, 2011, taxpayers in a trade or business will need to report all payments totaling $600 or more annually for property and services. Form 1099 must be filed for payments made in the course of a trade or business. This is a major expansion of the current Form 1099 reporting program and is being opposed by many businesses.

Currently, some forms of income payments (compensation, interest, and rent) to non-corporate taxpayers require a Form 1099 to be filed. Payments of less than $600 and payments to corporations do not require reporting on Form 1099.

Use of a bank-sponsored credit card to pay a business-related expense by the taxpayer transfers the reporting responsibility to the bank.

Payroll Tax Incentives

Employers who hire previously unemployed individuals after February 3, 2010 and before January 1, 2011 may qualify for a 6.2 percent payroll tax incentive for wages paid after March 18, 2010. The 6.2 percent payroll incentive corresponds to the employer's share of the social security tax. To qualify the new hire must be one who was unemployed during the 60-day period prior to beginning employment with the new employer.

For 2011, a new general business tax credit is intended to encourage retention of new employees. A qualified employee is one who is hired and remains an employee for a 52- consecutive-week period. The employee's wages for the last 26 weeks of employment must equal at least 80 percent of the employee's wages for the first 26 weeks. The credit is the lesser of $1,000 or 6.2-percent of the wages paid to the employee by the employer.

Kiddie Tax

The "kiddie tax" was extended from age 14 to age 18 by the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005. If the child has not reached the minimum age by the end of the tax year, has unearned income of more than $1,900 for 2010 (adjusted annually), and is required to file a tax return, the net unearned income over

$1,900 is taxed at the higher of the child's or parent's tax rate. Unearned income is income other than salary, wages, and other compensation for personal services actually rendered. An unmarried individual who is claimed as a dependent by another taxpayer (usually a parent) must generally file a return if: (1) there is only earned income and it exceeds the basic standard deduction of $5,700 for 2010, (2) there is only unearned income and it exceeds the minimum standard deduction for dependents of $950 in 2010, or (3) there is both earned and unearned income that exceeds the $950 minimum standard deduction with $300 or more of unearned income, or total income exceeds $5,700 for 2010.

This change makes gifting of raised commodities to children somewhat less attractive in terms of the tax savings. For example, in 2009 a farmer gifts 2009 grain with a fair market value of $5,000 and a zero tax basis, to a child age 17 who has $2,000 of investment income. Prior to the TIPRA change, the child would have had an exemption of $950 and would have paid $605 income tax ($6,050 income at the 10 percent rate). After TIPRA, the child would have a $950 exemption, pay 10-percent tax on $950 and pay at the parents' rate (say 25-percent) on $5,100 income, for total income tax of $1,370. Although the law change has reduced the income tax-saving aspect of the gift, there continues to be no self-employment tax (15.3-percent tax rate) paid on the gifted grain by either the farmer or the recipient child. See the discussion of gifts and donations of commodities on pages 22-23.

The Small Business and Work Opportunity Act of 2007 (SBWOTA) further extended the kiddie tax for tax years beginning after May 25, 2007 to include: (1) children under age 18 (those previously subject to the tax), (2) children who are age 18 at the end of the year if their earned income does not exceed one-half of their support, and (3) children who are full-time students ages 19 through 23 if their earned income does not exceed one-half of their support. The support test is based on the dependency exemption regulations and includes food, shelter, clothing, medical care, education, and capital items provided to the child. Support provided by scholarships is not taken into account. Darling Daughter turned 18 in 2010, and expenditures for her support totaled $14,000. Darling will be subject to the kiddie tax on her unearned income unless her earned income exceeds $7,000.

Jon, who is 22 and a full-time student, received several scholarships and worked on the family farm during the summer and school vacations. Jon's support, not counting the tuition paid by scholarships, was $12,000. If Jon's earned income is $6,000 or less, he would be subject to the kiddie tax on his unearned income. Reasonable compensation paid for work actually performed for the parents' business may provide opportunities for Jon to avoid the kiddie tax.

PLANNING AND USING A FARM OPERATING LOSS

Some producers, especially livestock producers, may find that their projected farm expenses exceed anticipated farm income for the current tax year. These farm losses are likely to cause cash flow difficulties. However, for some producers, farm losses may generate cash inflows in the form of tax refunds. Tax law allows choices with respect to farm losses. Farm losses realized in one tax year may be carried back 2 years or 5 years to obtain refunds of taxes previously paid. If the loss is not carried back, or if the full loss is not used (absorbed) in the carryback years, the loss may be carried forward to offset income and tax liabilities in future years. Many farmers had high incomes in the 2007 to 2009 period and carrying back a 2010 loss is likely to generate an income tax refund. If carrying a 2010 loss back has little or no tax benefit, a producer can elect to only carry the loss forward. Therefore, producers with farm losses should analyze their carryback and carryforward alternatives.

The farm loss reported on Schedule F (Form 1040) is generally not the same as a net operating loss (NOL) for income tax purposes. The NOL concept is simple, but computation of the NOL deduction and NOL carryback can be quite complex. This complexity arises because various tax benefits must be removed by modifying the deductions of the loss year and modifying the income in the carryback year or years. Similar modifications are made if the loss is carried forward. Because of these modifications, the tax benefits of the loss may be reduced significantly.

For a discussion of some possible loss situations and general strategies for producers to avoid, if possible, an NOL see G. Patrick, "Choices for Your Farm Operating Loss," at http://ruraltax.org/files/uploads/NOL%20Final%20Draft.pdf

DEFERRING INCOME AND PREPAYING EXPENSES

Cash-basis farmers may want to deliver and sell commodities this year and to defer the income into the next tax year. Farmers also prepay expenses for the inputs that will not be used until the next tax year and want to deduct the cost in the current tax year. Both techniques can be used to manage taxable income, but require that transactions be properly structured to have the desired tax effects.

Deferred Income from Sale of Commodities

Cash-basis crop and livestock producers often want to defer income from the sale of commodities from this year to next year. To do this, they enter into a bona fide arm's-length contract with the buyer that calls for payment in the year following the year of delivery of the grain, livestock, or other commodity. Farmers are eligible to use installment sale reporting because the raised commodity is not required to be inventoried [Treas. Reg.§15A.453-1(b)(4)]. To avoid constructive receipt of income, the contract should be in place before the commodity is delivered to the buyer. Furthermore, the contract should specify that the producer has no right to the payment until a specific date in the next tax year.

Installment sales of livestock may be somewhat more complicated than the sale of crops. The Packers and Stockyard Act generally requires buyers of livestock for slaughter to pay for the livestock before the close of the next business day after the purchase. This time limit was instituted to protect producers but can be waived by written agreement of the buyer and seller before the sale transaction occurs. As the recent Eastern Livestock Company LLC situation demonstrates, there is some additional risk for producers.

Producers finishing animals under contract commonly do not own the animals, but receive a fixed fee per animal delivered to the contractor. Because the producer does not own the animals, the producer is receiving payment for services performed rather than the sale of personal property, and the producer is <u>not</u> eligible for installment sale reporting. Some contract crop producers do not own the crop they are producing, and they would also be ineligible for the installment sale reporting.

Producers with animals purchased for resale, such as feeder animals, report the profit by subtracting the cost of the items purchased for resale in the year of their sale. If the income from the sale is deferred, the deduction for the cost of the items purchased for resale is also deferred.

Other animals, such as breeding stock, are also eligible for installment sale reporting. However, if an animal is sold at a loss, the installment sale reporting cannot be used for that animal because the loss is deductible only in the year of sale. If a sale involves the recapture of depreciation on a purchased animal, the installment sale method cannot be used for the gain that is treated as ordinary income. Depreciation recapture must be reported as income in the year of sale.

Generally, no interest is involved on installment sales with the objective of deferring income to the next tax year. No interest is required if all of the installment sale contract payments are to be made within 6 months [I.R.C. §§ 483(c)(1)(A) and 1274(c)(1)(B)] or the total sales price is $3,000 or less [I.R.C. §§1274(c)(3)(C) and483(d)(2)].

Prepaying Expenses

Farmers using the cash method of accounting are allowed to deduct the cost of supplies purchased during the year even if the supplies will not be used until the following tax year if they meet three sets of rules. One set of rules applies to all cash-basis taxpayers. The second set of rules, from I.R.C. §464(f), limits the deduction for prepaid expenses to 50 percent of deductible non-prepaid expenses unless the taxpayer is a "qualified farm related taxpayer." The third set of rules, also from I.R.C. §464, deals with farming syndicates and entities with limited partners or limited entrepreneurs.

To claim a deduction in the year of the expenditure, the cash basis producers must meet all three of the following conditions.

1. The expenditure must be for the supply rather than a deposit.
2. The prepayment must be made for a business purpose and not merely for tax avoidance.
3. The deduction must not result in a material distortion of income.

Rev. Rul. 79-229 and IRS Pub. 225, *Farmer's Tax Guide*, explain each of these three tests as follows.

Deposit vs. Payment

Whether a particular expenditure is a deposit or a payment depends on the facts and circumstances of each case. When it can be shown that the expenditure is not refundable and is made according to an enforceable sales contract, the expenditure will not be considered as a deposit. The following factors, although not all-inclusive, are indicative of a deposit rather than a purchase:

- The absence of specific quantity terms.
- The right to a refund of any unapplied payment credit at the end of the contract.
- The seller's treatment as a deposit on their books (e.g., payment of interest).
- The right to substitute other goods or products for those specified in the contract.

Business Purpose

The prepayment has a business purpose only if the producer has a reasonable expectation of receiving some business benefit from the prepayment. Fixing a maximum price, assuring a supply, and securing preferential treatment in anticipation of a shortage are some examples of business benefits that could be obtained from the prepayment.

No Material Distortion of Income

The fact that the first two tests are satisfied does not automatically mean that the expenditure is deductible in the year paid. A deferral of the deduction may be necessary to clearly reflect the producer's income. Some of the factors considered when determining whether the deduction results in a material distortion of income are:

- The relationship between the quantity purchased and the projected use next year.
- The expenditure in relation to the total income of the producer.
- Customary business practice of the producer in buying supplies and the business purpose for prepayment.
- Time of the year of the expenditure.

Treas. Reg. § 1.263(a)-4(f) applies a 12-month test to expenditures of cash-basis taxpayers for items other than interest. If a taxpayer prepays an expenditure to acquire or create an intangible asset, capitalization is not required if the benefits do not extend beyond the earlier of:

1. 12 months after the taxpayer first realizes the right or benefit, or
2. The end of the tax year following the year in which the payment occurs.

If the 12-month test is met, the material distortion of income test should not prevent a deduction in the year of purchase occurs.

<u>Example 10:</u> Prepaid Purchase of Chemicals

On December 20, 2010, Herb A. Cyde, a cash method farmer, purchased enough Round-Up™ to treat his expected 2011 acreage of corn and soybeans for delivery in the spring of 2011. Because of the early purchase, Herb received a 5-percent discount and paid $14,000 for the Round-Up™. Herb can deduct the $14,000 expenditure on his 2010 income tax return because it is an actual purchase and the business purpose for the early purchase is the 5-percent discount. The Round-Up™ will all be applied by late June of 2011, so the benefits do not extend more than 12 months after Herb acquired the right.

<u>Example 11:</u> 12-Month Rule

I.M. Liable, a cash method farmer, purchased farm liability insurance for the July 1, 2010 to June 30, 2011 period and paid the $1,200 annual premium. The benefits of the insurance do not extend beyond 12 months after I.M. first realizes the benefits of the insurance policy. I.M. can deduct the entire annual premium of $1,200 in 2010.

If I.M.'s liability policy covered the July 1, 2010 to June 30, 2012 period, the benefits extend beyond 12 months after I.M. first realized the benefits of the policy. Therefore, only the premium allocable to 2010 can be deducted in 2010. If the total premium was $2,400, only $600 ($2,400 ÷ 24 months × 6 months) is deductible in 2010.

50-Percent Rule

The 50-percent rule limits a taxpayer's deduction for prepaid expenses to 50 percent of total deductible expenses, other than the prepaid expenses, unless the taxpayer is a "qualified farm related taxpayer" [I.R.C. § 464(f)]. A "qualified farm related taxpayer" is any taxpayer:

1. Whose principal residence is on a farm, or
2. Whose principal occupation is farming, or
3. Who is a member of the family [I.R.C. §267(c)(4)] of a taxpayer who meets the requirements of 1 or 2 above. Family includes brothers, sisters, spouse (but not in-laws), ancestors, and descendents.

To be "qualified," the farm-related taxpayer must meet one of the two following requirements.

1. Aggregate prepaid farm supplies for the prior 3 years must be less than 50 percent of the aggregate deductible expenses other than the prepaid expenses, or
2. Extraordinary circumstances (such as a flood or a drought) caused prepaid expenses to exceed 50 percent of farming expenses other than prepaid expenses in the current year.

Example 12: Prepaid Purchase of Fertilizer

Patty Producer uses the cash method of accounting. In December 2010, she paid $20,000 to Farm Supply, Inc. for specific quantities and analyses of fertilizers to be applied in the spring of 2011 on her corn crop. Pattie's deductible expenses on Schedule F (Form 1040) for 2010, other than the prepaid fertilizer, were $100,000. Patty purchased the fertilizer in 2010 for two reasons. First, she was offered a discount for purchasing in December. Second, she was concerned about the availability of fertilizer in the spring.

Patty is allowed to deduct the $20,000 she paid for fertilizer on her 2010 Schedule F (Form 1040). She meets the three requirements of the general rule. I.R.C. § 464(f) does not limit her deduction for two reasons. First, Patty is a qualified farm-related taxpayer, so the 50-percent limitation does not apply to her. Second, Patty has not exceeded the 50-percent limit.

If Patty Producer had purchased fertilizer and lime in December 2009 and the fertilizer and lime was applied before January 1, 2010, the fertilizer and lime would be deductible expenses in 2009 and would not be prepaid expenses for 2010.

Farming Syndicate Rules

Under the farming syndicate rules, deductions for feed, seed, fertilizer, or similar farm supplies are limited to the year in which the items are actually used. A farming syndicate is defined as partnership or any other entity, other than a C corporation, engaged in the trade or business of farming:

1. If at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any federal or state agency having authority to regulate the offering of securities for sale, or
2. If more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs who do not actively participate in management [I.R.C. § 464(c)(1)].

3. I.R.C. § 464(c)(4) provides a number of exceptions for taxpayers who are actively engaged in a farming activity, reside at the farming activity or are a family member of an individual meeting one of the exceptions.

Example 13: Active Participation Exceptions Do Not Apply to Cousins

Three brothers operate a farm, and all are actively involved in management of the farm and are not a farming syndicate. With time, all three brothers pass on and leave their respective equal shares of the farm operation to their children. The three heirs form a family limited partnership, with two cousins being limited partners and the other cousin actively engaged in the farming operation. Although related as first cousins, the three heirs are not family members under I.R. C. § 267(c)(4), and the family limited partnership is a farm syndicate that is subject to prepaid expense limitations.

FARM INCOME AVERAGING

Farm income averaging is a tax management tool of relatively recent origin that can be used after the end of the tax year. In simple terms, farm income averaging allows a producer to elect to average a selected amount of farm income from the current year (referred to as the "election year"). The selected amount is divided by three and is taxed at the tax rates of the three prior years (referred to as "base years"). Currently, farm income averaging does not create or increase the AMT for the taxpayer. There is also flexibility in making or modifying farm income averaging decisions on an amended return.

Farm Income

"Farm income" is based on taxable farm income. It includes all income, gains, losses, and deductions attributable to any farming business. Gain from the sale or other disposition of land is not included, nor is the sale of timber. The instructions for Schedule J indicate that farm-related items are generally reported on Form 1040 Schedule D, Form 1040 Schedule F, Form 4797, Part II of Form 1040 Schedule E (Income or Loss from Partnerships and S Corporations), and Form 4835. Thus, farm income from flow-through entities such as S corporations and partnerships does qualify. Wages and other compensation received as a shareholder in an S corporation engaged in farming are also farm income. Farm income averaging is not available to regular corporations, trusts, or estates. Cash rent landowners are also excluded from farm income averaging.

Averaging Procedures

The basic concept of farm income averaging is relatively simple and uses Form 1040 Schedule J. A farmer may elect to average part or all of the farm income in the election year, e.g., 2010, and have that elected farm income treated as if it have been earned equally over the preceding three base years, 2007 to 2009, and taxed at the respective income rates for those years. Income is not carried back to prior years with income averaging. There is no change in the income reported for the base years. Rather, the unused portions of the tax brackets of the base years are used.

Note that the elected income is allocated equally over the three prior or base years. If one of the three preceding years has a very low income or loss, there is no possibility of allocating more of the elected farm income to that year. Furthermore, for future income tax averaging, say in 2011, the portions of the base years' tax brackets used with the previous income averaging in 2010 are not available for 2011. Although income averaging may reduce the income tax liability of a producer, income averaging has no effect on self-employment tax liability for the year of the election or any base year.

Example 14: Farm Income Averaging

David is an unmarried crop producer with 2010 Schedule F income of $150,000 and taxable income of $136,620. David's regular tax liability, without income averaging, would be $31,963, and his marginal tax rate would be 28 percent. If David had $12,000 of the unused 15-percent tax bracket for each one of the base years to compute his 2010 income tax, he could elect to income average $36,000, and this would be taxed at the 15 percent. With income averaging, David's total 2010 regular income tax liability would be $27,283, a savings of $4,680 ($36,000 X (0.28-0.15)). David's 2010 marginal tax rate is still 28 percent after averaging $36,000.

David could benefit from larger elections of farm income for income averaging as long as the average marginal tax rate from the three base years is less than the marginal tax rate for the election year.

Example 15: Optimal Income Averaging

David, from Example 14, had completely used the 15-percent tax brackets for the base years. Additional income in the base years from income averaging would be taxed at the 25-percent rate. David's marginal tax rate in the election year would also be 25 percent if David's taxable income was not over $82,400. If David elected to income average $54,140 ($136,620 - $82,400, the marginal tax rates would be equal, and David would save an additional $554, ($54,140 - $36,000) = $18,140 X 0.03), making his total savings from income averaging $5,234 ($4,680 + $554).

Farmers can elect, subject to some restrictions, the amount and type of income that they wish to average. Commonly, farmers will have ordinary income from Form 1040 Schedule F and depreciation recapture. They may also have Section 1231 gains reported on Form 4797 that are treated as long-term capital gains. A farmer can elect to average ordinary income and allocate 2010 farm capital gain income (unless offset by non-farm capital losses) to the 2010 year. For example, assume a producer has $100,000 of Form 1040 Schedule F net income, $30,000 of farm Section 1231 gains, and no non-farm income or losses. The farmer could elect to average up to $100,000 of farm income and allocate all of the Section 1231 gain to 2010. All of the elected income would be ordinary income and allocated equally to the three prior years. However, if the farmer elected to average $120,000 of farm income, at least $20,000 would be Section 1231 gains. In this situation, one-third of the elected Section 1231 gain would be taxed according to the "rules" for each base year.

Some Management Considerations

Income averaging will have the greatest attraction for farmers whose income in this year is much higher than in the preceding 3 years and who have made only limited capital expenditures eligible for Section 179 expensing or 50-percent additional first-year depreciation. Beginning farmers with limited income in prior years could be in this situation. Individuals do not have to have been in farming in the base years to qualify for farm income averaging. Farm families whose off-farm income has increased sharply (perhaps because of a new off-farm job) would be eligible to average their farm income and perhaps reduce their current tax liability. However, only the farm income is eligible for income averaging. Retiring farmers and others disposing of assets may also be able to take advantage of income averaging.

Depreciation recaptures on machinery, equipment, buildings, and purchased breeding stock are reported as ordinary income. The disposition of these assets in one tax year may result in a high marginal tax rate and benefits from income averaging. Dispositions of assets for up to a year after an individual ceases farming are presumed to be within a reasonable time and would be eligible for farm income averaging. Depending on individual circumstances, dispositions of assets over longer periods may also be acceptable for income averaging. Income averaging may also be helpful for an individual in a situation in which the usual year-end tax planning strategies do not apply. However, income averaging is not likely to substitute for regular year-end tax planning and keeping taxable income relatively stable from year-to-year.

CROP INSURANCE AND DISASTER PAYMENTS

Cash-basis farmers must generally report payments as income for the year the payment is received. If a producer receives crop insurance or disaster payments in the year of production, this can cause a bunching of income for farmers who normally store their crop and sell it in the year following the year of production. I.R.C. Section 451(d) allows a farmer who normally sells the crop in the year following the year of production to elect to postpone reporting the payments received until the year following the year of production. Such an election covers payments for all crops from a farm, requires the same treatment of both crop insurance and disaster payments, and is limited to physical losses of production. If a farmer has more than one farming business and he or she keeps separate books, separate elections can be made for each business. The election to postpone the recognition of income from the crop loss payments must be attached to the return (or amended return) for the year in which the payments were received. The election statement must include:

1. Name and address of the taxpayer.
2. Statement that the election is being made under I.R.C. Section 451(d).
3. Identification of the specific crops damaged or destroyed.
4. A declaration that, as normal business practice of the taxpayer, the income from the destroyed or damaged crop would have been included in gross income for a tax year following the year the crops were damaged or destroyed.
5. Cause of the damage or destruction of the crop(s).
6. Date of damage or destruction of the crop(s).
7. Total amount of payments received, itemized for each crop and the date when each payment was received.

8. Name(s) of insurance carrier or carriers making the payments.

There is an ambiguity in the election requirements. How is a farmer supposed to handle crop loss payments received for two crops that are normally marketed in different years? In Rev. Rul. 74-145, 1974-1 C.B. 113, the IRS took the position if a producer normally sold 50 percent of all crops in the year following the year of production, then all of the crop loss payments could be postponed until the following year under the I.R.C. Section 451(d) election.

Notice 89-55 and Treas. Reg. Section 1.451-6(a)(1) states that if a producer whose established normal business practice would be to report the income in the year following the year of production receives insurance proceeds as the result of damage or destruction of two or more specific crops, such proceeds may be included in the gross income of the following year. However, this can be interpreted as saying that payments for crops that are normally sold in the year of harvest cannot be postponed even if the election is made. It appears that producers can find authority to support at least two different positions.

A second issue is that only payments for the physical loss of a crop can be deferred into the year following the year of harvest. Some crop revenue products, such as Crop Revenue Coverage (CRC) and Revenue Assurance (RA), make payments if the price of the grain declines between planting and harvest. For example, the average price of the December corn futures contract during February 2008 was $4.04 ($8.80 for November soybeans). For crop revenue purposes, this is referred to as the "base price." Harvest time (October for CRC) prices of the November soybeans and December corn futures $9.66 and $3.72, respectively. Because harvest prices for corn are less than the base price, part of any indemnity is due to the price decline. One procedure to determine the amount of the insurance payment due to the decline in yields and prices is illustrated on pages 17-18 of Patrick, "Income Tax Management for Farmers in 2007," available at: http://www.agecon.purdue.edu/extension/pubs/taxplanning 2007.asp.

Crop insurance proceeds paid in the year following the year of harvest must be reported as income when received. This is the tax treatment even if the producer's normal business practice is to sell the crops in the year of harvest. There is no provision that would allow an acceleration of reporting. This would apply to delayed payments under crop and revenue insurance, such as CRC and RA as well as the new Supplemental Revenue Assistance Payments (SURE) disaster program under the 2008 Farm Bill. Insurance payments made on the county-based Group Risk Plan (GRP) and Group Risk Income Plan (GRIP) must be recognized when received. There would be similar treatment for the Average Crop Revenue Election (ACRE) program.

Producers who deferred crop insurance indemnities from 2009 to 2010 should report those indemnities as income for 2010. Indemnities on 2009 crops which were paid in 2010 (e.g., moldy corn) must be reported as income for 2010.

CASUALTY LOSSES

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. If a business asset is completely destroyed, an individual's loss is generally measured by one's basis in the asset. This may result in an individual having no deductible loss if a zero basis asset is lost. For example, 10 raised cows are lost in a flood. Although the cows have a fair market value (FMV) of $1,000 each, their tax basis is $0, and there is no deductible loss. Furthermore, if payment is received for this loss, the payment must be reported as income unless the indemnity is reinvested in similar qualifying property.

Other assets may have an adjusted tax basis, which measures the unrecovered capital investment. If an asset with an adjusted basis of $5,000 is destroyed and there is no insurance, the $5,000 adjusted basis is fully deductible as an ordinary loss. If an insurance indemnity of $5,000 or less is received, the deductible loss is the $5,000 reduced by the amount of indemnity received. If the indemnity exceeds $5,000, the amount over $5,000 would be recognized as taxable income unless the indemnity was reinvested in a similar asset within 2 years following the year of loss.

When business property is partially destroyed as the result of a casualty, an estimate of the loss as a result of the casualty must be made. An estimate of loss is given by the fair market value (FMV) before the casualty minus the FMV of the property after the casualty. The measure of loss is the lesser of the decline in value of property or the adjusted basis of the partially destroyed business property. The cost to repair the asset is commonly accepted as an estimate of the decline in value of the asset. Repairs must be necessary to restore the property to its previous condition, not be excessive, not fix more than the damage suffered, and not increase the value of the property above its value before the casualty. Note that the costs of the repairs are used as a measure of the decrease in the taxpayer's basis and are not being deducted as the casualty loss. The costs of repairing or restoring the damaged property can generally be deducted as ordinary and necessary expenses.

<u>Example 16:</u> Flood-Damaged Land

April spent $10,000 to clean up debris left on her farm from a flood and restore some washed-out areas. Her tax basis in the affected land was $50,000. April can use the $10,000 cost of clean-up and restoration as an estimate of the decrease in the value of her farm. This $10,000 casualty loss reduces her basis in the farm to $40,000 and would be reported on Form 4684, Casualties and Thefts.

More commonly, April would deduct the $10,000 expense for clean-up and restoration as an ordinary and necessary business expense on Schedule F, Form 1040.

<u>Example 17:</u> Insurance/Government Payments

If April, from Example 16, receives a $5,000 payment from the insurance company or government assistance, her casualty loss deduction of $10,000 would be reduced by the amount of the insurance or government payment.

Generally, April would deduct her clean-up and restoration expense of $5,000 on Schedule F, Form 1040.

SELF-EMPLOYMENT TAX UPDATE

Many farmers continue to be concerned about the self-employment (SE) tax. For 2010, earnings of up to $106,700 are subject to the 12.4-percent tax for social security, and all earnings are subject to the 2.9-percent Medicare tax. For 2011, the maximum social security portion is unchanged and there is no cost of living adjustment for 2011 benefits.

Change in Optional SE Tax Method

Under prior law, farmers were allowed to elect the optional method of paying SE tax. 1) If gross farm income was not more than $2,400, they could elect to pay SE tax on two-thirds of their gross farm income. 2) If gross farm income was over $2,400 and net farm profits were less than $1,733, they could elect to pay SE tax on $1,600. However, the optional farm method provided only one quarter of coverage annually for "currently insured" status under social security. An individual must have been covered for at least six of the 12 quarters preceding the quarter of death to qualify for survivors' benefits and at least 10 of the last 20 quarters to qualify for disability benefits.

As part of the 2008 Farm Bill, Congress updated the dollar limits for the optional farm and non-farm methods. The current law refers to "the lower limit" as the amount required to earn four quarters of coverage ($4,360 in 2010) under the Social Security Act. The "upper limit" is 150 percent of the lower limit. Thus, if gross farm income is not more than $6,300 in 2010, a farmer can elect to pay SE tax on two-thirds of his or her gross farm income to earn a quarter of coverage for each $1,090 of income. If gross farm income is greater than $6,300 and net farm profit is less than dividing the lower limit of $4,360 by 0.9235 or $4,712 for 2010, the farmer can pay SE tax on $4,721 to earn four quarters of coverage.

Land Rental to an Entity

There has been litigation on the rental of land to an entity in which the landowner materially participates. For many years, landowners would rent land to farm-operating entities (partnerships or corporations) in which they were involved. Although the rental payments were subject to income taxes, the rental payments were not included as earnings for self-employment tax.

About 1995, the IRS began to challenge these arrangements with some success in Tax Court. Three cases were appealed to the 8th Circuit Court. The Court took the position that rent must include compensation for services to make the rent subject to SE tax and sent the cases back to the Tax Court for a determination. (The 8th Circuit includes the states of Arkansas, Iowa, Minnesota, Missouri, North Dakota, and South Dakota.) The IRS apparently did not respond to the Tax Court, and the cases were decided in the taxpayers' favor. However, the IRS has indicated that they will not follow the decision outside the 8th Circuit. One other case in New York was settled without a court hearing. Although the IRS action indicates they may challenge the traditional treatment of these rental payments, it apparently has not been an issue in recent farm audits.

Conservation Reserve Payments

Landowners participating in the Conservation Reserve Program (CRP) receive payments for not farming some land and for engaging in certain conservation practices. These payments are described as "rental payments" in the USDA contracts, and they have traditionally been included as earnings for self-employment tax purposes for operating farmers and materially participating landowners. The Wuebker case argued that CRP payments were rent and excluded from earnings for self-employment by the rental real estate exception or I.R.C. §1402(a)(1). The Tax Court agreed, but the 6th Circuit Court reversed the decision. The IRS released a proposed Revenue Ruling in which they took the position that all CRP payments are included in earnings for self-employment regardless of whether the landowner was involved in farming or not. The Revenue Ruling has not been implemented, but the *2009 Farmer's Tax Guide* states that all CRP payments must be reported on Schedule F.

The 2008 Farm Bill adds the annual CRP payments made to individuals receiving social security retirement, survivor, or disability benefits to the exclusion of earnings from self-employment. For active farmers drawing social security benefits, the annual CRP payments do not count against the earnings limit. For those receiving social security benefits, the Schedule SE subtracts the CRP payments from the earnings from self-employment tax problem.

For those not receiving social security benefits, the situation is less clear. The IRS can argue their position that annual CRP payments were earnings subject to self-employment tax was correct or the Farm Bill provision would not have been necessary. Furthermore, by specifically excluding some payments, it implies others are subject to self-employment tax. These taxpayers can argue that CRP land is not used in agriculture, they generally have no agreement to materially participate in the farm operation, and they do not materially participate in farming.

Soil and Water Conservation Payments

Farmers can receive payments from a variety of soil and water conservation programs for various practices. For a discussion of these programs and payments see page 22 of Patrick, "Income Tax Management for Farmers in 2007," available at http://www.agecon.purdue.edu/extension/pubs/taxplanning2007.asp.

Gifts and Donations of Commodities

In some instances, cash-basis farm operators have made gifts of commodities with the idea of reducing taxes. Gifts may be made to spouses, children, other family members, and unrelated individuals. If the gift is made during the year in which the commodity is produced, expenses on Schedule F should be reduced by an amount representing the expenses of producing the gifted commodity (Rev. Rul. 55-531, 1955-2 C.B.520).

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Example 18: Gift of This Year's Commodities

If David gifted this year's commodities with a fair market value of $9,000 to his mother, he would reduce his expenses by $6,000, the cost of producing the commodity, and this would be his mother's basis in the commodity. Although David reports no income from the gift, his expenses are reduced, and there is only a limited SE tax saving benefit on the $3,000 profit that David did not have to report. Assuming that mother's income tax rate is lower than David's, there would also be some additional income tax saving benefit when mother sold the commodity and reduced the sales proceeds by her $6,000 basis.

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Example 19: Gift of a Prior Year's Commodity

If the gift is made in the year after the commodities are produced, no adjustment of expenses is generally made, and tax savings are considerably higher. First, David would get the benefit of the deduction of the $6,000 expenses for both self-employment and income taxes. Second, although mother's basis in the gifted commodity would be zero, the entire $9,000 sale proceeds would be taxed at mother's lower marginal income tax rate.

The IRS is concerned that the gifts have some economic significance other than tax avoidance. If the recipient participated in the farm operation in any way or owned property used by the farmer, the "gift" is likely to be questioned as to whether it is a gift or compensation. Deposit of proceeds in a joint bank account, even if not the farm account, is likely to be fatal to the gift. Furthermore, control of the commodity must be given up to avoid the "assignment of income" doctrine. Providing any guidance in the gifting agreement about disposition of commodity or not having sales documentation that names the spouse as the seller (e.g., patron of a cooperative or warehouse receipt) also causes problems.

Gains on the sale of commodities gifted to children under the age of 18 are likely to result in unearned income, and the amount exceeding $1,700 would generally be taxed at the parents' tax rate as discussed earlier. For 2008 and later years, the kiddie tax also applies to children age 19 to 23 if they are fulltime students and their earned income is less than 50 percent of their support.

Charitable donations of current or prior year commodities may reduce taxes for cash basis farmers, especially those who cannot itemize deductions. The deduction from the donation of a commodity that would produce ordinary income if sold is limited to the taxpayer's basis in the commodity [I.R.C. Section 170(e)(1)(A)]. Cash-basis farmers deduct production costs on Schedule F (Form 1040) as a business expense, resulting in an income tax basis of zero. Because their charitable contribution deduction is limited to their basis, their charitable contribution deduction is zero [Treas. Reg. Section 1.170A-1(c)(4), Examples (5) and (6)].

It is important that the commodity be transferred to the charity and not merely sold on the charity's behalf. Transfer of the commodity to the charity should be separate from the sale of the commodity. If the commodity is delivered to an elevator, the storage receipt should be made out to the charity. The receipt should be sent to the charity with a cover letter indicating they can treat the commodity as they see fit. The check should not be issued until the elevator receives instructions from the charity. Form 8283, Noncash Charity Contributions, would not need to be filed, because no charitable contribution deduction will be taken by the cash basis farmer.

Example 19: Tax Savings from Charitable Contributions

In January 2010, a cash-basis farmer delivers 2009 corn with a market value of $3,000 to the local elevator and sends the storage receipt to the church with a letter indicating the church may use the grain as they like. If the farmer had sold the grain for $3,000 and paid the taxes, how much would be left to contribute to the church?

SE tax
15.3% x $3,000 x 0.9235 = $423.89
Federal income tax
15% x ($3,000 - [$423.89 x 50%]) =$418.21
State and local tax

4.4% x ($3,000 - [$423.89 x 50%])=$121.67
After-tax contribution
$3,000 – [$423.89 + 418.21 + 121.67]
=$2,035.23

This charitable contribution results in a tax-savings of $964.77 for a taxpayer in the 15-percent income tax bracket and subject to the 15.3-percent SE tax rate. For a taxpayer in the 25- or 28-percent tax brackets, the tax-savings increase to $1,242.58 and $1,254.22, respectively, for making the charitable contribution in commodities.

Recent legislation extends the enhanced deduction from the charitable donation of food inventory. The deduction is equal to the lesser of basis plus half of the item's appreciation or two times basis. The enhanced deduction is available only for apparently wholesome food, defined as food intended for human consumption that meets all quality and labeling standards imposed by law or regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions. Raw farm commodities do not appear to qualify for this provision, although fresh fruits and vegetables may qualify. Furthermore, as discussed above, for cash basis farmers deducting expenses for donated commodities on Schedule F (Form 1040), the tax basis and resulting charitable contribution deduction would be zero.

TAX MANAGEMENT

Most farmers use the cash method of accounting. Farm expenditures are normally deductible when paid. Receipts are generally reported as income in the year in which they are received. As a result, farmers have the opportunity to review their year-to-date receipts and expenses, and make potentially money-saving adjustments for taxes. But that window of opportunity closes for all practical purposes with the end of a farmer's tax year. So November-December is the time to review and adjust if necessary.

One's tax management goal should be maximizing after-tax income or wealth over time, not minimizing taxes in any one year. Some people get so concerned about saving a few dollars in taxes this year that they miss the big picture. Because of the higher Section 179 expensing limits and 50-percent additional first-year depreciation, many farmers may simply assume that they will not have a tax problem, instead of viewing each year as a tax-planning opportunity.

Keeping taxable income relatively stable year-to-year has been a key to effective income tax management in the past, because of the progressive nature of income tax rates. Tax law changes over several years have "flattened" tax rates, reducing the progressiveness of income tax. Wide swings in taxable income are likely to result in higher taxes, although farm income averaging may help. The amount of income that is "tax-free" because of personal exemptions, the standard deduction, and possible tax credits has increased due to law changes and inflation. One should plan to report at least this "tax-free" amount of income each year. Self-employment taxes are larger than income taxes for many farmers and may be more difficult to manage because of no exemptions and limited deductions.

As a minimum, individuals should tally their receipts and expenditures before the end of the tax year. This allows year-end tax planning. Depending on the income situation, additional sales may be made before the end of December 2010 or delayed into 2011. A part of the 2011 direct payments from the government for corn, soybeans, and wheat can be collected in 2010 or after December 31, 2010.

The 50-percent additional first-year depreciation and Section 179 expensing deduction can have a major effect on taxable income, and the decision can be made after the close of the tax year. However, the depreciable assets must have been placed in service before the end of the year.

December purchases of feed, fertilizers, and chemicals to be used in 2011 can, up to a limit, also affect the taxable income. Although delivery of inputs purchased before January 1, 2011 is not required for a tax deduction, a purchase of specified products, rather than just a deposit, must be made in order to claim a deduction for prepaid expenses. This means that the invoice should list specific products and quantities, and the arrangement should not accrue interest to the purchaser.

Deferral of income and income taxes can still be an effective tax management strategy. If income taxes are deferred, even for a year, this is an interest-free loan from the government. Although the estimated tax payments required to avoid penalties have increased, farmers have an exception. If two-thirds or more of gross income is from farming, farmers can pay the income tax due by March 1 and avoid estimated tax penalties. Although farmers must file and pay by March 1, the due date of their return for many other purposes, such as retirement plan contributions, is April 15.

Tax implications of major decisions should still be considered before the transactions are finalized. Installment sale contracts often have tax benefits because the taxable gain on the sale is spread pro rata over the tax periods in which the contract payments are received, with certain exceptions. Tax-deferred or “like-kind” exchanges, such as the trade-in of machinery and equipment, may reduce taxes, but farmers need to consider both income and self-employment tax impacts. Because of the complexity of the tax laws and regulations, competent professional tax advice is generally very worthwhile.

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Appendix: MACRS Class Lives and Depreciation Rates

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) affected both the class life of some assets and the rate of depreciation for property used in farming. The system is called "MACRS" (Modified Accelerated Cost Recovery System), and the 150-percent declining-balance method applies to most property acquired by farmers after 1988.

3-Year MACRS property includes breeding hogs and the tractor units of semi-trailers for over-the-road use.

5-Year MACRS property includes cattle held for breeding or dairy purposes, computers, and some construction equipment. Congress specifically included automobiles, pickups, and other trucks in the 5-year class. Special depreciation limitations and recordkeeping requirements apply to passenger vehicles. For passenger vehicles acquired in 2010, the maximum combined depreciation and Section 179 expensing deduction is $3,060. This increases to $4,900 in the second year, $2,950 in the third year, and $1,775 thereafter. If business use is less than 100 percent, the maximum deductions are reduced accordingly. The 50-percent additional first-year depreciation does apply to vehicles with more than 50-percent business use, and up to a maximum of $8,000 of depreciation can be claimed for a vehicle with 100-percent business use. Pick-ups and SUVs with a gross vehicle weight exceeding 6,000 pounds are not subject to the depreciation and Section 179 limits discussed above. Pick-ups and SUVs with a gross vehicle weight of less than 6,000 are classified as passenger vehicles and are subject to the special deduction limitations and recordkeeping requirements. The depreciation deductions are $3,160 for the year placed in service, $5,100 in the second year, $3,050 in third year and $1,875 in later years.

7-Year MACRS property includes most agricultural machinery and equipment. Grain bins, fences, and general office equipment are also included in this seven-year class. For 2009 only, most new 7-year property will be depreciated as 5-year property.

10-Year MACRS property includes single-purpose agricultural and horticultural structures placed in service after 1988, fruit trees, and vineyards. For orchards and vineyards placed in service after 1988, depreciation is calculated using the straight-line method. Allowable depreciation for pre-1989 acquisition of these assets is calculated using the double declining-balance (200-percent declining-balance) method.

Deductions by year, as a percentage of the initial depreciable basis, for assets acquired after 1988 are shown in Table 1. These MACRS percentages reflect the "half-year convention" for the year of purchase. The equivalent of six months' depreciation is allowed whether an asset is placed in service on January 1 or December 31. If a $100,000 asset were purchased in 2010, the first year's depreciation allowed would generally be $25,000 for 3-year MACRS property, $15,000 for 5-year property, $10,710 for 7-year property, or $7,500 for 10-year property. The "half-year" convention is also used for the year of disposition. For example, if a tractor acquired in 2005 is sold in 2010, the fifth recovery year, allowable depreciation for 2010 would be one-half of the 12.25 percent in the table. If an asset is traded in a like-kind exchange, one can elect to depreciate the basis in old asset and the boot portion over the class life of the new asset.

Depreciable land improvements, such as field tiling, are assets in the **15-year MACRS class**. Farm buildings, such as general-purpose barns and machinery sheds, are **20-year MACRS** property. The 150-percent declining-balance method with a shift to straight-line depreciation, to maximize the depreciation deduction, is used for property in the 15- and 20-year MACRS classes.

Rental houses and apartment buildings acquired in 1987 and later years will have a **27.5-year MACRS life**. Nonresidential real property such as office buildings, factories, and stores will have a **31.5-year life** if acquired before May 13, 1993 and **39 years MACRS life** if acquired on or after May 13, 1993.

Table 1. MACRS Depreciation Deduction Percentages for Property Used in Farming by Class-Life of MACRS Property Acquired after 1988

	Class-Life of MACRS Property					
Recovery Year	3-Year	5-Year	7-Year	10-Year	15-Year	20-Year
1	25.00	15.00	10.71	7.50	5.00	3.750
2	37.50	25.50	19.13	13.88	9.50	7.219
3	25.00	17.85	15.03	11.79	8.55	6.677
4	12.50	16.66	12.25	10.02	7.70	6.177
5	--	16.66	12.25	8.74	6.93	5.713
6	--	8.33	12.25	8.74	6.23	5.285
7	--	--	12.25	8.74	5.90	4.888
8	--	--	6.13	8.74	5.90	4.522
9	--	--	--	8.74	5.91	4.462
10	--	--	--	8.74	5.90	4.461
11	--	--	--	4.37	5.91	4.462
12	--	--	--	--	5.90	4.461
13	--	--	--	--	5.91	4.462
14	--	--	--	--	5.90	4.461
15	--	--	--	--	5.91	4.462
16	--	--	--	--	2.95	4.461
17	--	--	--	--	--	4.462
18	--	--	--	--	--	4.461
19	--	--	--	--	--	4.462
20	--	--	--	--	--	4.461
21	--	--	--	--	--	2.231

Source: Internal Revenue Service, *Depreciation*, Pub. 534, 1993 and *How to Depreciate Property*, Pub. 946, 1995