



# Income Tax Management for Farmers in 2007

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**INCOME TAX MANAGEMENT**  
**FOR FARMERS IN 2007**

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# **INCOME TAX MANAGEMENT FOR FARMERS IN 2007\***

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Congress has passed a number of major tax bills in recent years, and some additional tax provisions have also been included in other legislation. The Small Business and Work Opportunity Tax Act (SBWTOA) was enacted on May 25, 2007, simplifying tax reporting for some family businesses, further increasing the Section 179 deduction, and extending the tax on children's unearned income. The Tax Relief and Health Care Act, enacted on December 20, 2006 provided temporary relief from the Alternative Minimum Tax (AMT). The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) was actually enacted in 2006. It extended the Section 179 expensing limits and maximum tax rate on capital gains and also increased to 18 the age limit for taxing a minor's unearned income at the parents' rate. The Pension Protection Act (PPA) of 2006 tightened rules for deducting charitable contributions. The Energy Tax Incentives Act passed in 2005 provided modest tax credits for costs incurred to improve energy in an individual's principal residence, credits for energy saving vehicles, and credits for biodiesel and renewable diesel production.

The recent changes in Section 179 expensing have almost eliminated many farmers' need to pay any federal income tax, assuming they are making capital purchases. However, reducing income tax liability may not be sufficient reason to make additional investments in depreciable assets. Furthermore, eliminating one's tax liability for this year is not necessarily good tax planning. Good tax planning should seek to maximize after-tax wealth over time, not to minimize taxes paid in a particular year. With the tax law changes that are occurring, farmers may need to update their tax planning techniques.

The first section of this publication briefly discusses a number of recent tax law changes affecting most individuals. Emphasis is given to those changes taking effect in 2007 or 2008. The second section emphasizes changes affecting businesses in 2007 and 2008, including the domestic production activities deduction and effects of changes in Section 179 expensing and depreciation. The third section reviews options for the weather-related sales of livestock and crop insurance payments. There is a discussion of tax-deferred exchanges of real estate and personal property (like machinery and equipment) in the fourth section. Government program payments, cost-sharing, and other conservation-related payments with their reporting options are covered in the fifth section. Farm income averaging and other recent tax developments affecting Midwestern agricultural producers are covered in the sixth section. The publication closes with a brief discussion of tax management.

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\* 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, and Bob Taylor; and to Charles Cuykendall, Cornell University; David Frette, CPA, Washington, IN, and David Miller, Ohio State University. For a more basic discussion of income taxes and agriculture, see Patrick and Harris, *Income Tax Management for Farmers*, NCR#2, MWPS, Iowa State University, 2002.

## **RECENT TAX LAW CHANGES AFFECTING INDIVIDUALS**

The Tax Act of 2003 reduced taxes for almost all individuals, and the law has had continuing effects. First, the 10-percent regular tax bracket continues to be extended and increased by indexing. For single individuals, it is increased to \$7,825 in 2007 and to \$8,025 in 2008. For married individuals filing a joint return, the 10-percent tax bracket has been increased to \$15,650 in 2007 and to \$16,050 in 2008. The 10-percent bracket has been extended through 2010. The 15-percent tax bracket was also expanded for married couples filing joint returns. The standard deduction for a married couple filing jointly was increased to \$10,700 for 2007, twice the standard deduction for a single individual. These changes temporarily, through 2010, continue to eliminate the so-called “marriage tax penalty” for many couples. Second, previously scheduled reductions of the regular income tax rates above the 15-percent rate were accelerated. For 2007, the maximum regular income tax rate continues at 35 percent, down from 39.6 percent in 2001, with no further declines scheduled.

A married couple filing jointly in 2007 has a standard deduction of \$10,700 and two personal exemptions of \$3,400, allowing them an adjusted gross income (AGI) of \$17,500 before they incur any federal income tax liability. The next \$15,650 of AGI would be taxed at a marginal rate of 10 percent, and the next \$48,050 (up to an AGI of \$81,200 or a taxable income of \$63,700) would be taxed at the 15-percent rate. If the couple has two children, each qualifying for the \$1,000 child tax credit, their AGI could be \$44,415 before they would owe any federal income tax in 2007, although there would likely be some self-employment tax and state income tax liabilities at these levels of AGI. Thus, the payoff from further reducing taxable income is low. Some families may also qualify for the refundable earned income credit. Thus, these families should avoid excessively reducing their 2007 income for tax purposes.

### **Reduced Individual Capital Gain Rates**

The tax rate on most long-term capital gains has been reduced from 20 percent to 15 percent for gains properly taken into account after May 5, 2003 and before 2011. For those individuals in the 15-percent or lower ordinary tax rate bracket, the reduction was from 10 percent to 5 percent and to zero percent in 2008 to 2010. If pass-through entities (partnerships and S corporations) are involved, those capital gains are also subject to the lower tax rates through 2010. As under prior law, capital losses are generally fully deductible against capital gains. Up to \$3,000 of capital losses can be deducted against ordinary income, and unused capital losses may be carried forward indefinitely. Short-term capital gains (gains on assets generally held for a year or less) are still taxed at ordinary income tax rates.

Capital gain income includes the gain (or loss) from the sale of investments such as stocks and mutual funds. For cash basis farmers, capital gain income also includes the Internal Revenue Code (I.R.C.) Section 1231 gains from the disposition of raised animals used for draft, breeding, dairy, or sporting purposes if held for 12 months or more (24 months or more for cattle and horses). Gains from the disposition of depreciable personal property, like machinery and equipment, are treated as ordinary income, rather than capital gain income, to the extent of all previous depreciation and I.R.C. Section 179 allowances. For depreciable real property, gain from disposition of property is generally not treated as capital gain to the extent of depreciation allowances in excess of straight-line depreciation. Gains from the disposition of “collectibles” continue to be taxed at a maximum rate of 28 percent, while gains on depreciable real property in

excess of straight-line (unrecaptured Section 1250 gain) are taxed at a maximum rate of 25 percent.

The 5-percent rate on capital gains is scheduled to drop to zero in 2008. Thus, a married couple, filing jointly and claiming the standard deduction, could have up to \$83,000 of gross income (including capital gains) in 2008 and have the zero percent tax rate apply on those long-term capital gains.

### **Dividend Tax Relief**

Dividends received by an individual after May 5, 2003 from domestic and qualified foreign corporations are taxed at the same rate that applies to the individual's capital gains. Previously, dividends were included in gross income and taxed at the ordinary income rates. For a couple filing jointly with a taxable income of \$75,000 in 2007, \$1,000 of qualifying dividends would be taxed at the 15-percent capital gain rate, a tax savings of \$100 compared with the 25-percent ordinary income tax bracket. If the zero percent tax rate applies to long-term capital gains in 2008, it also applies to dividends. This provision was extended by TIPRA through tax years beginning on or before December 31, 2010.

I.R.C. Section 316 defines a dividend "as a distribution of property, including money, by a corporation to its shareholders that is made out of current or accumulated earnings and profits." Thus, farm and other cooperative patronage distributions are not eligible for the reduced rates. Dividends paid to policy holders by insurance companies and distributions from money market funds out of interest also do not qualify for the reduced rates. S corporations may make distributions to shareholders, but these distributions are not dividends and do not qualify for the reduced tax rate. But dividend distributions from farm corporations organized as C corporations do qualify.

### **Other Changes Affecting Individuals**

The child tax credit continues at \$1,000 for 2007 and 2008, and this has been extended through 2009. The child tax credit generally applies to children who are eligible to be claimed as dependents and are under age 17. However, the child tax credit is phased out for higher income taxpayers. The phase-out starts at a modified adjusted gross income of more than \$75,000 for single individuals or heads of households and \$110,000 for a married couple filing jointly.

The alternative minimum tax (AMT) exemption amounts were increased by TIPRA to \$40,250 for unmarried individuals and to \$62,550 for joint filers for 2006 only. The AMT was established a number of years ago to ensure that individuals taking advantage of tax preferences, deductions, and tax credits would pay some income tax. However, the AMT exemption amount, unlike many tax law provisions such as the personal exemption and standard deduction, is not indexed (increased annually for inflation). As a result, an increasing proportion of taxpayers have potentially become subject to the AMT. Congress has opted to increase the AMT exemption amounts year-by-year rather than index them.

As of November 28, 2007, Congress has not extended the AMT exemption amounts and credits for 2007. The potential effect on many families is very significant. For example, a married couple with a taxable income of \$125,000 and 6 children under age 17 would have a regular tax, before credits, of \$24,098 for 2007. The 6 children result in a child tax credit of

\$6,000, reducing income taxes to \$18,098. Assuming that their AMT income (adding back the 8 exemption deductions and certain itemized deductions) is \$159,300, under the 2006 tentative AMT exemption amount of \$62,550, their tax before credits would be \$25,760. Because the personal tax credits were allowed in 2006, their net tax liability would be \$19,760, or about \$1,662 more than without the AMT. If the current exemption amount of \$45,000 is used and the tax credits are not allowed, their net 2007 tax liability would be \$30,323, \$10,563 more than under 2006 rules. This illustrates the AMT's impact on some taxpayers if Congress does not act.

TIPRA also extended the "kiddie tax" from age 14 to age 18. If the child has not reached the minimum age by the end of the tax year, has unearned income of more than \$1,700 for 2007 (adjusted annually), and is required to file a tax return, the net unearned income over \$1,700 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 \$5,350 for 2007, (2) there is only unearned income and it exceeds the minimum standard deduction for dependents of \$850 in 2007, or (3) there is both earned and unearned income that exceeds the \$850 minimum standard deduction with \$300 or more of unearned income, or total income exceeds \$5,350 for 2007.

This change makes gifting of raised commodities to children somewhat less attractive in terms of the tax savings. For example, in 2007 a farmer gifts 2006 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 \$850 and would have paid \$650 income tax (\$6,150 income at the 10% rate). After TIPRA, the child would have an \$850 exemption, pay 10% tax on \$850, and pay at the parents' rate (say 25%) on \$5,300 income for total income tax of \$1,410. Although the law change has reduced the income tax-saving aspect of the gift, there continues to be no self-employment tax (15.3% tax rate) paid on the gifted grain by either the farmer or the recipient child. See the discussion of gifts of commodities on page 29.

SBWOTA further extended the kiddie tax for tax years beginning after May 25, 2007 to include: (1) children under age 18 (those currently 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 2008, and expenditures for her support totaled \$14,000. Darling will be subject 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 parent's business may provide opportunities to avoid the kiddie tax.

The PPA tightened the restrictions on charitable contributions. Taxpayers who itemize deductions are generally allowed to deduct the value of contributions to qualified organizations. If the basis of the ordinary income property contributed is less than its fair market value, the deduction is limited to the property's basis. The donor is generally required to have a receipt

from the charity indicating the name of the charity, date and location of the contribution, and a description of the property contributed. The charity does not value the contribution. The new law does not allow a deduction for the contribution of used clothing or household goods unless the receipt specifies that the items are in good used condition or better. This change is effective for contributions after August 17, 2006. For tax years beginning after August 17, 2006, the taxpayer claiming a cash charitable contribution must have a bank record or a written communication from the donee charity organization showing the date and amount of the contribution, regardless of the amount of the donation.

The PPA changed the deductibility of qualified conservation easements by allowing the value of the charitable deduction taken to exceed 50 percent of the donor's AGI. However, at the same time, the PPA tightens what is a qualified conservation easement. This was done to prevent abuses of the intent of the provisions. Taxpayers may also take a deduction for charitable contributions of "apparently wholesome food" intended for human consumption for the lesser of their basis or fair market value of the food. Raw farm commodities do not appear to qualify for this provision. Furthermore, for cash basis farmers deducting expenses on Schedule F (Form 1040), the tax basis and resulting charitable contribution would be zero. The donation of raised commodities to charitable organizations is discussed in greater detail on pages 29 and 30.

## **RECENT TAX LAW CHANGES AFFECTING BUSINESSES**

The I.R.C. Section 179 deduction was increased to \$100,000 for tax years beginning in 2003, 2004, and 2005 by the 2003 Tax Act. The American Jobs Creation Act extended the \$100,000 limit (before indexing) for 2006 and 2007. This was further extended by TIPRA for tax years beginning after 2007 and before 2010. The Small Business and Work Opportunity Tax Act of 2007 further increased the Section 179 deduction to \$125,000 for 2007, with indexing for inflation after 2008 and before 2011.

The American Jobs Creation Act of 2004 provided an income tax deduction (Section 199) for taxpayers involved in domestic production activities. This provision is intended to create incentives for greater employment in the U.S. economy and also to comply with the World Trade Organization (WTO) regulations. Crops and livestock produced in the U.S. do qualify as domestic production activities. This deduction increased to 6 percent of the qualifying income for tax years beginning in 2007, 2008, and 2009. It is scheduled to further increase to 9 percent for tax years beginning after 2009.

### **Domestic Production Activities Deduction**

The domestic production activities deduction for tax years beginning in 2007 to 2009 is limited to the smallest of:

1. 6 percent of qualified production activity income (QPAI),
2. 6 percent of the taxable income of a taxable entity or adjusted gross income of an individual taxpayer (computed without the I.R.C. Section 199 deduction), or
3. 50 percent of the FormW-2 wages paid by the taxpayer during the year.

This deduction is computed on Form 8903 and is taken on the front of the Form 1040 as an adjustment to income. Thus, the deduction is for adjusted gross income only and does not reduce earnings from self-employment.



## **Qualified Production Activities Income**

Qualified production activities income, commonly referred to as QPAI, is equal to domestic production gross receipts (DPGR) minus the cost of goods sold, other deductions and expenses directly allocable to such receipts, and the share of other deductions and expenses not directly allocable to such receipts. For farmers, the qualifying activities include cultivating soil, raising livestock, and fishing, as well as storage, handling, and other processing (other than transportation activities) of agricultural products.

For many farmers, their QPAI will be equal to the sum of net income reported on their Form 1040 Schedule F and net gain from the sale of raised livestock reported on Form 4797. However, as explained below, there a number of possible exceptions to this guideline.

## **Domestic Production Gross Receipts**

Domestic production gross receipts (DPGR) are generally the receipts from the sale of qualified production property. For cash basis farmers, this would be the receipts from the sales of livestock, produce, grains, and other products raised by the producer. DPGR includes the full sales price of livestock (like feeder livestock) and other products purchased for resale. Gains from the sale of raised draft, breeding, and dairy livestock reported on Form 4797 also qualify.

Sales proceeds from livestock purchased for draft, breeding, or dairy purposes would probably not qualify unless the taxpayer had purchased the animals as young stock and had a significant role in raising them.

Government subsidies and payments not to produce are substitutes for gross receipts and do qualify as DPGR. Thus, subsidy payments that are directly linked to production, such as the loan deficiency payments (LDPs) and countercyclical payments, would qualify. Direct payments under the 2002 Farm Bill are not a substitute for sales of a commodity and would not qualify as DPGR. Payments under the Conservation Reserve Program (CRP) are related to past production and are clearly a substitute for gross receipts. Crop and revenue insurance payments received for physical crop losses would also be included in DPGR.

Gains from the sale of land, machinery, and equipment are excluded from DPGR. Rent received from land is specifically excluded from DPGR. Custom hire income (e.g., combining, spraying, trucking, etc.) reported on Schedule F is also excluded from DPGR. Government cost-sharing conservation payments and stewardship and incentive payments probably do not qualify. Because a custom livestock feeder does not have the benefits and burdens of ownership of the animals, the receipts would not qualify as DPGR.

If a taxpayer has less than 5 percent of his or her total gross receipts from items that are not DPGR, a safe harbor provision allows a taxpayer to treat all their gross receipts as DPGR. For example, a farmer has non-DPGR income of \$5,000 from planting the neighbor's no-till soybeans. As long as qualifying DPGR exceeds \$95,000, the farmer can include the \$5,000 as part of his or her DPGR, and no cost allocations are necessary. If qualifying DPGR is \$95,000 or less, then \$5,000 custom hire income must be kept separate and expenses allocated between DPGR and non-DPGR activities as discussed later. In computing the 5-percent limit, gross receipts from the sale of assets used in a trade or business, such as machinery and equipment,

livestock, and other business assets, are not reduced by the adjusted basis of business property. However, for assets held for investment purposes, only the net gain is included.

### **Computing QPAI**

To determine QPAI, the farmer's DPGR is reduced by the appropriate costs. If items purchased for resale (like feeder livestock) are included in DPGR, the cost of these items is deducted. Directly allocable and indirectly allocable deductions, expenses, or losses related to the items included in DPGR are deducted. For a farmer whose entire crop sales receipts qualify as DPGR, QPAI would be computed by subtracting the allowable expenses, and QPAI would be equal to net farm income on Form 1040 Schedule F. If the farmer also had gains from the sale of raised livestock on Form 4797, QPAI would be the sum of net income from Form 1040 Schedule F and the livestock gain from Form 4797.

### **Computation of the Deduction**

The domestic production activities deduction in 2007, 2008, and 2009 is computed as the smallest of:

1. 6 percent of QPAI,
2. 6 percent of adjusted gross income (AGI), or
3. 50 percent of Form W-2 wages paid during the year.

For an individual taxpayer, AGI would include other taxable income and deductible losses. For purposes of the 6-percent limitation, AGI is computed without the Section 199 deduction.

Example 1: Joe Farmer operates as a sole proprietor and has gross farm receipts of \$250,000 from the sale of crops and livestock. All of Joe's receipts qualify as DPGR, and he has Form 1040 Schedule F expenses of \$200,000, including \$10,000 of Form W-2 wages for part-time help. Joe has net farm income of \$50,000 on Form 1040 Schedule F, and his QPAI is also \$50,000. Assuming Joe's AGI exceeds \$50,000, his domestic production deduction would be the lesser of \$3,000 (6 percent of \$50,000 QPAI) or \$5,000 (50 percent of \$10,000 W-2 wages).

For some farm situations, the domestic production activities deduction can be limited by Form W-2 wages.

Example 2: Assume Joe's wife, Mary, provides the part-time help on the farm and is not paid. Income and expenses, other than hired labor, are the same as Example 1. Joe's QPAI would be \$60,000, and Form W-2 wages are zero. Joe would not qualify for the domestic production deduction.

Note: Joe could reasonably compensate Mary for her work on the farm and qualify for the domestic production activities deduction. If Joe paid Mary \$8,000, his QPAI would be \$52,000, and he would qualify for a \$3,120 domestic production activities deduction (6% of \$52,000). Mary's wages would be subject to social security taxes, but Joe's earnings for self-employment tax would be reduced by the amount of the wages paid.

Although there are various ways of computing wages for the domestic production activities deduction limitation, wages for which withholding is not required are always excluded. Thus, wages paid in commodities, wages paid to a child (under the age of 18) of the proprietor

(or a child of all of the partners), and compensation paid in nontaxable fringe benefits are not counted in determining the Form W-2 wage limitation for an employer.

For tax years beginning after May 17, 2006, only those wages allocable to DPGR activities are qualified wages for the 50-percent of wages limitation. Thus, if an employee was involved in DPGR and non-DPGR activities, only the wages associated with the DPGR activities would be included in the wage limitation calculation. For example, if an employee worked on the farm and was involved in doing custom work for other farmers, only the work on the farm would be DPGR associated activities. If the spouse was involved in recordkeeping for the farm, only the DPGR related portion of wages paid to the spouse would qualify.

The final Section 199 regulations require, for tax years beginning after June 1, 2006, that individuals involved in an active trade or business must apply the regulations only to items attributable to the trade or business or to the trade or business of a pass-through entity. Furthermore, compensation received by an individual employee for services performed as an employee is not considered gross receipts for purposes of computing QPAI.

### **Other Situations**

S corporations, partnerships, and other pass-through entities do not pay income tax, and their income and expenses flow through to the shareholders or partners. The Section 199 limitations are applied at the shareholder, partner, or similar level for both QPAI and Form W-2 wage allocation. An individual who has been allocated QPAI from a pass-through entity is also treated as having been allocated Form W-2 wages from that entity in an amount equal to the owner's applicable share of such wages for 2007 and later tax years.

An individual may be involved in multiple entities. An individual who has a negative QPAI (a loss) and positive Form W-2 wages in one entity may take a Section 199 deduction by combining this with another entity with a positive QPAI and little or no W-2 wages. Losses and deductions of pass-through entities may also be limited by the at-risk and passive activity rules. Income and expenses of the pass-through entities involved in qualified production activities are generally combined.

Taxable entities, such as regular corporations, are eligible for the domestic production activities deduction at the entity level, rather than at the owner level. Taxable income of the corporation, before any Section 199 deduction, would replace AGI as one of the three limitations on the deduction. Taxpayers who have generally reduced corporate income by making wages and rent payments to shareholders may want to consider leaving more income in the corporation to take advantage of the domestic production activities deduction.

Rent received from land is explicitly excluded from DPGR. Thus, cash rent landowners do not qualify for the domestic production activities deduction. Share-rent landowners could argue that their receipts are from the sale of commodities they produced in a trade or business. Share-rent landowners are considered in the business of farming for soil and water conservation deductions and farm income averaging. However, it could be argued that tax law treats landowners' receipts as rent, although they are not reported as rental income on Schedule E. From a practical standpoint, few share-lease landowners will have the Form W-2 wages paid necessary to meet the wage limitation and thus would not qualify for the DPAD.

Cooperatives may be engaged in manufacturing, production, growth, or extraction of agricultural or horticultural products or in the marketing of such products. Farmers receiving a patronage distribution from such a cooperative may have a domestic production activities deduction. The domestic production activities deduction amount is reported on Form 1099-PATR box 6, and the producer would include the amount on line 17 of the Form 8903. No income or W-2 wage limitations apply to cooperative's distributions of DPAD.

### **Depreciation and Section 179 Expensing**

Farmers and others in an active trade or business can elect to treat the cost of up to \$125,000 of qualifying property purchased during 2007 as an expense (rather than as a depreciable capital expenditure). Under earlier legislation, the annual Section 179 expensing limit was increased to \$25,000 for 2003. Congress aggressively increased and extended the Section 179 deduction in recent years. Current legislation has extended Section 179 through 2010 with indexing. 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.

Section 179 expensing can be used for 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/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.

Purchased new or used property can be expensed under Section 179. Inherited property or property acquired from a spouse, ancestors, or lineal descendants is not eligible for Section 179 expensing. On like-kind exchanges (swaps or trades), only the boot portion paid is eligible for expensing.

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 \$125,000 (\$128,000 in 2008) 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 expensing election is phased out on a dollar-for-dollar basis if over \$500,000 of qualified property is placed in service during 2007 (\$510,000 in 2008). For example, if a farmer buys \$525,000 of machinery in 2007, the maximum Section 179 expensing allowed would be reduced \$25,000 (\$525,000 - \$500,000), making the limit \$100,000. An individual is not allowed to elect the full \$125,000 and carryover the \$25,000 excess. Only the boot portion on like-kind trades is considered for the \$500,000 limit. Thus, if the boot portion of the \$500,000 purchase with a like-kind trade-in was only \$175,000, then the full \$125,000 expensing could be elected.

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 loss so that aggregate taxable income would be positive. This would permit a Section 179 expense for an asset acquired by the farm business. Gain or loss from the sale of livestock, machinery, and other business assets reported on Form 4797 is also included in taxable income for purposes of applying this taxable income limitation. "Suspended losses" from passive activities are not considered in determining the taxable income limit.

The American Jobs Creation Act provides greater flexibility with respect to late Section 179 elections and changes in Section 179 elections. Originally, 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. Currently, a taxpayer may change, make, 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 2002 and before 2011. If a Section 179 election is revoked, that revocation is irrevocable for that property. For example, assume a farmer elected to expense \$25,000, the entire cost of a used planter in 2006, and then revoked that election in 2007. The farmer could no longer elect to expense any of the cost of the planter for 2006, but other qualifying assets could be expensed for 2006. Current regulations do not appear to allow a Section 179 election to be made on an amended return for years after 2007.

### **Final Quarter Limitation and Mid-Quarter Convention**

The depreciation regulations generally allow one-half year's depreciation in the year of acquisition and one-half year's depreciation in the year of disposition. A special limitation on regular depreciation applies if more than 40 percent of the total depreciable bases of property acquired in a tax year is placed in service during the last three months of the year. Nonresidential real property and residential real property are excluded from this calculation. This "final quarter limitation" affects all assets acquired during the tax year and may substantially reduce the amount of depreciation allowed, especially on end-of-the-year purchases. The final quarter limitation is computed after the Section 179 expensing is applied.

Example 3: Assume a \$100,000 combine (7-year MACRS property in Table 1) was the only asset acquired during 2007 and it was placed in service after September 30. Only one and one-half months of depreciation would be allowed. Instead of deducting \$10,710 of the "half-year" depreciation, one could deduct depreciation for only one and one-half months, or \$2,680. The depreciation not allowed in the year of purchase would be taken in later years. Thus the total depreciation is not affected. For example, 20.85 percent would be allowed in the second year for the combine subject to the final quarter limitation in the year of purchase, rather than the 19.13 percent for the second year in Table 1. For further details, see IRS Publication 946, "How to Depreciate Property," Table A-18, page 85.

As noted previously, determination of whether the final quarter limitation applies is made after any Section 179 expensing. Whether Section 179 expensing is elected, which assets are selected for expensing, and whether the entire \$125,000 allowance for 2007 is used may have a considerable impact on the depreciation for the year. It may be possible to avoid application of the limitation by electing to apply Section 179 expensing to depreciable assets acquired in the final quarter of the year.

**Table 1. MACRS Depreciation Deduction Percentages for Property Used in Farming  
by Class-Life of MACRS Property Acquired after 1988 (150% DB)**

<u>Class-Life of MACRS Property</u>						
<u>Recovery Year</u>	<u>3-Year</u>	<u>5-Year</u>	<u>7-Year</u>	<u>10-Year</u>	<u>15-Year</u>	<u>20-Year</u>
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, 1995 and *How to Depreciate Property*, Pub. 946, 1995.

Example 4: Assume a farmer acquired a \$25,000 machine in the first quarter, a \$30,000 machine in the second quarter, and a \$45,000 machine in the last quarter of the year. If there was no Section 179 expensing, the final quarter limitation would apply, and a “mid-quarter convention” would apply to all assets purchased that year. Each asset is treated as if it had been acquired on the mid-point of the quarter in which it was placed in service. Depreciation for this seven-year property would be computed, using percentages from IRS Pub. 946 Tables A-15, A-16 and A-17 as:

\$25,000	x	18.75 percent =	\$4,687.50
\$30,000	x	13.39 percent =	\$4,017.00
<u>\$45,000</u>	x	2.68 percent =	<u>\$1,206.00</u>
\$100,000		TOTAL	\$9,910.50

Example 5: Assume the farmer elected \$20,000 Section 179 expensing on the \$45,000 machine acquired in the last quarter. Then only \$80,000 of qualifying property would have been acquired during the year, with less than one-third acquired during the fourth quarter. The 40-percent test would not be satisfied, and the half-year convention would apply to all of the purchases. Depreciation would be computed using the percentages from Table 1 above as:

\$25,000	x	10.71 percent =	\$2,677.50
\$30,000	x	10.71 percent =	\$3,213.00
<u>\$25,000</u>	x	10.71 percent =	<u>\$2,677.50</u>
\$80,000		TOTAL	\$8,568.00

In this instance, the combined depreciation and expensing deduction would total \$28,568.00. This is about \$18,658 more than if the final quarter limit applied.

For assets subject to the mid-quarter convention as a result of the final quarter limitation, depreciation in the year of disposition would be allowed through the mid-point of the quarter of disposition. However, the regulations indicate that if one purchases and disposes of an asset within a tax year, the transaction is assumed to occur on the same day, and one receives NO depreciation on that asset. Only those assets that were acquired during the year and are “on hand” at the end of the year are considered for the 40-percent test and are eligible for depreciation.

### **Alternative Depreciation Methods**

Producers have considerable initial flexibility with respect to depreciation. Once a producer begins depreciating an asset using a particular method, that method must be continued for the life of the asset. However, decisions with respect to methods can be made when the asset is placed in service. Table 2 compares the annual depreciation deductions for Section 179 expensing with seven-year MACRS, the regular seven-year MACRS method, and the straight-line method over the alternative 10-year life (Alternative MACRS). These represent the range of the fastest to the slowest depreciation methods available. Using some of the \$125,000 Section 179 expensing results in much or all of the cost recovered in the year of purchase. Under regular MACRS, nearly 60 percent of cost recovery occurs within the first four years. In contrast, with alternative MACRS, 65 percent of cost recovery is left after four years.

Section 179 expensing and use of the MACRS table result in a producer recovering the cost of the depreciable assets as rapidly as possible. However, if taxable income is low or negative, the tax saving effect of this depreciation may be largely “wasted.” For example, if taxable income is low, the income tax savings on another dollar of depreciation may be 10 or 15 percent or nothing. However, if the depreciation deduction were postponed until a year when income was higher, the income tax savings could be 25 percent or more.

**Table 2. Depreciation Alternatives for \$100,000 7-Year Property Acquired in 2007**

Year	<u>Expensing, \$50,000</u>		<u>Regular MACRS</u>		<u>Alternative MACRS</u>	
	<u>1<sup>st</sup> Year</u>	<u>Regular MACRS</u>	Depreciation	Remaining Balance	Depreciation	Remaining Balance
2006	55,355	44,645	10,710	89,290	5,000	95,000
2007	9,565	35,080	19,130	70,160	10,000	85,000
2008	7,515	27,565	15,030	55,130	10,000	75,000
2009	6,125	21,440	12,250	42,880	10,000	65,000
2010	6,125	15,315	12,250	30,630	10,000	55,000
2011	6,125	9,190	12,250	18,380	10,000	45,000
2012	6,125	3,065	12,250	6,130	10,000	35,000
2013	3,065	0	6,130	0	10,000	25,000
2014					10,000	15,000
2015					10,000	5,000
2016					5,000	0

Which of the possible options for Section 179 expensing and depreciation should be taken by individual producers will depend on both their overall 2007 tax situation as well as their expected tax situation in future years. There are trade-offs 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. Both time value of money considerations (a dollar to be received in 2012 is not worth as much as a dollar in hand today) and expected future income are important in making these decisions. If the farmer’s marginal tax rate or tax bracket is unchanged, then tax benefits from Section 179 expensing and additional first-year depreciation are higher for MACRS assets with longer class lives. In general, the expensing election and additional first-year depreciation are applied to the qualifying property with the longest lives and those assets that are the least likely to be resold or traded. If the current marginal tax rate is low, relative to the anticipated tax rate for future years, then slower methods of depreciation are likely to result in greater tax savings.

**Recovering “Lost” Depreciation**

For many years, the initial basis of an asset was adjusted by the amount of depreciation allowed, but not less than the depreciation allowable. In other words, the basis of the asset was reduced by the allowable depreciation whether that depreciation was actually taken or not. For



example, perhaps a farmer had acquired a new machine and inadvertently did not enter the machine on the depreciation schedule and took no depreciation. When there was a disposition of the machine, its basis would be reduced for the allowable depreciation even though the producer had not taken any depreciation and had not received any tax benefit. The depreciation allowable was permanently “lost.”

Rev. Proc. 2002-9 allowed a taxpayer who had claimed less than the allowable depreciation for an asset to change the method of determining depreciation to claim the full depreciation allowable. For example, perhaps an asset was found being depreciated as seven-year MACRS property instead of the correct five-year MACRS property life. However, if the unclaimed depreciation had not been found until after disposition of the asset, the allowable depreciation was subtracted from the initial basis to determine the adjusted basis of the asset. Rev. Proc 2004-11 now permits a taxpayer to change the method of determining depreciation on a depreciable asset and claim allowable depreciation not taken in the year of disposition. Form 3115 would be used to change the accounting method for the asset, and approval is automatic for qualified changes.

### **Family Business Tax Simplification**

The 2007 Act allows a married couple who files a joint tax return and who owns an unincorporated business not to file a partnership return if the following conditions are met: (1) the only members of the joint venture are a married couple, (2) both spouses materially participate in the business, and (3) both elect to have the provision apply. If the couple opts out of the partnership reporting, each files a Schedule F as a sole proprietor, and some forms (Form 1065 and K-1) are avoided. It should be noted that by making the election, the couple loses some of the flexibility (such as guaranteed payments) associated with partnership taxation.

### **WEATHER-RELATED EVENTS AND TAXES**

Congress has recognized that weather-related events can have adverse effects on farmers, and these adverse effects can be exacerbated by the tax law. As a result, there are a number of specific provisions that allow livestock and crop producers to even out their taxable income by changing when receipts are reported for tax purposes.

#### **Weather-Related Sales of Livestock**

Many Indiana livestock producers have been adversely affected by weather conditions in 2007. Because of reduced feed supplies, some livestock producers have reduced herd size through larger than normal sales of dairy or breeding livestock. In other instances, some animals may have been sold earlier than they normally would have been sold. In both cases, weather-related conditions could cause producers to have higher than normal taxable incomes in 2007 and lower than normal taxable incomes in 2008. Income tax law allows farmers affected by weather-related conditions to defer reporting of this income to even out their income and avoid potentially higher taxes.

There are two provisions in tax law that attempt to cushion producers from the consequences of the weather-related sales of livestock. Livestock held for draft, breeding, or dairy purposes and sold because of weather-related conditions are provided a two-year reinvestment period under the first provision (this replacement period is extended if the area is eligible for federal assistance and/or drought conditions persist). The second provision, which applies to all livestock (other than poultry), allows cash basis taxpayers whose primary trade or business is farming a deferral of receipts from sales in excess of normal business practice because of weather-related conditions resulting in a disaster area declaration. Both provisions apply only to those sales that are in excess of the normal business practice of the producer.

### **Sale with Replacement**

The gain on the weather-forced sale of livestock held for draft, breeding, or dairy (not sporting) purposes does not need to be reported as income if the proceeds are used to buy replacement livestock within two years after the end of the tax year of the year of sale. Although declaration of a disaster area is not necessary, a producer must be able to show that weather-related conditions forced the sale of more livestock than would normally be sold. For example, a cow-calf producer with 100 cows who normally sells 15 cows per year may sell 60 cows in 2007 because of limited forage and feed supplies. Gains from the sale of the extra 45 cows would not be reported as income if the producer purchased at least 45 replacement animals before the end of 2009 or the extended replacement period, if applicable. The new livestock must be used for the same purpose as the livestock that was sold. Beef cows must be replaced with beef cows.

A producer's tax basis in the replacement livestock equal to the basis in the livestock sold plus any additional amount invested in the replacement livestock that exceeds the proceeds from the sale. For example, a producer sells 45 raised beef cows (with a zero tax basis) for \$500 each. The gain of \$22,500 (45 cows sold in excess of normal business practice X \$500) is deferred. If the producer purchased 45 cows in 2008 for \$600 each, the tax basis in each replacement animal would be \$100 (the \$600 cost minus the \$500 proceeds from sale).

To make the election under I.R.C. Section 1033(e) to defer recognition of gain, a producer does not report the gain and attaches a statement to the current year's tax return. The statement shows the following:

- (1) Evidence of weather-related conditions that forced the sale of the livestock.
- (2) Computation of the amount of gain realized on the sale.
- (3) The number and kind of livestock sold.
- (4) The number and kind of livestock that would have been sold as normal business practice without the weather-related sales.

If a producer spends \$22,500 and buys 45 cows before the end of 2009, the basis of the replacement animals will be zero, the same as the raised cows sold. If the producer spends less than \$22,500 on the 45 replacement animals, the difference between what was spent and \$22,500 must be reported as 2007 income. If fewer than 45 replacement cows are purchased, the gain from the animals not replaced must be reported as 2007 income regardless of the cost of the replacement animals. When filing an amended 2007 return, the producer will be subject to additional tax and interest on the tax.

## **Sale without Replacement**

Producers who are forced to sell livestock because of weather-related conditions may be eligible for an exception to the rule that livestock-sale proceeds must be reported as income in the year they are received. This exception allows postponement of reporting these receipts as income for one year for both income and self-employment tax purposes. To qualify, an area that affects the livestock must have been declared a disaster area. The animals do not need to have been located in the disaster area and can have been sold before or after the disaster area declaration. However, only the livestock sales in excess of normal business practice qualify for deferral.

A declaration must be attached to the tax return for the year in which the weather-related sale occurred. To make the election the statement should include the following:

- (1) A declaration that the election is being made under Section 451(e).
- (2) Evidence of the weather conditions that forced the early sale on the livestock and when the area was declared a disaster area.
- (3) A statement explaining the relationship between the disaster area and early sale.
- (4) The total number of animals sold in each of the three preceding years.
- (5) The number of animals that would have been sold as normal business practice if the weather-related condition had not occurred.
- (6) Total number of animals sold and the number sold because of the weather-related event during the tax year.
- (7) Computation of the amount of income (see calculation below) to be deferred for each classification of livestock.

For example, a cow-calf producer normally feeds the calves and sells them as yearlings. However, because of drought, which caused the area in which the farm is located to be declared a disaster area, the farmer sold 100 calves in 2007 rather than feeding them and selling them as yearlings in 2008. Under normal practice, no calves would be sold, so the proceeds from the sale of the 100 head ( $\$450 \text{ per head} \times 100 \text{ calves} = \$45,000$ ) can be deferred until 2008.

## **Deferral of 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 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 they keep 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) state 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 until the year following the year of harvest. Some crop revenue insurance products, such as Crop Revenue Coverage (CRC) and Revenue Assurance (RA), make payments if the price of a crop declines between planting and harvest. For example, the average price of the December 2007 corn futures during February 2007 was \$4.06 per bushel. For revenue insurance purposes, this is the base price. Harvest time prices of the December 2007 corn futures have been about \$3.80, which is less than the base price. The exact price depends on the type of revenue coverage purchased by a producer. Because the harvest price is less than the base price, part of the insurance proceeds is due to the decline in price. In contrast, the price of the 2007 November soybean futures contract increased from February to harvest, and any insurance proceeds would be due solely to physical losses.

One procedure to determine the amount of the insurance payment due to the decline in yields of corn is as follows:

Example 6:

Assume:      Approved yield is 160 bushels per acre  
                  Base price of corn is \$4.06 per bushel  
                  Harvest price of corn is \$3.80 per bushel

Insurance coverage level is 75%  
Actual yield of 75 bushels per acre

The final revenue guarantee level is 160 bushels X \$4.06 X 75% = \$487.20 per acre  
Calculated revenue is 75 bushel actual yield X \$3.80 harvest price = \$285.00 per acre  
Insurance proceeds = \$487.20 guarantee - \$285.00 calculated = \$202.20 per acre

Yield loss is 160 bushel approved yield – 75 actual yield = 85 bushels per acre  
85 bushel yield loss X \$3.80 harvest price = \$323.00 value of physical loss per acre

Price loss is \$4.06 – 3.80 = \$0.26 per bushel X 75 actual yield = \$19.50 per acre

Total loss is \$323.00 + \$19.50 = \$342.50 per acre  
Physical loss is \$323.00 / \$342.50 = 94.31% of total loss  
94.31% physical loss X \$202.20 insurance proceeds =  
\$190.60 payment per acre due to physical loss

Based on this procedure, \$190.60 per acre of insurance payment would be eligible for possible deferral as the value of the physical loss. The remaining \$11.51 of insurance payment would be due to the price decline of the December corn futures and is not eligible for possible deferral.

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. Insurance payments made on the county-based Group Risk Plan (GRP) and Group Risk Income Plan (GRIP) must be recognized when received.

## **LIKE-KIND EXCHANGES**

I.R.C. Section 1031 requires taxpayers to postpone reporting of gain or loss on property they give up if they trade that property for like-kind property. These like-kind exchanges are also referred to as "swaps," trades, tax-deferred exchanges, or 1031 exchanges. Sometimes they are erroneously referred to as tax-free exchanges. These exchanges are not tax-free; rather, the reporting of gains or losses is postponed by adjustments of the tax basis of the asset acquired. Many like-kind exchanges involve farm real estate (real property), but most trade-ins of machinery and equipment (personal property) also qualify as like-kind exchanges. IRS regulations allow the taxpayer to transfer the remaining tax basis in the personal property given up to the like-kind property acquired as explained in the next section.

### **Like-Kind Exchanges of Personal Property**

Determining whether property is like-kind property can be difficult. Depreciable personal property can satisfy the like-kind exchange requirement if the properties are "like-class" and are either in the same General Asset Class (which does not include agricultural items) or the same Product Class. The IRS proposes using the North American Industry Classification System

(NAICS) to replace the discontinued Standard Industrial Classification (SIC) for Product Class. Under the SIC classification, Farm Machinery and Equipment was Class 3523. Under the NAICS classification, Farm Machinery and Equipment becomes Class 333111. Among the many items listed in this category are combines, tractors, planters, tillage equipment, manure spreaders, livestock equipment, and haying machinery. Thus, essentially any machinery or equipment manufactured by a farm machinery and equipment manufacturer would meet the like-kind test. Thus, the definition of like-kind property is very broad for agriculture.

Different sex livestock are specifically defined as not being like-kind property. Different species of animals are defined as being in different classes and thus do not meet the like-kind test. Dairy and beef cattle are arguably like-kind property, but there is no clear authority.

In a like-kind exchange, the farmer typically trades in the old asset for the asset to be acquired and pays additional money. For example, a farmer trades an old combine with a tax basis of \$30,000 and \$60,000 additional money for a replacement combine (new or used) selling for \$100,000. Effectively, the dealer gave a trade-in allowance of \$40,000 for the old combine. If the farmer had sold the combine for \$40,000, there would have been a gain of \$10,000 to be reported (recognized) for tax purposes. However, because this qualifies as a like-kind exchange, the gain is not recognized, and the tax basis of the replacement combine is \$90,000, the \$30,000 adjusted tax basis of the combine traded in plus the \$60,000 cash boot. Under IRS Notice 2000-4, the taxpayer would have continued to depreciate the \$30,000 adjusted basis of the combine that was traded in as if it had not been traded. Only the \$60,000 cash boot would have been depreciated as the new asset.

The IRS has issued regulations [Reg. 1.168(i)-6T(i)] that allow a taxpayer to elect out, on an asset-by-asset basis, of the depreciation procedures in Notice 2000-4 discussed above. The taxpayer should enter "Election made under Section 1.168(i)-6T(i)" at the top of Form 4562 and attach a list of assets for which the election is being made. This considerably simplifies the depreciation schedule for an individual involved in a number of trades with only a small reduction in the depreciation deduction that would be allowed in the year of trade.

If the adjusted tax basis of the old combine had been \$50,000 and the trade-in allowance was only \$40,000, effectively there was a loss of \$10,000 on the old combine. Because this was a like-kind exchange, rather than a sale, that loss is not recognized. The tax basis in the replacement combine would be the \$50,000 basis of the old combine plus the \$60,000 boot for a total of \$110,000. If the trade-in value of an asset is less the asset's adjusted basis, it would be good tax management to have the old asset sold in a separate transaction from the purchase of the new asset. Ideally, the sale of an asset at a loss and purchase of a replacement asset should involve different individuals or companies to avoid having the transactions considered as a like-kind exchange and the loss deferred by the adjustment of the basis of the replacement asset.

### **Like-Kind Exchanges of Real Property**

For real property, like-kind is interpreted very broadly. Any real estate can be exchanged for any other real estate and qualify as like-kind as long as the property given up was, and the acquired property is, used in a trade or business or held for investment. Thus, farm land can be

traded for an apartment complex or real estate with improvements can be traded for unimproved real estate. As with like-kind exchanges of personal property, the gain or loss on the relinquished property (property given up) is deferred, and the basis of the replacement property is adjusted. The basis of the replacement property is generally the basis of the relinquished property plus the value of any additional boot.

The two primary problem areas associated with like-kind exchanges of real property are the timing associated with completion of the transaction and the potential for depreciation recapture under Section 1245 and Section 1250. Farm properties that are given up can also involve recapture of soil and water conservation expenditures (Section 1252) or exclusion of conservation cost-sharing payments (Section 1255). This can result in some tax even if there is a like-kind exchange.

A like-kind exchange of real property could, but does not necessarily, involve two property owners simply swapping properties. An individual property owner relinquishing property may have a specific replacement property identified, but the owner of the replacement property may want cash rather than other property. This transaction can be handled as a like-kind exchange by the first property owner and as a sale by the second property owner. The most typical situations involve a non-simultaneous or deferred exchange. In a deferred exchange, first the relinquished property is transferred, and then the replacement property is acquired. For such a transaction to qualify as a like-kind exchange, certain rules must be followed with respect to timing, and actual or constructive receipt of the proceeds must be avoided by the first property owner.

There are two timing issues on a deferred exchange. First, the replacement property must be identified on or before the 45<sup>th</sup> day after the taxpayer transferred the relinquished property (the day of closing). Second, the replacement property must be received (closed on) by the earlier of a) 180 days after the date the taxpayer transferred the relinquished property or b) the due date (including extensions) of the taxpayer's tax return for the year in which the property was transferred. The identification rule has a number of specific requirements with respect to procedures that must be followed to comply with the rule. Generally, a real estate agent, qualified intermediary, or other individual who has not had any dealings with the taxpayer in the prior two years will be involved in the exchange process.

Treasury Reg. 1.1031(k)-1(g) provides four safe harbor rules to prevent the taxpayer who relinquished the property from having actual or constructive receipt of money or other property. First, the obligation of the recipient of the relinquished property to transfer replacement property can be secured or guaranteed by a mortgage, standby letter of credit, or third party guarantee. Second, a qualified escrow account or qualified trust can be used to hold the money. Third, the taxpayer can hire a qualified intermediary to handle the exchange. Fourth, an agreement can be made that provides for an increase in the amount of money or property that the taxpayer can receive based on the time between relinquishing property and receiving the replacement property. Under the last three safe harbor rules, the taxpayer cannot have the right to receive, pledge, borrow, or otherwise benefit from the proceeds before the end of the exchange period unless no replacement property is identified.

Commonly, a farm involves a house, land, and some improvements such as tile drainage, grain storage, a single-purpose livestock facility (Section 1245 property), and a machine shed (Section 1250 property). These assets are grouped by class and handled individually. If the house has been owned by the taxpayer and was the principal residence of the taxpayer for at least two of the five previous years, then gain of up to \$250,000 (\$500,000 for a married couple if both satisfy the requirements) can be excluded from income even if cash is received. Thus, most farmers would sell their principal residence separately from the rest of the farm and exclude the gain. As long as the amounts of Section 1245 and Section 1250 property on the replacement property are at least as great as the amounts of Section 1245 and Section 1250 property, respectively, on the relinquished property, there would be no Section 1245 or Section 1250 recapture on the like-kind exchange. However, if the amounts of Section 1245 and Section 1250 property on the replacement property are less than on the relinquished property, then there would be some recapture (taxable income) to be reported by the taxpayer relinquishing property.

Like-kind exchanges offer the possibility of avoiding the reporting of gains on the exchange of property. These are usually quite simple and straightforward for personal property. Transactions involving real estate can be more complex, and the tax implications may be much larger. Taxpayers need to proceed carefully, usually with expert assistance, to ensure that the necessary procedures are followed.

## **GOVERNMENT PAYMENTS**

Government payments continue to be a significant portion of farm income for many Indiana producers. Some payments are related to the farm income support program, and others are related to producers' participation in soil and water conservation programs. Farmers using the cash method of accounting generally report receipts as income when constructively received and deduct expenses when actually paid. However, farmers have some control over when government program payments are received and reported for income tax purposes. Special provisions allow the deduction of some conservation related expenditures, while some payments can be excluded from income. These provisions allow some additional year-end tax planning opportunities for producers.

### **Government Farm Program Payments**

The Farm Security and Rural Investment Act of 2002 provides for three types of payments to crop producers: direct payments, countercyclical payments (CCPs), and marketing loans/loan deficiency payments. Producers could have requested one-half of their 2007 direct payments in December of 2006, and those payments would have been reported as 2006 income. Producers can request one-half of their 2008 payments in 2007. Although these 2008 payments are available to qualifying producers in 2007, because of a special provision enacted by Congress, these payments are not considered as income until actually received by the producer. Thus, producers with a low taxable income in 2007 may want to take the available portion or the 2008 payment on or before December 31, 2007. Producers wishing to defer income into 2008 can delay requesting payment until after December 31, 2007. The date that previous government payments have been taken does not affect when a producer's 2008 payments can be taken.



Given the level of commodity prices, the marketing loan program, loan deficiency payments (LDPs) and countercyclical payments (CCPs) are unlikely to affect many producers in 2007. For a discussion of these payments, see Patrick, "Tax Planning for Farmers in 2006."

### **Conservation-Related Payments**

A number of conservation-related payments may be made by various government programs. In general, these payments are ordinary income that is subject to income and self-employment taxes. In the case of some cost-sharing payments, there may be an offsetting deduction, or some payments may qualify to be excluded from income.

The Conservation Security Program (CSP) makes stewardship payments to qualified farmers for attaining minimum soil and water quality standards before enrollment in the program. The Secretary of Agriculture determined that payments made under the CSP were primarily for conservation purposes and, if they met the requirements of I.R.C. Section 126, could be excluded from income (Federal Register, Vol. 70, No. 1221, June 24, 2005). This determination was erroneously interpreted by some as excluding CSP payments from income. Rev. Rul. 2006-46, 2006-39 IRB 511 clarifies that stewardship payments under CSP do not involve new capital expenditures on the part of the farmer and are not eligible for exclusion under I.R.C. Section 126. Stewardship benefits would be ordinary income and earnings for self-employment tax for operating farmers.

Incentive payments may be made to farmers under a variety of programs to encourage them to sign up for specific programs (Signing Incentive Payments or SIP) or to adopt certain production practices (Production Incentive Payments or PIP). The SIPs and PIPs are ordinary income and earnings for self-employment tax purposes for operating farmers.

To encourage expenditures for soil and water conservation purposes, Congress has allowed a deduction of up to 25 percent of gross farm income for qualifying expenditures. To qualify, expenditures must be consistent with an approved conservation plan and involve land used in the business of farming. Land used for timber production, used in a not-for-profit (hobby) activity, or rented for a fixed amount is not considered as being used in the business of farming. Cash rent landowners who are considering making soil and water conservation expenditures may want to change the terms of their lease. Expenditures for depreciable conservation assets are not eligible for deduction as soil and water conservation expenses and should be depreciated. Ordinary and necessary expenses that are otherwise deductible, such as periodic ditch cleaning, are also not soil and water conservation expenditures, are not subject to the 25 percent of gross income limitation, and should be deducted on Schedule F.

### **Cost-Sharing Payments**

In most counties, cost-sharing payments are available for expenditures on approved agricultural conservation practices. Establishment of grassed waterways and filter strips would be common examples. Because there is nothing to wear out, these expenditures are not eligible for depreciation and would normally be added to the basis of the property. However, to encourage conservation, Congress enacted I.R.C. Section 175, which allows a producer to elect

to deduct expenditures up to 25 percent of the gross income from farming (including income from crops, livestock, fruits, and other agricultural or livestock products as well as sale of livestock). Gains from the disposition of machinery and equipment or land are not included. If expenditures do exceed 25 percent of the gross income from farming in a year, the excess can be carried forward into future years. Alternatively, some cost-sharing payments may be eligible to be excluded from income, as discussed below. Cost-sharing payments must be reported in income as government program payments on line 6a of Form 1040 Schedule F (Form 1040), but the expenditures are deducted on line 14. This reduces farm income for both income and self-employment purposes. If the land is held for five years or less, gain on the sale of land is treated as ordinary income up to the amount of previously deducted soil and water conservation expenses. If the land has been held less than 10 years but more than five years, then a declining percentage of the previously deducted soil and water conservation expenses is treated as ordinary income.

Some cost-sharing payments may involve expenditures for assets, such as metal or concrete structures, that can be depreciated. Such expenditures are not eligible for deduction as soil and water conservation expenses, but would be depreciated. However, if the cost-sharing payment was reported as income and depreciation was deducted, the net effect would be to increase the producer's income for the year in which the cost-sharing payment was received. I.R.C. Section 126 allows the exclusion of the cost-sharing payment from income if the payment is from an authorized list of programs, is for a capital expenditure, does not substantially increase gross receipts from the property that was improved, and the Secretary of Agriculture certifies that the payment was made primarily for conservation purposes.

The amount that can be excluded is the present value of the greater of:

- 1) 10 percent of average gross receipts from the affected property for the last three years, or
- 2) \$2.50 per acre.

Some expenditures, such as an erosion control structure, may have clearly defined areas of impact. Other expenditures, such as manure storage facilities, may have less well-defined areas of impact. Producers will want to define the area affected as being as large as possible. The present value computation involves dividing the dollar figure derived from 1 or 2 above and dividing by an assumed interest rate. Assuming a lower interest rate will result in a larger present value and a larger potential amount that would be excludible. For example, assume a structure affected 100 acres, 10 percent of average gross receipts is \$20 per acre, and the interest rate is 5 percent. In this instance, the present value of the amount to exclude would be calculated as:

$$(100 \times \$20) / 0.05 = \$2,000 / 0.05 = \$40,000$$

Thus, up to \$40,000 of a cost-sharing payment could be excluded from income. If the land were sold at a gain within 10 years of receiving the cost-sharing payment, the gain, to the extent of the income exclusion, would be treated as ordinary income. This is similar to recapture of depreciation. If sold for a gain more than 10 years after the payment was received, the recapture is reduced by 10 percent for each year or part of a year that the property is held beyond 10 years.

## **Conservation Reserve Program**

The Conservation Reserve Program (CRP) can involve several types of payments to producers. The annual “rent” payment is treated as ordinary income. Chief Counsel’s Office of IRS (CCA 200325002) took the position that these payments are earnings for self-employment tax purposes for operating farmers or individuals who buy a farm with land enrolled in the CRP and perform the contractual obligations necessary to maintain the land in the CRP program. However, the IRS has previously taken the position in Rev. Ruling 60-32, 1960-1 C.B. 23 that these land diversion payments are not earnings for the self-employment tax, if the landowner did not materially participate in farming operations.

In Notice 2006-108, 2006-51 I.R.B. 1118 (December 5, 2006) the IRS reiterated their position that CRP rental payments (including incentive payments) are earnings from self-employment for both (1) farmers actively engaged in farming who enroll land in the CRP and personally fulfill the CRP contractual obligations and (2) individuals not otherwise actively engaged in farming who enroll land in the CRP and arrange for a third party to perform the CRP contractual obligations. The IRS indicated that it intended to issue a revenue ruling. To date, that has not occurred, and the IRS has not revoked Rev. Ruling 60-32 discussed above. Thus, there is still substantial authority to exclude CRP payments from earnings from self-employment on current tax returns. However, the exclusion could be disallowed on an audit.

## **Other Conservation Programs**

Payments can also be made under programs such as the Environmental Quality Incentives Program (EQIP), which may affect livestock producers, the Wetlands Reserve Program (WRP), Conservation Reserve Enhancement Program (CREP), and several others. Annual program payments and incentive payments that are made to encourage adoption of certain production practices are ordinary income and generally subject to self-employment tax. The cost-sharing payments are generally handled as deductible soil and water conservation expenditures under I.R.C. Section 175, or they may be excludible from income under I.R.C. Section 126. In some instances, programs may involve the landowner granting 30-year or permanent easements. These conservation-related easements are treated as other easements. The payment is first treated as a return of basis in the property and, to the extent it exceeds the producer’s basis in the affected property, as long-term capital gain. The payment received for granting an easement that is for less than 30 years is treated as ordinary income in its entirety.

## **Self-Employment Tax Considerations**

Traditionally, government payments were assumed to take the same form as other farm income. For an operating farmer, government payments were earnings for self-employment taxes. A share-lease landowner who did not materially participate in the farming activities reported income and expenses on Form 4835, and net income was not included as earnings for self-employment tax. A cash rent landowner reported income and expenses on Schedule E (Form 1040) and, for most tax purposes, was not considered to be a farmer.

Notice 2006-108 and CCA200325002, discussed earlier, have created some confusion over self-employment tax treatment of government payments. IRS has taken the position that by agreeing to the CRP contract and hiring an agent to do the necessary work, the taxpayer has a trade or business, and the payments are subject to self-employment tax. This position has not been tested in the courts, nor has IRS extended the interpretation to other program payments.

### Summary of Tax Treatment

Table 3 summarizes the income tax and self-employment tax treatment of the various different types of conservation related payments for various types of taxpayers.

**Table 3. Tax Treatment of Conservation Payments by Type of Taxpayer**

Type of Payment	Type of Taxpayer			
	Operating Farmer Schedule F	Share Lease Landowner Form 4835	Cash Rent Landowner	Rural Non-farm Landowner
Stewardship	Ordinary income, subject to SE	Ordinary income, arguably not subject to SE tax*	Generally not applicable	Generally not applicable
Incentive	Ordinary income, subject to SE	Ordinary income, arguably not subject to SE tax*	Ordinary income, not subject to SE tax*	Generally not applicable
Cost-Sharing for Nondepreciable Capital Expenditures (I.R.C. Section 175)	Payment reported as income, deduction taken for expenses Net generally \$0 for SE tax	Payment reported as income, deduction taken for expenses Net generally \$0 for SE tax	Payment reported as income, arguably not subject to SE, expenditures added to basis*	Payment reported as income, arguably not subject to SE, expenditures added to basis*
Cost-Sharing for Depreciable Capital Expenditures (I.R.C. Section 126)	Payment excluded from income to the extent allowable. Unexcluded portion is ordinary income, subject to SE tax	Payment excluded from income to the extent allowable. Unexcluded portion is ordinary income, arguably not subject to SE tax*	Payment excluded from income to the extent allowable. Unexcluded portion is ordinary income, arguably not subject to SE tax*	Payment excluded from income to the extent allowable. Unexcluded portion is ordinary income, arguably not subject to SE tax*
Annual (e.g., CRP)	Ordinary income, subject to SE tax	Ordinary income, arguably not subject to SE tax*	Ordinary income, arguably not subject to SE tax*	Generally not applicable
Permanent Easements	Payments reduce basis of affected land, payments in excess of basis result in §1231 gain, not subject to SE tax	Payments reduce basis of affected land, payments in excess of basis result in §1231 gain, not subject to SE tax	Payments reduce basis of affected land, payments in excess of basis result in §1231 gain, not subject to SE tax	Payments reduce basis of affected land, payments in excess of basis result in capital gain, not subject to SE tax
*These payments would generally not be considered as earnings for SE tax purposes. The IRS, based on CCA 200325002 and Notice 2006-108, could argue that these payments are subject to SE tax.				

## **OTHER TAX CONSIDERATIONS AFFECTING PRODUCERS**

The American Jobs Creation Act of 2004 provided that a farmer's regular tax liability is used to determine the Alternative Minimum Tax (AMT). This allows a farmer to get the full effect of farm income averaging. The American Jobs Creation Act also extended the replacement period for the weather-related sale of livestock as discussed earlier. This section reviews farm income averaging, the IRS position on revoking the election to treat Commodity Credit Corporation loans as income, and the payment of rent by an entity in which the landowner materially participates. Finally, the tax treatment of gifts of commodities to family members and donations to charitable organizations is discussed.

### **Farm Income Averaging**

Farm income averaging has undergone a number of changes that have been favorable to producers. The most recent change, effective for 2004 and later tax years, involves the AMT calculation. The AMT was instituted to require individuals receiving substantial tax preferences to pay some income tax. Individuals computed their regular tax and their AMT tax liability and paid the higher amount. Farmers often found that the tax reduction from farm income averaging was eliminated when the AMT was calculated. Beginning with tax year 2004, a farmer's regular tax liability is determined without regard to farm income averaging and compared with the AMT liability. As a result, the farmer receives the full benefit of income averaging in reducing regular tax, while the AMT, if any, is unchanged.

"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 farm income averaging.

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., 2007, and have that elected farm income treated as if it have been earned equally over the preceding three base years, 2004 to 2006, 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 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 2008, the portions of the base years' tax brackets used with the previous income averaging in 2007 are not available for 2008. 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.

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. The maximum tax rate on long-term capital gains has been 15 percent for dispositions after May 5, 2003. A farmer can elect to average ordinary income and allocate 2007 farm capital gain income (unless offset by non-farm capital losses) to the 2007 year. For example, assume a producer has \$50,000 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 \$50,000 of farm income and allocate all of the Section 1231 gain to 2007. All of the elected income would be ordinary income and allocated equally to the three prior years. However, if the farmer elected to average \$60,000 of farm income, at least \$10,000 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.

Income averaging will have the greatest attraction for farmers whose income in one year is much higher than in the preceding three years and who have made only limited capital expenditures eligible for Section 179 expensing. 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 recapture on machinery, equipment, buildings, and purchased breeding stock is reported as ordinary income. The disposition of these assets in one 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.

### **Revoking Election to Treat CCC Loans as Income**

Many producers use the Commodity Credit Corporation (CCC) loan program, in which commodities are used as security for loans at or after harvest. Producers can treat those loans in one of two different ways for tax purposes. Under the “loan” method, the CCC loans can be treated as other loans: loan proceeds are not treated as income, and loan repayment is not a deductible expense. Alternatively, a farmer could elect under I.R.C. Section 77 to treat the loan proceeds as income when received – the “income” method. Under previous law, once the election to treat a CCC loan as income had been made, it could not be revoked without the IRS Commissioner’s permission. Revenue Procedure 2002-9 added the Section 77 election to the changes in accounting methods that receive the automatic consent of the Commissioner for 2002 and later years. This makes revoking the election an alternative to be considered.

Farmers who have treated CCC loans as income can revoke that election by filing Form 3115, Application for a Change in Accounting Method. Because consent is automatic, Form 3115 can be filed with the tax return for the year of the change, and there is no user fee charged. The change is made on a “cut-off” basis. All CCC loans received in the year of change are treated as loans. There is no change with respect to treatment of CCC loans in prior years that have been reported as income. One copy of Form 3115 is filed with the tax return, and a copy is sent to the Internal Revenue Service, Associate Chief Counsel (Domestic), Attention CC:DOM CORP:T, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

Producers have flexibility in reporting future CCC loans. If a producer revokes the Section 77 election for 2007 and uses the loan method, nothing prevents that producer from electing to report 2008 CCC loans as income. Presumably, this new election could be revoked for the 2009 tax year.

### **Self-Employment Tax Update**

Many farmers continue to be concerned about the self-employment (SE) tax. For 2007, earnings of up to \$97,500 are subject to the 12.4 percent tax for social security, and all earnings are subject to the 2.9 percent Medicare tax. For 2008, the maximum social security portion will increase to \$102,000.

Farmers with SE earnings of less than \$400 and gross farm income (receipts) of more than \$2,400 may use the optional farm method and pay SE tax on \$1,600 of earnings. However, the optional farm method provides 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. Thus, farmers who regularly rely on the optional farm method will not have or will lose their currently insured status and qualification for these benefits. Additional quarters of coverage can be obtained by those having and reporting net farm income of \$2,000 or more for SE tax purposes for 2007 (\$2,100 or more in 2008). Earnings of the taxpayer from non-farm employment would also provide additional quarters of social security coverage.

There has been on-going 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 8<sup>th</sup> 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 8<sup>th</sup> 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 8<sup>th</sup> 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 audits.

## 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). For example, if David gifted 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.

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% 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 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 7: In December 2007, a cash basis farmer delivers 2007 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 percent x \$3,000 x 0.9235 =	\$423.89
Federal tax 15 percent x (\$3,000 - 211.94 [\$423.89 X 50%]) =	418.21
State and local tax 4.4 percent x (\$3,000 - 211.94)	<u>121.67</u>
\$3,000 -	964.77 = \$2,035.23

This results in a tax-savings of \$964.77 for a taxpayer in the 15 percent income tax bracket and subject to the 15.35percent SE tax rate. For a taxpayer in the 25 percent tax bracket, the savings increase to \$1,242.58.

## 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, 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. Recent tax law changes 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 on or before the end of December 2007 or delayed into 2008. A part of the 2008 direct payments from the government for corn, soybeans, and wheat can be collected in

2007 or after December 31, 2007. The Section 179 expensing deduction can have a major impact 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 2008 can, up to a limit, also affect the taxable income. Although delivery of inputs purchased before January 1, 2008 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 been increased to 90 percent of the tax liability, farmers continue to 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-free 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 a very worthwhile investment.

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