



# Income Tax Management for Farmers in 2008

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**INCOME TAX MANAGEMENT  
FOR FARMERS IN 2008**

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# INCOME TAX MANAGEMENT FOR FARMERS IN 2008\*

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Congress has passed at least 11 laws since early December 2007, including the 2008 Farm Bill, which have specific tax provisions. Many of the tax provisions in these laws have little or no impact on farmers or agriculture. Others, such as the Economic Stimulus Act of 2008, with the 50-percent additional first-year depreciation and expanded Section 179 expensing, affect farms as well as other businesses. The tax provisions in the Farm Bill are generally specific to farmers and landowners.

The 2008 incomes of many farmers are at record levels. However, increases in rent and input prices have cut into margins and, with recent declines in commodity prices, can affect taxable income levels. Because of potentially high taxable income, year-end tax planning is critical in 2008. Determining year-to-date receipts and expenses, including depreciation, is essential for effective tax planning. Actions can be taken before the end of the tax year to manage taxable income for 2008. Additional first-year depreciation, Section 179 expensing, and farm income averaging provide opportunities for tax planning after the end of the year. Although variability in yields and commodity and input prices make it difficult to predict future income, good tax planning should consider more than just the current year's income. Good tax planning

should also consider the self-employment tax as well as income tax. The Indiana state and local income tax rates are nearly flat rate taxes, but some of the federal deductions are not allowed for state and local tax purposes.

The first section of this publication briefly discusses a number of recent changes in tax laws that affect most individuals. The second section discusses recent changes affecting small business. The changes in depreciation and Section 179 expensing are emphasized as part of a broader review of this area. Third is a discussion of procedures for the deferral of income from sales of commodities in 2008. Procedures to ensure the deductibility of prepaid expenses are also reviewed. Farm income averaging is discussed in the fourth section. The fifth section reviews reporting of crop insurance and disaster payments. Common farm casualty losses are reviewed in section six. Recent developments with respect to self-employment taxes, including the Conservation Reserve Program (CRP) payments are discussed in the seventh section. The eighth section summarizes other recent tax developments affecting farmers and landowners. The publication closes with a brief discussion of tax management.

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\* This publication is intended for general educational purposes only. For information on specific tax situations, consult a competent tax advisor. For helpful comments on earlier versions of this publication, appreciation is expressed to Purdue colleagues Freddie Barnard, Craig Dobbins, Howard Doster, Gerry Harrison, Laura Hoelscher, Jess Lowenberg-DeBoer, Alan Miller, Bob Taylor, and Luc Valentin; and to 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 LAW CHANGES AFFECTING INDIVIDUALS

A married couple, filing jointly, in 2008 has a standard deduction of \$10,900 and two personal exemptions of \$3,500, allowing them an adjusted gross income (AGI) of \$17,900 before they incur any federal income tax liability. The next \$16,050 of AGI would be taxed at a marginal rate of 10 percent, and the next \$49,050 (up to an AGI of \$83,000, or a taxable income of \$65,100) 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 \$43,583 before they would owe any federal income tax in 2008, 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 2008 income for tax purposes.

### Reduced Capital Gain/Dividend Rates

For the 2008 to 2010 period, individuals in the 15-percent or lower ordinary income tax bracket have a zero percent tax rate on qualifying long-term capital gains. For individuals in the 25-percent or higher tax bracket, the tax rate on qualifying long-term capital gains is 15 percent.

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 dispositions 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.

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. A couple with gross income of \$86,000, including \$10,000 of long-term capital gains, would have \$7,000 of capital gains taxed at the zero percent rate and \$3,000 at the 15-percent capital gains rate.

Dividends received from qualified domestic and foreign corporations after May 5, 2003 and for tax years beginning before January 1, 2010 are taxed at the same rate as long-term capital gains. If the zero percent tax bracket applies to long-term capital gains of taxpayers in 2008, it also applies to their qualified dividends.

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.

### **Child Tax Credit**

The child tax credit continues at \$1,000 for 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.

### **Kiddie Tax**

The “kiddie tax” was extended from age 14 to age 18 by the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005. If the child has not reached the minimum age by the end of the tax year, has unearned income of more than \$1,800 for 2008 (adjusted annually), and is required to file a tax return, the net unearned income over \$1,800 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 \$5,450 for 2008, (2) there is only unearned income and it exceeds the minimum standard deduction for dependents of \$900 in 2008, or (3) there is both earned and unearned income that exceeds the \$900

minimum standard deduction with \$300 or more of unearned income, or total income exceeds \$5,450 for 2008.

This change makes gifting of raised commodities to children somewhat less attractive in terms of the tax savings. For example, in 2008 a farmer gifts 2007 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 \$900 and would have paid \$610 income tax (\$6,100 income at the 10% rate). After TIPRA, the child would have a \$900 exemption, pay 10% tax on \$900 and pay at the parents’ rate (say 25%) on \$5,200 income for total income tax of \$1,390. 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 and donations of commodities on pages 19-21.

The Small Business and Work Opportunity Act of 2007 (SBWOTA) further extended the kiddie tax for tax years beginning after May 25, 2007 to include: (1) children under age 18 (those previously subject to the tax), (2) children who are age 18 at the end of the year if their earned income does not exceed one-half of their support, and (3) children who are full-time students ages 19 through 23 if their earned income does not exceed one-half of their support. The support test is based on the dependency exemption regulations and includes food, shelter, clothing, medical care, education, and capital items provided to the child. Support provided by scholarships is not taken into account. Darling Daughter turned 18 in 2008, and expenditures for her support totaled \$14,000. Darling will be subject to

the kiddie tax on her unearned income unless her earned income exceeds \$7,000.

Jon, who is 22 and a full-time student, received several scholarships and worked on the family farm during the summer and school vacations. Jon's support, not counting the tuition paid by scholarships, was \$12,000. If Jon's earned income is \$6,000 or less, he would be subject to the kiddie tax on his unearned income.

Reasonable compensation paid for work actually performed for the parent's business may provide opportunities for Jon to avoid the kiddie tax.

### **Charitable Contributions**

The Pension Protection Act of 2006 (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 charitable 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. The 2008 Farm Bill extended the 100-percent limit of donor's AGI for farmers and ranchers through 2009.

### **Alternative Minimum Tax**

Congress enacted the alternative minimum tax (AMT) a number of years ago to ensure that individuals taking advantage of tax preferences, deductions, and tax credits would pay some income tax. The AMT exemption amount, unlike many tax law provisions such as the personal exemptions and standard deductions, is not indexed for inflation. As a result, an increasing proportion of taxpayers are potentially subject to the AMT. Congress has opted to increase the AMT deduction amounts annually rather than index them. Often this is done late in the year, making preparations for the tax season difficult. For 2008, the AMT extensions were passed in early October.

For 2008, the AMT exemption amount is \$69,950 for married individuals filing a joint return and \$46,200 for unmarried individuals. Nonrefundable personal tax credits may offset both regular and AMT tax liability. Nonrefundable personal tax credits include the dependent-care credit, child tax credit, Hope scholarship credits and lifetime learning credits among others.

## RECENT TAX LAW CHANGES AFFECTING BUSINESSES

The I.R.C. Section 179 expensing has been increased almost annually by Congress. Most recently, the Economic Stimulus Act (ESA) of 2008 increased the Section 179 expensing limit to \$250,000 for tax years beginning in 2008. The ESA also included 50-percent additional first-year depreciation of new property placed in service during calendar year 2008.

Other topics in this section deal with recovering depreciation not properly claimed, the limits on the amount of farming losses that maybe used to offset nonfarm income, and shifting from the accrual to cash method of accounting.

### Depreciation and Section 179 Expensing

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

Farmers and others in an active trade or business can elect to treat the cost of up to \$250,000 of qualifying property purchased during 2008 as an expense (rather than as a depreciable capital expenditure). Congress has aggressively increased and extended the Section 179 deduction in recent years. Under current legislation, the Section 179 limit is scheduled to drop back to \$133,000 for 2009 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 after the close of the tax year.

To qualify for Section 179 expensing, all of the following requirements be met:

1. The property must be tangible personal property used in a trade or business. Farm machinery and equipment; livestock used for draft, breeding, or dairy purposes; grain storage; single purpose livestock or horticultural structures; and field tile all qualify for Section 179 expensing. General-purpose farm buildings, such as machinery sheds or hay barns, are not eligible for Section 179 expensing. Real estate is not eligible for Section 179 expensing.
2. The property must be purchased, but new or used property can be expensed under Section 179. Inherited property or property acquired from a related party (spouse, ancestors, or lineal descendants) is not eligible for Section 179 expensing.
3. For property acquired in like-kind exchanges (swaps or trades), only the boot portion paid is eligible for expensing.

#### Example 1: Trades and Section 179

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

4. The Section 179 expensing election is phased out on a dollar-for-dollar basis if over \$800,000 of qualified property is placed in service during 2008.

#### Example 2: Investment Limit

Luc Farmer buys \$825,000 of machinery in 2008. Luc's maximum Section 179 expensing allowed would be reduced by \$25,000 (\$825,000 - \$800,000), making Luc's election limit \$225,000 (\$250,000 –

\$25,000). An individual is not allowed to elect the full \$250,000 and carry over the \$25,000 excess.

Only the boot portion on like-kind trades is considered in determining the \$800,000 limit. Thus, if the \$825,000 purchase in Example 2 was a like-kind exchange and the boot portion was \$775,000, then the full \$250,000 Section 179 expensing could be elected.

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

6. The entire Section 179 expensing election can be taken on one large item, reducing the basis for cost recovery. Alternatively, several small items can be completely written off in the year of purchase. Less than the full \$250,000 expensing election can also be claimed. The amounts expensed are treated the same as depreciation when the property is sold or traded and for depreciation recapture purposes.

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

that are likely to be kept in the business for their entire depreciable life.

The American Jobs Creation Act provides greater flexibility with respect to late Section 179 elections and changes in Section 179 elections. Initially, Section 179 elections could be made only on the original return for the year and could not be changed on an amended return. Thus, if a return was audited and a change proposed, the taxpayer could not make or change the Section 179 election. 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 2008. If a Section 179 election is revoked, that revocation is irrevocable for that property.

#### Example 3: Revocation of Section 179

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, but regulations are likely to be modified by IRS.

#### **Additional First-Year Depreciation**

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

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

1. The original use of the property must start with the taxpayer (property must be new).
2. The property must be MACRS property with a recovery period of not more than 20 years.
3. The taxpayer must purchase the property or enter into a binding contract to purchase the property in 2008. If there was a binding contract to acquire the property before 2008, the property does not qualify.
4. The property generally must be placed in service in calendar year 2008. The deadline is extended for some property with a recovery period of 10 years or more, but only the portion of the basis attributable to expenditures in calendar year 2008 qualifies.
5. The taxpayer is not required to use the Alternative Depreciation System (ADS) for the property. A producer with orchards, vineyards, or groves who elected not to capitalize pre-production expenses is generally required to use ADS.

**Example 4: Total Depreciation**

In July 2008, Able Farmer trades his old tractor with an adjusted basis of \$35,000 for a new tractor, pays \$40,000 boot, and uses the tractor during harvest. The tractor is new, 7-year MACRS property, purchased and placed in service in 2008. Because the tractor is qualifying property, the additional first-year depreciation deduction is 50 percent of the \$75,000 initial basis of the tractor, or \$37,500. Able can also take regular MACRS of 10.71 percent of the remaining \$37,500 basis in the new tractor, or an additional \$4,016. Total depreciation on the new tractor in 2008 would be \$41,516.

An election not to take the 50-percent additional first-year depreciation can be made by a taxpayer by MACRS classes. A

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

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

**Planning 2008 Cost Recovery**

For assets acquired before 2008, the method of cost recovery and Section 179 expensing, if any, would generally have been determined in the year when the assets were placed in service. Cost recovery in 2008 on these assets would be determined by multiplying the appropriate cost recovery percentage from Table 1 in the Appendix by the depreciable basis of the asset. Thus, there are essentially no tax management options with existing assets.

Because the provisions of the Section 179 and additional first-year depreciation are different, taxpayers can manage their 2008 deductions by choosing which provisions to use with specific assets. For example, as discussed previously, the 50-percent additional first-year depreciation applies only to new assets whose original use starts with the taxpayer. Because of the “all or nothing” aspect of the additional first-year depreciation, a taxpayer may use Section 179 expensing and make the election not to take the additional depreciation.

**Example 5: “All or Nothing”**

Harry Farmer purchased a new tractor for \$80,000 and traded a planter with an adjusted basis of \$10,000 and \$20,000 boot for a new planter in 2008. Both the new tractor and new planter would be eligible for

additional first-year depreciation of \$40,000 and \$15,000, respectively. The \$80,000 tractor and \$20,000 boot on the planter would also be eligible for Section 179 expensing. Depending on his income, Harry might elect to forgo the additional first-year depreciation on the tractor. Because the tractor and planter are both 7-year MACRS property, Harry would also have to forgo the additional first-year depreciation on the planter. However, Harry could take up to \$100,000 in Section 179 expensing on the tractor and planter to manage his taxable income for 2008.

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

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

#### Example 6: Depreciation Eligibility

Sally Farmer has a machinery shed and shop built for \$80,000 in 2008. The machinery shed is not eligible for Section 179 expensing, but, as 20-year MACRS property, is eligible for \$40,000 of additional first-year depreciation and \$1,500 (\$40,000 X 3.75%) of MACRS depreciation, for a total of \$41,500 in cost recovery.

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

Farmers do have a number of options with respect to cost recovery through MACRS, additional first-year depreciation, and Section 179 expensing in 2008. There are trade-offs among options between the value of tax-savings of deductions for income and self-employment tax purposes in one year versus those deductions being spread over several future years.

For 2009, agricultural machinery and equipment have been shifted from the 7-year MACRS class to the 5-year MACRS class. This results 4.29 percent additional cost recovery in the year of purchase. The additional depreciation for 2009 is small relative to the 50-percent additional first-year depreciation. Furthermore, the maximum Section 179 deduction is currently \$133,000 for 2009.

#### **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 or had not taken any 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 7-year MACRS property instead of the correct 5-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.

### **Limitations on Farm Losses**

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

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

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

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

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

### **Shifting to Cash Accounting**

Most farmers use the cash method of accounting. Under the cash method, income and expenses are determined without considering inventories. The cash method, as is discussed in the next section, allows a farmer to plan and adjust income through deferral of sales or income from sales or acceleration of deductible expenditures.

Rev. Proc. 2008-52 (IRB No. 2008-36) allows the automatic approval of a change to cash accounting by farmers currently on the accrual method, assuming that they are otherwise eligible for cash accounting. There is no user fee paid to IRS, and approval is automatic. Procedures for making the change are described in Paragraph 14.13 of the Appendix of Rev. Proc. 2008-52.

## **DEFERRING INCOME AND PREPAYING EXPENSES**

Cash-basis farmers may want to deliver and sell commodities this year and to defer the

income into the next tax year. Farmers also prepay expenses for the inputs that will not

be used until the next tax year and want to deduct the cost in the current tax year. Both techniques can be used to manage taxable income, but require that transactions be properly structured to have the desired tax effects.

### **Deferred Income from Sale of Commodities**

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

Installment sales of livestock may be somewhat more complicated than the sale of crops. The Packers and Stockyard Act generally requires buyers of livestock for slaughter to pay for the livestock before the close of the next business day after the purchase. This time limit was instituted to protect producers but can be waived by written agreement of the buyer and seller before the sale transaction occurs.

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

do not own the crop they are producing and they would also be ineligible for the installment sale reporting.

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

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

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

### **Prepaying Expenses**

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

third set of rules, also from I.R.C. §464, deals with farming syndicates and entities with limited partners or limited entrepreneurs.

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

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

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

#### Deposit vs. Payment

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

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

#### Business Purpose

The prepayment has a business purpose only if the producer has a reasonable expectation

of receiving some business benefit from the prepayment. Fixing a maximum price, assuring a supply, and securing preferential treatment in anticipation of a shortage are some examples of business benefits that could be obtained from the prepayment.

#### No Material Distortion of Income

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

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

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

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

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

### Example 7: Prepaid Purchase of Chemicals

On December 20, 2008, Herb A. Cyde, a cash method farmer, purchased enough Round-Up™ to treat his expected 2009 acreage of corn and soybeans for delivery in the spring of 2009. Because of the early purchase, Herb received a 5-percent discount and paid \$14,000 for the Round-Up™. Herb can deduct the \$14,000 expenditure on his 2008 income tax return because it is an actual purchase and the business purpose for the early purchase is the 5-percent discount. The Round-Up™ will all be applied by late June of 2009, so the benefits do not extend more than 12 months after Herb acquired the right.

### Example 8: 12-Month Rule

I.M. Liable, a cash method farmer, purchased farm liability insurance for the July 1, 2008 to June 30, 2009 period and paid the \$1,200 annual premium. The benefits of the insurance do not extend beyond 12 months after I.M. first realizes the benefits of the insurance policy. I.M. can deduct the entire annual premium of \$1,200 in 2008.

If I.M.'s liability policy covered the July 1, 2008 to June 30, 2010 period, the benefits extend beyond 12 months after I.M. first realized the benefits of the policy.

Therefore, only the premium allocable to 2008 can be deducted in 2008. If the total premium was \$2,400, only \$600 ( $\$2,400 \div 24 \text{ months} \times 6 \text{ months}$ ) is deductible in 2008.

### 50-Percent Rule

The 50-percent rule limits a taxpayer's deduction for prepaid expenses to 50 percent of total deductible expenses, other than the prepaid expenses, unless the taxpayer is a "qualified farm related taxpayer" [I.R.C.

§ 464(f)]. A "qualified farm related taxpayer" is any taxpayer:

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

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

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

### Example 9: Prepaid Purchase of Fertilizer

Patty Producer uses the cash method of accounting. In December 2008, she paid \$20,000 to Farm Supply, Inc. for specific quantities and analyses of fertilizers to be applied in the spring of 2009 on her corn crop. Pattie's deductible expenses on Schedule F (Form 1040) for 2008, other than the prepaid fertilizer, were \$100,000. Patty purchased the fertilizer in 2008 for two reasons. First, she was offered a discount for purchasing in December. Second, she was concerned about the availability of fertilizer in the spring.

Patty is allowed to deduct the \$20,000 she paid for fertilizer on her 2008 Schedule F (Form 1040). She meets the three

requirements of the general rule. I.R.C. § 464(f) does not limit her deduction for two reasons. First, Patty is a qualified farm-related taxpayer, so the 50-percent limitation does not apply to her. Second, Patty has not exceeded the 50-percent limit.

If Patty Producer had purchased fertilizer and lime in December 2008 and the fertilizer and lime was applied before January 1, 2009, the fertilizer and lime would be deductible expenses in 2008 and would not be prepaid expenses for 2009.

### Farming Syndicate Rules

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

1. If at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any federal or state agency having authority to regulate the offering of securities for sale, or

2. If more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs who do not actively participate in management [I.R.C. § 464(c)(1)]. I.R.C. § 464(c)(4) provides a number of exceptions for taxpayers who are actively engaged in a farming activity, reside at the farming activity, or are a family member of an individual meeting one of the exceptions.

### Example 10: Active Participation Exceptions Do Not Apply to Cousins

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

## FARM INCOME AVERAGING

Farm income averaging is a tax management tool of relatively recent origin which can be used after the end of the tax year. In simple terms, farm income averaging allows a producer to elect to average a selected amount of farm income from the current year (referred to as the “election year”). The selected amount is divided by three and is taxed at the tax rates of the three prior years (referred to as “base years”). Currently, farm income averaging does not create or increase

the AMT for the taxpayer. There is also flexibility in making or modifying farm income averaging decisions on an amended return.

### **Farm Income**

“Farm income” is based on taxable farm income. It includes all income, gains, losses, and deductions attributable to any farming business. Gain from the sale or other disposition of land is not included, nor is the

sale of timber. The instructions for Schedule J indicate that farm-related items are generally reported on Form 1040 Schedule D, Form 1040 Schedule F, Form 4797, Part II of Form 1040 Schedule E (Income or Loss from Partnerships and S Corporations), and Form 4835. Thus, farm income from flow-through entities such as S corporations and partnerships does qualify. Wages and other compensation received as a shareholder in an S corporation engaged in farming are also farm income. Farm income averaging is not available to regular corporations, trusts, or estates. Cash rent landowners are also excluded from farm income averaging.

### **Averaging Procedures**

The basic concept of farm income averaging is relatively simple and uses Form 1040 Schedule J. A farmer may elect to average part or all of the farm income in the election year, e.g., 2008, and have that elected farm income treated as if it have been earned equally over the preceding three base years, 2005 to 2007, and taxed at the respective income rates for those years. Income is not carried back to prior years with income averaging. There is no change in the income reported for the base years. Rather, the unused portions of the tax brackets of the base years are used.

Note that the elected income is allocated equally over the three prior or base years. If one of the three preceding years has a very low income or loss, there is no possibility of allocating more of the elected farm income to that year. Furthermore, for future income tax averaging, say in 2009, the portions of the base years' tax brackets used with the previous income averaging in 2008 are not available for 2009. Although income averaging may reduce the income tax liability of a producer, income averaging has no effect on self-employment tax liability for the year of the election or any base year.

### Example 11: Farm Income Averaging

David is an unmarried crop producer with 2008 Schedule F income of \$150,000 and taxable income of \$136,620. David's regular tax liability, without income averaging, would be \$32,232, and his marginal tax rate would be 28 percent. If David had \$12,000 of the unused 15-percent tax bracket for each one of the base years to compute his 2008 income tax, he could elect to income average \$36,000, and this would be taxed at the 15 percent. With income averaging, David's total 2008 regular income tax liability would be \$27,552, a savings of \$4,680 ( $\$36,000 \times (0.28 - 0.15)$ ). David's 2009 marginal tax rate is still 28 percent after averaging \$36,000.

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

### Example 12: Optimal Income Averaging

David, from Example 11, had completely used the 15-percent tax brackets for the base years. Additional income in the base years from income averaging would be taxed at the 25-percent rate. David's marginal tax rate in the election year would also be 25 percent if David's taxable income was not over \$78,850. If David elected to income average \$57,770 ( $\$136,620 - \$78,850$ ), the marginal tax rates would be equal and David would save an additional \$653, ( $\$57,770 - \$36,000 = \$21,770 \times 0.03$ ), making his total savings from income averaging \$5,333 ( $\$4,680 + \$653$ ).

Farmers can elect, subject to some restrictions, the amount and type of income that they wish to average. Commonly, farmers will have ordinary income from Form 1040 Schedule F and depreciation recapture. They may also have Section 1231

gains reported on Form 4797 that are treated as long-term capital gains. A farmer can elect to average ordinary income and allocate 2008 farm capital gain income (unless offset by non-farm capital losses) to the 2008 year. For example, assume a producer has \$100,000 of Form 1040 Schedule F net income, \$30,000 of farm Section 1231 gains, and no non-farm income or losses. The farmer could elect to average up to \$100,000 of farm income and allocate all of the Section 1231 gain to 2008. All of the elected income would be ordinary income and allocated equally to the three prior years. However, if the farmer elected to average \$120,000 of farm income, at least \$20,000 would be Section 1231 gains. In this situation, one-third of the elected Section 1231 gain would be taxed according to the “rules” for each base year.

### **Some Management Considerations**

Income averaging will have the greatest attraction for farmers whose income in one year is much higher than in the preceding three years and who have made only limited capital expenditures eligible for Section 179 expensing or 50-percent additional first-year depreciation. Beginning farmers with limited income in prior years could be in this situation. Individuals do not have to have been in farming in the base years to qualify for farm income averaging. Farm families

whose off-farm income has increased sharply (perhaps because of a new off-farm job) would be eligible to average their farm income and perhaps reduce their current tax liability. However, only the farm income is eligible for income averaging. Retiring farmers and others disposing of assets may also be able to take advantage of income averaging.

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

## **CROP INSURANCE AND DISASTER PAYMENTS**

Cash-basis farmers must generally report payments as income for the year the payment is received. If a producer receives crop insurance or disaster payments in the year of production, this can cause a bunching of income for farmers who normally store their crop and sell it in the year following the year of production. I.R.C. Section 451(d) allows a farmer who normally sells the crop in the year following

the year of production to elect to postpone reporting the payments received until the year following the year of production. Such an election covers payments for all crops from a farm, requires the same treatment of both crop insurance and disaster payments, and is limited to physical losses of production. If a farmer has more than one farming business and he or she keeps separate books, separate elections can be

made for each business. The election to postpone the recognition of income from the crop loss payments must be attached to the return (or amended return) for the year in which the payments were received. The election statement must include:

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

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

Notice 89-55 and Treas. Reg. Section 1.451-6(a)(1) states that if a producer whose established normal business practice would be to report the income in the year following the year of production receives insurance proceeds as the result of damage or destruction of two or more specific crops,

such proceeds may be included in the gross income of the following year. However, this can be interpreted as saying that payments for crops that are normally sold in the year of harvest cannot be postponed even if the election is made. It appears that producers can find authority to support at least two different positions.

A second issue is that only payments for the physical loss of a crop can be deferred into the year following the year of harvest. Some crop revenue products, such as Crop Revenue Coverage (CRC) and Revenue Assurance (RA), make payments if the price of the grain declines between planting and harvest. For example, the average price of the December corn futures contract during February 2008 was \$5.40 (\$13.36 for November soybeans). For crop revenue purposes, this is referred to as the “base price.” Harvest time (October for CRC) prices of the November soybeans and December corn futures \$10.36 and \$4.13 respectively. Because harvest prices are less than the base price, part of any indemnity is due to the price decline. One procedure to determine the amount of the insurance payment due to the decline in yields and prices is illustrated on pages 17-18 of Patrick, “Income Tax Management for Farmers in 2007,” available at: [http://www.agecon.purdue.edu/extension/pubs/taxplanning\\_2007.asp](http://www.agecon.purdue.edu/extension/pubs/taxplanning_2007.asp).

Crop insurance proceeds paid in the year following the year of harvest must be reported as income when received. This is the tax treatment even if the producer’s normal business practice is to sell the crops in the year of harvest. There is no provision that would allow an acceleration of reporting. This would apply to delayed payments under crop and revenue insurance, such as CRC and RA as well as the new Supplemental Revenue Assistance Payments (SURE) disaster program under the 2008

Farm Bill. Insurance payments made on the county-based Group Risk Plan (GRP) and

Group Risk Income Plan (GRIP) must be recognized when received.

## CASUALTY LOSSES

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

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

When business property is partially destroyed as the result of a casualty, an estimate of the loss as a result of the casualty must be made. An estimate of loss is given by the fair market value (FMV) before the casualty minus the FMV of the property after the casualty. The measure of loss is the lesser of the decline in value of property or the adjusted basis of the partially

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

### Example 13: Flood-Damaged Land

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

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

### Example 14: Insurance/Government Payments

If April, from Example 13, receives a \$5,000 payment from the insurance company or government assistance, her casualty loss deduction of \$10,000 would be

reduced by the amount of the insurance or government payment.

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

## **SELF-EMPLOYMENT TAX UPDATE**

Many farmers continue to be concerned about the self-employment (SE) tax. For 2008, earnings of up to \$102,000 are subject to the 12.4-percent tax for social security, and all earnings are subject to the 2.9-percent Medicare tax. For 2009, the maximum social security portion will increase to \$106,800.

### **Change in Optional SE Tax Method**

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

As part of the 2008 Farm Bill, Congress updated the dollar limits for the optional farm and non-farm methods. The current law refers to "the lower limit" as the amount required to earn four quarters of coverage (\$4,200 in 2008) under the Social Security Act. The "upper limit" is 150 percent of the lower limit. Thus, if gross farm income is not more than \$6,300 in 2008, a farmer can elect to pay SE tax on two-thirds of his or her gross farm income to earn a quarter of coverage for each \$1,050 of income. If

gross farm income is greater than \$6,300 and net farm profit is less than dividing the lower limit of \$4,200 by 0.9235 or \$4,548 for 2008, the farmer can pay SE tax on \$4,200 to earn four quarters of coverage.

### **Land Rental to an Entity**

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 farm audits.

## **Conservation Reserve Payments**

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

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

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

farm operation, and they do not materially participate in farming.

## **Soil and Water Conservation Payments**

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

## **Gifts and Donations of Commodities**

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

### Example 15: Gift of This Year’s Commodities

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

Example 16: Gift of a Prior Year's Commodity

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

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

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

Charitable donations of current or prior year commodities may reduce taxes for cash basis farmers, especially those who cannot itemize deductions. The deduction from the donation of a commodity which would

produce ordinary income if sold is limited to the taxpayer's basis in the commodity [I.R.C. Section 170(e)(1)(A)]. Cash basis farmers deduct production costs on Schedule F (Form 1040) as a business expense, resulting in an income tax basis of zero. Because their charitable contribution deduction is limited to their basis, their charitable contribution deduction is zero [Treas. Reg. Section 1.170A-1(c)(4), Examples (5) and (6)].

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

Example 17: Tax Savings from Charitable Contributions

In December 2008, a cash basis farmer delivers 2008 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

$$15.3\% \times \$3,000 \times 0.9235 = \$423.89$$

Federal income tax

$$15\% \times (\$3,000 - [\$423.89 \times 50\%]) = \$418.21$$

State and local tax

$$4.4\% \times (\$3,000 - [\$423.89 \times 50\%]) = \$121.67$$

#### After-tax contribution

$$\begin{aligned} & \$3,000 - [423.89 + 418.21 + 121.67] \\ & = \$2,035.23 \end{aligned}$$

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

Recent legislation extends the enhanced deduction from the charitable donation of food inventory. The deduction is equal to the lesser of basis plus half of the item's appreciation or two times basis. The

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

### **TAX MANAGEMENT**

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

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

Keeping taxable income relatively stable year-to-year has been a key to effective

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

As a minimum, individuals should tally their receipts and expenditures before the end of the tax year. This allows year-end tax planning. Depending on the income situation, additional sales may be made before the end of December 2008 or delayed into 2009. A part of the 2009 direct payments from the government for corn,

soybeans, and wheat can be collected in 2008 or after December 31, 2008.

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

December purchases of feed, fertilizers, and chemicals to be used in 2009 can, up to a limit, also affect the taxable income. Although delivery of inputs purchased before January 1, 2009 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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## Appendix: MACRS Class Lives and Depreciation Rates

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

**Three-year MACRS property** includes breeding hogs and the tractor units of semi-trailers for over-the-road use.

**Five-year MACRS property** includes cattle held for breeding or dairy purposes, computers, and some construction equipment. Congress specifically included automobiles, pickups, and other trucks in the five-year class. Special depreciation limitations and recordkeeping requirements apply to passenger vehicles. For passenger vehicles acquired in 2008, the maximum combined depreciation and Section 179 expensing deduction is \$2,960. This increases to \$4,800 in the second year, \$2,850 in the third year, and \$1,775 thereafter. If business use is less than 100 percent, the maximum deductions are reduced accordingly. The 50-percent additional first-year depreciation does apply to vehicles with more than 50-percent business use, and up to a maximum of \$10,960 of depreciation can be claimed for a vehicle with 100-percent business use. Pick-ups and SUVs with a gross vehicle weight exceeding 6,000 pounds are not subject to the depreciation and Section 179 limits discussed above. Pick-ups and SUVs with a gross vehicle weight of less than 6,000 are classified as passenger vehicles and are subject to the special deduction limitations and recordkeeping requirements. The depreciation deductions are \$3,160 for the year placed in service, \$5,100 in the second year, \$3,050 in third year and \$1,875 in later years.

**Seven-year MACRS property** includes most agricultural machinery and equipment. Grain bins, fences, and general office equipment are also included in this seven-year class.

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

Deductions by year, as a percentage of the initial depreciable basis, for assets acquired after 1988 are shown in Table 1. These MACRS percentages reflect the “half-year convention” for the year of purchase. The equivalent of six months’ depreciation is allowed whether an asset is placed in service on January 1 or December 31. If a \$100,000 asset were purchased in 2003, the first year’s depreciation allowed would generally be \$25,000 for three-year MACRS property, \$15,000 for five-year property, \$10,710 for seven-year property, or \$7,500 for 10-year property. The “half-year” convention is also used for the year of disposition. For example, if a tractor acquired in 2003 is sold in 2008, the fifth recovery year, allowable depreciation for 2008 would be one-half of the 12.25 percent in the table. If an asset is traded in a like-kind exchange, one can elect to depreciate the basis in old asset and the boot portion over the class life of the new asset.

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

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

Table 1. MACRS Depreciation Deduction Percentages for Property Used in Farming by

Class-Life of MACRS Property Acquired after 1988

<u>Recovery Year</u>	<u>Class-Life of MACRS Property</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, 1993 and *How to Depreciate Property*, Pub. 946, 1995

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