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# Yearend Farm Tax Planning Considerations

Gary J. Hoff, E.A.*

*Synopsis: As the end of 2007 nears, farmers may be able to save thousands of dollars of federal income tax or self employment tax with adequate planning. This article describes some of the possible areas for saving, e.g., farm income averaging, taking advantage of the ceiling on the "retirement portion" of the Self Employment Tax, using the Section 179 expense election for small businesses and the Section §199 domestic production activity deduction, and contributing to a retirement plan.*

## Farm Income Averaging

Individuals who are involved in a farm business may elect to calculate their current tax liability as if the current farm income was averaged over the three prior years. The election is made by filing Schedule J, *Income Averaging for Farmers and Fishermen* with their 2007 tax return. Due to outstanding yields and high crop prices, you should make sure your tax preparer checks to see if income averaging will apply.

Tax law defines a farm business as a trade or business involving the cultivation of land or raising or harvesting of any agricultural or horticultural commodity. It also includes the raising, shearing, feeding, caring for, training, and managing of animals. Crop share landlords are included if a written lease is executed before the tenant begins significant activities on the land. Income earned by individuals working as a farm employee or providing contract harvesting of a commodity does not qualify for the election. Farm income passing through from a partnership or S corporation also qualifies for averaging.

Federal income tax is calculated using graduated tax rates, called tax brackets. For example, in 2007 married taxpayers filing a joint return pay tax at a rate of 10% on their first $15,650 of taxable income. Additional taxable income in excess of $15,650 but less than $63,700 is taxed at 15%. Additional income up to $128,500 is taxed at 25%. There are also rates of 28%, 33%, and for taxable income in excess of $349,700 the rate is 35%. The tax brackets are adjusted for inflation each year. Therefore, they were somewhat lower in prior years.

Taxpayers determine the amount of farm income they wish to average. This income is then carried equally back to the three prior years.

> **Example 1.** Assume Ted and Rhoda Tiller have taxable income of $250,000 in 2007 and qualify as farmers. Therefore, they have $54,150 of income taxed at a 33% rate. In 2004, 2005, and 2006, their marginal tax rate never exceeded 25%. This means they never had any income taxed in the 28% bracket. By electing income averaging, they are able to utilize any unused 25% bracket and the 28% bracket. This will result in at least a 5% savings on the farm income they elect to average.

Even if the taxpayer has not taken advantage of income averaging in past years, he may want to file amended returns and elect to average the prior year's income. While this may not save tax in the amended year, it can free up tax brackets to allow greater tax savings from 2007 averaging.

**Example 2.** Assume Ted and Rhoda did not use the entire 25% bracket in 2001, 2002 and 2003. Averaging part of the 2004 income to fill these brackets will further reduce the amount of 2004 income in the 25% bracket. This may allow a greater carryback of 2007 income to the 25% bracket.

If you determine it is advantageous to amend the 2004 return, the amended return must be filed by April 15, 2008 or two years from the date the tax was paid.

Unfortunately, income averaging will not reduce the self-employment tax.

**Taking advantage of the ceiling on the "retirement Portion" of SE Tax**

In many years the self-employment (SE) tax liability is greater than the income tax liability for many farmers. Thus, the strategy of reducing or delaying SE tax liability by deferring income from one year to the next is often recommended. However, 2007 may not be the year to use such a strategy.

The much higher farm incomes in 2007 may cause a farmer's Net Earnings from Self Employment to exceed the maximum amount subject to the 12.4% "retirement portion" of the SE tax. This amount is capped at $97,500 in 2007 and $102,000 in 2008. Net Earnings from Self Employment that exceed these limits are only taxed at the 2.9% "Medicare rate" of the SE tax. It may not be wise to defer income otherwise taxed in 2007 into 2008, as seen in the following example.

**Example 3.** Assume Ted and Rhoda expect unusually high farm income in 2007 and expect their 2007 Self Employment Net Earnings to be $100,000 more than the $97,500 ceiling on earnings subject to the "retirement portion" of the SE tax. This $100,000 will escape the 12.4% "retirement portion" of the SE tax in 2007 (it only will be subject to the 2.9% Medicare portion of the tax).

However, what if Ted and Rhoda, expecting high income in 2007, decide to defer some of this income to 2008, e.g., by delaying additional sales of the 2007 crop until 2008 and prepaying additional expenses for the 2008 crop year in 2007? If they succeed in deferring $100,000 of Self Employment Net Earnings from 2007 until 2008, and if their 2008 Self Employment Net Earnings would have been $60,000 without the deferral, then they will pay substantially more SE tax in 2008 than they would have without the deferral.

With the deferral, they will have moved $100,000 of Self Employment Net Earnings out of 2007 (where it escaped the 12.4% "retirement portion" of the SE tax) and added it to their 2008 Self Employment Net Earnings. But $42,000 of the amount deferred from 2007 will be subject to the 12.4% rate in 2008, and only the remainder will exceed the 2008 ceiling of $102,000 subject to the 12.4% "retirement portion" of the SE tax. Therefore, the deferral has cost them $5,208 ($42,000 × 12.4%) of additional self-employment tax.

**IRC §179 expense deduction**

Farmers who purchase machinery and equipment to use in their trade or business may deduct up to $125,000 of the total 2007 purchases as long as this does not exceed their business income. Business income includes both the net farm income reported on Schedule F plus any wages earned. If total purchases exceed $500,000, the deduction is reduced by $1 for each $1 of purchases over $500,000.

**Example 4.** Lawrence, an active farmer, purchased $520,000 of equipment in 2007. His expense deduction is limited to $105,000. The $20,000 excess over the ceiling amount reduced the deduction $20,000.

**Example 5.** Sarah is also an active farmer. Her only business income is from her farming operation. In 2007, the net profit was $80,000 and her total purchases totaled $100,000. Her §179 deduction is limited to $80,000.

**Example 6.** Assume Sarah in Example 5 is married and her husband received wages of $35,000 from the factory where he is employed. Because the total business income on Sarah's joint return totals $115,000 ($80,000 + $35,000), she is able to deduct the entire $100,000 as a §179 deduction.

In order to qualify for a 2007 deduction, the property must be delivered to the farm and available for service. However, the equipment need not be used in 2007.

**Example 7.** Assume Lawrence in Example 4 paid $400,000 for a new combine which is included in the $520,000 total. However, the combine was not delivered to his farm until March 23, 2008. Therefore, his qualifying purchases total $120,000. If Lawrence has at least $120,000 of business income, he will be entitled to claim a $120,000 §179 deduction. Lawrence can use the combine as part of his 2008 purchases.

Both new and used equipment qualify for the §179 deduction. Agricultural structures, storage facilities, and purchased breeding livestock also qualify. Equipment purchased from a related party does not qualify for the deduction. If the property is acquired as a part of a trade, only the cash difference is eligible for the deduction.

**Example 8.** Hi Yield Farm trades two used cultivators for a new larger cultivator costing $30,000. The equipment dealer allows Hi Yield a $10,000 trade-in allowance. The cash difference paid is $20,000. Only $20,000 qualifies for the §179 deduction.

Any amounts deducted using §179 will reduce the basis of the assets that can be deducted using regular depreciation.

If the property purchased is used partially for personal purposes, only the business portion is eligible for the §179 deduction, but only if the business portion exceeds 50%.

**Example 9.** Larry and Mary Landowner farm over 5,000 acres. In 2007, they purchased a new lawn tractor, costing $12,000, to mow their lawn, roadsides, and the waterways of the farms. The Landowners have records that show 70% of the mower use is for farm purposes.

Therefore, \$8,400 (\$12,000 × 70%) is eligible the §179 deduction.

**Example 10.** Use the same facts as Example 9 except the records only show 50% farm usage. Therefore, none of the purchase price is eligible for the deduction as the farm use did not exceed 50%.

If the business use of property on which the §179 deduction was elected drops to 50% or less in a subsequent year, the deduction must be recaptured in that subsequent year. Any recapture is added to the basis of the property for purposes of regular depreciation.

**IRC §199 Domestic Production Activity Deduction**

The IRC §199 deduction is even more valuable to the farmer in 2007. The deduction is now 6% of the lesser of the qualified production activity income (QPAI) or adjusted gross income for individuals, but limited to 50% of the W-2 wages paid that relate to the activity.

QPAI is the excess of the domestic production gross receipts (DPGR) for the tax year minus the sum of the cost of goods sold and minus other expenses and losses allocable to the DPGR. This income is determined on an item-by-item basis.
DPGR includes gross receipts from any lease, rental, license, sale, exchange, or other disposition of tangible personal property that is produced, grown, or extracted by the taxpayer in whole or in significant part within the United States.

DPGR does not include gross receipts from the following activities.

- The lease, license, or rental of property by you for use by any related person.
- The lease, license, rental, sale, exchange, or other disposition of land.

**Example 11.** All of the receipts on Jim's Schedule F qualify as DPGR. Therefore, all of the Schedule F expenses are used to determine the QPAI. In this example Jim's QPAI is \$140,000 and he has \$20,000 of W-2 wages connected to the Schedule F. Jim's potential §199 deduction is 6% × \$140,000 or \$8,400. Because 50% of the W-2 wages equal \$10,000, the §199 deduction is \$8,400.

**Establish a Retirement Plan**

If you have not previously established a retirement plan, you may want to consider opening and contributing to a plan this year. While some retirement plans can be established prior to filing the tax return, a SIMPLE IRA must be established between January 1 and October 1. Therefore, it is too late to open a SIMPLE plan for 2007. Other plans, such as the SEP may be established by the tax filing deadline, plus extensions.

Your first consideration is whether you want to include your farm employees in the plan. Next, you must decide if you want a plan which receives tax deductible contributions or a plan where the contributions are not deductible but the distributions are tax-free.
Some of the available retirement plans include:

**SIMPLIFIED EMPLOYEE PENSION (SEP).** This is a written plan that allows you to make deductible contributions toward your own retirement (if you are self-employed) and your employee's retirement without getting involved in a more complex qualified plan.

Under a SEP, you make the contributions to a traditional retirement arrangement (SEP-IRA) set up by or for each eligible employee. The plan is owned and controlled by the employee with the employer making contributions to the financial institution where the SEP-IRA is maintained. An account **must** be set up for each eligible employee. An eligible employee is one who meets all of the following requirements:

- Has reached age 21;
- Has worked for you in at least three of the last five years; and
- Has received at least $500 in compensation from you in 2007.

While it is possible to use less restrictive requirements, you may not use more restrictive ones. You can set up a SEP for the year as late as the due date (including extensions) of your income tax return for the year.
The maximum contribution for the employee cannot exceed the lesser of 25% of the employee's compensation or $45,000 for 2007. The maximum contribution for the employers SEP is based on his net earnings from self-employment taking into account both the deduction for one-half of his self-employment tax and the contribution to his own SEP IRA.

**SIMPLE IRA PLANS.** The savings incentive match plan for employees (SIMPLE) is a written plan that provides a simplified way to make contributions to provide retirement income. Under a SIMPLE IRA, the employees can choose to make salary reduction contributions to the plan rather than receiving these amounts as part of their regular pay. In addition the employer will contribute matching or nonelective contributions.

A SIMPLE IRA is set up for each eligible employee. An eligible employee is any one who received at least $5,000 in compensation during any two years proceeding the current calendar year and is reasonably expected to receive at least $5,000 during the current calendar year. The term "employee" includes a self-employed individual who received earned income. The employer may use less restrictive qualifications but not more restrictive qualifications.

The employee can elect to contribute up to 100% of his compensation, not to exceed $10,500, for 2007. However, if the employee participates in any other employer plan during the year and has salary reductions or deferred compensation under those plans, the overall annual contribution limit is $15,500.

As the employer, you are generally required to match each employee's salary reduction contribution on a dollar-for-dollar basis up to 3% of the employee's compensation. Alternatively, you can choose to make nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 (or some lower amount you select) of compensation from you for the year. If you make this choice, you must make nonelective contributions whether or not the employee chooses to make salary reduction contributions.

A SIMPLE plan must be established between January 1 and October 1 of the current year.

**QUALIFIED PLANS.** For the self-employed individual, these may be referred to as Keogh plans. They include both defined contribution plans and defined benefit plans. The difference is how the plan contribution is calculated. These plans also require contributions for eligible employees. However the defined benefit plan has a contribution limit of $180,000 in 2007. These plans must be established by the end of the tax year.

**ROTH IRA. T**his is an individual plan, rather than an employer plan. The taxpayer may contribute up to $4,000 or the amount of his earned income in 2007. If he is age 50 or over, he can contribute an additional $1,000.
Contributions to the Roth IRA are not deductible. However, any earnings are tax-free as are all distributions as long as the first contribution to the plan was at least five years prior to the first distribution. In addition, the taxpayer must be age 59 ½ or older at the time of the distribution. There are exceptions to the distribution rule due to death, disability, or being a first-time home buyer.

If you are over the age of 50, you may be eligible for additional catch-up contributions for all of the plans.

You should seek the advice of your tax preparer or financial planner in determining the best type of retirement plan for your situation.

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**Gary J. Hoff is an extension specialist in the Department of Agricultural and Consumer Economics. AGRICULTURAL LAW AND TAXATION BRIEFS are available at www.farmdoc.uiuc.edu/legal/.*