

### **13. Farm Income Tax Management**

**Mark Dikeman**

**<dikemanm@ksu.edu>**

*Mark Dikeman works as Coordinator of Professional Development and Training for the Kansas Farm Management Association. Before moving to this position, he worked as an Extension Ag Economist in the Holton KFMA office. Mark received a B.S. degree in Animal Sciences and Industry and a M.S. degree in Agricultural Economics from Kansas State University.*

#### ***Abstract/Summary***

*In good years or bad, agricultural producers have a variety of tax management tools at their disposal. However, utilizing many of these strategies requires planning ahead. This presentation will provide an introduction to farm and ranch taxation, discuss tax management "theory", and look at some of the options available to farm and ranch taxpayers.*

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# Farm Income Tax Management

## **Mark Dikeman**

Coordinator of Professional Development & Training  
Kansas Farm Management Association  
dikemanm@ksu.edu  
785-539-0373 – Office  
785-364-0590 – Mobile



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## Presentation Outline

- Introduction to income tax
- Tax theory
- Managing income
- Managing tax
- Tax preparers



# Introduction to Income Tax



## Introduction to Income Tax

### Common types of farm income

1. Capital gain income – Result of selling a *capital asset* for more than original cost (cost before depreciation)
  - Sale of raised cows, land, stocks, etc
    - Raised cows become capital assets at 2 years
  - Short-term (usually held <1 year)
    - Subject to *ordinary rates*
  - Long-term (usually held >1 year)
    - Subject to *capital gain rates*



# Introduction to Income Tax

## Common types of farm income

2. Ordinary income – Any income that is not capital gain
  - Farm or business income, interest, rent, depreciation recapture, SS
  - Subject to *ordinary rates*



# Introduction to Income Tax

## Common types of farm income

3. Earned income
  - Subset of ordinary income
  - W2 wages
  - Schedule F, C, or E Page 2
  - Also subject to *Social Security and Medicare tax*
  - May be subject to *Additional Medicare tax*



# Introduction to Income Tax

## Tax brackets

- Referred to by the ordinary tax rate applicable to that bracket
- Each bracket has both an ordinary and LT capital gain tax rate
- Tax rates are marginal
  - The tax rate for that bracket only applies to income in that bracket and does not change rate on income in lower brackets



# Introduction to Income Tax

## Tax brackets

- Ordinary income is taxed before any LT capital gain is taxed
- Example calculations at the end of the presentation



# Introduction to Income Tax

## Tax brackets – 2015 Married Filing Joint

Taxable Income		Ordinary Income	Capital Gain
0	18,450	10.0%	0.0%
18,450	74,900	15.0%	0.0%
74,900	151,200	25.0%	15.0%
151,200	230,450	28.0%	15.0%
230,450	411,500	33.0%	15.0%
411,500	464,850	35.0%	15.0%
464,850	+	39.6%	20.0%



# Introduction to Income Tax

## Tax brackets – 2015 Single

Taxable Income		Ordinary Income	Capital Gain
0	9,225	10.0%	0.0%
9,225	37,450	15.0%	0.0%
37,450	90,750	25.0%	15.0%
90,750	189,300	28.0%	15.0%
189,300	411,500	33.0%	15.0%
411,500	413,200	35.0%	15.0%
413,200	+	39.6%	20.0%



# Introduction to Income Tax

## Form 1040

	Total income
-	"Above the line" deductions
=	Adjusted gross income
-	Itemized or standard deduction
-	Personal exemptions
=	<b>Taxable income</b>

	Income Tax
-	Nonrefundable credits
+	Other taxes (SE tax)
-	Payments/Refundable credits
=	<b>Amount you owe/Refund</b>

Farm Income Tax Management



<b>Income</b>	7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	
	8a	Taxable interest. Attach Schedule B if required	8a	
	b	Tax-exempt interest. Do not include on line 8a	8b	
	9a	Ordinary dividends. Attach Schedule B if required	9a	
	b	Qualified dividends	9b	
	10	Taxable refunds, credits, or offsets of state and local income taxes	10	
	11	Alimony received	11	
	12	Business income or (loss). Attach Schedule C or C-EZ	12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>	13	
	14	Other gains or (losses). Attach Form 4797	14	
	15a	IRA distributions	15a	
	b	Taxable amount	15b	
	16a	Pensions and annuities	16a	
	b	Taxable amount	16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
	18	Farm income or (loss). Attach Schedule F	18	
	19	Unemployment compensation	19	
	20a	Social security benefits	20a	
	b	Taxable amount	20b	
	21	Other income. List type and amount	21	
<b>Adjusted Gross Income</b>	22	Combine the amounts in the far right column for lines 7 through 21. This is your <b>total income</b>	22	
	23	Reserved	23	
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
	25	Health savings account deduction. Attach Form 8889	25	
	26	Moving expenses. Attach Form 3903	26	
	27	Deductible part of self-employment tax. Attach Schedule SE	27	
	28	Self-employed SEP, SIMPLE, and qualified plans	28	
	29	Self-employed health insurance deduction	29	
	30	Penalty on early withdrawal of savings	30	
	31a	Alimony paid	31a	
b	Recipient's SSN	31b		
32	IRA deduction	32		
33	Student loan interest deduction	33		
34	Reserved	34		
35	Domestic production activities deduction. Attach Form 8903	35		
36	Add lines 23 through 35	36		
37	Subtract line 36 from line 22. This is your <b>adjusted gross income</b>	37		



	38	Amount from line 37 (adjusted gross income)		38
<b>Tax and Credits</b>	39a	Check <input type="checkbox"/> You were born before January 2, 1951, <input type="checkbox"/> Blind. <input type="checkbox"/> Spouse was born before January 2, 1951, <input type="checkbox"/> Blind. Total boxes checked <b>▶</b> 39a		
	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here <b>▶</b> 39b <input type="checkbox"/>		
<b>Standard Deduction for—</b> • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, \$6,300 Married filing jointly or Qualifying widow(er), \$12,600 Head of household, \$9,250	40	<b>Itemized deductions</b> (from Schedule A) or your <b>standard deduction</b> (see left margin)		40
	41	Subtract line 40 from line 38		41
	42	<b>Exemptions.</b> If line 38 is \$154,950 or less, multiply \$4,000 by the number on line 6d. Otherwise, see instructions		42
	43	<b>Taxable income.</b> Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43
	44	<b>Tax</b> (see instructions). Check if any from: <b>a</b> <input type="checkbox"/> Form(s) 8814 <b>b</b> <input type="checkbox"/> Form 4972 <b>c</b> <input type="checkbox"/>		44
	45	<b>Alternative minimum tax</b> (see instructions). Attach Form 6251		45
	46	Excess advance premium tax credit repayment. Attach Form 8962		46
	47	Add lines 44, 45, and 46 <b>▶</b>		47
	48	Foreign tax credit. Attach Form 1116 if required	48	
	49	Credit for child and dependent care expenses. Attach Form 2441	49	
50	Education credits from Form 8863, line 19	50		
51	Retirement savings contributions credit. Attach Form 8880	51		
52	Child tax credit. Attach Schedule 8812, if required	52		
53	Residential energy credit. Attach Form 5695	53		
54	Other credits from Form: <b>a</b> <input type="checkbox"/> 3800 <b>b</b> <input type="checkbox"/> 8801 <b>c</b> <input type="checkbox"/>	54		
55	Add lines 48 through 54. These are your <b>total credits</b>	55		
56	Subtract line 55 from line 47. If line 55 is more than line 47, enter -0- <b>▶</b>	56		
<b>Other Taxes</b>	57	Self-employment tax. Attach Schedule SE	57	
	58	Unreported social security and Medicare tax from Form: <b>a</b> <input type="checkbox"/> 4137 <b>b</b> <input type="checkbox"/> 8919	58	
	59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
	60a	Household employment taxes from Schedule H	60a	
	b	First-time homebuyer credit repayment. Attach Form 5405 if required	60b	
	61	Health care: individual responsibility (see instructions) Full-year coverage <input type="checkbox"/>	61	
	62	Taxes from: <b>a</b> <input type="checkbox"/> Form 8959 <b>b</b> <input type="checkbox"/> Form 8960 <b>c</b> <input type="checkbox"/> Instructions; enter code(s)	62	
	63	Add lines 56 through 62. This is your <b>total tax</b> <b>▶</b>	63	



	63	Add lines 56 through 62. This is your <b>total tax</b> <b>▶</b>	63
<b>Payments</b>  If you have a qualifying child, attach Schedule EIC.	64	Federal income tax withheld from Forms W-2 and 1099	64
	65	2015 estimated tax payments and amount applied from 2014 return	65
	66a	<b>Earned income credit (EIC)</b>	66a
	b	Nontaxable combat pay election <b>66b</b>	
	67	Additional child tax credit. Attach Schedule 8812	67
	68	American opportunity credit from Form 8863, line 8	68
	69	Net premium tax credit. Attach Form 8962	69
	70	Amount paid with request for extension to file	70
71	Excess social security and tier 1 RRTA tax withheld	71	
72	Credit for federal tax on fuels. Attach Form 4136	72	
73	Credits from Form: <b>a</b> <input type="checkbox"/> 2439 <b>b</b> <input type="checkbox"/> Reserved <b>c</b> <input type="checkbox"/> 8885 <b>d</b> <input type="checkbox"/>	73	
74	Add lines 64, 65, 66a, and 67 through 73. These are your <b>total payments</b> <b>▶</b>	74	
<b>Refund</b>	75	If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you <b>overpaid</b>	75
	76a	Amount of line 75 you want <b>refunded to you</b> . If Form 8888 is attached, check here <b>▶</b> <input type="checkbox"/>	76a
	b	Routing number <b>▶</b> <input type="checkbox"/> Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings	
77	Amount of line 75 you want <b>applied to your 2016 estimated tax</b> <b>▶</b>	77	
<b>Amount You Owe</b>	78	<b>Amount you owe.</b> Subtract line 74 from line 63. For details on how to pay, see instructions <b>▶</b>	78
	79	Estimated tax penalty (see instructions)	79





# “Above the Line” Deductions

Above the line deductions are reductions to income

- Health Savings Account (HSA) contribution
- Self Employment Tax deduction
- SEP/SIMPLE (Retirement) contributions
- Self Employed Health Insurance deduction
- Traditional IRA contribution
- Domestic Production Activities Deduction (DPAD)



## Health Savings Account (HSA)

- Savings account used in conjunction with a high deductible health insurance plan
- Contributions are made pre-tax
- Must be used for qualified medical expenses
- Beneficial when you cannot itemize deductions
- Max contribution
  - Individual \$3,350
  - Family \$6,650



# Self Employment Tax Deduction

- For a W2 employee, the employer pays half of an employee's SS & Medicare Tax
- Self employed individuals pay both the employee's and employer's share of SS & Medicare
- To offset (or make it "fair"), self employed individuals are eligible to deduct half of the self employment tax due



# Retirement Plan Contributions

- Self employed individuals can contribute to a tax-deferred retirement plans
  - Simplified Employee Pension (SEP)  
Max  $\approx$  18.6% farm income or \$53,000
  - Savings Incentive Match Plan for Employees (SIMPLE)  
Employer share:  $\approx$  2.8% farm income  
Employee share: up to \$12,500 (\$15,000 if  $>50$ )



# Retirement Plan Contributions

- Self employed individuals can contribute to a tax-deferred retirement plans
  - Self Employed 401(k)
    - Employer share:  $\approx 18.6\%$  SE income
    - Employee share: up to \$18,000 (\$24,000 if  $>50$ )
    - Max \$53,000 total of both shares
- Cannot discriminate against eligible employees



# Self Employed Health Insurance

- Self employed individuals may be able to deduct HI premiums paid as above the line deduction
  - Does not reduce SE income
- Deduction is limited to 92.35% of self employed income (Schedule F or C)
- Cannot deduct health insurance purchased on the exchange!



## Traditional IRA Deduction

- Any individual with earned income can contribute to an Individual Retirement Arrangement (IRA)
- Max \$5,500 (\$6,500 if >50)



## Retirement Plan Tax Impact

- Traditional IRA, SEP, SIMPLE, SE 401(k):
  - Contributions are deductible when made
  - Withdrawal at retirement is taxable
- Roth IRA:
  - Contributions are not deductible when made
  - Withdrawal at retirement is most often tax-free



# Domestic Production Activities Deduction (DPAD)

- DPAD was introduced as a production incentive for manufacturers
- For DPAD, farmers are considered manufacturers
- Deduction is essentially 9% of farm income (with a few adjustments) plus gain from the sale of farm assets
- Limited to  $\frac{1}{2}$  of wages paid
  - Someone with no employees gets no deduction
- Limited to taxable income



# Adjusted Gross Income (AGI)

- AGI is gross income after above the line deductions are removed but before standard or itemized deductions and exemptions
- Not the same as taxable income
- AGI is used to determine eligibility for many credits and deductions



## Standard & Itemized Deductions

- Taxpayers are eligible to deduct the greater of standard deduction or itemized deductions from AGI to calculate taxable income
- 2015 Standard deduction
  - Married filing joint \$12,600
  - Head of Household \$9,250
  - Single \$6,300



## Standard & Itemized Deductions

- Itemized deductions include:
  - Medical expenses that exceed 10% of AGI (7.5% if  $\geq 65$ )
  - State income taxes paid
  - Home real estate taxes
  - Non-business personal property tax
  - Home mortgage interest
  - Charitable contributions
  - Misc expenses (tax prep, attorney, etc) that exceed 2% of AGI



# Standard & Itemized Deductions

- In 2015, itemized deductions may be reduced for taxpayers with AGI above
  - \$309,900 (MFJ)
  - \$284,050 (HoH)
  - \$258,250 (Single)



# Personal Exemptions

- Taxpayers are eligible to deduct from AGI a personal exemption for the taxpayer, spouse, and each dependent
- Personal Exemption \$4,000 (2015)
- In 2015, personal exemptions may be reduced for taxpayers with AGI above
  - \$309,900 (MFJ)
  - \$284,050 (HoH)
  - \$258,250 (Single)



# Self Employment Tax

- Self Employment (SE) tax is paid on income earned in a trade or business
- SE tax is the self employed taxpayers contribution to Social Security & Medicare
- SE Tax = 15.3%
  - Social Security portion = 12.4%
    - Paid on 92.35% of SE income (up to \$118,500)
  - Medicare portion = 2.9%
    - Paid on 92.35% of SE income (no limit)



## Tax Deductions vs Tax Credits

- Tax deductions reduce taxable income
- Tax credits reduce tax liability
  - A tax deduction of \$1,000 would reduce tax liability by \$150 for someone in the 15% bracket
  - A tax credit of \$1,000 reduces tax liability by \$1,000





# Tax Credits

- Tax credits with the greatest impact
  - Education Credits
  - Child Tax Credit
  - Earned Income Credit
- Tax credits may be non-refundable, partially refundable, or fully refundable
  - Non-refundable credits can only reduce tax liability, they cannot create a refund
  - Refundable credits can create a refund



## Tax Credits – Education Credits

- American Opportunity Credit (AOC)
  - More beneficial of the 2 education credits
  - Credit equal to 100% of first \$2,000 plus 25% of second \$2,000 of higher ed expense
  - \$2,500 credit maximum per student
  - Includes tuition, books, and other required supplies
  - Can only be taken in first 4 years of college
  - AOC not available if AGI > \$180,000 (MFJ)
  - 40% refundable



## Tax Credits – Education Credits

- Lifetime Learning Credit
  - Credit equal to 20% of tuition expense only
  - Can be taken by anyone any number of times
  - Lifetime Learning credit not available if AGI > \$130,000
  - Non-refundable



## Tax Credits – Child Tax Credit

- Credit equal to \$1,000 for each dependent **16 years old and under**
- Partially refundable
- Reduced by \$50 for every \$1,000 over \$110,000 (MFJ) or \$75,000 (single)



# Tax Credits – Earned Income Credit

- EIC is available to low income tax payers who have earned income (W2, F, or C)
  - 2015 maximum credit
    - 1 child \$3,359
    - 2 children \$5,548
    - 3 or more children \$6,242
    - No children \$503
- Phase out based on AGI
- Frequently abused by shady tax preparers



## Tax Theory



# Tax Theory

## Common tax management strategies

- Minimize tax (by minimizing income)
- Maximize a tax bracket
- Maximize after tax dollars
- Spike every fourth year



# Tax Theory

## Minimize tax (by minimizing income)

- Q: Is there such a thing as too little farm income
- A: Farm income should be enough to cover:
  1. Family living (not covered by off farm income)
  2. Land principal payments
  3. Accelerated debt retirement
  4. Reinvestment/Expansion
  5. Cushion



# Tax Theory

## Maximizing a tax bracket

- Target the top of a bracket
- Potential for tax savings, especially in the 25% bracket when above the SS max
- Consistently targeting a bracket not always wise with increasing accrual income



# Tax Theory

## Maximizing after tax income

- Minimize lowest effective tax rate
  - $\text{Total tax} \div \text{taxable income}$
- May result in a larger tax liability but at a lower overall effective rate



# Tax Theory

## Maximizing after tax income

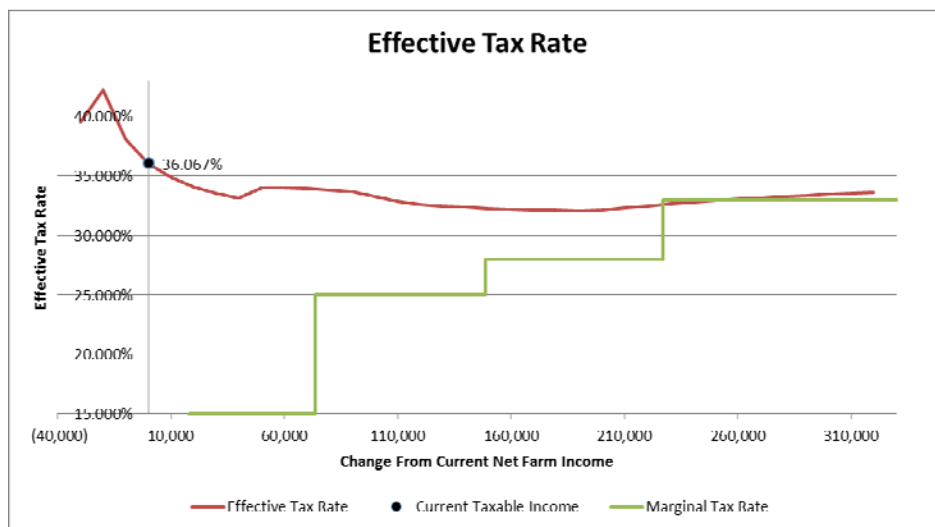
- Example:

- MFJ, 2 dependents under 17
- No off-farm income
- \$5,000 SE health insurance
- \$75,000 NFI
- \$36,501 taxable income
- \$13,165 tax (\$10,597 SE tax)
- 36.07% effective tax rate



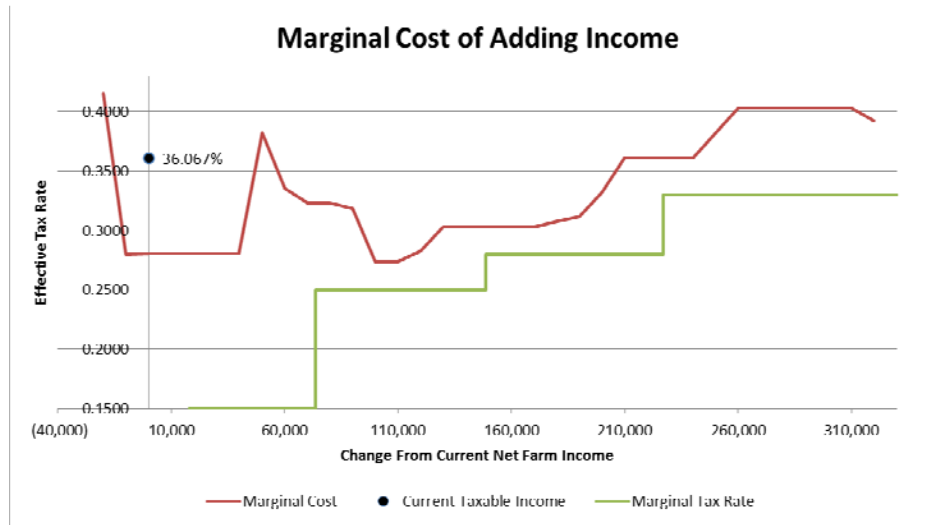
# Tax Theory

## Maximizing after tax income



# Tax Theory

## Maximizing after tax income



Farm Income Tax Management



# Tax Theory

## Maximizing after tax income

- Example:
  - Same scenario
  - \$175,000 NFI instead of \$75,000
  - \$132,203 taxable income
  - \$43,958 tax (\$19,195 SE tax)
  - 33.25% effective tax rate

Farm Income Tax Management



# Tax Theory

Spike every fourth year

- Keep income levels low for 3 years
- Sell off all inventory in 4<sup>th</sup> year
- Takes advantage of the limit on Social Security portion of SE tax and income averaging
- Doesn't account for:
  - Time value of money
  - Cost of storage or borrowing
  - Cash for family living
  - Impact on future social security benefit

Farm Income Tax Management



# Tax Theory

Schedule F	147,500	147,500	147,500	147,500	590,000
1/2 SE Tax	(8,597)	(8,802)	(9,025)	(9,229)	
AGI	138,904	138,699	138,476	138,271	
Standard Deduction	(11,600)	(11,900)	(12,200)	(12,400)	
Exemptions	(14,800)	(15,200)	(15,600)	(15,800)	
<b>Taxable Income</b>	<b>112,504</b>	<b>111,599</b>	<b>110,676</b>	<b>110,071</b>	<b>444,849</b>
Income Tax	20,376	19,960	19,526	19,230	79,092
SE Tax	17,193	17,603	18,049	18,458	71,303
Additional Medicare	0	0	0	0	0
<b>Total Liability</b>	<b>37,569</b>	<b>37,563</b>	<b>37,575</b>	<b>37,688</b>	<b>150,395</b>

Schedule F	30,000	30,000	30,000	500,000	590,000
1/2 SE Tax	(2,120)	(2,120)	(2,120)	(13,950)	
AGI	27,881	27,881	27,881	486,051	
Standard Deduction	(11,600)	(11,900)	(12,200)	(12,400)	
Exemptions	(14,800)	(15,200)	(15,600)	(15,800)	
<b>Taxable Income</b>	<b>1,481</b>	<b>781</b>	<b>81</b>	<b>457,851</b>	<b>460,192</b>
Income Tax	148	78	8	82,693	82,927
SE Tax	4,239	4,239	4,239	27,899	40,616
Additional Medicare	0	0	0	2,250	2,250
<b>Total Liability</b>	<b>4,387</b>	<b>4,317</b>	<b>4,247</b>	<b>112,842</b>	<b>125,793</b>

Farm Income Tax Management





# Tax Theory

## Things to think about

1. Plan long term
  - What are your farm goals?
  - Net worth growth requires taxable income
  - Low taxable income consumes net worth
2. Avoid borrowing from the future
  - Don't deduct an expense you haven't paid for yet
  - §179 or bonus depreciation on financed equipment/building purchases



# Tax Theory

## Things to think about

3. Complete an accrual income statement each year
  - Tax farm income should move in the same direction as changes in current inventory
  - Can indicate taxable income next year
4. Is it wise to spend \$100 to save \$25?
5. Your banker likes to see income, which indicates ability to repay loans



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# Managing Income



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## Constructive Receipt

- Constructive receipt is the point where you have control of funds
- You have control of funds if:
  - You have received a check
  - You have the ability to receive a check



# Deferred Sales Contract

- A deferred sales contract is valid if:
  - It specifies quantity, price, grade and time of payment (usually in the following year)
  - You have no right to the proceeds until the stated payment date (or there are substantial limitations or restrictions)
  - It is between a buyer and seller
    - A sale barn is not a buyer, they are a broker or agent



# Managing Income

- Farmers have an array of tools available to manage income or tax
- Don't wait until after the fact
  - Meet with your tax preparer ahead of time
  - Many of the tools available require pre-planning
- PP – Pre-planning
- AF – After the fact



## Managing Income – ↑ Income

1. Sell inventory (PP)
2. Elect out of installment treatment with deferred sales contracts (AF)
  - Tax proceeds of sale in the year sold rather than the year received
3. CCC loans treated as income (PP)
4. Convert Traditional IRA to Roth IRA (PP)



## Managing Income – ↓ Income

1. Defer crop insurance (AF)
  - Available if proceeds received in year of production
  - Available if you normally sell >50% of grain in the year following production
  - Only available on yield loss or prevented planting (revenue portion not deferrable)



## Managing Income – ↓ Income

2. Defer disaster proceeds (AF)
  - Available if proceeds received in year of production



## Managing Income – ↓ Income

3. Defer weather related livestock sales (AF)
  - Elect to defer taxation one year
    - Applies to breeding stock or market animals
    - Must be in a Federally declared disaster area
    - Allowed to defer sales in excess of normal business practice (3 years?)



## Managing Income – ↓ Income

### 4. Defer weather related livestock sales (AF)

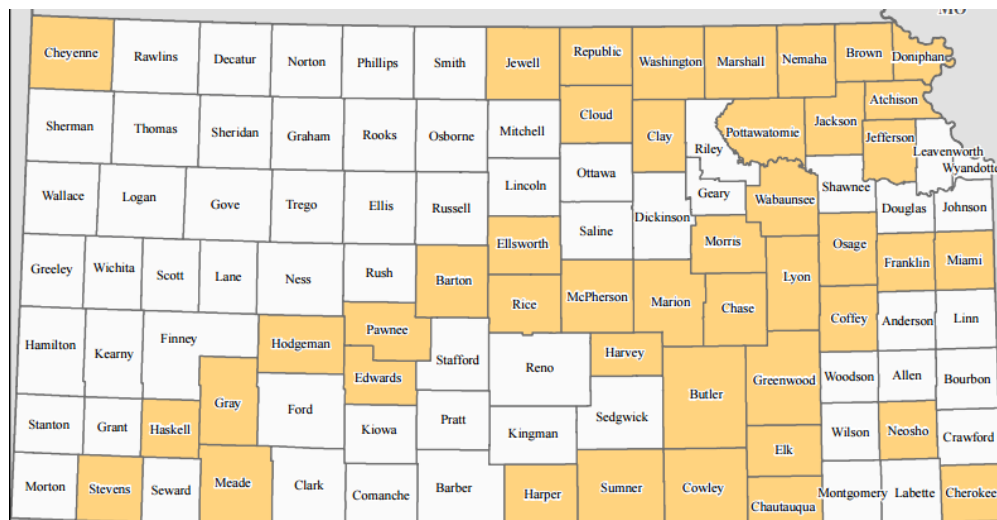
- Involuntary conversion
  - Available only for breeding livestock
  - Allowed to defer sales in excess of normal business practice (3 years?)
  - Must be able to document that weather conditions forced additional sales
  - Replacements must be purchased within 2 years (4 years if in a declared disaster area)
  - Basis of replacements is reduced by amount deferred



Farm Income Tax Management

## Managing Income – ↓ Income

- Defer weather related livestock sales (AF)



Farm Income Tax Management

# Managing Income – ↑ Expense

1. Accelerate depreciation using §179 deduction or bonus depreciation (AF)
  - Asset must be placed in service before December 31
  - When used with financed equipment, little depreciation remains to help offset non-deductible principal payments in the future



## Equipment and Building Leases

- Be careful of capital asset leases
- IRS may classify a lease as a purchase if:
  - The lease contains an easily identifiable interest component
  - You build equity in the asset
  - You have the option to buy the asset at the end of the lease for a *nominal amount*
- Few equipment or building leases qualify



## Managing Income – ↑ Expense

### 2. Prepay expenses (PP)

- No more than 50% of total expense
- Must be a business purpose
  - Tax avoidance is not a business purpose
- Must be actual purchase rather than a down payment
  - Specific quantity (gal, tons, lbs, etc)



## Managing Income – ↑ Expense

### 2. Prepay expenses (PP)

- Purchases made using dealer financing do not qualify
- Prepay is never available for resale livestock
- Prepaid expenses that create a large negative checking account balance may be disallowed





## Managing Income – ↑ Expense

3. Expense capital purchases using de minimus safe harbor rules (AF)
  - IRS recently (attempted to) clarify what is a repair and what is an improvement
  - Defined any item under \$200 as a supply
  - Allow an election to treat anything under the safe harbor amount (\$500) as a de minimus repair
    - Applies per invoice or per item



## Managing Income – ↑ Expense

4. Charitable contributions (PP)
5. Retirement plan contributions
  - Traditional IRA, SEP (AF)
    - Plan can be established after 12/31
    - Contributions can be made after 12/31
  - SIMPLE, SE 401(k)
    - SIMPLE must be established by 10/1 (PP)
    - SE 401(k) must be established by 12/31 (PP)
    - A portion of contributions can be made after 12/31



## Managing Income – ↑ Expense

- Retirement plan contributions
  - Increase total cash outlay but decrease amount paid to IRS
  - Do not affect SE income
  - Cannot discriminate against qualified employees



## Managing Income – ↑ Expense

6. Domestic Production Activities Deduction (AF)
  - “Paper” deduction that reduces AGI
  - 9% of DPA Income (DPAI) or taxable income
  - Limited to ½ of wages paid by the farm
  - Calculated on Form 8903
  - Should be included on every 1040 with a positive F and employees!



## Managing Income – ↑ Expense

### 7. Employee medical reimbursement arrangement or §105 plan (PP)

- Allows employer to reimburse employee for out of pocket medical expenses and health insurance
- Reimbursed expenses can be for the employee or the employee's family
- Reimbursements deducted as a farm expense (reducing SE income)
- Typical arrangement:
  - Sole proprietor hires spouse
  - Pays a nominal wage and provides §105 plan



## Managing Income – ↑ Expense

### 7. Employee medical reimbursement arrangement or §105 plan (PP)

- IRS does not like §105 plans
  - Proper documentation is crucial
  - Use a third party administrator
- Cannot discriminate against qualified employees
- Under PPACA, potential \$100/day fine with more than 1 qualified employee



# Managing Income – ↓ Expense

1. Slow down depreciation (AF)
  - Elect to depreciate assets using straight-line (SL) method
  - Elect to depreciate assets using SL method and use Alternative Depreciation System (ADS)
2. Capitalize long life repairs (AF)
  - Depreciate rather than deduct
  - Applies to repairs in the “grey” area



## Managing Tax



# Managing Tax

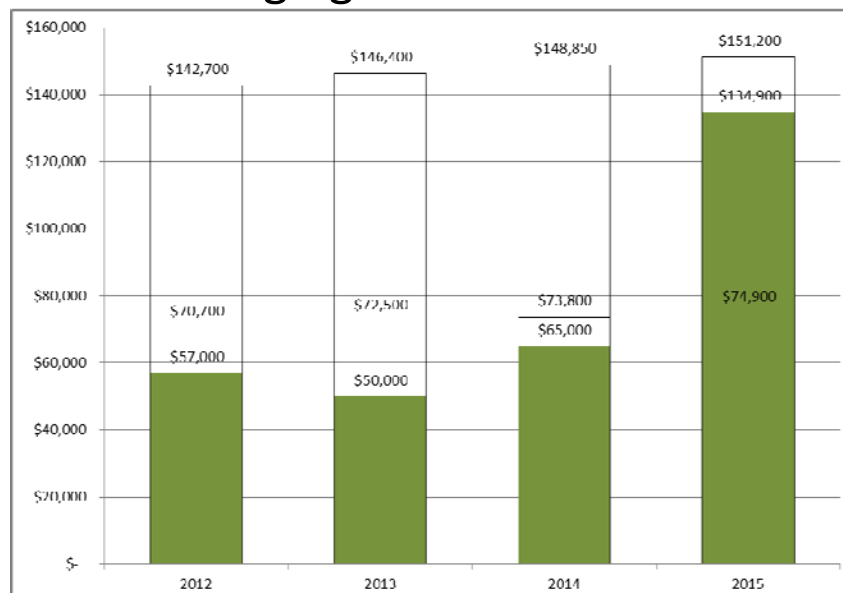
## 1. Income averaging (AF)

- One of the most important farm tax planning tools
- Fill unused brackets in prior 3 years
- Does not affect SE tax
- Tax software attempts to optimize but doesn't always get it right



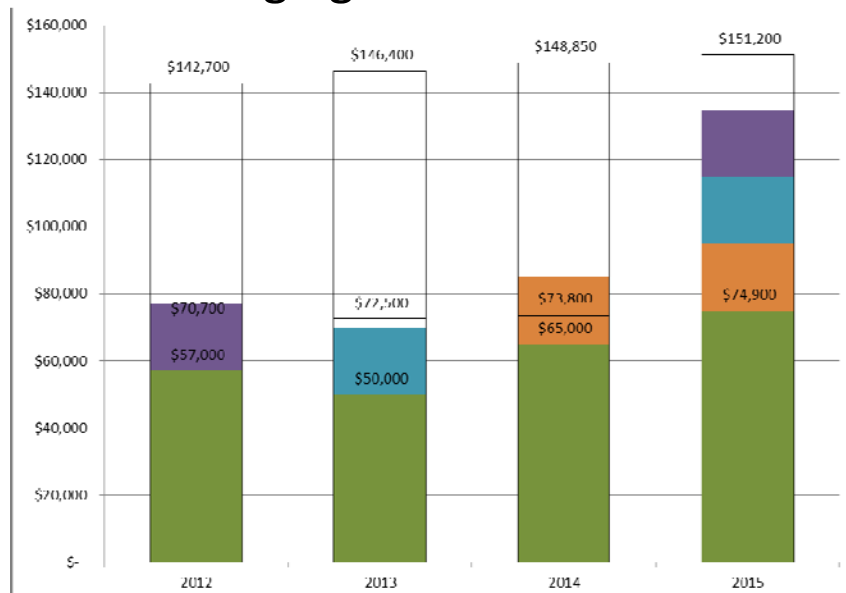
# Managing Tax

## 1. Income averaging



# Managing Tax

## 1. Income averaging



Farm Income Tax Management



# Managing Tax

## 2. Net Operating Loss (NOL) (AF)

- NOL is only created when taxable income is negative
- NOL in current year carried back 5 years
- Tax is recalculated for 5<sup>th</sup> prior year
  - Reduction in tax owed is refunded
- Any remaining NOL is carried to the 4<sup>th</sup> prior year, then to 3<sup>rd</sup>, and so on until used up
- If not used up in 5 years, carried forward 20 years

Farm Income Tax Management



# Managing Tax

## 2. Net Operating Loss (NOL) (AF)

- Default – Carry back 5 years
- Election – Carry back 2 years
- Election – Carry forward 20 years
- Does not affect SE tax



# Managing Tax

## 3. Partnership, LLC, S-Corp (PP)

- Potential to reduce SE income
  - Rent paid to individual by entity
  - S-Corp income (above wages) is not subject to Social Security or Medicare
- Must be a business purpose to create an entity
  - Liability protection
  - Transition planning
  - Tax avoidance is not a business purpose



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# Managing Tax

3. Partnership, LLC, S-Corp (PP)
  - An entity may create other potential recordkeeping, compliance, and cash flow issues
  - Must be operated correctly!



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## Tax Preparers





## Tax Preparers

- You are ultimately responsible for what is on your return
  - Review your return and ask questions!
  - Have they utilized income averaging and DPAD?
- Some are better than others
- They don't always ask the questions they should
- Don't let them make §179 or bonus decisions without your input



## Tax Preparers

- Many preparers complete returns based only on information you provide
  - If you don't provide it, they don't use it
- Make sure that you provide:
  - Value of buildings and improvements (pivots, fence, etc) when land is purchased
  - Breeding livestock sales separated from market animal sales
  - Raised breeding livestock sales separated from purchased breeding livestock sales
  - Financed capital asset purchase details



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# Tax Preparers

- Talk to your preparer about your plans/goals (retirement, transition, etc)



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## Questions?



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## Additional Information



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## Tax Calculation

- Determine taxable ordinary income
  - Subtract LT capital gain from total taxable income
- Determine taxable ordinary income in each bracket
  - Fill each bracket starting with the 10% bracket
- Determine taxable LT capital gain in each bracket
  - Fill unused portion of each bracket with LT capital gain
- Calculate ordinary income tax for each bracket
- Calculate LT capital gain tax for each bracket



# Tax Calculation - Example 1

\$20,000 Taxable income, \$1,000 LT capital gain

Taxable LT capital gain =  
\$1,000

Taxable ordinary income =  
\$19,000 (\$20,000 - \$1,000)



# Tax Calculation - Example 1

\$19,000 Taxable ordinary income

\$1,000 Taxable LT capital gain

Bracket		Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0	18,450	10.0%	0.0%		18,450			
18,450	74,900	15.0%	0.0%		56,450			
74,900	151,200	25.0%	15.0%		76,300			
151,200	230,450	28.0%	15.0%		79,250			
230,450	411,500	33.0%	15.0%		181,050			
411,500	464,850	35.0%	15.0%		53,350			
464,850	+	39.6%	20.0%					
Total								



# Tax Calculation - Example 1

\$19,000 Taxable ordinary income

\$1,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0			
18,450 74,900	15.0%	0.0%		56,450			
74,900 151,200	25.0%	15.0%		76,300			
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			18,450				



# Tax Calculation - Example 1

\$19,000 Taxable ordinary income

\$1,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0			
18,450 74,900	15.0%	0.0%	550	55,900			
74,900 151,200	25.0%	15.0%		76,300			
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			19,000				



# Tax Calculation - Example 1

\$19,000 Taxable ordinary income

\$1,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0	0		
18,450 74,900	15.0%	0.0%	550	55,900			
74,900 151,200	25.0%	15.0%		76,300			
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			19,000		0		



# Tax Calculation - Example 1

\$19,000 Taxable ordinary income

\$1,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0	0		
18,450 74,900	15.0%	0.0%	550	55,900	1,000		
74,900 151,200	25.0%	15.0%		76,300			
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			19,000		1,000		



# Tax Calculation - Example 1

\$19,000 Taxable ordinary income

\$1,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0	0	1,845	0
18,450 74,900	15.0%	0.0%	550	55,900	1,000		
74,900 151,200	25.0%	15.0%		76,300			
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			19,000		1,000		



# Tax Calculation - Example 1

\$19,000 Taxable ordinary income

\$1,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0	0	1,845	0
18,450 74,900	15.0%	0.0%	550	55,900	1,000	83	0
74,900 151,200	25.0%	15.0%		76,300			
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			19,000		1,000		



# Tax Calculation - Example 1

\$19,000 Taxable ordinary income

\$1,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0	0	1,845	0
18,450 74,900	15.0%	0.0%	550	55,900	1,000	83	0
74,900 151,200	25.0%	15.0%		76,300			
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			19,000		1,000	1,928	0



# Tax Calculation - Example 2

\$85,000 Taxable income, \$15,000 LT capital gain

Taxable LT capital gain =  
\$15,000

Taxable ordinary income =  
\$70,000 (\$85,000 - \$15,000)





## Tax Calculation - Example 2

\$70,000 Taxable ordinary income

\$15,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%		18,450			
18,450 74,900	15.0%	0.0%		56,450			
74,900 151,200	25.0%	15.0%		76,300			
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>							



## Tax Calculation - Example 2

\$70,000 Taxable ordinary income

\$15,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0			
18,450 74,900	15.0%	0.0%		56,450			
74,900 151,200	25.0%	15.0%		76,300			
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			18,450				



## Tax Calculation - Example 2

\$70,000 Taxable ordinary income

\$15,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0			
18,450 74,900	15.0%	0.0%	51,550	4,900			
74,900 151,200	25.0%	15.0%		76,300			
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			70,000				



## Tax Calculation - Example 2

\$70,000 Taxable ordinary income

\$15,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0	0		
18,450 74,900	15.0%	0.0%	51,550	4,900			
74,900 151,200	25.0%	15.0%		76,300			
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			70,000				



## Tax Calculation - Example 2

\$70,000 Taxable ordinary income

\$15,000 Taxable LT capital gain

Bracket		Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0	18,450	10.0%	0.0%	18,450	0	0		
18,450	74,900	15.0%	0.0%	51,550	4,900	4,900		
74,900	151,200	25.0%	15.0%		76,300			
151,200	230,450	28.0%	15.0%		79,250			
230,450	411,500	33.0%	15.0%		181,050			
411,500	464,850	35.0%	15.0%		53,350			
464,850	+	39.6%	20.0%					
<b>Total</b>				70,000		4,900		



## Tax Calculation - Example 2

\$70,000 Taxable ordinary income

\$15,000 Taxable LT capital gain

Bracket		Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0	18,450	10.0%	0.0%	18,450	0	0		
18,450	74,900	15.0%	0.0%	51,550	4,900	4,900		
74,900	151,200	25.0%	15.0%		76,300	10,100		
151,200	230,450	28.0%	15.0%		79,250			
230,450	411,500	33.0%	15.0%		181,050			
411,500	464,850	35.0%	15.0%		53,350			
464,850	+	39.6%	20.0%					
<b>Total</b>				70,000		15,000		



## Tax Calculation - Example 2

\$70,000 Taxable ordinary income

\$15,000 Taxable LT capital gain

Bracket		Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0	18,450	10.0%	0.0%	18,450	0	0	1,845	0
18,450	74,900	15.0%	0.0%	51,550	4,900	4,900		
74,900	151,200	25.0%	15.0%		76,300	10,100		
151,200	230,450	28.0%	15.0%		79,250			
230,450	411,500	33.0%	15.0%		181,050			
411,500	464,850	35.0%	15.0%		53,350			
464,850	+	39.6%	20.0%					
<b>Total</b>				70,000		15,000		



## Tax Calculation - Example 2

\$70,000 Taxable ordinary income

\$15,000 Taxable LT capital gain

Bracket		Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0	18,450	10.0%	0.0%	18,450	0	0	1,845	0
18,450	74,900	15.0%	0.0%	51,550	4,900	4,900	7,733	0
74,900	151,200	25.0%	15.0%		76,300	10,100		
151,200	230,450	28.0%	15.0%		79,250			
230,450	411,500	33.0%	15.0%		181,050			
411,500	464,850	35.0%	15.0%		53,350			
464,850	+	39.6%	20.0%					
<b>Total</b>				70,000		15,000		



## Tax Calculation - Example 2

\$70,000 Taxable ordinary income

\$15,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0	0	1,845	0
18,450 74,900	15.0%	0.0%	51,550	4,900	4,900	7,733	0
74,900 151,200	25.0%	15.0%		76,300	10,100	0	1,515
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			70,000		15,000	9,578	1,515

Farm Income Tax Management



## Tax Calculation - Example 2

\$70,000 Taxable ordinary income

\$15,000 Taxable LT capital gain

Bracket	Ord Rate	CG Rate	Ord Income	Unused Bracket	CG Income	Ord Tax	CG Tax
0 18,450	10.0%	0.0%	18,450	0	0	1,845	0
18,450 74,900	15.0%	0.0%	51,550	4,900	4,900	7,733	0
74,900 151,200	25.0%	15.0%		76,300	10,100	0	1,680
151,200 230,450	28.0%	15.0%		79,250			
230,450 411,500	33.0%	15.0%		181,050			
411,500 464,850	35.0%	15.0%		53,350			
464,850 +	39.6%	20.0%					
<b>Total</b>			70,000		15,000	9,578	1,515

Total Tax = 9,578 + 1,515 = 11,093

Farm Income Tax Management

