

**INCOME TAX MANAGEMENT**  
**FOR FARMERS IN 2011**

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**DRAFT**

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## INCOME TAX MANAGEMENT FOR FARMERS IN 2011\*

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Many farmers will have record incomes in 2011. However, livestock producers and crop producers adversely affected by the weather may have substantially lower incomes. Effective income tax planning and management seeks to maximize after-tax wealth, and typically involves consideration of receipts and expenditures for multiple years. Increased volatility of both input and output prices has made farm incomes more variable and more difficult to predict.

Tax planning is also difficult because Congress has enacted a number of short-term tax laws intended to stimulate the economy that affect only the 2011 and 2012 tax years. A number of the “Bush tax-cut” provisions were extended and, without Congressional action, are scheduled to expire at the end of 2012. Continuing concerns about both weak economic growth and deficit spending combine to impact policy discussions of future taxes.

Many farmers have deferred receipts from prior years into 2011. Because of the wide range of variability of 2010 and 2011 commodity prices, year-end tax planning is critical in 2011. Determining the 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 2011. Additional first-year depreciation, Section 179 expensing, and

income averaging provide opportunities for tax planning after the end of the tax year. Good tax planning should also consider the self-employment tax as well as income tax.

The Indiana state and local income taxes are nearly flat-rate taxes, but a number of the federal deductions are not allowed for state and local tax purposes. Other states may have other limitations on determination of revenue and expenses. These factors add additional complications to tax planning tax form preparation.

The first section of this publication discusses changes in depreciation and Section 179 expensing area and how these changes affect many producers. The second section discusses some other recent changes affecting farm businesses. Third is a discussion of planning and procedures for the deferral of income from sales of commodities in 2011. Procedures to ensure the deductibility of prepaid expenses for 2012 are reviewed. Farm income averaging is discussed in the fourth section. Crop insurance, disaster sales of livestock and casualty losses are reviewed. Developments with respect to self-employment taxes, including the Conservation Reserve Program (CRP) payments, are discussed. 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 Linda Curry, LGUTEF; Charles Cuykendall, Cornell University; David Frette, CPA, Washington, IN, and David Miller, Ohio State University. For a more in-depth discussion of income taxes and agriculture, go to [www.RuralTax.org](http://www.RuralTax.org).

## TAX LAW CHANGES AFFECTING DEPRECIATION AND EXPENSING

The I.R.C. Section 179 expensing has been increased almost annually by Congress. Most recently, the Creating Small Business Jobs Act of 2010 increased the Section 179 expensing limit to \$500,000 for tax years beginning in 2010 and 2011. The Jobs Act also extended the 50-percent additional first-year depreciation of qualifying new property placed in service during calendar year 2010. The Tax Relief Act of 2010 increased the additional first-year depreciation after September 8, 2010 and before January 1, 2012 to 100 percent and extended it for 2012 at a reduced rate of 50 percent.

### Depreciation and Section 179 Expensing

Producers and landowners can generally recover the cost of assets which last more than a year through depreciation. Depreciable assets are placed in classes reflecting their useful life under the Modified Cost Recovery System (MACRS) of depreciation. For assets used in a farming business, the 150-percent declining-balance method with a shift, later in the life of the asset, to straight-line depreciation maximizes the depreciation deduction. MACRS is reviewed in the appendix.

Farmers and others in an active trade or business can elect to treat the cost of up to \$500,000 of qualifying property purchased during 2010 and 2011 as an expense (rather than as a depreciable capital expenditure). Congress has aggressively increased and extended the Section 179 deduction in recent years. Under current legislation, the 2012 limit on Section 179 expensing is scheduled to drop back to \$125,000 (\$139,000 with indexing).

The Jobs Act expanded the definition of Section 179 property to include qualified leasehold improvement property, qualified

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

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

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

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

2. The property must be purchased, but new and used property both 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. The tax basis in the relinquished property would be depreciated, generally as part of the total basis of the new asset.

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Example 1: Trades and Section 179

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

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4. The Section 179 expensing election is phased out on a dollar-for-dollar basis if over \$2,000,000 of qualified property is placed in service during 2010 or 2011. Under current law, the placed in service limit decreases to \$560,000 for 2012.

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Example 2: Investment Limit

Luc Farmer buys \$2,025,000 of machinery in 2011. Luc's maximum Section 179 expensing allowed would be reduced by \$25,000 (\$2,025,000 - \$2,000,000), making Luc's election limit \$475,000 (\$500,000 - \$25,000). An individual is not allowed to elect the full \$500,000 and carry over the \$25,000 excess.

If Luc had purchased \$2,100,000 of qualifying property in 2011, his maximum Section 179 election limit is \$400,000. (\$500,000 - \$100,000 excess investment).

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Only the boot portion on like-kind trades is considered in determining the \$2,000,000 limit. Thus, if the \$2,025,000 purchase in Example 2 was a like-kind exchange and the boot portion was \$25,000 or more, then the full \$500,000 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, salary and business income can be combined with Form 1040 Schedule F for aggregate taxable income. This could permit a Section 179 expense for an asset acquired by a farm business with a loss on Schedule F. Gains or losses from the sale of livestock, machinery, and other business assets reported on Form 4797 are also included in taxable income for purposes of applying this taxable income limitation.

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

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

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

an amended return for tax years beginning after 2007. If a Section 179 election is revoked, that revocation is irrevocable for that property.

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**Example 3: Revocation of Section 179**

Assume Helen Farmer purchased a used planter for \$25,000 and a sprayer for \$10,000 in 2009. Helen elected to expense \$25,000, the entire cost of a used planter in 2009, and then revoked that election in 2010. Helen could no longer elect to expense any of the cost of the planter for 2009, but part or all \$10,000 of the other qualifying assets, the sprayer, acquired in 2009 could be expensed for 2009.

Note: Indiana and a number of other states do not follow the federal Section 179 expensing rules for state income taxes. Typically, these states have lower limits on the Section 179 expensing election and the deduction which they will allow. States also vary in their rules as to how to add back the excess Section 179 expensing taken for federal income tax purposes.

**Additional First-Year Depreciation**

The Economic Stabilization Act of 2008 provided a “bonus” or additional first-year depreciation (AFYD) 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. The 50 percent AFYD deduction was initially extended by the Jobs Act to qualified property placed in service before January 1, 2011. The 2010 TRA increased first-year tax write-off to 100 percent for qualifying property placed in service after September 8, 2010 and before January 1, 2012.

For qualifying property placed in service after December 31, 2011 and before January 1, 2013 the AFYD deduction is reduced to 50 percent. This additional first-year or bonus depreciation is allowed for both regular and AMT tax purposes.

The year-by-year Section 179 expensing and AFYD deduction amounts for producers and landowners are summarized in Table 1.

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

1. The original use of the property must start with the taxpayer (property must be new).
2. The property must be MACRS property with a recovery period of not more than 20 years.
3. The property generally must be placed in service before January 1, 2013. The deadline is extended for some longer production period property.
4. The taxpayer is not required to use the Alternative Depreciation System (ADS) for the property. A producer with orchards, vineyards, or groves who elected not to capitalize pre-production expenses is generally required to use ADS.

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**Example 4: Total Depreciation: '09-'12**

In July 2009, Able Farmer traded his old tractor with an adjusted basis of \$35,000 for a new tractor and paid \$80,000 boot. The tractor was new, purchased and placed in service in 2009. Thus, the new tractor is qualified for the AFYD deduction. For 2009, this deduction is 50 percent of the \$115,000 initial basis of the tractor, or \$57,500. Able also takes the 7-year MACRS deduction of

Table 1. Section 179 Expensing and Additional First-Year Depreciation for Producers

Year	2007	2008	2009	2010	2011	2012
Maximum Section 179 Deduction	\$125,000	\$250,000	\$250,000	\$500,000	\$500,000	\$139,000
Section 179 Investment Limit	\$500,000	\$800,000	\$800,000	\$2,000,000	\$2,000,000	\$560,000
Additional 1 <sup>st</sup> Year Depreciation	0%	50%	50%	50% before 9/9/10 100% after 9/8/10	100%	50%

10.71 percent of the remaining \$57,500 basis in the new tractor, or an additional \$6,158. Total new tractor depreciation in 2009 would be \$63,658.

#### Default Rule

AFYD is the default rule for qualifying property. If a qualifying asset is purchased in 2011, the entire basis can be deducted in 2011. An election not to take the AFYD deduction can be made by a taxpayer on the tax return by identifying the MACRS 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” for all qualifying assets in a MACRS class acquired during the year. Unlike the Section 179 deduction, a taxpayer cannot claim only a portion of the AFYD deduction on an asset. Qualifying assets in different MACRS classes acquired during a tax year can be treated differently with respect to AFYD.

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#### 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 2011. Both the new tractor and new planter are 7-year MACRS property and qualify for AFYD. Harry’s 2011 AFYD deduction is \$110,000.

Harry might elect to forgo the AFYD deduction on the tractor, but Harry would also have to forgo the AFYD deduction on the planter. Harry could deduct \$11,781 regular MACRS depreciation on his 2011 purchase of \$110,000 of farm machinery.

If Harry had acquired an \$80,000 tractor (7-year MACRS property) and a \$30,000 computer system (5-year MACRS property), Harry could take an AFYD deduction as follows:

- Both the tractor and computer (\$110,000),
  - Just on the tractor (\$80,000),
  - Just on the computer, (\$30,000),
  - or neither the tractor nor computer (\$0).
-

## Planning Cost Recovery in 2011

For assets acquired before 2011 the method of cost recovery and amount of Section 179 expensing, if any, would generally have been determined in the year when the assets were placed in service. Cost recovery in 2011 on these assets would be determined by multiplying the appropriate cost recovery percentage from Appendix Table 1 by the depreciable basis of the asset. Thus, there are essentially no tax management options

Note: Taxpayers do have a choice of the AFYD rate for qualifying assets placed in service in 2010. Because of the retroactive change in AFYD rate from 50 percent to 100 percent, IRS is allowing taxpayers to choose between the 50 and 100 percent AFYD rates for tax years including September 9, 2010. The election to use the 50 percent AFYD rate is made by attaching a statement to a timely filed return (including extensions).

Because the provisions of the Section 179 expensing and additional first-year depreciation are different, taxpayers can manage their 2011 deductions by choosing which provisions to use with specific assets. As discussed previously, the 100-percent AFYD deduction applies only to new assets whose original use starts with the taxpayer. Because of the “all or nothing” aspect of the AFYD, a taxpayer may decide to use Section 179 expensing and elect not to take the AFYD deduction.

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### Example 6: Harry Farmer and Section 179

As noted in Example 5, Harry’s AFYD deduction would be either \$110,000 or \$0 depending on whether he took the AFYD or elected out. Harry can elect out of AFYD by attaching a statement that the election is

being made and what class or classes of property is affected for the specified tax year. Harry would be eligible to elect Section 179 expensing from \$0 to \$110,000. The Section 179 deduction may be limited by the taxable income limitation. However, Harry has considerable flexibility in his income tax management.

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## Some Planning Considerations

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

Some new assets, such as machinery sheds, shops, and general purpose barns, are eligible for AFYD, but not Section 179 expensing. 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 AFYD.

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### Example 7: Depreciation Eligibility

Sally Farmer has a machinery shed and shop built for \$80,000 in 2011. The machinery shed is not eligible for Section 179 expensing, but, as 20-year MACRS property, it is eligible for an \$80,000 AFYD deduction. If Sally elected out of AFYD, her regular MACRS depreciation would be \$3,000 ( $\$80,000 \times 3.75$  percent).

If Sally placed the asset in service in 2012, she would qualify for a \$40,000 AFYD deduction and \$1,500 of MACRS depreciation, for a total of \$41,500 in cost

recovery for 2012. If Sally elected out of 2012 AFYD, her regular MACRS depreciation would be \$3,000 (\$80,000 X 3.75 percent).

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The 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 AFYD deduction in excess of taxable income creates a net operating loss (NOL). A farmer can carry the NOL back 2 years or 5 years, and then carry the NOL forward up to 20 years. Alternatively, the farmer can elect to forgo the carry back period. Good tax management will generally avoid carry forward and NOL situations.

Cash rent and share lease landowners are generally not in the trade or business of farming. Their qualified investments, such as field tile, are eligible for MACRS

depreciation and AFYD, but not Section 179 expensing. AFYD provides a limited period of time for rapid tax deduction of qualifying investments.

If the business use of an asset drops to 50 percent or less before the end of the asset's recovery period, taking a Section 179 deduction in year of purchase results in recapture in the year of conversion. In contrast, an AFYD deduction is not recaptured in the year of conversion unless the asset is listed property, such as a car used for business.

Farmers and landowners do have a number of options with respect to cost recovery through MACRS, additional first-year depreciation, and Section 179 expensing in 2011 and 2012. 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.

## **SOME OTHER CHANGES AFFECTING FARM BUSINESSES**

Topics in this section deal with the limitation on farm losses and the reduction in the amount of social security tax paid by the employee and the self-employed individual. Some of the Form 1099 reporting requirements due to take effect in 2012 have been repealed and there have been minor changes in Schedule F (Form 1040).

### **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 they have negative total farm income for the 5 years may still deduct \$300,000 of farm losses. Losses which are limited in a specific tax year are carried forward and treated as a deduction as attributable to farming. The limitation on loss deductions applies only to taxpayers, other than C corporations, who receive payments through the 2008 Farm Bill.

## Social Security Tax Reduced

The social security tax rate is reduced, effective for wages received in 2011. A similar tax decrease also applies to earnings from self-employment received in tax years beginning in 2011. The employee's social security tax rate is reduced from 6.2 percent to 4.2 percent for wages paid during 2011. Self-employed individuals have the social security portion of the self-employment (SE) tax rate reduced from 12.4 percent to 10.4 percent. The Medicare tax rate, 2.9 percent in total, is not affected for employees or self-employed individuals.

Self-employed individuals reduce their income from self-employment by 7.65 percent, an amount equivalent to the employer's share of social security taxes to determine net earnings from self-employment. The net earnings from self-employment is multiplied by the reduced tax rate of 13.3 percent (10.4 percent + 2.9 percent) as illustrated in Example 8.

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### Example 8: SE Tax Calculation

Paula Farmer has net income of \$90,000 on her 2011 Schedule F (Form 1040).

Schedule F net income	\$90,000
7.65% reduction	<u>(6,885)</u>
Net earnings from SE	<u>\$83,115</u>
SE tax \$83,115 X 13.3%	<u>\$11,054</u>

The income tax deduction for 50 percent of the SE tax is increased to 59.6 percent of the SE tax (6.2% ÷ 10.4%) and 50 percent of the 2.9% Medicare tax. These adjustments are made to keep the employee's and employer's income tax deductions identical on the same amounts of income from self-employment and wages. These reductions in social security tax paid will not reduce the future benefits of an individual.

## Expanded Form 1099 Reporting Repealed

The health insurance legislation passed in 2010 required, effective for payments after December 31, 2011, the taxpayers in a trade or business would be required to report all payments totaling \$600 or more annually for property and services. Form 1099 must be filed for payments made in the course of a trade or business. This is a major expansion of the current Form 1099 reporting program, but was repealed in 2011.

Currently, some forms of income payments (compensation, interest, and rent) to non-corporate taxpayers require a Form 1099 to be filed. Payments of less than \$600 and payments to corporations do not require reporting on Form 1099. If parts or materials are supplied by the service provider secondarily to providing the service, the entire amount is reportable.

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### Example 9: Form 1099 Reporting

Dan Fixit performed some repairs on Sam Farmer's combine and charged \$550 for labor. Because the payment was less than \$600 for the year, no Form 1099-MISC would be required.

If Dan had supplied \$75 of parts and charged \$625, the entire \$625 payment must be reported on a Form 1099-MISC.

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## Schedule F Changes

Schedule F (Form 1040) for 2011 returns five parts. Lines 1a and 2a refer to payments for *specified* sales of livestock and other resale items. These payments are those received through a merchant card (credit cards) or third party network (e.g., PayPal® Goggle Check-out®) and are reported to the farmer on Form 1099-K, Merchant Card and

Third Party, Lines 1b and 2b are for other sales of livestock and other resale items not reported on lines 1a and 2a.

### **Payroll Tax Incentives**

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

prior to beginning employment with the new employer.

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

### **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 these transactions need to be properly structured to have the desired tax effects.

#### **Deferring 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 must enter into a bona fide arm's-length contract with the buyer that calls for payment in the year following the year of delivery of the grain, livestock, or other commodity. Farmers are eligible to use installment sale reporting because the raised commodity is not required to be inventoried [Treas. Reg. §15A.453-1(b)(4)].

To avoid constructive receipt of income, the contract should be in place before the

commodity is delivered to the buyer. Furthermore, the contract should specify that the producer has no right to the payment until a specific date in the next tax year.

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

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

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 10: Prepaid Purchase of Chemicals

On December 20, 2011, Herb A. Cyde, a cash method farmer, purchased enough Round-Up™ to treat his expected 2012 acreage of corn and soybeans for delivery in the spring of 2012. 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 2011 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 2012, so the benefits do not extend more than 12 months after Herb acquired the right.

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#### Payment and Prepaid Expenses

To be deductible for a cash-basis producer, the expenditures must actually be paid during the tax year. Regular or prepaid expenditures are considered as paid if paid by the producer, charged to a credit card, or paid using funds from a third party. Charging the purchase to an account with the supplier or using financing with the seller does not constitute payment and the expenditures would not be deductible expenses in the current year.

If Herb from Example 10 had just charged the Round-Up to his account at the input supplier, the \$14,000 expenditure would not be deductible in 2011.

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#### Example 11: 12-Month Rule

I.M. Liable, a cash method farmer, purchased farm liability insurance for the July 1, 2011 to June 30, 2012 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 2011.

If I.M.'s liability policy covered the July 1, 2011 to June 30, 2013 period, the benefits extend beyond 12 months after I.M. first realized the benefits of the policy.

Therefore, only the premium allocable to 2011 can be deducted in 2011. If the total premium was \$2,400, only \$600 ( $\$2,400 \div 24 \text{ months} \times 6 \text{ months}$ ) is deductible in 2011.

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### 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 percent of the aggregate deductible expenses other than the prepaid expenses, or
2. Extraordinary circumstances (such as a flood or a drought) caused prepaid expenses to exceed 50 percent of

farming expenses, other than prepaid expenses, in the current year.

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### Example 12: Prepaid Purchase of Fertilizer

Patty Producer uses the cash method of accounting. In December 2011, she paid \$20,000 to Farm Supply, Inc. for specific quantities and analyses of fertilizers to be applied in the spring of 2012 on her corn crop. Pattie's deductible expenses on Schedule F (Form 1040) for 2011, other than the prepaid fertilizer, were \$100,000. Patty purchased the fertilizer in 2011 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 2011 Schedule F (Form 1040). She meets the three tests to be qualified farm-related taxpayer. Furthermore, Patty has not exceeded the 50-percent limit.

If Patty Producer had purchased fertilizer and lime in December 2011 and the fertilizer and lime was applied before January 1, 2012, the fertilizer and lime would be deductible in 2011 and would not be prepaid expenses.

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### 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 13: Active Participation Exceptions Do Not Apply to Cousins

Three brothers operate a farm, and all are actively involved in management of the farm

and are not a farming syndicate. With time, all three brothers pass on and leave their respective equal shares of the farm operation to their children.

The three heirs form a family limited partnership, with two cousins being limited partners and the other cousin actively engaged in the farming operation. Although related as first cousins, the three heirs are not family members under I.R.C. § 267(c)(4), and the family limited partnership is a farm syndicate that is subject to prepaid expense limitations.

## FARM INCOME AVERAGING

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

### Farm Income

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

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

### Averaging Procedures

The basic concept of farm income averaging is relatively simple and uses Form 1040 Schedule J. A farmer may elect to average part or all of the farm income in the election year, e.g., 2011, and have that elected farm

income treated as if it have been earned equally over the preceding three base years, 2008 to 2010, 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 2012, the portions of the base years' tax brackets used with the previous income averaging in 2011 are not available for 2012 and later years. 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.

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#### Example 14: Farm Income Averaging

Danica is an unmarried crop producer with 2011 Schedule F income of \$150,000 and taxable income of \$140,500. Danica's regular tax liability, without income averaging, would be \$32,957, and her marginal tax rate would be 28 percent. If Danica had \$13,000 of the unused 15-percent tax bracket for each one of the base years to compute her 2011 income tax, she could elect to income average \$39,000, and this would be taxed at the 15 percent. With income averaging, Danica's total 2011 regular income tax liability would be \$27,104, a savings of \$5,850 ( $\$39,000 \times (0.28 - 0.15)$ ). Danica's 2011 marginal tax rate is still 28 percent after averaging \$39,000.

Danica 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.

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#### Example 15: Optimal Income Averaging

Danica, from Example 14, had completely used the 15-percent tax brackets for the base years. Additional income in the base years from income averaging would be taxed at the 25-percent rate. Danica's marginal tax rate in the election year would also be 25 percent if her taxable income was not over \$83,600. If Danica elected to income average \$56,900 ( $\$140,500 - \$83,600$ ), the marginal tax rates would be equal, and Danica would save an additional \$461 ( $\$54,370 - \$39,000 = \$15,370 \times 0.03$ ), making her total savings from income averaging \$6,311 ( $\$5,850 + \$461$ ).

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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 2011 farm capital gain income (unless offset by non-farm capital losses) to the 2011 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 2011. All of the elected income would be ordinary income and allocated equally to the three prior years. However, if the farmer elected

to average \$120,000 of farm income, at least \$20,000 would be Section 1231 gains. In this situation, one-third of the elected Section 1231 gain would be taxed according to the “rules” for each base year.

### **Some Management Considerations**

Income averaging will have the greatest attraction for farmers whose income in this year is much higher than in the preceding 3 years and who have made only limited capital expenditures eligible for Section 179 expensing or 50- or 100-percent additional first-year depreciation. Beginning farmers with limited income in prior years could be in this situation. Individuals do not have to have been in farming in the base years to qualify for farm income averaging. Farm families whose off-farm income has increased sharply (perhaps because of a new off-farm job) would be eligible to average their farm income and perhaps reduce their current tax liability. However, only the farm income is eligible for income averaging.

Retiring farmers and others disposing of assets may also be able to take advantage of income averaging.

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

## **CROP INSURANCE AND DISASTER PAYMENTS**

Cash-basis farmers must generally report payments as income for the year the payment is received. If a producer receives crop insurance or disaster payments in the year of production, this can cause a bunching of income for farmers who normally store their crop and sell it in the year following the year of production. I.R.C. Section 451(d) allows a farmer who normally sells the crop in the year following the year of production to elect to postpone reporting the payments received until the year following the year of production. Such an election covers payments for all crops from a farm, requires the same treatment of both crop insurance and disaster payments, and is limited to physical

losses of production. If a farmer has more than one farming business and he or she keeps separate books, separate elections can be made for each business. The election to postpone the recognition of income from the crop loss payments must be attached to the return (or amended return) for the year in which the payments were received. The election statement must include:

1. Name and address of the taxpayer.
2. Statement that the election is being made under I.R.C. Section 451(d).
3. Identification of the specific crops damaged or destroyed.
4. A declaration that, as normal business practice of the taxpayer, the income

from the destroyed or damaged crop would have been included in gross income for a tax year following the year the crops were damaged or destroyed.

5. Cause of the damage or destruction of the crop(s).
6. Date of damage or destruction of the crop(s).
7. Total amount of payments received, itemized for each crop and the date when each payment was received.
8. Name(s) of insurance carrier or carriers making the payments.

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

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

producers can find authority to support at least two different positions.

A second issue is that only payments for the physical loss of a crop can be deferred into

crop revenue products, such as the COMBO policy which replaced Crop Revenue Coverage (CRC) and Revenue Assurance (RA), make payments if the price of the grain declines sufficiently between planting and harvest. For example, the average price of the December corn futures contract during February 2011 was \$6.01 (\$13.49 for November soybeans). For crop revenue purposes, this is referred to as the “base price.” The 2011 harvest time future contract prices of the November soybeans and December corn futures were \$6.32 and \$12.14, respectively. Because harvest prices for soybeans 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,

This would include the COMBO and group policies. (GRP and GRIP) as well as Revenue Assistance Payments (SURE).

Insurance payments made on the county-based Group Risk Plan (GRP) and Group Risk Income Plan (GRIP) are not based on actual physical losses of a producer. Thus, the indemnity must be recognized when received.

There would be similar treatment for the Average Crop Revenue Election (ACRE) program.

Producers who deferred crop insurance indemnities from 2010 to 2011 should report those 2010 indemnities paid as 2011 income.

## **WEATHER-RELATED SALES OF LIVESTOCK**

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

### **Sale with Replacement**

The gain on the weather-forced sale of livestock held for draft, breeding or dairy (not sporting) purposes does not need to be reported as income if the proceeds are used to buy replacement livestock within two years after the end of the tax year of the year of sale. Although declaration of a disaster area is not necessary, a producer must be able to show that weather-related conditions forced the sale of more livestock than would normally be sold. For example, a beef producer who normally sells five cows per year may sell 20 cows in 2011 because of

limited feed supplies. Gains from the sale of the extra 15 cows would not be reported as income if the producer purchased at least 15 replacement animals before the end of 2013. The new livestock must be used for the same purpose as the livestock which was sold. Beef cows must be replaced with beef cows.

A producer's tax basis in the replacement livestock equal to the basis in the livestock sold plus any additional amount invested in the replacement livestock that exceeds the proceeds from the sale. For example, a producer sells 20 raised beef cows (with a \$0 tax basis) for \$500 each. The gain of \$7,500 (15 cows sold in excess of normal business practice X \$500) is deferred. If the producer purchased 15 cows in 2013 for \$600 each, the tax basis in the replacement animals would be \$100 (the \$600 cost minus the \$500 proceeds from sale).

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

- (1) Evidence of weather-related conditions which forced the sale of the livestock.
- (2) Computation of the amount of gain realized on the sale.

- (3) The number and kind of livestock sold.
- (4) The number and kind of livestock that would have been sold as normal business practice without the weather-related sales.

If a producer spends \$7,500 and buys 15 cows before the end of 2013, the basis of the replacement animals will be \$0, the same as the raised cows sold. If the producer spends less than \$7,500 on the 15 replacement animals, the difference between what was spent and \$7,500 must be reported as 2011 income.

If less than 15 replacement cows are purchased, the gain from the animals not replaced must be reported as 2011 income regardless of the cost of the replacement animals. When filing an amended 2012 return, the producer will be subject to additional tax and interest on the tax.

### **Sale without Replacement**

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

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

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

For example, a producer normally farrows and feeds 2,000 pigs per year. However, because of drought which caused the area in which the farm is located to be declared a disaster area, the farmer sells 1,000 pigs as feeder pigs in 2011, rather than feeding them and selling them as market hogs in 2012. Under normal practice, no feeder pigs would be sold, so the proceeds from the sale of the 1,000 head can be deferred ( $\$35 \text{ per head} \times 1,000 \text{ feeder pigs} = \$35,000$ ) can be deferred until 2012.

## CASUALTY LOSSES

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

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

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

property to its previous condition, not be excessive, not fix more than the damage suffered, and not increase the value of the property above its value before the casualty. Note that the costs of the repairs are used as a measure of the decrease in the taxpayer's basis and are not being deducted as the casualty loss. The costs of repairing or restoring the damaged property can generally be deducted as ordinary and necessary expenses.

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### Example 16: 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.

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### Example 17: Insurance/Government Payments

If April, from Example 16, receives a \$5,000 payment from the insurance company or government assistance, her casualty loss deduction of \$10,000 would be reduced by the amount of the insurance or government payment. Commonly April would deduct her clean-up and restoration expense of \$5,000 on Schedule F, Form 1040.

## SELF-EMPLOYMENT TAX UPDATE

Many farmers continue to be concerned about the self-employment (SE) tax. For 2011, earnings of up to \$106,800 are subject to the 12.4-percent tax for social security, and all earnings are subject to the 2.9-percent Medicare tax. For 2012, the maximum social security portion increases \$110,100 and there is 3.6 percent cost of living adjustment for 2012 benefits.

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

Under prior law, farmers were allowed to elect the optional method of paying SE tax.

1) If gross farm income was not more than \$2,400, they could elect to pay SE tax on two-thirds of their gross farm income. 2) If gross farm income was over \$2,400 and net farm profits were less than \$1,733, they could elect to pay SE tax on \$1,600.

However, the optional farm method provided only one quarter of coverage annually for “currently insured” status under social security. An individual must have been covered for at least six of the 12 quarters preceding the quarter of death to qualify for survivors’ benefits and at least 10 of the last 20 quarters to qualify for disability benefits.

As part of the 2008 Farm Bill, Congress updated the dollar limits for the optional farm and non-farm methods. The current law refers to “the lower limit” as the amount required to earn four quarters of coverage (\$4,520 in 2012) under the Social Security Act. The “upper limit” is 150 percent of the lower limit. Thus, if gross farm income is not more than \$6,780 in 2012, 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 \$1,130 of income. If gross farm income is greater than \$6,780 and net farm profit is less than dividing the lower limit of \$4,520 by 0.9235 or \$4,894

for 2012, the farmer can pay SE tax on \$4,721 to earn four quarters of coverage.

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

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

About 1995, the IRS began to challenge these arrangements with some success in Tax Court. Three cases were appealed to the 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 Revenue Ruling has not been implemented, but the *2009 Farmer's Tax Guide* states that all CRP payments must be reported on Schedule F.

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

For those not receiving social security benefits, the situation is less clear. The IRS can argue their position that annual CRP payments were earnings subject to self-employment tax was correct or the Farm Bill provision would not have been necessary. Furthermore, by 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).

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### Example 18: Gift of This Year's Commodities

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

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Example 19: Gift of a Prior Year's Commodity

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

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

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

Charitable donations of current or prior year commodities may reduce taxes for cash basis farmers, especially those who cannot

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

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

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Example 19: Tax Savings from Charitable Contributions

In December 2010, a cash-basis farmer delivers 2010 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

$\$3,000 - [\$423.89 + 418.21 + 121.67]$   
 $= \$2,035.23$

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

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

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## 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 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 2012 or delayed into 2013. A part of the 2012 direct payments from the government for corn, soybeans, and wheat can be collected in 2010 or after December 31, 2011.

The 50- or 100-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 2012 can, up to a limit, also affect the taxable income. Although delivery of inputs purchased before January 1, 2012 is not required for a tax deduction, a purchase of specified products, rather than just a deposit, must be made in order to claim a deduction for prepaid expenses. This means that the invoice should list specific products and quantities, and the arrangement should not accrue interest to the purchaser.

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

Tax implications of major decisions should still be considered before the transactions are finalized. Installment sale contracts often have tax benefits because the taxable gain on the sale is spread pro rata over the tax periods in which the contract payments are received, with certain exceptions. Tax-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 very worthwhile.

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## Appendix: MACRS Class Lives and Depreciation Rates

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

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

**5-Year MACRS property** includes cattle held for breeding or dairy purposes, computers, and some construction equipment. Congress specifically included automobiles, pickups, and other trucks in the 5-year class. Special depreciation limitations and recordkeeping requirements apply to passenger vehicles. For passenger vehicles acquired in 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.

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

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

Deductions by year, as a percentage of the initial depreciable basis, for assets acquired after 1988 are shown in Table 1. These MACRS percentages reflect the “half-year convention” for the year of purchase. The equivalent of six months’ depreciation is allowed whether an asset is placed in service on January 1 or December 31. If a \$100,000 asset were purchased in 2003, the first year’s depreciation allowed would generally be \$25,000 for 3-year MACRS property, \$15,000 for 5-year property, \$10,710 for 7-year property, or \$7,500 for 10-year property. The “half-year” convention is also used for the year of disposition. For example, if a tractor acquired in 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 2. 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