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TAX MANAGEMENT TIPS FOR FARMERS

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2001 - End-of-Year Tax Planning

1. The basic management guideline is to avoid wide fluctuations in taxable income because a relatively uniform income from year-to-year results in the lowest income tax and largest Homestead and farmland preservation credits over time. However, even in a low income year, plan to use personal exemptions and the standard deduction.

2. Some changes:

   (a) Capital gains rates for sale of long-term capital assets held for 12 months or longer (24 months for breeding cattle and horses) are 20% if taxable income is in the 27.5% bracket or higher and 10% for that portion of capital gain between taxable income and the top of the 15% bracket ($27,050 single and $45,200 married). To the extent of depreciation on depreciable real estate, it will be recaptured like 1245 property (i.e., farm personal property such as machinery), but at a maximum rate of 25%.
   (b) Starting in 2001, if you are in the 15% tax bracket, capital gains on assets held five years or more will be taxed at 8% rather than 10% until the gain pushes you into the 27.5% bracket. For taxpayers in the 27.5% bracket or higher, the five-year holding period begins only for assets acquired after December 31, 2000. However, a special election can be made in filing your 2001 taxes to have the holding period begin January 2, 2001. This will require reporting any gain to January 1, 2001 on your 2001 return. Cannot report any losses from this election.
   (c) The self-employed health insurance deduction is 60% in 1999-2001, and increases to 70% for 2002 and 100% for 2003.
   (d) The sale of principal residence after May 6, 1997 is tax free on up to $500,000 of gain for married filing jointly ($250,000 single) if occupied by owner for two of last five years. Your residence would not include any land you have previously used for business purposes.
   (e) An increase from $250 to $2,000 for the annual unemployed spousal IRA contribution.
   (f) Penalty free IRA distributions may be taken to pay for medical expenses and/or health insurance premiums to the degree expenses exceed 7.5% of adjusted gross income.
   (g) The section 179 (direct expense) deduction for capital purchases is $24,000 in 2001 and 2002, and $25,000 in 2003.
   (h) A income averaging provision for farm income (Schedule F averaged and Schedule J) is permanent and negative taxable income can be used from the base years. 1999 and 2000 returns may be amended.
   (i) A 5-year net operating loss carry-back for farm losses, or use current losses by converting regular IRAs to Roth IRAs.
   (j) Starting in 2000, when an asset is traded in on a new item, the asset traded in continues to be depreciated under its life and method and only the cash and/or financed difference is set up on a new schedule.

3. Depending on your tax situation, you may wish to reduce or increase net income for 2001. Following are some of the best income eveners:

   (a) Buy or delay purchase of supplies such as fertilizer, seed, farm supplies, small tools, and repairs (tax shelters can only deduct items when used). Note: these expenses cannot exceed 50% of your total Schedule F expenses for the year for which economic performance has occurred. In most cases, it will be hard to reach that level of expenditure.
   (b) Pay in 2001 or delay payment to 2002 on real estate taxes and other annual bills. (Insurance premiums, real estate rental for 2002 and interest cannot be paid in advance to obtain an earlier tax deduction, but 2001 expenses of insurance, rentals and interest can be deferred to 2002 if income is low this year).
   (c) Watch the timing of sales of livestock and crops ready for market near year-end. Possibly they can be held for sale next year at little cost or sold earlier to even out taxable income.
   (d) Some expenses are deductible as current year business expenses even though not made every year. These include minor repairs on improvements and machinery, painting of buildings, purchase of small tools and supplies, and within limitations, cost of approved soil and water conservation expenses. Get these jobs done and paid for before year-end if you wish to reduce net income.
   (e) Where capital purchases have been made, or can be made, study the depreciation alternatives carefully. The direct expense deduction of up to $24,000 on personal property can be taken on current year capital purchases. Its use, however, cannot reduce your taxable income from farming (plus other <u>earned</u> income) below zero. Taxable income includes net farm profit plus gains on the sale of business assets such as breeding livestock. Where pre-productive expenses are not a consideration, there are three choices for depreciation: Modified Accelerated Cost Recovery System (MACRS) which is 7-year 150% declining balance on machinery; MACRS straight line; and the Alternative Depreciation System (ADS), which is 10-year straight line on machinery. For the first year the mid year convention is used (1/2 year's depreciation), unless 40% or more of your capital purchases are made during the last 3 months of the year. In that case, the mid-quarter convention is used (87.5% of a year's depreciation for purchases made during the first 3 months, 62.5% for purchases in the second quarter, 37.5% for the third quarter, and 12.5% in the final quarter).
   (f) Pay your children wages for work actually performed for the farm. If the child is under 19 <u>or</u> regularly enrolled in school, they can earn any amount and the parent can still claim an exemption for them <u>if</u> the parents pay over half the child's support. The parents must use the dependent exemption. The child must file a tax return only if they earn over the standard deduction ($4,550) unless they have unearned income. In that case, the standard deduction is <u>earned</u> income plus $250 up to a maximum of $4,550. A return, usually a 1040A, must be filed by a child under 14 if investment income is greater than $750. Children under 14 will have unearned income taxed at the parents' rate. Form 8615 is used to calculate the tax. Parents may elect to report the child's income in their return (Form 8814).
   (g) For Michigan income tax an individual who is eligible to be claimed as a dependent on someone else's return and has an adjusted gross income of $1,500 or less is entitled to a refund of all Michigan tax withheld.
   (h) Frequently unrecorded and forgotten expenses include:
      (1) Educational expenses that maintain or improve your skills, such as magazine subscriptions, books, fees at extension or other agricultural organization meetings.
      (2) Travel expenses connected with your business, particularly if it includes meals and lodging.

(3) Entertainment expenses when hosting others where the predominant purpose is the furthering of your farm business operation.

4. Social Security and hospital insurance rates for the self-employed are 12.4% and 2.9% for a total of 15.3% on 0.9235 of net farm profit up to $80,400 for 2000. One-half of the Social Security tax will be deducted as an adjustment to income. In addition, the 2.9% hospital insurance tax continues on income over $80,400. The 2002 income level is $84,900.

Long-Range Tax Planning

1. Maintain a good set of records to insure that all expenses are taken. Small cash purchases are easily forgotten. A good record keeping system is essential for end-of-year tax planning, as well as working with credit agencies.

2. Where income is high enough, plan the purchases of machinery to fully utilize the direct expense deduction.

3. Plan your personal deductions. Many medical expenses and contributions formerly spread over 2 years can be paid in 1 year and itemized as deductions. In the next year, the standard deduction may be taken. Changes in itemized deductions include medical expenses in excess of 7.5% of AGI, no personal interest is deductible, moving expenses are now an itemized deduction and most miscellaneous deductions are deductible only to the degree they exceed 2% of AGI.

4. If your medical insurance and medical expenses are not currently deductible, explore the medical benefit alternatives for the self-employed and choose an alternative that best fits your situation.

5. Investigate a Self-employed Retirement Plan. There are four potential tax deferred retirement plans available. A defined contribution Keogh and Simplified Employee Plan (SEP) require that certain employees also be covered. Tax deferred contribution limits to a profit-sharing plan@ are an effective 13.0435% (15% of net income less the contribution). A simple plan replaced SEPs starting in 1997. The fourth alternative is an Individual Retirement Account (IRA). Employees do not have to be covered if a self-employed person utilizes an IRA; however, the maximum contribution is $2,000 per year in 2001, with an additional $2,000 in an unemployed spousal IRA. An IRA deduction cannot be utilized if the contributor is eligible to participate in another retirement plan and when AGI exceeds $63,000 for a married taxpayer, or $43,000 for a single taxpayer with reduced contribution limits for AGI down to $53,000 and $33,000, respectively. These phase-out levels increase over the next few years.

6. Where income is low or negative, consider the transfer of regular IRA balances to a Roth IRA to take advantage of future non-taxable income. However, adjusted gross income cannot exceed $100,000 to be eligible for a transfer.

7. Your farm business is a built-in deferred compensation and tax loss program. Investments and current expenses are made that substantially improve the value of the business property which can be sold at a later date, frequently at capital gains rates. Establishing a fruit orchard and increasing the size of a

breeding livestock herd, for example, fits this situation. Crops that fit this category are timber, fruit trees, and Christmas trees as well as the build-up in year-end inventories.

8. Use installment sales of capital items to spread income over a number of years. However, with fewer and wider tax brackets and depreciation recapture considerations, an installment sale may not be advantageous.

9. If approaching retirement, keep in mind the new $500,000 per couple ($250,000 each) exclusion of gain from tax for that portion of a farm sale attributed to your residence. Also, plan for more of your income from rent, dividends, interest, and pensions rather than earned income so that income will not be taxed as self-employment income for Social Security or reduce Social Security benefits. Earned income levels that will decrease Social Security benefits for 2001 are $10,680 per year for those under age 65. The decreases are $1 for every $2 of excess earnings for those under 65. For age 65 and over there is no reduction, but Social Security taxes are still paid on earned income.

10. Be sure to deduct as large a portion of business-personal expenses as is justified in your situation. Frequently, considerably more than 50% of the electricity and phone costs, can be considered business. Also choose the method for auto deductions which is best for you. The standard mileage rate for 2001 is 34.5 cents per mile for business mileage. Mileage for charitable purposes can be itemized at 14 cents per mile; for medical purposes, 12 cents per mile.

11. Be aware of the Alternative Minimum Tax in tax planning. Alternative Minimum Taxable Income (AMTI) includes tax preference items such as the difference between MACRS and ADS depreciation, and tax-free interest as well as regular income. There is a single $49,000 exemption for those filing joint returns ($35,750 single) and a tax rate of 26% on the first $175,000 of alternative minimum taxable income and 28% on AMTI in excess of $175,000. It is paid to the degree the tax exceeds your regular tax, which for farmers is likely to occur when investment tax credit carryover reduces the regular tax, when MACRS depreciation deductions are very large and taxable income is low, or when using farm income averaging.