# Tax Issues for Farmers: Rules & Tax Management

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# Income Tax Items Covered

- Should you want to pay taxes?
- What is the difference between "tax avoidance" and "tax evasion"?
- What are self-employment taxes and why are they important?
- How can taxes be managed?

# Why It Is Important to Pay Taxes!

- It means you are making a profit! (The more taxes you pay, the more profit you are making.)
- You increase your Social Security Benefits when you retire through the payment of Self-Employment Taxes.
- You obtain disability and survivor benefits through the payment of Self-Employment Taxes as well.

# 2016 and 2017 Tax Rates

| Ordinary Income | Capital Gain and Qualified Dividends[1] |
|---|---|
| 10% | 0% |
| 15% | 0% |
| 25% | 15% |
| 28% | 15% |
| 33% | 15% |
| 35% | 15% |
| 39.6% | 20% |

[1]Qualified dividends are dividends received from a domestic corporation or a qualified foreign corporation.

## Progressive Tax System

- So a taxpayer filing as single is in the 28 percent tax bracket, does this mean that person is paying the US Treasury 28 percent of their taxable income?
- YES or NO?
- No!!! Must look at the "Effective Tax Rate".

# Effective Tax Rate

- Total Tax paid divided by Total Income from ALL sources.
- \$29,517.50 ÷ 186,500.00 = 15.8%
- In other words, 15.8 percent of your income is used to pay the Federal income tax liability.
- Marginal tax rate is 28 percent.

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## Cash Method of Accounting

- Easy to keep and allows for income tax management.
- Include income in the year when actually received.
- Include expenses in the year when actually paid.
- Postpone income and/or prepay expenses to manage taxes. (Simply time when income is received and expenses are paid)

## Objective of Income Tax Management

- Maximize after-tax net income over time by reducing the tax bite associated with high income years.
- Must consider tax as a cost, like any other cost of doing business.
- Minimizing taxes can result in over-investment.
- Tax avoidance = Minimum legal tax
- Tax evasion = Jail
- Manage the business then manage income taxes.

# Annual Income Tax: Variable Income

| Year | Taxable Income | Marginal Tax Rate | Tax Owed |
|---|---|---|---|
| 2009 | $24,000 | 15% | $2,469 |
| 2010 | $100,000 | 25% | $17,353 |
| 2011 | $2,000 | 10% | $201 |
| 2012 | $145,000 | 28% | $28,379 |
| 2013 | $42,000 | 15% | $5,411 |
| 2014 | $155,000 | 28% | $30,647 |
| 2015 | $78,000 | 25% | $11,043 |
| Totals | $546,000 | | $95,803 |

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# Annual Income Tax: Steady Income

| Year | Taxable Income | Marginal Tax Rate | Tax Owed |
|---|---|---|---|
| 2009 | $78,000 | 25% | $11,881 |
| 2010 | $78,000 | 25% | $11,869 |
| 2011 | $78,000 | 25% | $11,756 |
| 2012 | $78,000 | 25% | $11,566 |
| 2013 | $78,000 | 25% | $11,364 |
| 2014 | $78,000 | 25% | $11,219 |
| 2015 | $78,000 | 25% | $11,043 |
| Totals | $546,000 | | $80,698 |

# Tax Impact of Variable Income

- $15,105 more tax paid due to income variability ($95,803 - $80,698)
- Income Tax Management evens out taxable income over time.
- Goal is to avoid the higher tax rates or brackets.
- Best to be in one bracket over a period of years.

# Tax Management

- Some tools work prior to year end.
- Some tools work after the tax year has ended.

## Tax Management Tools

- Depreciation & Section 179 Deduction (refer to Depreciation Tools presentation)
- Prepaying Farm Expenses
- Income Averaging
- Increase deductions (property tax, State estimated tax, charitable contributions, and/or medical payments) in high income years.

## Farm Income Averaging

- Takes advantage of unused or unfilled lower tax brackets from 3 prior years.
- Example: 2014 – Due to a sizable Livestock Forage Disaster Program payments, taxable income is $195,000 (25% tax bracket starts at $148,850).

# Farm Income Averaging

- Manage the tax bite by averaging with prior years' taxable income.
- 2011 – $10,000 below beginning of 25% bracket.
- 2012 - $15,000 below beginning of 25% bracket.
- 2013 - $20,000 below beginning of 25% bracket.

## Farm Income Averaging

- Move $30,000 from 2014 and put $10,000 additional income in 2011, 2012, and 2013 and save roughly $3,000 in total tax.
- Income averaging does not reduce self-employment tax; net investment income tax; or phase-out of personal exemptions and itemized deductions

## Farm Income Averaging

- Can use ordinary income as well as capital gains (all or any part).
- Elected Farm Income is from Schedule F or capital asset sales but not land.
- Individual, Partner, & S Corp Shareholder can use this provision (not a C-Corporation).
- Pay the increase in income tax only.

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# Prepaid Farm Expenses

- Farm-related (cash basis) taxpayers may deduct up to 50% of the cost of prepaid supplies and feed in the year of purchase rather than when the items is used.
- Farm-related taxpayer:
    1. Main home is on the farm,
    2. Principal business is farming, or
    3. A family member of someone who meets both 1 and 2 above.

## Prepaid Farm Supplies Expense

- It is the amount paid during the current tax year for items not to be used until the next tax year. Excludes items not used due to extraordinary circumstances (flood, fire, drought, etc.)
- Deduction for prepaid farm supplies expense is limited to 50% of other deductible farm expenses in either the current year or the prior 3 years.
- Has to be for business purpose (not tax avoidance), cannot be a deposit (farmer is bound to accept delivery), and cannot materially distort income.

## Prepaid Supplies Expense

- The allowed deduction is 50% of the total deductible expenses (excluding prepaid amounts) for the tax year.
- Example: in 2015 you purchased and used $100,000 of feed, seed, and fertilizer. At the end of the year you can prepay for up to $50,000 of supplies that will be used in 2016. (Any amount above $50,000 will be deductible in 2016.)

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## Prepaid Supplies Example (cont.)

- Now in 2016, purchased $40,000 of feed and supplies during the year and carried forward $50,000 prepaid items from 2015.
- At year end the amount that can be prepaid and deducted is $20,000 (50% of the actual deductible expense for 2015).
- There is an exception (discussed next).
- The tax law restricts this from being abused.

# Exceptions

- Exception: no limit if you are a farm-related taxpayer and either of the following apply:

1. The excess prepayment is due change in business operations due to extraordinary circumstances (flood, drought, etc.).
2. Total prepaid expenses for prior 3 years is less than 50% of total deductible expenses for the same 3 year period.

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# Office in Home

- Space in the home used as your principal place of business.
  - Can be a room
  - Can be an area that is not a separate room
  - Must be for exclusive and regular business use (not the kitchen or dining room table).
- There cannot be another principal place of business.

# Home Office Deduction

Limited to gross income from the business use of home being greater than total business expenses.

If gross income is less than expenses, insurance, utilities and possible depreciation will be limited.

Safe Harbor since 2013 allows a $5.00 / sq. ft. deduction up to 300 square feet of the home. ($1,500 maximum)

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# Doubling Up on Deductions

Can be useful:

- Property taxes: Make 2 payments in the same year in year (Jan. and Dec.)
- Oklahoma estimated tax payments: make the January payment in December.
- Medical expenses
- Charitable contributions

# Tax Planning & Management

- Year-round every day job.
- Basic tax law knowledge needed.
- When you don't know and ask questions.
- Ask "what if" rather than say 'this is what I did'. (The oops cannot always be fixed.)
- Professional advice will likely be needed.
- Year-end tax planning is always useful (level taxable income over time).

# References

The Farmer's Tax Guide:
IRS Publication 225
https://www.irs.gov/publications/p225/

Rural Tax Organization – Tax Topics
http://RuralTax.Org