

# CHAPTER 7

## OTHER TOOLS TO MANAGE TAX LIABILITY

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## Introduction

Chapter 5 presented timing techniques that can be useful in leveling out the peaks and valleys of farm income to avoid higher tax brackets. Chapter 6 explained the ways that various types of income are taxed and strategies for maximizing the income that is taxed at the lowest rates. This chapter describes additional tax law provisions that help farm producers manage or reduce their overall tax liability.

Either market or growing conditions may cause fluctuations in farm income. Legal restrictions may cap a deduction for expenses that are prepaid. Market considerations may promote either making such pre-purchases or delaying the sale of products. In such cases, farm producers may need to rely on additional tools provided in the tax law.

## Farm Income Averaging

Individual taxpayers with certain farm income may elect a 4-year method of income averaging. The tax on the election year taxable income is calculated by borrowing unused tax brackets from the 3 prior years (referred to as *base years*). The taxpayer chooses the amount (called *elected farm income* or EFI) of the current year farm income that will be taxed at base-year rates. This allows a farm producer with higher than usual income another technique for keeping income out of higher marginal tax rate brackets.

C corporations, estates, and trusts may not use the election. The IRS reports that this tax-saving method of calculating tax is being underutilized by taxpayers.

## Elected Farm Income (EFI)

EFI is limited to the lesser of the taxpayer's total taxable income [after subtracting any net operating loss (NOL) deductions] or the taxable income attributed to any farming business (called *electible farm income*). Electible farm income includes not only net farm profits from Schedule F (Form 1040), Profit or Loss from Farming, but also an owner's share of net farm income from an S corporation (including wages), partnership, or LLC. It does not include wages from a C corporation. Gains from the sale of farm business property (excluding land and timber) regularly used in farming for a substantial period are included in electible farm income.

A farming business includes nursery production, sod farming, and the production of ornamental trees and plants, as well as the production of livestock, fruit, nuts, vegetables, horticultural products, and field crops. However, gain from the sale of trees that are more than 6 years old when cut is not electible farm income, because these trees are no longer classified as ornamental trees. The income, gain, or loss from the sale of grazing and development rights or other similar rights classified as attributable to a farming business is not electible farm income.

The terms *regularly used* and *substantial period* are not defined in the Internal Revenue Code or congressional committee reports. However, Treasury regulations state that if a taxpayer ceases farming and later sells farm business property (other than land) within a reasonable time after the cessation of farming, gains or losses from the sale are farm income. A sale within 1 year is deemed to be within a reasonable time. Taxpayers must consider all of the facts and circumstances of sales beyond 1 year from the cessation of the farm business to determine if the asset was still regularly used in the farm business.

### Example 7.1 Facts and Circumstances

At the time Allie Gator quit farming in 2009, she sold her land, buildings, and most of her farm equipment. She did not sell her pickup truck at that time because she used it in her new construction business. She did not find a buyer for her combine until June 2011. She also sold her pickup in 2011.

Gain on the combine is electible farm income because Allie's only reason for holding it was to find a buyer after terminating her farm business. Gain on the pickup is not electible farm income because it was

realized more than a year after Allie terminated her farm business and she kept the pickup to use it in a non-farm business.

## Income-Averaging Tax

To calculate the income-averaging tax for the election year, taxpayers subtract EFI from the current year's taxable income and calculate the tax on the remaining income using the current-year income tax rates. The tax on the EFI is calculated by

1. adding one-third of the EFI to the taxable income of each base year,
2. computing the tax on the total from step 1 for each base year using the tax rates for each base year, and
3. subtracting the tax paid for each base year from the tax computed in step 2 for each base year.

The total tax for the election year is the sum of the tax on the election year income reduced by the EFI and the amount from step 3 for each of the base year calculations

Farm income averaging does not affect self-employment (SE) tax for either the election year or the base years. It also does not increase the alternative minimum tax.

Taxpayers report their income-averaging election and compute their income-averaging tax on Schedule J (Form 1040), Income Averaging for Farmers and Fishermen. The relevant lower tax rates for capital gains apply in the election year as well as in the base-year calculations.

### Example 7.2 Income Averaging

Fruit growers Mr. and Mrs. B & B Goodyear had a substantial increase in farm income in 2011. Receipts were up and costs were down. Mrs. Goodyear works off-farm. Their \$58,000 Schedule F (Form 1040) profits, combined with their nonfarm income and deductions, result in a \$93,000 taxable income. They file a joint return. Their taxable incomes for 2011 and the previous 3 years are shown in Figure 7.1.

**FIGURE 7.1: Goodyears' Taxable Income**

Year	Taxable Income
2011	\$93,000
2010	30,900
2009	60,550
2008	28,200

The Goodyears elected to income average in 2011. Their maximum EFI is \$58,000 (the amount of taxable income attributed to farming). Their optimum EFI may be the taxable income that exceeds their 15% tax bracket or \$24,000 (\$92,000 – 68,000). They decided to designate \$24,000 of their Schedule F (Form 1040) profit as EFI and tax \$8,000 per year at the tax rates borrowed from each of the 3 base years.

**Question 1.** Will all of the EFI be taxed at 15%?

**Answer 1.** In 2009 their 15% tax bracket ended at \$67,900, and their taxable income was \$60,550, leaving \$7,350 of the 15% rate bracket available for EFI from the election year. This \$7,350 is taxed at the 15% tax rate. However, the remaining \$650 (\$8,000 – \$7,350) added to the 2009 base-year income is taxed at the 25% rate from the 2009 tax brackets. For 2008 and 2010, all \$8,000 will be taxed at the lower rate.

**Question 2.** Should the Goodyears reduce EFI to avoid the 25% tax bracket from 2009?

**Answer 2.** For each \$1 of EFI subject to the 25% tax rate from 2009, \$2 is taxed at the 15% rate from the other 2 base years. Therefore, the marginal tax rate for the Goodyear's EFI is 18.33%  $[(15 + 15 + 25) \div 3]$ . If they put less than \$24,000 in their EFI for 2011, their income taxed at their 2011 tax rates will exceed \$69,000, and their marginal tax rate on the income taken out of the EFI will be 25%.

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**Question 3.** How much income tax will the Goodyears save by income averaging in 2011?

**Answer 3.** They will save \$2,205 [10% (25% rate – 15% rate) on the first \$22,050 (3 × \$7,350)], and \$130 [6.67% (25% – 18.33%) on the remaining \$1,950 of EFI], for a \$2,335 total tax reduction.

## Base Year Losses

The IRS allows the use of negative taxable incomes in the base years when performing the income-averaging calculation. This, in effect, allows such taxpayers to borrow 0% tax rates from the base years with eligible losses. However, there can be no double benefit from the negative taxable incomes already reflected in any net operating loss (NOL) arising from that year (see Chapter 10).

### Example 7.3 Income Averaging and Net Operating Losses

Abdul had a \$45,000 Schedule F (Form 1040) loss in 2010. He and his wife filed a joint return and claimed five personal and dependent exemption deductions (including three children). Their taxable income is a negative \$74,650, as shown in Figure 7.2.

**FIGURE 7.2: 2010 Taxable Income**

Schedule F	\$ – 45,000
Standard deduction	– 11,400
Exemptions	– 18,250
Taxable income	<u>\$ – 74,650</u>

Abdul's NOL for 2010 is \$45,000. This NOL must be removed from taxable income, leaving a negative \$29,650 to be used as base-year income for 2010 on Abdul's Schedule J (Form 1040), Income Averaging for Farmers and Fishermen, when he files his 2011 tax return.

## Questions and Answers

**Question 1.** Which taxpayers qualify for farm income tax averaging?

**Answer 1.** The Internal Revenue Code says that “individuals engaged in a farming business” qualify, and it specifically excludes estates and trusts. The IRS instructions indicate that individual owners of partnerships, LLCs, and S corporations qualify (farm income flows through the business and retains its character in the hands of the individual owner taxpayer). C corporations do not qualify for farm income averaging. Wages and dividends from a C corporation are not qualified farm income.

**Question 2.** Does the EFI retain its character as unused brackets are carried forward, and may the taxpayer select the type of income to include in EFI?

**Answer 2.** Taxpayers are allowed to carry forward the unused lower brackets as ordinary farm income and keep capital gains in current-year taxable income, or select the best combination of ordinary farm income and qualified capital gains to meet their tax management objectives. When a combination of ordinary farm income and capital gains is included in EFI, the IRS indicates that an equal portion of each type of income must be taxed at each base-year rate. The taxpayer cannot tax all of the capital gains at just one prior-year's rate.

Any capital gain that is taxed at a base-year rate is taxed at the capital gains tax rate in effect for that prior year. Therefore, 2011 farm business capital gains of a taxpayer in a 25% income tax bracket could be eligible for a 0% rate for capital gains if the taxpayer has a base year with taxable income in the 15% income tax bracket and those gains are included in EFI.

**Question 3.** Do farm owners who rent their farm or land for agricultural production qualify?

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**Answer 3.** If the farm owner materially participates in the farming activity and properly reports the income on Schedule F (Form 1040), this income qualifies for income averaging. Final regulations allow farm owners who do not materially participate but who receive crop-share rental income (properly reported on Form 4835, Farm Rental Income and Expenses) to also use the farm income-averaging rules. For crop-share rents, the lessor must have a written crop-share lease agreement. Cash rental income reported on Schedule E (Form 1040), Supplemental Income and Loss, is not income attributable to a farming business.

**Question 4.** How much farm use is required to meet the “regularly used in farming” rule that applies to gains from the sale of farm business property?

**Answer 4.** All sales reported on Schedule F (Form 1040) are qualified. Sales of raised dairy and breeding livestock reported on Form 4797, Sales of Business Property, qualify. Sales of farm property for which depreciation and I.R.C. § 179 deductions were claimed also qualify. Therefore, it appears as if all sales of farm machinery, buildings, and livestock qualify as being “regularly used.”

**Question 5.** Can taxpayers make the election to income average on an amended return?

**Answer 5.** Yes.

**Question 6.** If an NOL was carried to a base year, does the income-averaging election affect how much of that NOL is used in the base year?

**Answer 6.** No, the amount of the NOL used in the base year is not refigured as a result of taxing one-third of the EFI at that base year’s rate. Similarly, the base-year’s income, deductions, and credits are not affected by the additional income taxed at that year’s rates (for example, the taxable portion of social security benefits and the allowable deductions on Schedule A (Form 1040), Itemized Deductions, are not recalculated). The income-averaging computation on Schedule J (Form 1040) simply uses the tax brackets of the base years without altering the tax returns originally filed for those base years.

**Question 7.** Must a taxpayer use the same filing status in each year?

**Answer 7.** No, the tax is computed based on the filing status in effect for each base year and the election year.

**Question 8.** Can a taxpayer use income averaging even though it provides no current-year tax savings?

**Answer 8.** Yes, this technique may be used to shift income to the oldest base-period year, which drops out of the calculations for the following year. This may also allow the base-period incomes (and marginal tax rates) to be leveled out in anticipation of income averaging in future years. Use caution when including capital gains in the income-averaging computation because of the 0% rate of tax on adjusted net capital gain for 2008 through 2012 (but not for earlier or later years).

## Planning Guidelines

Generally it is better to implement economically sound income tax management practices throughout the year rather than use income averaging as the only tax management strategy. Use tax management practices that reduce taxable income and then elect income averaging as needed. Income averaging provides an opportunity for reducing only the regular income tax rates applied to the current year taxable income. Farm income averaging does nothing to reduce gross income or its impact on the many phase-outs of deductions and credits that are triggered by higher gross income.

An exception to this general rule may make income averaging a better option than reducing current year taxable income by using the techniques described in Chapter 5. The exception arises when net earnings from self-employment exceed the base for the social security component of the SE tax (\$106,800 of net earnings for 2011). Realizing high income that is exempted from this component of SE tax but that is eligible to be taxed at lower base year rates due to farm income averaging may be advantageous.

Income averaging should be used to transfer as much high-bracket income as possible from the election year to low tax brackets in the base years. There will be cases in which the EFI used in a base

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year is not taxed in the lowest bracket, but income averaging still saves taxes. A farm taxpayer needs the following information to determine whether and how much 2011 farm income should be averaged:

- Taxable income for 2011 as well as ordinary income and capital gain attributed to farming
- Taxable income from his or her 2008, 2009, and 2010 tax returns
- Income tax brackets for 2011 and the 3 prior years (see Figure 7.3)

**FIGURE 7.3: Top End of Taxable Income Tax Brackets**

Bracket	Single	Married Filing Jointly	Head of Household	Married Filing Separately
<b>2011</b>				
10%	\$ 8,500	\$ 17,000	\$ 12,150	\$ 8,500
15%	34,500	69,000	46,250	34,500
25%	83,600	139,350	119,400	69,675
28%	174,400	212,300	193,350	106,150
33%	379,150	379,150	379,150	189,575
<b>2010</b>				
10%	\$ 8,375	\$ 16,750	\$ 11,950	\$ 8,375
15%	34,000	68,000	45,550	34,000
25%	82,400	137,300	117,650	68,650
28%	171,850	209,250	190,550	104,625
33%	373,650	373,650	373,650	186,825
<b>2009</b>				
10%	\$ 8,350	\$ 16,700	\$ 11,950	\$ 8,350
15%	33,950	67,900	45,500	33,950
25%	82,250	137,050	117,450	68,525
28%	171,550	208,850	190,200	104,425
33%	372,950	372,950	372,950	186,475
<b>2008</b>				
10%	\$ 8,025	\$ 16,050	\$ 11,450	\$ 8,025
15%	32,550	65,100	43,650	32,550
25%	78,850	131,450	112,650	65,725
28%	164,550	200,300	182,400	100,150
33%	357,700	357,700	357,700	178,850

### Priority of Goals

1. Elect farm income until the marginal rate of the election year is not greater than the average of the marginal rates that are borrowed from the base years. Be sure to consider the effective rate if there are capital gains in the base year or in EFL.
2. Load the oldest base year followed by an equal amount in the other base years to the extent this can be done without increasing tax.
3. Elect additional income attempting to level the income of the current and prior 2 base years to prepare these years to be base years for next year's income averaging (again, only to the extent that this can be done without increasing tax).

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## CCC Commodity Loans And Loan Deficiency Payments

When the market price of a commodity falls below the marketing assistance loan rate offered by the Commodity Credit Corporation (CCC), producers may realize more income by taking advantage of one or more of the government program options. Those options and the income tax consequences of each option are discussed in this section. This allows the farm producer to maximize the use of lower tax brackets while selling the crop at the most favorable market price and avoiding the accumulation of income that might be pushed into higher marginal tax rates.

### CCC Nonrecourse Marketing Assistance Loan

Instead of selling a commodity, producers can use the commodity as collateral for a nonrecourse loan from the CCC. This alternative puts cash in the producer's pocket at the time of harvest and lets the producer wait to see whether market prices improve.

The Internal Revenue Code allows taxpayers to elect to treat these loans as income in the year received. They make the election on Schedule F (Form 1040), Profit or Loss from Farming. If the producer has not made this election, the CCC loan is treated the same way as any other loan. The IRS provides procedures for an automatic change in accounting method in the event that a taxpayer wants to stop reporting loans as income.

#### Example 7.4 Using CCC Commodity Loans under Election to Manage Taxable Income

Isabella is a crop farmer whose commodity is currently selling for 75% of the amount Isabella expects the market price to be next spring. She would like to wait until then to sell her crop, but her taxable income is currently projected to be only \$20,000 without any additional sales. It was a great crop year and Isabella expects her commodity to ultimately sell for \$60,000. She files a joint tax return with her husband and they are normally able to keep their taxable income near the top of the 15% federal income tax bracket and out of the 25% federal income tax bracket. If Isabella is unable to increase her current-year income, they will waste much of their 15% tax bracket this year and will also push \$60,000 of income into the 25% tax bracket next year. Farm income averaging could be used to obtain tax savings on some but not all of this income.

Isabella should consider obtaining a \$40,000 CCC commodity loan and electing to treat the loan as current year income. The \$40,000 loan will be taxed at a 15% tax rate.

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**If market prices subsequently rise above the loan rate**, producers can repay the loan, with interest, and then sell the commodity for more than the loan amount.

The income tax consequences of the sale depend upon whether or not the taxpayer made the election to treat the loan as income. In any event, the interest expense is deductible on Schedule F (Form 1040).

- Typically, the producer did not make the election to treat the loan as income, so he or she has no basis in the commodity. Therefore, the full sale price is reported as Schedule F (Form 1040) income.
- If the producer made the election to report the loan as income, he or she has basis in the commodity equal to the amount of the loan. That basis is subtracted from the sale price to determine the gain on the sale, which is reported in the resale section of Schedule F (Form 1040). (This treatment is the same as if the farm producer had purchased the crop for resale. Such resale crops have a basis equal to their original cost because that amount is not deductible at the time of purchase. Therefore, only the amount of sale price in excess of that original cost is taxable at the time of sale.)

**Example 7.5 Subsequent Sale of Commodity with Loan Under Election**

The following year, Isabella, from Example 7.4, sold her carryover commodity for \$60,000. However, because the crop was collateral for a CCC loan and Isabella had elected to report the loan as income, she recognizes only \$20,000 of income from the sale (\$60,000 sale proceeds minus \$40,000 of basis from the CCC loan under election). This increase in income may be much easier to tax-manage through the tax-planning techniques discussed in Chapter 5. In addition, Isabella and her husband were able to take advantage of the 15% bracket in the previous year by including the \$40,000 loan in their income.

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**If market prices do not rise above the loan rate**, producers should choose to redeem the commodity by paying the posted county price (PCP) to the CCC. By making that payment, the producer is no longer obligated on the loan and can keep the difference between the original loan rate and the PCP. This replaces the previous option of forfeiting the grain to the CCC.

A producer who redeems the commodity by paying the PCP will receive a Form CCC-1099-G from the CCC for the difference between the loan rate and the PCP (market gain). That amount must generally be reported as an agricultural program payment on Schedule F (Form 1040).

However, if the producer elected to treat the loan as income, the difference between the loan rate and the PCP is not reported as taxable income because the full loan amount was already reported in taxable income in the year it was received. Instead, the difference is subtracted from the producer's basis in the commodity so that the producer now has basis in the commodity equal to the PCP. The producer should still report the market gain on line 6a (agricultural program payments) on Schedule F (Form 1040) but not include it as taxable on line 6b.

**Loan Deficiency Payment**

If the market price of a commodity is below the loan rate, producers can choose not to borrow from the CCC but to instead claim a loan deficiency payment (LDP) for the crop. This presents another opportunity to increase taxable income when market prices are down at year end. The loan deficiency payment is equal to the difference between the loan rate and the PCP on the date the LDP is claimed. Producers obtain the same result as if they had taken the loan and paid the PCP rate on the date they claimed the LDP. The LDP is reported as an agricultural program payment on lines 6a and 6b of Schedule F (Form 1040).

**✓ Observation**

Note that reconciling taxpayer records to the amounts reported on Form CCC-1099-G can be challenging:

- CCC loan activity is not reported on the Form 1099. Borrowings and program payments may be commingled in taxpayer records.
- Often, advance government payments are made. If market conditions later are better than expected, these advances must be repaid. Sometimes these payments are simply netted from subsequent government payments; at other times they are paid by taxpayer check and can be confused with PCP "purchase" payments or repayments of CCC loans.
- Program payments are typically direct-deposited to the producer's bank account. Sometimes these payments are applied directly to CCC loan balances.
- Interest paid to the CCC on loans is not reported to the taxpayer on a Form 1099.



## Like-Kind Exchanges

A cardinal rule of taxation is that all income, from whatever source derived, whether received in cash or property, is taxable unless specifically excluded by law. Therefore, if a farm operator plows a neighbor's field and receives a steer in exchange, the farm operator must report custom work income equal to the market value of the steer. If a farmer trades five steers for a used plow, the farmer must report steer sales on Schedule F (Form 1040) equal to the value of the plow received.

The Internal Revenue Code (I.R.C.) provides an exception to this general rule for like-kind exchanges. These exchanges are often referred to as § 1031 exchanges after the I.R.C. section that describes them. I.R.C. § 1031 allows the gain in such exchanges to be deferred rather than recognized at the time of the exchange. When a taxpayer disposes of property, gain is *realized* to the extent that the value of whatever is received exceeds the total of the taxpayer's income tax basis in the property given up and any expenses of sale. Under the like-kind exchange rules, the realized gain is *recognized* (or reported as taxable on the taxpayer's tax return) only to the extent of cash and other unlike property received. The difference between the realized gain and the recognized gain is deferred. This deferral is accomplished by reducing the basis of the like-kind property received by the amount of the deferred gain.

### Example 7.6 Like-kind Exchange Concepts

Pablo exchanged property that qualifies as like-kind. His basis in the property given up is \$4,000. He received like-kind property with a \$10,000 value. Pablo therefore realizes a \$6,000 gain (\$10,000 value of property received minus his \$4,000 tax basis). However, Pablo recognizes gain only to the extent of unlike property received (none). Therefore, he defers the entire \$6,000 gain. His \$4,000 basis in the property he received is the \$10,000 price of the property received, reduced by the \$6,000 gain deferred on the exchange. If Pablo later sells the property received for its \$10,000 market value, he will then be taxed on the \$6,000 gain that was deferred at the time of the exchange.

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## Rules and Requirements

A § 1031 transaction must actually be an exchange of qualifying property. A sale of property, followed by a purchase of like-kind property, does not qualify for non-recognition of gain as a like-kind exchange unless the sales proceeds are held by a qualified intermediary and stringent timeframes regarding the replacement property are met. Gain or loss is recognized if the taxpayer actually or constructively receives money or non-like-kind property before the taxpayer actually receives the like-kind replacement property. Both the relinquished property and the acquired property must be used in a trade or business or held for investment.

- For real property, *like-kind* is interpreted very broadly. Any real estate can be exchanged for any other real estate as long as the relinquished property was, and the acquired property is, used in a trade or business or held for investment. Consequently, a farm can be exchanged for city real estate, and improved real estate can be exchanged for unimproved real estate. However, care must be exercised to ensure that any property subject to recapture rules (such as the depreciation recapture rules) that is included as part of the real estate given up is replaced with an equal amount of such recapture property in the replacement real estate received. The depreciation recapture rules apply to single-purpose livestock and horticultural facilities, silos, grain bins, and drainage tile. If this requirement is not met, the taxpayer must recognize ordinary income.
- *Like-kind* is interpreted to mean *like class* for personal property. Under Treasury regulations, *like class* means that both the relinquished and replacement properties are in the same product class under the North American Industry Classification System (NAICS). Most equipment used in a farm business is contained within product class 333111, which includes such items as combines, planters, tractors, plows, haying equipment, and milking machines. Farmers generally qualify for like-kind treatment when they exchange farm equipment for farm equipment. However,

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automobiles, general-purpose trucks, heavy general-purpose trucks, information systems, and other office equipment are all assigned to separate product classes. Livestock of different sexes are not property of a like kind, whereas exchanges of same-sex livestock have qualified as tax-free exchanges.

Farm taxpayers generally enter into like-kind exchanges every time they trade in a piece of equipment on another piece of equipment. Such treatment allows gain to be deferred by reducing the basis of the equipment received by the gain not recognized. The cost basis that the taxpayer depreciates is not the list price, nor is it just the cash paid to boot: it also includes the adjusted tax basis (often referred to as remaining book value) of the traded-in equipment. This approach to determining basis results in the same answer as reducing the purchase price by the gain deferred under the § 1031 rules.

**Example 7.7 Equipment Trade-in as Like-Kind Exchange**

Christy Chang had a planter with a \$6,000 depreciated basis. On March 15, 2011, she acquired a newer planter that the dealer had listed for \$12,000. Christy traded in her old planter and paid the dealer \$4,000 in cash. That trade is a like-kind exchange. The \$8,000 trade-in allowance (\$12,000 list price minus \$4,000 cash paid) was the dealer's opinion of the value of Christy's old planter. This becomes the sales price of the old planter. Christy therefore realized a \$2,000 gain, but she does not have to recognize any gain because she received no cash or other unlike property. Christy defers the \$2,000 realized gain by reducing the basis in the newer planter. Christy's basis in the newer planter is:

Cost	\$12,000
Less: Deferred gain	<u>– 2,000</u>
Basis	<u>\$10,000</u>

Note that this is the same result as calculating the basis by adding the \$6,000 adjusted tax basis of trade-in to the \$4,000 cash paid to boot.

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## Other Rules and Reporting Requirements for Like-Kind Exchanges

Taxpayers must use IRS Form 8824, Like Kind Exchanges, as a supporting statement for like-kind exchanges that either generate no taxable gain or gain that is reported on other forms [including Form 4797, Sale of Business Property, and Schedule D (Form 1040), Capital Gains and Losses]. A separate Form 8824 should be attached to Form 1040, U.S. Individual Income Tax Return, for *each* exchange. Form 8824 should be filed for the tax year in which the seller (exchanger) transferred property to the other party in the exchange.

If the relinquished property is subject to depreciation recapture or other recapture rules, part or all of the recapture must be recognized in the year of the like-kind exchange if the like-kind property received is not also property subject to the same recapture rules. Furthermore, any recapture potential not recognized in the year of the exchange carries over as an attribute of the asset received in the exchange, and it may trigger ordinary income recapture upon any subsequent sale of the property received.

### ✓ Observation

#### Related Parties

Like-kind exchanges between related parties can result in recognition of gain if either party disposes of the received property within 2 years after the exchange.

## Tax Planning Opportunities with the Like-Kind Exchange Rules

In many cases, a taxpayer benefits from deferring gain on an asset that is sold by using the like-kind exchange rules to roll the gain into a replacement asset. In some situations, however, it is better to recognize the gain at the time the asset is sold. The key to a successful tax plan is to analyze whether the cost of recognizing gain at the time the asset is sold is offset by the benefit of having additional basis in the property later. This question brings together many of the tax-planning issues discussed in Chapters 5 and 6.

- If gain is recognized, will it be ordinary income or income eligible for the reduced rate for capital gains?
- Will the property received in the exchange be depreciable? If so, how quickly?
- What is the income tax rate for the year of the exchange compared to years when depreciation will be claimed or the property received in the exchange might be sold?
- What impact does the self-employment tax have on the choice?
- Are there any state tax considerations that may favor recognizing gain and therefore having a higher basis in the property received?

The gain deferral under § 1031 is mandatory for all qualifying transactions. Therefore, a taxpayer who wants to recognize gain must carefully plan the transaction so that it is not a like-kind exchange.

### Example 7.8 Sale versus Like-Kind Exchange

John is considering buying a \$60,000 tractor. His current tractor has a \$20,000 adjusted tax basis, but the dealer will give John a \$25,000 trade-in allowance. John's neighbor offered to buy the old tractor for \$25,000. Should John trade or sell?

Assume that John is in the 25% federal income tax bracket, has a \$100,000 Schedule F (Form 1040) profit, and has purchased no other depreciable property this year. Also assume that the self-employment tax rate is 15.3% rather than the 13.3% that applies only in 2011.

With a like-kind exchange (trade-in), John would have no gain. His basis in the new tractor would be the \$35,000 cash paid plus the \$20,000 basis of the tractor he traded. John wants to maximize his deductions, so he claims the maximum \$35,000 § 179 deduction (limited to cash paid) and continues to claim the \$8,000 current-year depreciation on the trade basis. Therefore, his purchase generates \$35,000 of increased tax deductions. This reduces John's self-employment tax by \$4,945 ( $\$35,000 \times 0.9235 \times 0.153$ ). The deduction for one-half of the self-employment tax is therefore reduced by \$2,472, resulting in a \$32,528 ( $\$35,000 - \$2,472$ ) net decrease in taxable income. At John's 25% income tax rate, he will save \$8,132 of federal income tax. The total federal tax savings of the purchase using a like-kind exchange are \$13,077 ( $\$4,945 + \$8,132$ ).

If John sells his old tractor to the neighbor, he will recognize the \$5,000 gain. All of this gain is ordinary income because of the depreciation recapture rules, but it is not subject to self-employment tax. Without a trade-in, John will pay the dealer the full \$60,000 purchase price and can elect a \$60,000 § 179 deduction. He no longer receives the \$8,000 current-year depreciation on the old tractor, so the net reduction in his current-year Schedule F net income is \$52,000. This reduces John's self-employment tax by \$7,347 ( $\$52,000 \times 0.9235 \times 0.153$ ). The deduction for one-half of the self-employment tax is therefore reduced by \$3,674, resulting in a \$48,326 ( $\$52,000 - \$3,674$ ) net decrease in taxable income. At John's 25% federal income tax rate, he will save \$12,082 of federal income tax. The total tax savings of the sale followed by a purchase that is not a like-kind exchange are \$19,429 ( $\$7,347 + \$12,082$ ).

In the year of acquisition, John can reduce his tax liability by \$6,352 ( $\$19,429 - \$13,077$ ) by selling rather than exchanging his old tractor. However, tax planning is seldom a one-year proposition. With the trade, John will continue to depreciate the carry-over basis from the old tractor because he has deducted only \$8,000 of basis in the current year. He will deduct the remaining \$12,000 of basis in future years. If he continues in the same rate bracket, these future deductions will save John \$1,696 in self-employment

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tax and \$2,788 in income tax for a total of \$4,484. In this case, John is still better off structuring the transaction as a sale (\$6,352 savings in the exchange year, reduced by \$4,484 future taxes, for a net saving of \$1,868).

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## Shifting Income to Another Taxpayer

Chapter 5 discussed reducing self-employment tax by paying wages to the taxpayer's children under the age of 18. There are additional tax benefits to having other family members as bona fide employees, paying them for the use of farm assets they may own, or giving assets to them for them to sell.

Each taxpayer is entitled to his or her own standard deduction. In addition, if a taxpayer is not claimed as a dependent of another taxpayer, he or she is eligible for his or her own personal exemption deduction. Each taxpayer also has his or her own tax rate brackets to fill (unless subject to the so-called *kiddie tax*). These provisions of the tax law provide tax-planning possibilities for the farm family.

### Example 7.9 Employing Family Members

Sven is in the 25% tax bracket and on average has a \$100,000 Schedule F (Form 1040) profit. His 20-year-old daughter, Mary, is in college but spends many weekends, most school breaks, and summers working on the farm. She and Sven determine that \$7,000 is reasonable compensation for the work she does on the farm. Mary still qualifies as Sven's dependent.

Because Mary is not under age 18, she and Sven must pay FICA tax on her \$7,000 wage. Therefore, there will be no significant net savings from the reduction in Sven's self-employment tax. Because Mary is a dependent, she is ineligible for any deduction for a personal exemption. However, she is eligible for a standard deduction (\$5,800 in 2011). Mary has no other income, so her taxable income is \$1,200 (\$7,000 wages minus \$5,800 standard deduction). This leaves Mary in the 10% tax bracket, so she pays \$180 of income tax.

Sven reduces his taxable income by \$7,000 which saves \$1,750 of income taxes. The net federal income tax savings to the family is \$1,570 (\$1,750 – \$180) and the cash stays in the family.

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This approach could also be considered in paying wages to parents who have retired from the farm and find themselves in a lower tax bracket than the family members currently operating the farm.

#### ✓ Observation

There may be non-tax considerations that enter into payments to others. College financial aid may be impacted by the student having increased earnings. Social security benefits may be reduced for a retired parent who has not yet reached full retirement age. In addition, increased earnings for those collecting social security benefits could result in more of those benefits being subject to income tax.

### Example 7.10 Gift of Farm Asset

Gail, a dairy farmer, would like to give her daughter Beth \$10,000 in 2011. Because this is Gail's only gift to Beth this year and it is under the \$13,000 annual gift tax exclusion for 2011, she can make the gift without any gift tax consequences. However, Gail is in the 25% income tax bracket and Beth is in the 15% bracket. Gail normally sells \$10,000 of raised cows each year that qualify for capital gain treatment. Instead of gifting cash to Beth, she could gift \$10,000 of cows that Beth could then sell. If Gail sells the cows, the gain will be taxed at a 15% tax rate on capital gains. Beth is in the 0% tax bracket for capital gains, so the family can save \$1,500 in income tax.

## Non-farm Tax Planning

The majority of annual tax planning is likely to be driven by the income and expenses of the farm operation and how these items are managed using the techniques presented in this chapter as well as in Chapters 5 and 6. However, farmers and non-farmers alike may benefit from the following tax-planning considerations.

### “Bunching” Itemized Deductions

Taxpayers often find that their itemized deductions fall just short of the amount of their standard deduction, and therefore they claim the standard deduction each year. The “bunching” strategy involves shifting itemized deductions into alternate years, so that the taxpayer is eligible for itemizing in those years. In the intervening years, the taxpayer claims the standard deduction.

#### Example 7.11 Managing Itemized Deductions

Barney and Betty normally have about \$9,000 of itemized deductions. Therefore, they plan to claim the \$11,600 standard deduction for 2011 instead of itemizing deductions. Assuming the standard deduction is also \$11,600 for 2012, they will deduct \$23,200 over the 2-year period.

If Barney and Betty accelerate \$5,000 of itemized deductions from 2012 to 2011, they can deduct \$14,000 in itemized deductions in 2011. In 2012, they will have only \$4,000 of itemized deductions, so they will use the \$11,600 standard deduction. They now claim \$25,600 (\$14,000 + \$11,600) of tax deductions over the 2-year period and gain \$2,400 (\$25,600 – \$23,200) in deductions.

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Itemized deductions can be bunched by techniques such as

1. Making all planned charitable contributions in one year;
2. Grouping planned medical expenses (Junior’s braces, wisdom teeth, etc.);
3. Making an estimated state income tax payment by December 31 to cover the full amount of state tax that will be due at the time of filing. [This will not benefit the taxpayer who is subject to the alternative minimum tax (AMT), because taxes are not a deduction for the AMT.]

### Retirement Accounts

Contributions to retirement accounts also provide a tax-deferral opportunity. Such contributions can reduce the taxpayer’s overall tax if the taxpayers are in a lower tax bracket in the years when they withdraw funds than in the years when they contribute the funds. Traditional Individual Retirement Accounts (IRAs) are a common vehicle for both farm and non-farm taxpayers. Not only are the contributions tax deductible, but the earnings are also tax deferred.

#### Example 7.12 Traditional Individual Retirement Account

Hose is in the 25% tax bracket and has a \$75,000 farm profit. He expects to be in the 15% tax bracket when he withdraws the funds in retirement 10 years from now. He contributes and deducts \$5,000 this year, which saves him \$1,250 ( $\$5,000 \times 25\%$ ) of taxes. When he withdraws this \$5,000 in retirement, his tax will be only \$750 ( $\$5,000 \times 15\%$ ). Hose not only reduced his total tax by \$500 but also delayed the tax by 10 years. In addition, the account generates earnings that are not taxed until Hose withdraws them.

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Retirement accounts should be considered when taxpayers encounter a low-income year. Contributions to Roth IRAs may be a good option for those years. The disadvantage of Roth contributions compared to a traditional IRA is that the Roth contributions are not deductible, but that disadvantage is

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relatively small for a year in which the taxpayer is in a low tax bracket. The advantage of Roth IRAs is that the earnings are not simply tax deferred, as with traditional IRAs; qualified withdrawals from Roth IRAs are not subject to tax. This means that the earnings are **not taxed at all**. Taxpayers who are currently in a lower tax bracket than they expect to be when they retire should consider a Roth IRA. For some A taxpayers with a balance in a traditional IRA, it may be appropriate to convert the account to a Roth IRA. A conversion triggers taxable income currently but the taxpayer may take advantage of operating losses (see Chapter 10) or simply a lower than usual tax bracket.

Retirement accounts may also be used to maximize the benefits of having the taxpayer's children on the farm payroll, as discussed earlier in this chapter. Because IRA contributions are limited in amount (generally \$5,000 in 2011) and are limited to earned income (wages and net earnings from self-employment), the family can increase tax-deductible and tax-deferred contributions by paying wages to children.

**Example 7.13 IRAs for Taxpayer's Children Working on the Farm**

Fred and Wilma file a tax return showing a \$30,000 farm profit. They each contribute \$5,000 to their IRAs. They could hire their son Dale for \$5,000. Dale would then also be able to make a \$5,000 contribution to his IRA. In addition, Fred and Wilma will receive the tax benefits discussed previously from hiring their son.

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**Health Plans**

Health and accident insurance provided to employees can be claimed as a deduction by the employer on Schedule F (Form 1040) and does not have to be included in the employee's income.

**Example 7.14 Health Insurance**

Ariana Land owns and operates a farm. Ariana has a health plan that provides health insurance for employees. In 2011, Ariana paid \$15,000 for health insurance premiums under the plan. Ariana can deduct \$15,000 on her Schedule F (Form 1040), and her employees do not have to include that \$15,000 in their income. If the employees' marginal tax rate (including income and employment taxes) is 35%, providing health insurance rather than paying \$15,000 more in wages reduces the employees' taxes by \$5,250 ( $35\% \times \$15,000$ ).

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A health plan can also reimburse employees for the cost of health insurance and for health care costs that are not covered by health insurance.

**Example 7.15 Reimbursement of Health Care Costs**

The insurance that Ariana (from Example 7.14) provides for her employees requires the employees to pay 100% of the first \$1,000 of health care costs and 20% of the next \$5,000 of health care costs. In 2011, Ariana's employee John Tiller paid \$1,200 for health care that was not covered by the health insurance.

If Ariana's health plan also provides for reimbursing employees for their out-of-pocket costs, Ariana can deduct her reimbursement of John's \$1,200 expense. John does not have to include the \$1,200 in income. If John's marginal tax rate is 35%, reimbursing his health care costs instead of paying him another \$1,200 in wages reduces his taxes by \$420 (35% of \$1,200).

Similarly, if Ariana's health plan provided reimbursements for the cost of health insurance rather than providing health insurance, Ariana could deduct those reimbursements and her employees would not have to include them in income.

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### **Family Members**

A health plan can include health insurance for family members of employees and reimbursement of health care costs for family members of employees. If the business owner employs his or her spouse, the business owner can be included in the health plan as a member of the employee's family.

#### **Example 7.16 Husband is an Employee**

If Ariana's health plan (from Examples 7.14 and 7.15) includes members of employee's families, and her husband, Levi, is an employee of her business, then Ariana's business can pay for health insurance that includes coverage for both Levi and Ariana and her business can reimburse Levi for out-of-pocket health care costs for both himself and Ariana.

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Self-employed individuals who are not eligible to participate in an employer-subsidized health plan can deduct the cost of health insurance for themselves and members of their family from income subject to federal income tax, but that deduction does not provide the same tax benefit as a health plan that includes the self-employed individual's spouse as an employee. Partners in a partnership, members of an LLC that is taxed as a partnership, and shareholders of S corporations can also claim the self-employed health insurance deduction. The advantages of an employee health plan, as compared to the self-employed health insurance deduction, are:

1. It allows the cost of health insurance to be deducted from income subject to the self-employment tax, as well as from income subject to federal income tax.
2. It allows reimbursements for out-of-pocket health care costs to be deducted, as well as the cost of health insurance.

#### **Example 7.17 Husband is not an Employee**

If Levi (from Example 7.16) is not an employee of Ariana's business, Ariana's cost of health insurance for her family can be deducted from income subject to federal income tax, but the out-of-pocket health care costs can be deducted only as itemized deductions, and none of the costs can be deducted from Ariana's self-employment income.

To illustrate, assume that the cost of health insurance for Levi and Ariana is \$8,000 per year and their out-of-pocket expenses for health care are \$3,000. Also assume that Levi and Ariana's taxable income is in the 15% federal income tax bracket.

If Levi is not Ariana's employee, Ariana can deduct the \$8,000 cost of their health insurance from their joint income subject to income tax, which reduces their federal income tax by \$1,200 (15%  $\times$  \$8,000).

If Levi is Ariana's employee and is included in her health plan for employees, Ariana can deduct both the \$8,000 cost of the health insurance and the \$3,000 reimbursement from her business income. That reduces her self-employment tax by \$1,554 ( $\$11,000 \times 0.9235 \times 15.3\%$ ) (for years other than 2011) and their joint income tax by \$1,533 [ $\$11,000 - (50\% \times \$1,554) \times 15\%$ ]. The \$3,087 ( $\$1,554 + \$1,533$ ) total savings from the health plan is \$1,887 ( $\$3,087 - \$1,200$ ) greater than the tax savings without the health plan.

Ariana must file all tax forms applicable to her employment of Levi. Therefore, she must file Forms W-2, W-3, and 943, but she should not include the cost of Levi's health insurance as taxable compensation because it is not subject to income tax or FICA tax.

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### **Nondiscrimination**

For 2011 and later years, most employers who provide either group health or accident insurance or a medical reimbursement plan are subject to certain nondiscrimination rules. A plan generally may not

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discriminate in favor of highly compensated individuals in either eligibility or benefits. A highly compensated employee is any of the following individuals:

1. one of the five highest paid officers,
2. an employee who owns (directly or indirectly) more than 10% in value of the business, and
3. an employee who is among the highest paid 25% of all employees (other than those who can be excluded from the plan).

The following employees may be excluded from the plan:

1. employees who have not completed 3 years of service,
2. employees who have not attained age 25,
3. part-time or seasonal employees,
4. employees represented by a collective bargaining agreement in which health benefits were the subject of good faith bargaining, and
5. employees who are nonresident aliens and who receive no earned income from the employer that constitutes income from a source within the United States.

*Part-time* is defined as under 25 hours per week, but if other employees with similar work have substantially more hours, then a part-time employee may work up to (but not including) 35 hours per week. *Seasonal* is defined as under 7 months per year, but if other employees with similar work have substantially more months, then a seasonal employee may work up to (but not including) 9 months per year.

If a plan favors highly compensated individuals, you must include all or part of the health benefits you provide to these employees in their wages subject to federal income tax withholding. However, you can exclude these amounts from the employee's wages subject to social security, Medicare, and FUTA taxes. The benefits provided to employees who are not highly compensated individuals are still tax-free.

The term *officer* generally means an executive with administrative authority in the business. Unincorporated entities such as sole proprietorships and partnerships may have officers for this purpose. The indirect (constructive) ownership rules deem an employee to hold the ownership interest of his or her spouse, parents, children, and grandchildren. Therefore, a plan must be nondiscriminatory before an employee-spouse can receive fully excludable benefits.

## SUMMARY

In addition to managing the timing of deductions and income, farmers can use income averaging, special tax rules for CCC commodity loans and loan deficiency payments, like-kind exchanges, shifting income to another taxpayer, bunching itemized deductions, retirement accounts, and health plans to manage their income tax liability to keep it as low as possible.