
Income Tax Planning

Quick Notes...

Income tax planning should be a year- round process.

Good tax planning begins with a good record keeping system.

Take time to understand the acceptable methods of managing taxable income by increasing or decreasing income and expenses.

Income tax planning done before December 31 may be the most important decision made by farmers and ranchers. Actually, tax planning is a year round process not just once or twice a year.

Good tax planning begins with a good record keeping system, either a farm account book or a computerized system. Before any summaries are used for tax planning be sure that each account is carefully reviewed. If any entry is in the wrong account, you can get an erroneous picture of your taxable position. Know the difference between a repair, improvement, and overhaul; all expenses are not deductible when figuring taxable income. Some may be personal and capital expenses.

Federal income tax rates, self-employment and several state tax rates are progressive. The more you make, generally the more you pay.

Many self-employed farmers and ranchers can manage taxable income by increasing or decreasing income and expenses. Use caution and deferred sales contracts if delivering commodities and waiting for income after the first of the year. The IRS requires a written arms length agreement specifically stating that you do not have the right to receive the income until a specified date or under a specified series of events. Merely having the buyer hold the check is not acceptable.

If your income is too low consider creating income by increasing your sales. You should always try to have enough income to cover your exemptions and standard deductions. If your business shows a loss and you still have a negative taxable income on your personal return, you may have what is known as a net operating loss. Net operating losses can be carried forward to reduce your taxable income in future years or may be carried back over the past three years to receive a refund if taxes were paid in those years.

The most common way to manage your taxable position, as a cash basis taxpayer, is to increase your operating expenses. Concentrate

on the current expenses first such as fuel, feed, real estate taxes, and professional fees. While you are not allowed to prepay interest you can make sure that interest is current to December 31. Prepaid expenses such as fertilizer, seed and chemicals, if not delivered to the farm, require that the vendor provide you with a contract stating the quality and price of the commodity. The contract must not pay you interest, it must be signed by both parties and not be negotiable.

Pay your children for work they perform on the farm or ranch. You do not have to pay social security taxes on wages earned by your children under the age of 18. In most cases the children will not probably have to pay any taxes and they can still be claimed as a dependant on your return.

Machinery and equipment purchases can be used to lower income. Up to \$17,500 of qualified purchases may be used as Section 179 deductions. However, you and your spouse (as a joint return) must have earned income of at least \$17,500 before the deduction and if more than \$200,000 of qualified property is purchased, phase out rules can reduce and even eliminate the 179 deduction.

Most equipment, crop storage facilities, fencing, irrigation sprinklers, wells and even livestock can qualify for section 179 deduction.

It is wise when using the Section 179 deduction to plan purchases of machinery so the deduction can be used each year. A \$35,000 purchase of two machines in the same year limits the deduction to \$17,500, where a \$17,500 purchase in two years would permit the full \$35,000 to be written off in two years. Be aware of pitfalls such as selling the assets or business use changes because recapture rules come into play.

Depreciation begins when property is ready and available for its specified use. Depreciation is normally calculated on the "mid-year" method as long as you do not purchase any more than 40% of qualified purchases after the beginning of the tenth month of your taxable year. If you do purchase more than 40% after the tenth month, October 1 for calendar year payers, you will be required to use the "mid-quarter" method of calculating depreciation. Tip: In some cases you may still meet the requirements by claiming Section 179 expense option on purchases of equipment made after October 1, because Section 179 property is not part of the qualified purchase cost.

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