

Chapter 7 *

OVERVIEW OF TAXES

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.

Fluctuations in farm income may be caused by either market or growing conditions. 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 engaged in a farming business may be able to average some or all of their farm income to calculate tax on the current year's income. This may result in higher-than-usual income being taxed at lower marginal tax rate brackets. C corporations, estates, and trusts cannot use the election. The IRS reports that this tax-saving method of calculating tax is being underutilized by taxpayers.

The taxpayer chooses an amount of farm income (elected farm income) from the current year that will be included in the income averaging calculation. The elected farm income is added to the taxable income in the 3 prior years (base years). Total Federal income tax over the four tax years (current year plus three base years) is compared before and after averaging. If the total is lower when income is averaged, the current year income tax liability is reduced by the difference, resulting in a lower Federal tax liability in the current year.

Farm income averaging does not affect self-employment (SE) tax or state income taxes 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.

*This material is based upon work supported by the U.S. Department of Agriculture, under agreement number FSA21CPT0012032. Any opinions, findings, conclusions, or recommendations expressed in this publication are those of the author(s) and do not necessarily reflect the views of the U.S. Department of Agriculture. In addition, any reference to specific brands or types of products or services does not constitute or imply an endorsement by the U.S. Department of Agriculture for those products or services.

Elected Farm Income (EFI)

Elected Farm Income (EFI) is limited to the lesser of 1) the taxpayer's total taxable income [after subtracting any net operating loss (NOL) deductions] or 2) the taxable income attributed to any farming business (called *electible farm income*).

Electible farm income includes net farm profits from Schedule F (Form 1040) and the 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 also 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.

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.

Example 7.1: Income Averaging

Fruit growers Mr. and Mrs. B & B Goodyear had a substantial increase in farm income in 2022. 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 \$110,550 taxable income. They file a joint return. Their taxable incomes for 2022 and the previous 3 years are shown in Figure 7.1, below.

Figure 7.1. Goodyears' Taxable Income

Year	Taxable Income
2022	\$110,550
2021	30,900
2020	71,600
2019	28,200

The Goodyears elected to income average in 2022. 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 12% tax bracket or \$27,000 (\$110,550 – 83,550). They decided to designate \$27,000 of their Schedule F (Form 1040) profit as EFI and tax \$9,000 per year at the tax rates borrowed from each of the 3 base years.

Question 1. Will all of the EFI be taxed at 12%?

Answer 1. In 2020 their 12% tax bracket ended at \$80,250, and their taxable income was \$71,600, leaving \$7,350 of the 12% rate bracket available for EFI from the election year. This \$8,650 is taxed at the 12% tax rate. However, the remaining \$350 (\$9,000 – \$8,650) added to the 2020 base-year income is taxed at the 22% rate from the 2020 tax brackets. For 2019 and 2021, all \$9,000 will be taxed at the lower 12% rate.

Question 2. Should the Goodyears reduce EFI to avoid the 22% tax bracket from 2019?

Answer 2. For each \$1 of EFI subject to the 22% tax rate from 2020, \$2 is taxed at the 12% rate from the other 2 base years. Therefore, the marginal tax rate for the Goodyear’s EFI is 15.33% $[(12 + 12 + 22) \div 3]$. If they put less than \$27,000 in their EFI for 2022, their income taxed at their 2022 tax rates will exceed \$83,550, and their marginal tax rate on the income taken out of the EFI will be 22%.

Question 3. How much income tax will the Goodyears save by income averaging in 2022?

Answer 3. They will save \$2,665. They would have paid \$5,940 (\$27,000 x 22%) without income averaging. Instead, they paid \$3,275 (\$9,000 in 2019 @ 12% + \$8,650 in 2020 @ 12% + \$350 in 2020 @ .22% + \$9,000 in 2021 @ 12%).

Base Year Losses

The IRS allows the use of negative taxable incomes in base years when performing the income-averaging calculation. This, in effect, allows such taxpayers to apply 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 7.2: Income Averaging and Net Operating Losses

Abdul had a \$45,000 Schedule F (Form 1040) loss in 2020. 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, below.

Figure 7.2. 2020 Taxable Income

Schedule F	\$ - 45,000
Standard deduction	- 11,400
Exemptions	- 18,250
Taxable income	\$ - 74,650

Abdul's NOL for 2020 is \$45,000. This NOL must be removed from taxable income, leaving a negative \$29,650 to be used as base-year income for 2020 on Abdul's Schedule J (Form 1040), Income Averaging for Farmers and Fishermen, when he files his 2022 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, but 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, farm business capital gains of a taxpayer taxed at 15% in 2022 could be eligible for a 0% rate for capital gains if the taxpayer has a base year with taxable income below the 0% capital gain

maximum and those gains are included in EFI.

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

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.

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 often-cited exception to this general rule is to use income averaging to reduce Self-Employment (SE) contributions until every fourth year. Net earnings are held low with income averaging for three years, reducing SE tax as low as possible. Then net earnings from self-employment are allowed to spike in the fourth year, exceeding the maximum amount subject to the social security component of SE tax (\$147,000 for 2022) and saving on SE tax for the four-year period. This practice should be evaluated in light of the time value of money.

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 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 (if so) how much, 2022 farm income should be averaged:

- Taxable income for 2022, as well as ordinary income and capital gain attributed to farming
- Taxable income from 2019, 2020, and 2021 tax returns, including any Schedule D worksheets used to calculate income tax due
- If a taxpayer elected to use income averaging in any of the 3 prior years, Schedule J (Form 1040) will be needed, as well as associated worksheets for each year
- Income tax brackets for 2022 and the 3 prior years

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 EFI.
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. Attempt to level the income of the current and prior 2 base years by electing additional income

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).

Farm Income Averaging After the Cessation of Farming

Treasury regulations state that if a taxpayer ceases farming and 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 one year is deemed to be within a reasonable time. Taxpayers must consider all of the facts and circumstances of sales beyond one year from the cessation of the farm business to determine if the asset was still regularly used in the farm business.

Example 7.3: Facts and Circumstances of Reasonable Time After the Cessation of Farming

Joseph quit farming in 2019 and sold most of his farm equipment. He did not sell his pickup truck at that time because he used it in a new construction business. He did not find a buyer for his baler until June 2021. He also sold his pickup in 2021.

Gain on the baler is electible farm income because Joseph's only reason for holding it was to find a buyer after terminating the farm business. Gain on the pickup is not electible farm income because it was realized more than a year after Joseph terminated his farm business and he kept the pickup to use in a non-farm business.

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 who files a joint tax return with her husband, and they are normally able to keep their taxable income near the top of the 12% federal income tax bracket and out of the 22% federal income tax bracket. It was a great crop year and Isabella expects her commodity to ultimately sell for \$170,000. However, it 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. If Isabella is unable to increase her current-year income, they will waste much of their 12% tax bracket this year and will potentially push \$63,550 of income into the 22% tax bracket next year. Farm income averaging could be used to obtain tax savings on some but not all of this income.

Because Isabella does not want to sell her commodity at the current market price, she should consider obtaining a CCC commodity loan and electing to treat the loan as current year income. If the loan is less than \$63,550, all of it will be taxed at a 12% tax rate.

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).

- If a producer did not make the election to treat the loan as income, they have 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, they have 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

Isabella, from Example 7.4, was able to borrow \$63,000 from CCC using her crop as collateral, which she elected to report as income on her income tax return. The following year, she sold her carryover commodity for \$165,000. Because the crop was collateral for a CCC loan and Isabella had elected to report the loan as income, she recognizes only \$102,000 of income from the sale (\$165,000 sale proceeds minus \$63,000 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 12% bracket in the previous year by including the \$63,000 loan in their income.

Figure 7.4 Reporting Subsequent Sale of Commodity with Loan Under Election

Part I Farm Income—Cash Method. Complete Parts I and II. (Accrual method. Complete Parts II and III, and Part I, line 9.)			
1a	Sales of purchased livestock and other resale items (see instructions)	1a	165,000
b	Cost or other basis of purchased livestock or other items reported on line 1a	1b	63,000
c	Subtract line 1b from line 1a	1c	102,000

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. These directly applied payments may distort taxable income when a commodity is sold, so accurate accounting is important.
- 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 works 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 used equipment, the farmer must report steer sales on Schedule F (Form 1040) equal to the value of the equipment 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. Ordinarily, 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.

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.
- The Tax Cuts and Jobs Act (TCJA) eliminated tax-deferred, like-kind exchanges for personal property after 2017. Personal property used on the farm includes machinery and equipment, autos and trucks, office equipment, and livestock.

Farmers and ranchers who trade-in personal property, like trucks and tractors, on another piece generally now have two reportable tax events. The trade-in value of the item traded is a taxable sale and is reported in the same way as a cash sale on Form 4797 Sales of Business Property. Any depreciation recapture or capital gains will be recognized as income. See Chapter 3 on Disposition of Property Used in Farming. The sales price (generally the trade allowance of the old property plus trade difference) of the item acquired in the trade will become basis for depreciation. See Chapter 4 on Depreciation and I.R.C. §179 Expensing.

Example 7.6: Equipment Trade-In

Christy had a planter with a \$60,000 depreciated basis. On March 15, 2022, she acquired a newer planter that the dealer had listed for \$120,000. Christy traded in her old planter and paid the dealer \$40,000 in cash.

The trade-in value Christy received for her planter was \$80,000 (\$120,000 cost of the new planter - \$40,000 cash paid). She reports the sale of the old planter on Form 4797 with a \$80,000 sale price and \$60,000 remaining basis. The basis in the newer planter Christy acquired is \$120,000. She may use any applicable method including Bonus Depreciation and §179 to expense the planter.

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, Sales 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.

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. 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 7.7: Employing Family Members

Sven is in the 24% 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 \$17,000 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 \$17,000 wage. Therefore, there will be no significant net savings from the reduction in Sven's self-employment tax. Because Mary is filing as Single, she is eligible for a standard deduction (\$12,950 in 2022). Mary has no other income, so her taxable income is \$4,050 (\$17,000 wages minus \$12,950 standard deduction). This leaves Mary in the 10% tax bracket, so she pays \$405 of income tax.

Sven reduces his taxable income by \$17,000 which saves \$4,080 of income taxes. The net federal income tax savings to the family is \$3,675 (\$4,080 – \$405) and the cash stays in the family.

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 7.8: Gift of Farm Asset

Gail, a dairy farmer, would like to give her daughter Beth \$10,000 in 2022. Because this is Gail's only gift to Beth this year and it is under the \$16,000 annual gift tax exclusion for 2022, she can make the gift without any gift tax consequences. However, Gail is in the 24% income tax bracket and Beth is in the 10% 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 7.9: Managing Itemized Deductions

Barney and Betty normally have about \$20,000 of itemized deductions. Therefore, they plan to claim the \$25,900 standard deduction for 2022 instead of itemizing deductions. Assuming the standard deduction is also \$25,900 for 2023, they will deduct \$51,800 over the 2-year period.

If Barney and Betty accelerate \$10,000 of itemized deductions from 2023 to 2022, they can deduct \$30,000 in itemized deductions in 2022. In 2023, they will have only \$10,000 of itemized deductions, so they will use the \$25,900 standard deduction. They now claim \$55,900 (\$30,000 + \$25,900) of tax deductions over the 2-year period and gain \$4,100 (\$55,900 – \$51,800) in deductions.

Itemized deductions can be bunched by techniques such as

- Making all planned charitable contributions in one year;
- Grouping planned medical expenses (Junior's braces, wisdom teeth, etc.);
- 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. Total deduction of state and local income, sales, and property taxes is limited to a combined total deduction of \$10,000.

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 Arrangements (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 7.10: Traditional Individual Retirement Account

Jose is in the 24% tax bracket and has a \$75,000 farm profit. He expects to be in the 12% tax bracket when he withdraws the funds in retirement 10 years from now. He contributes and deducts \$5,000 this year, which saves him \$1,200 ($\$5,000 \times 24\%$) of taxes. When he withdraws this \$5,000 in retirement, his tax will be only \$500 ($\$5,000 \times 10\%$). Jose not only reduced his total tax by \$700 but also delayed the tax by 10 years. In addition, the account generates earnings that are not taxed until Jose withdraws them.

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 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 expect to be in a higher tax bracket when they retire should consider a Roth IRA. For some 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 \$6,000 in 2022) 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 7.11: 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 \$6,000 to their IRAs. They could hire their son Dale for \$6,000. Dale would then also be able to make a \$6,000 contribution to his IRA. In addition, Fred and Wilma will receive the tax benefits discussed previously from hiring their son.

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 7.12: Health Insurance

Ariana Land owns and operates a farm. Ariana has a health plan that provides health insurance for employees. In 2022, 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 22%, providing health insurance rather than paying \$15,000 more in wages reduces the employees' taxes by \$3,300 ($22\% \times \$15,000$).

When structured correctly, a health reimbursement arrangement (HRA) can reimburse employees for the cost of health insurance and for health care costs that are not covered by health insurance. These plans fall under I.R.C. §105 and must be properly structured and correctly documented, so it is suggested that a third-party administrator be utilized to ensure compliance. Several private companies provide third-party administration services for a fee.

Example 7.13: Reimbursement of Health Care Costs

The insurance that Ariana (from Example 7.12) 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 2022, Ariana's employee John Tiller paid \$1,200 for health care that was not covered by the health insurance.

In addition to providing her employees with health insurance, Ariana provides a health reimbursement arrangement that reimburses employees for their out-of-pocket costs, up to \$2,000. 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 22%, reimbursing his health care costs instead of paying him another \$1,200 in wages reduces his taxes by \$264 ($22\% \times \$1,200$).

Similarly, if Ariana's health reimbursement arrangement 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.

Family Members

A health reimbursement arrangement 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 HRA as a member of the employee's family.

Example 7.14: Husband is an Employee

If Ariana's HRA (from Examples 7.12 and 7.13) 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.

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 an HRA 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 HRA, 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 7.15: Husband is Not an Employee

If Levi (from Example 7.14) 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 12% 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 \$960 ($12\% \times \$8,000$).

If Levi is Ariana's employee and is included in her HRA 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 ($\$11,000 \times 0.9235 \times 15.3\%$) and their joint income tax by \$1,227 [$\$11,000 - (50\% \times \$1,554) \times 12\%$]. The \$2,781 ($\$1,554 + \$1,227$) total savings from the HRA is \$1,821 ($\$2,781 - \960) greater than the tax savings without the health reimbursement arrangement.

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.

Nondiscrimination

For 2022 and later years, most employers who provide either group health or accident insurance or a health reimbursement arrangement are subject to certain nondiscrimination rules. A plan generally may not 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).

When properly structured, an HRA may be offered only to a class of employees as long as the class of employees is reasonable and does not discriminate. Employee classes could be based on the following criteria:

1. Full-time or part-time
2. Hourly or salaried
3. Seasonal or non-seasonal
4. Temporary or permanent

In addition, 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.