Business point

MAXIMIZE AFT

Start now to determine how to reach your optimal tax obligation.

Editor's note: Kent Vickre and Dwight Raab write a tax and finance column for each issue of Pioneer GrowingPoint® *magazine. Vickre is state coordinator of the Iowa Farm Business Association. Raab is state coordinator of Illinois Farm Business Farm Management. They address issues that influence agri-business success.*

As the end of the year nears, assuming you operate your business on a calendar year for tax reporting purposes, it's time to get back to your recordkeeping and consider plans and strategies to put in place to maximize after-tax profit.

Differing crop yields cross the Midwest are evidence that the 2010 growing season provides a range of incomes as variable as any other year. As usual, farm profits depend on input costs, commodity prices, crop yields and your management skills. Livestock enterprises had a better year in 2010 than 2009 with higher prices for hog, cattle and dairy products. With the variability in farm incomes, it's critical to perform an evaluation of income and expenses year-to-date prior to the end of the year.

The goal of a good tax plan is to maximize after-tax income over time. We accomplish this by filling lower income tax brackets to their optimal level and minimizing unplanned fluctuations that would push you into a higher income tax bracket.

The optimal income means different things to different individuals and depends on your specific situation. A short list of the situations might include:

- Increased cash flow for business needs or for family living expense
- Social Security earning limits
- College financial aid
- The availability of tax exemptions and credits.

Consider your options

Some common methods optimizing after-tax income include:

- **Prepay operating inputs.** The IRS will require a specific quantity and price of those inputs. Remember: Prepaid expenses are limited to 50 percent of deductible expenses.
- **Defer crop insurance proceeds.** You may elect to defer income to the following year if you normally sell in the following year. Make sure your tax preparer adds the election statement to your tax return.
- **Pay children a reasonable wage for farm work.** You are not required to withhold Social Security tax and Medicare tax on your children under age 18 if you operate a sole proprietorship. However, you're still required to

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file the appropriate payroll tax forms.

- **Pay any accrued interest.** Your bank will be able to provide these amounts to you. These really aren't "prepaid" expenses: You're just paying all the interest that's due to Dec. 31.
- **Consider income averaging.** Ask your tax preparer if income averaging will decrease your 2010 tax liability.
- **Give to charity.** If you can itemize your deductions on Schedule A of Form 1040, consider doubling church and charity contributions or State Income Tax by paying in December instead of next year.
- **Review CCC loan tax treatment.** If you have "sealed grain" carrying over at year end, simply electing to change the tax treatment may increase or decrease your taxable income. You may need to file additional forms with your return.
- **Consider purchasing needed capital assets.** You might buy items such as equipment, buildings or breeding livestock. However, just because it's tax deductible doesn't mean it will make your business more profitable. Consider the financial impact of purchasing an asset and not just the tax deduction.

Fund a retirement account

Another way to manage your tax liability for 2010 is to fund your retirement account, either an IRA, an SEP or a Keogh. Because some plans must be set up well in advance of the year end, check with your tax adviser to verify whether this option will work for you. The limits for 2010 for the traditional deductible retirement accounts are:

Traditional IRA. These are available to any individual under the age of 70½ with earned income. For 2010, the maximum contribution is $5,000 or your earned income (whichever is less). Additionally, a non-working spouse can put up to $5,000 into a spousal IRA. For individuals age 50-plus, an additional $1,000 "catch up" contribution is allowed. This increases the limit to $6,000 annually.

However, be aware of income phase-out limits. These limits differ depending on filing status (married filing joint, head of household, single, etc.) and the type of IRA (traditional or spousal). For example, if you're married filing a joint return and were eligible to participate in any employer sponsored retirement plan, the IRA contribution drops when your income exceeds $89,000.

SEP and Keogh. These retirement plans may permit greater contributions and deductions, but they also require more recordkeeping and have added regulations attached to them. However, you'll generally run into provisions requiring contributions for other employees who meet certain minimum qualifications. The deduction is limited to a percent of net self-employed income minus the self-employment tax deduction for a self-employed individual or a percent of wages for an employee.

Currently the maximum percent is 20 percent for a self-employed individual and 25 percent of wages for eligible employee with a maximum limit of $49,000. However, certain plans already established may have different contributions percents and limits.

What's the best choice?

Perhaps the most difficult part of tax planning is to decide on your "optimum" taxable level. It's important to review your current profit and make sure to tax plan for the 2011 year at the same time. Even a rough tax plan can help you evaluate your planning horizon over a two-year period.

You should consider both taxable income and accrued income when making financial management decisions. Taxable income is your income reported on the tax return. Accrued income is calculated using inventory change and economic asset depreciation. This method best reflects your "earned income."

By comparing both incomes, you can gauge how much tax liability you're shifting into coming years. This should help you decide on an "optimum income level" for your tax planning.

Remember: Tax planning should only be one part of your financial management. A good financial management system involves a year-round process starting with a good, detailed recordkeeping system.

Capital asset purchases

A word of caution: Just because the higher Section 179 Expensing limits make a larger share of your capital purchases tax deductible doesn't mean it will make your business more profitable. Consider the cash-flow commitments needed in future years for financed purchases. These principal payments are paid with "after-tax" dollars.

For example: If a farmer buys equipment (seven-year depreciable property), and it's financed over seven years, the principal payments needed are close to the depreciation expense. But, if you elect to expense the entire $500,000 in the current year, you have no depreciation left to use as an expense in a later year.

Many times this can have a snowball effect. The increased cash flow needed for payments creates a tax liability problem. After several years, producers feel they are "forced" to purchase capital assets to manage taxes. This is why tax management alone is not adequate and an accrual farm analysis is so important.