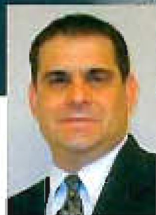
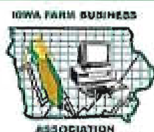
Business point

Silver Clouds &

Impressive farm profits in 2007 make early tax preparation essential.



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



As Dec. 31 approaches, most producers shift focus to tax management. The combination of good 2006 yields (carried into 2007) and the strong corn market are resulting in higher 2007 taxable farm income in general.

This year, producers who wait until year end to start recordkeeping and tax planning may be shocked at their tax liability. In a panic, they may base December expenditures on tax planning instead of on their operation's overall financial goals.

Some producers who have been able to manage tax planning in prior years simply by prepaying inputs may need to consider other options.

These options require more time to evaluate and select the optimum choice for the farming operation. A key consideration should be tax management, not simply tax avoidance. A good plan should consider tax brackets, income averaging and both tax deductions and phase-out of credits and limits.

Additionally, some years you may want to "adjust" your taxable income depending on specific situations. These may include tight cash flow, Social Security earning limits, college financial aid, use of tax exemptions and credits. By considering all the variables, tax planning becomes a multiple-year game plan a grower should review and adjust throughout the year.

Review profits first

To help decide on your income level, it's important to review your current profit. You should consider both taxable income and accrued income when making financial management decisions.

- Taxable Income: This is your income reported on the tax return.
- Accrued Income: This 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 the following years. This should help you decide on an "optimum income level" to use for your tax planning.

Here are some common examples of tactics cash-basis farmers can use to decrease taxable income:

- Prepay operating inputs. Be sure to specify a quantity and price. Remember that 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.
- Pay children a reasonable wage for farm work. You don't have to pay Social Security tax on your children under age 18. However, you are required to file the appropriate payroll tax forms.
- Pay any accrued interest.
- Consider income averaging. Depending on your taxable income in prior years, income averaging may decrease your tax liability.
- If you itemize, consider doubling up on church and charity or state income tax by paying in December instead of the following year.
- Purchase deductible assets such as equipment and 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 any asset.

Dark Linings

- 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.
- Utilize the "quick write off" depreciation for capital assets. For 2007, the Section 179 deduction increased to $125,000. The 179 election is limited to qualified capital purchases for items such as equipment, grain bins or breeding livestock with a dollar-for-dollar phase-out starting at $500,000.

Additionally qualified items that exceed the $125,000 limit are eligible for regular depreciation. A word of caution: This may be a good financial decision in regard to tax liability reduction, but you need to consider whether the principal payments will need to be paid with after-tax dollars. Hence, this can cause real cash-flow problems in later years.

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 out the entire $125,000 in 2007, you'll have no depreciation left to use as an expense.

Many times this can have a snowball effect because the increased cash flow needed for payments creates a tax liability. After several years, producers feel they're 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.

Retirement strategies

Fund your retirement account — IRA, SEP, Keogh. Because some plans need to be set up before year end, be sure to check into this now. The limits for 2007 for the traditional deductible retirement accounts are:

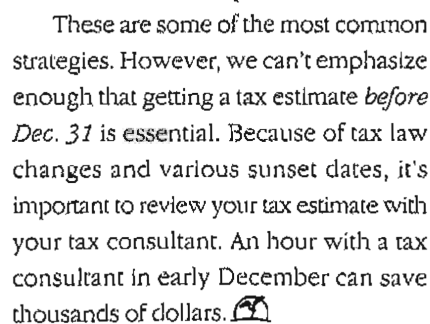
Traditional IRA. These are available to any individual under the age of 70½ with earned income. For 2007, the maximum contribution is $4,000 or your earned income (whichever is less). Additionally, a nonworking spouse also can put as much as $4,000 into a spousal IRA. For individuals age 50 plus, an additional $1,000 "catch up" is allowed, increasing the limit to $5,000.

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 plan such as a 401, the IRA contribution is reduced when your income exceeds $83,000.

Roth IRAs require different treatment: Talk to a qualified tax consultant.

Sep/Keogh. These retirement plans may permit greater contributions and deductions, however, you generally will run into provisions requiring contributions for other employees who meet certain minimum qualifications. The deduction is limited to a percentage 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 is 20 percent for a self-employed individual and 25 percent of wages for an eligible employee. The maximum limit is $45,000. However, certain plans already established may have different contribution percents and limits.



These are some of the most common strategies. However, we can't emphasize enough that getting a tax estimate *before Dec. 31* is essential. Because of tax law changes and various sunset dates, it's important to review your tax estimate with your tax consultant. An hour with a tax consultant in early December can save thousands of dollars.