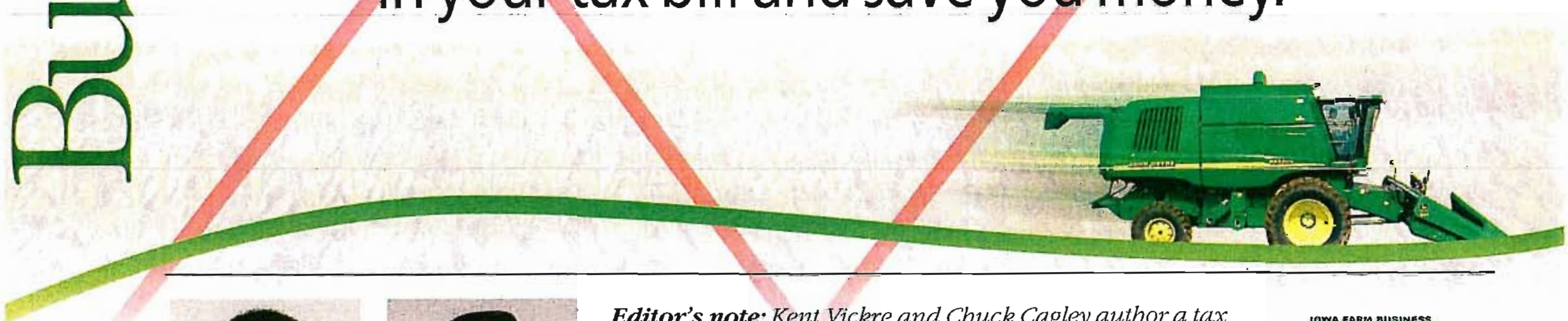
Business point

Better than average

Income averaging can smooth swings in your tax bill and save you money.



Editor's note: *Kent Vickre and Chuck Cagley author 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.*

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If your 2006 income was higher than you expected, and you expect the tax bill to be higher as well, income averaging may be a way to even the ledger and save some money. Farmers who didn't perfect their year-end tax planning in December may find some tax relief still available. In fact, income averaging is one of your few tax management options after Dec. 31.

Who benefits from income averaging?

In general, you'll benefit from income averaging most when your current farm income is higher than the past three years. To benefit from income averaging, your current income must be in a higher tax bracket than the previous three years: In essence, you're shifting current high tax bracket income to unfilled lower tax brackets in previous years.

According to the Internal Revenue Service, to qualify for income averaging, a person must be in the trade or business of cultivating land or raising or harvesting any agricultural or horticultural commodity. This includes:

- Growing field and row crops such as corn, soybeans, hay, etc.
- Operating a nursery or sod farm
- Raising or harvesting trees bearing fruits, nuts or other crops
- Raising ornamental trees (but not evergreen trees more than 6 years old when severed from the roots)
- Raising, shearing, feeding, caring for, training and managing animals.

This would include most mainstream grain and livestock farmers. If you qualify, you can elect to use all or part of your current year farm income to average over the three preceding years. However, the elected amount to average *must* be allocated equally to each year, and it can't exceed your current year taxable income. The farm income you choose to average is called the Elected Farm Income (EFI). For farm income averaging purposes, farm income also includes income from the sale of an asset used in the farming business, such as breeding livestock and equipment, *but not* gain from the sale of land or timber.

Also remember you *must* elect to use farm income averaging by filing a Schedule J with your Federal tax return. It is *not* automatic.

To demonstrate the benefit of income averaging, here's an example:

John's 2005 tax return shows a total income of $71,146 of which $1,146 is interest income and $70,000 was from his farming business. John's 2005 return also included a total of $13,146 in deductions and exemptions, so his taxable income is $58,000. Note we must use "taxable income" (after deductions and credits) rather than "gross income." This is because the income-averaging tax savings is due to the tax brackets rate change, which is determined by taxable income. John's history shows his taxable income for 2004 was $15,000, for 2003 was $18,000 and for 2002 was $21,000.

Since John's 2005 income is higher than the past three years, he elects to use farm income averaging. The accompanying table illustrates the effect of averaging John's elected farm income of $28,300 over the past year. Column A shows the tax calculation without income averaging. Column B shows the adjusted tax calculation after income averaging.

Note: Tax is calculated using the appropriate tax bracket and rates for each year.

By electing to use farm income averaging, John's total federal tax savings was $2,544 — the difference between the total Total Tax lines in the table. John will see the savings in 2005 by paying $8,627 instead of $11,171 in federal income tax (this doesn't include any self-employment tax).

John's return represents a simple, straightforward example demonstrating the essence of income averaging.

Things to know about farm income averaging:

1. Only federal income tax is affected, not self-employment taxes or state taxes.
2. The farm income averaging election does not apply to alternative minimum tax (AMT) for the base year.
3. Farm income from a pass-through entity such as a partnership, S-Corp or LLC to an owner is eligible for income averaging.
4. It's not necessary to have been involved in a farming trade or business in any of the three preceding years used for income averaging.
5. Negative taxable income is allowed in base year calculations.
6. Landlords are eligible if the lease payments are based on a share of the land production and it is specified in a written agreement *before* the tenant begins significant activity on the land.
7. Farm income averaging is *not* available to regular corporations, trusts or estates.
8. You can claim the election on an amended return. The deadline for refund filing is three years from the original return due date or two years from when the tax was paid, whichever is later.

Income averaging can provide tax savings in a high-income year and help if your Dec. 31 tax planning wasn't perfect. It also can be used as a planning tool for the future. Several points are worth remembering:

1. Since the EFI must be applied equally to the preceding three years, you may want to consider leaving an equal unfilled amount in the past three years to maximize the benefit of income averaging.
2. You may want to use income averaging even if it doesn't reduce the current year's tax liability (assuming the three previous year's incomes are low). By doing this, you will fill up part of the third year and lower the current year's income. This may increase potential tax savings if you expect a higher income in the future.
3. Because the Social Security earning limit applies to the current year's earned income, you may plan to use the Social Security phase-out limits and income averaging together for a reduced combined tax rate as a part of your year-end tax planning strategy.

For an example of income averaging for a married couple, see www.pioneer.com/growingpoint Key> 6304

As you can see, income averaging can be a useful tool in your tax planning strategy toolbox. However, since it involves past years' tax laws, be sure to visit with your tax consultant as you plan. You can get helpful advice on what's best for your situation. ■

Schedule J analysis of John's operation:

		Example A: Tax WITHOUT income averaging	Example B: Tax WITH income averaging
2005 Tax Return			
Taxable Income	$58,000	$11,171	
Less EFI*	<28,300>		
2005 Taxable Income	$29,700		$4,096
2004 Tax Return			
Taxable Income	$15,000	$1,896	
		(2004 tax rates)	
Plus ⅓ EFI*	9,433		
2004 Taxable Income	$24,433		$3,307
			(2004 tax rates)
2003 Tax Return			
Taxable Income	$18,000	$2,354	
		(2003 tax rates)	
Plus ⅓ EFI*	9,433		
2003 Taxable Income	$27,433		$3,765
			(2003 tax rates)
2002 Tax Return			
Taxable Income	$21,000	$2,854	
		(2002 tax rates)	
Plus ⅓ EFI*	9,433		
2002 Taxable Income	$30,433		$4,563
			(2002 tax rates)
Total Tax		$18,275	$15,731

*EFI — Elected Farm Income

This example shows that fictional farmer John would pay less by using income averaging to decrease his 2005 tax bill.