2003 - End-of-Year Tax Planning

The basic management guideline is to avoid wide fluctuations in taxable income because a relatively uniform income from year-to-year results in the lowest income tax and largest Homestead and Farmland Preservation Credits over time.

(a) Even in a low income year, plan to have enough income to use personal exemptions and the standard deduction.

(b) If taxable income is over $58,000 married ($40,250 single) and deductions include state taxes, accelerated depreciation and others, the Alternative Minimum Tax (AMT) may apply and must be calculated to see if it increases your income taxes.

2. Some changes:

(a) The 10 percent bracket on taxable income increased to $7,000 for single and $14,000 for married filing jointly. The 15 percent bracket increased to double that of singles ($28,400 and $56,800). The higher brackets were reduced to 25, 28, 33 and 35 percent. The additional 30 percent first-year depreciation deduction for both regular tax and alternative minimum tax is increased to 50 percent for qualified property purchased after May 5, 2003. This is original use (new) property with a recovery period of 20 years or less. A farm required to use the Alternative Depreciation System is not eligible.

(b) For capital assets sold and installment payments received before May 6, 2003, capital gains rates for sale of long-term capital assets held for 12 months or longer (24 months for breeding cattle and horses) are 20 percent if taxable income is in the 25.0 percent bracket or higher and 10 percent for that portion of capital gain between taxable ordinary income and the top of the 15 percent bracket ($28,400 single and $56,800 married). To the extent of depreciation on depreciable real estate, it comes under 1250 rules and may be taxed as ordinary income or unrecaptured 1250 gain at a maximum rate of 25 percent.

If you are in the 10 percent or 15 percent tax bracket, capital gains on assets held five years or more and sold before May 6, 2003 will be taxed at 8 percent rather than 10 percent until the gain pushes you into the 25.0 percent bracket. For taxpayers in the 25.0 percent bracket or higher, the five-year holding period doesn’t apply.

(c) For capital assets sold and installment payments received after May 5, 2003 the 15 percent rate replaces the 20 percent rate, and the 5 percent rate replaces the 10 percent and 8 percent rates.

(d) CCC loans can count either as borrowed funds or as income if the appropriate forms are filed.
(e) The sale of principal residence after May 6, 1997 is tax free on up to $500,000 of gain for married filing jointly ($250,000 single) if occupied by owner for two of last five years. Your residence would not include land you have used for business purposes.

(f) Penalty free IRA distributions may be taken to pay for medical expenses and/or health insurance premiums to the degree expenses exceed 7.5 percent of adjusted gross income.

(g) The section 179 (direct expense) deduction for capital purchases is $100,000 in 2003, with the phase out beginning at $400,000 of qualified property placed in service.

(h) The income averaging provision for farm income (Schedule J) is permanent and negative taxable income can be used from the three base years.

(i) A 5-year net operating loss carry-back for farm losses is available, or use current losses by converting regular IRAs to Roth IRAs.

As of 2000, when an asset is traded-in, the asset traded-in continues to be depreciated under its life and method and only the cash and/or financed difference is set up on a new depreciation schedule.

The self-employed health insurance deduction is 100 percent for 2003.

Child tax credit increased to $1,000 from $600 for children 16 and under as of December 31, 2003. Many taxpayers received up to $400 of this credit during the summer.

The marriage penalty is reduced by increasing the standard deduction to double the single deduction ($4,750 and $9,500).

For Michigan income taxes, if filing by paper rather than by e-filing, there may be a very long delay in receiving a refund.

3. Depending on your tax situation, you may wish to reduce or increase net income for 2003. Following are some of the best income eveners:

(a) Buy or delay purchase of supplies such as fertilizer, seed, farm supplies, small tools, and repairs (tax shelters can only deduct items when used). Note: these expenses should not exceed 50 percent of your total Schedule F expenses for the year for which economic performance has occurred. In most cases, it will be hard to reach that level of expenditure.

(b) Pay in 2003 or delay payment to 2004 on real estate taxes and other annual bills. (Insurance premiums, real estate rental for 2004 and interest cannot be paid in advance to obtain an earlier tax deduction, but 2003 expenses of insurance, rentals and interest can be deferred to 2004 if income is low this year).

(c) Watch the timing of sales of livestock and crops ready for market near year-end. Possibly they can be held for sale next year at little cost or sold earlier to even out taxable income. CCC loans can count as borrowed funds or as income if the appropriate forms are filed.
(d) Some expenses are deductible as current year business expenses even though not made every year. These include minor repairs on improvements and machinery, painting of buildings, purchase of small tools and supplies, and within limitations, cost of approved soil and water conservation expenses. Get these jobs done and paid for before year-end if you wish to reduce net income.

(e) Where capital purchases have been made, or can be made, study the depreciation alternatives carefully. The direct expense deduction of up to $100,000 on personal property can be taken on current year capital purchases. Its use, however, cannot reduce your taxable income from farming (plus other earned income) below zero. Taxable income includes net farm profit plus gains on the sale of business assets such as breeding livestock. For purchases of new (not used) property you are required to take an additional 30 percent/50 percent first year depreciation unless you elect out of taking it. Where pre-productive expenses are not a consideration, there are three choices for depreciation: Modified Accelerated Cost Recovery System (MACRS) which is 7-year 150 percent declining balance on machinery; MACRS straight line; and the Alternative Depreciation System (ADS), which is 10-year straight line on machinery. If required to use ADS you cannot use the additional 30 percent or 50 percent first-year depreciation (e.g. most fruit farmers). For the first year of depreciation the mid-year convention is used (1/2 year's depreciation), unless 40 percent or more of your capital purchases are made during the last 3 months of the year. In that case, the mid-quarter convention is used (87.5 percent of a year's depreciation for purchases made during the first 3 months, 62.5 percent for purchases in second quarter, 37.5 percent for third quarter, and 12.5 percent in final quarter).

(f) Pay your children wages for work actually performed for the farm. If the child is under 19 or regularly enrolled in school, they can earn any amount and the parent can still claim an exemption for them if the parents pay over half the child's support. The parents must use the dependent exemption. The child must file a tax return only if they earn over the standard deduction ($4,750) unless they have unearned income. For children under 14, the standard deduction is earned income plus $250 up to a maximum of $4,750. A return, usually a 1040A, must be filed by a child under 14 if investment income is greater than $750. Children under 14 will have unearned income taxed at the parents' rate. Form 8615 is used to calculate the tax. Parents may elect to report the child’s income in their return (Form 8814).

(g) For Michigan income tax an individual who is eligible to be claimed as a dependent on someone else's return and has an adjusted gross income of $1,500 or less is entitled to a refund of all Michigan tax withheld.

(h) Frequently unrecorded and forgotten expenses include:

1. Educational expenses that maintain or improve your skills, such as magazine subscriptions, books, fees at extension or other agricultural organization meetings.

2. Travel expenses connected with your business, particularly if it includes meals and lodging.

3. Entertainment expenses when hosting others where the predominant purpose is the furthering of your farm business operation.
4. Social Security and hospital insurance rates for the self-employed are 12.4 percent and 2.9 percent for a total of 15.3 percent on 0.9235 of net farm profit up to $87,000 for 2003. One-half of the Social Security tax will be deducted as an adjustment to income. In addition, the 2.9 percent hospital insurance tax continues on income over $87,000. The 2004 social security wage base will be $87,900. To earn one quarter of coverage in 2003, $890 of earnings are required (for 2004 it’s $900 of earnings).

**Long-Range Tax Planning**

1. Maintain a good set of records to insure that all expenses are taken. Small cash purchases are easily forgotten. A good record keeping system is essential for end-of-year tax planning, as well as working with credit agencies.

2. Where income is high enough, plan the purchases of machinery to fully utilize the direct expense deduction and the 30 percent/50 percent additional first-year depreciation.

3. Plan your personal deductions. Many medical expenses and contributions formerly spread over 2 years can be paid in 1 year and itemized as deductions. In the next year, the standard deduction may be taken. Itemized deductions include medical expenses in excess of 7.5 percent of AGI, no personal interest is deductible, moving expenses are an itemized deduction and most miscellaneous deductions are deductible only to the degree they exceed 2 percent of AGI (Adjusted Gross Income).

4. Investigate a Self-employed Retirement Plan. There are four potential tax deferred retirement plans available. A defined contribution Keogh and Simplified Employee Plan (SEP) require that certain employees also be covered. Tax deferred contribution limits to a profit-sharing plan are an effective 13.0435 percent (15 percent of net income less the contribution). A SIMPLE plan replaced SEPs starting in 1997. The fourth alternative is an Individual Retirement Account (IRA). Employees do not have to be covered if a self-employed person utilizes an IRA; however, the maximum contribution is $3,000 per year in 2003, with an additional $3,000 in an unemployed spousal IRA ($3,500 for those over 50). An IRA deduction cannot be utilized if the contributor is eligible to participate in another retirement plan and when AGI exceeds $70,000 for a married taxpayer, or $50,000 for a single taxpayer with reduced contribution limits for AGI down to $60,000 and $40,000, respectively.

5. Where income is low or negative, consider the transfer of regular IRA balances to a Roth IRA to take advantage of future non-taxable income. However, adjusted gross income cannot exceed $100,000 to be eligible for a transfer.

6. Your farm business is a built-in deferred compensation and tax loss program. Investments and current expenses are made that substantially improve the value of the business property which can be sold at a later date, frequently at capital gains rates. Establishing a fruit orchard and increasing the size of a breeding livestock herd, for example, fits this situation. Crops that fit this category are timber, fruit trees, and Christmas trees as well as the build-up in year-end inventories.
7. Use installment sales of capital items to spread income over a number of years. However, with fewer and wider tax brackets and depreciation recapture considerations, an installment sale may not be advantageous.

8. If approaching retirement, keep in mind the $500,000 per couple ($250,000 each) exclusion of gain from tax for that portion of a farm sale attributed to your residence. Also, plan for more of your income from rent, dividends, interest, and pensions rather than earned income so that income will not be taxed as self-employment income for Social Security or reduce Social Security benefits. Earned income level that will decrease Social Security benefits for 2003 is $11,520 per year for those under age 65 ($11,640 for 2004). The decreases are $1 for every $2 of excess earnings for those under 65. For age 65 plus two months (born in 1938) over there is no reduction, but Social Security taxes are still paid on earned income.

9. Be sure to deduct as large a portion of business-personal expenses as is justified in your situation. Frequently, considerably more than 50 percent of the electricity and phone costs can be considered business. Also, choose the method for auto deductions, which is best for you. The standard mileage rate for 2003 is 36.0 cents per mile for business mileage (37.5 for 2004). Mileage for charitable purposes can be itemized at 14 cents per mile; for medical purposes, 12 cents per mile (14 and 14 for 2004).

10. Be aware of the Alternative Minimum Tax in tax planning. Alternative Minimum Taxable Income (AMTI) includes tax preference items such as tax-free interest. There is a $58,000 exemption for those filing joint returns ($40,250 single) and a tax rate of 26 percent on the first $175,000 of alternative minimum taxable income and 28 percent on AMTI in excess of $175,000. It is paid to the degree the tax exceeds your regular tax and is affecting more returns every year. The additional 30 percent/50 percent first year depreciation deduction is allowed on both regular tax and AMT.