

INCOME TAX MANAGEMENT

by

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Introduction

Hopefully you are operating your farm business at a profit. Federal and State income taxes and Social Security taxes will result from operating a business at a profit. The income tax management question is: Will you be in a higher marginal income tax bracket in 1998 than in recent years? If 1998 has been a good year in terms of taxable income you may be in a higher marginal tax bracket than you were in 1997 or expect to be in 1999.

A decline in milk or other farm product prices could signal a decline in farm profits in 1999 when compared to 1998. If you estimate your taxable income will either increase or decrease from 1998 to 1999, you should do some tax management yet this year.

Tax management is not tax evasion, it is tax avoidance. It is using the tax laws to maximize your income after taxes. There are several strategies that can be used to lower your taxable income. However, you should remember that some tax management decisions have farm management consequences. In other words, don't tax manage your business into a negative cash flow or a loss position.

Information Required

First, **establish** your normal income level and pattern by looking at your tax records for the last 4 or 5 years. If your income level has been changing, take that into account when comparing past income to current income and projecting 1999 income.

Second, **estimate** your taxable income for 1998. This usually has two parts: determining your taxable income to date, and estimating your taxable income for the remainder of the year. The nearer to the end of the year, the easier it is to estimate your taxable income for the remainder of the year. Of course this has a trade-off. The longer you wait to estimate your taxable income the less time you have to implement tax management strategies.

Third, **estimate** your taxable income for 1999.

Fourth, **determine** if shifting receipts or expenses between 1998 to 1999, to level your taxable income will be advantageous. Within limits, you can legally do this if you are a cash basis taxpayer. The tax saving obtained depends on the marginal tax rates. There is a change (from 15 to 28 percent) in the federal tax rate at approximately \$45,000 of taxable income (depending on number of dependents and marital status). The total marginal taxes (sum of federal, state, and social security tax rates) on the dollars below \$45,000 is approximately 35 percent. The total marginal tax rate on income above \$45,000 is approximately 48 percent. The next bracket change is at \$68,400 and leads to a lower marginal tax rate because income above this level are not subject to the retirement portion of the Social Security Tax (12.4 percent).

Tax management will lead to tax saving if the marginal tax rates on income in the tax years of concern (1998 and 1999) are different. If taxable income is moved from 1998 to 1999 and the marginal tax rates on the moved taxable income are the same, there isn't any tax saving. If the marginal rates are identical and taxable income is moved to 1999, there will be tax postponement. In that case, the returns from

postponing taxes are limited to the amount you will earn by investing the postponed taxes plus or minus any changes in the tax rates because of new tax laws. Remember, interest income or other earning on the investment of the postponed taxes will be taxable in 1999.

Income Averaging

Starting in 1998, farmers may elect to average their farm income over three years. Income averaging allows farmers to compare their marginal tax rate to the previous three years and take advantage of the earlier (lower) rates. Suppose a farmer was taxed at the 15 percent rate for the previous three years but will be in the 28 percent federal tax bracket in 1998. That farmer can have the income taxed at the 15 percent rate if there is room in the 15 percent tax brackets for 1995 through 1997.

Other Income Leveling Strategies

The taxpayer can use three other strategies to level taxable income.

- Shifting income between years

- Shifting expenses between years

- Selection of a depreciation method for each category of assets purchased

The first two strategies, shifting income and expenses, must be done before the end of the tax year of concern, in this case, in 1998. "Income Averaging" and the third strategy can be determined after the end of the tax year. However, some foresight is required because the third strategy applies to only the boot paid for certain income-producing assets² purchased in 1998. Therefore if no income producing assets were purchased in 1998, depreciation related strategies are not available.

Delaying Sales -- This is not an easy option for producers of perishable commodities, such as milk, to use. Milk must be sold every day or every other day and the ability to delay milk sales is almost non-existent. However, dairy farmers can delay sales of calves, corn, hay, cull cows, or other items. Delaying cull cow sales is not as effective as other types of income delays because of the special tax treatment given to the sale of cull cows. (They are not subject to FICA tax and currently the State of Wisconsin has 60 percent exclusion on capital gains.) Producers of storable commodities and some classes of livestock have more options for shifting income between years.

Increasing Expenses -- Buying the fertilizer, seed, and other supplies you need for spring 1999 planting before the end of 1998 is a legitimate way to increase current year expenses. Also, you can pay your 1998 property taxes normally due in January and July of 1999 before the end of 1998. Note: Your total prepaid expenses can not exceed 50 percent of actual cash expenses.

Selecting Depreciation Method -- If you have purchased assets at any time during 1998, you will need to select a depreciation method for that asset or group of assets. Depreciation is the expense deduction allowed to provide cost recovery to the purchaser of business or income producing assets with a determinable useful life of greater than one year. The fastest cost recovery (depreciation) method would be selected if you wish to reduce your 1998 taxable income.

The method of cost recovery that allows for deducting the cost of an income producing asset in the year of purchase is **Section 179 expensing**. Section 179 expensing is a depreciation method³. The maximum amount of Section 179 you can claim in 1998 is \$18,500, up from the \$18,000 allowed in 1997. This option may be one to consider if you had above average income in 1998 and expect lower incomes in 1999 and later years. . Note: The amount allowable for Section 179 depreciation will be \$19,000 in 1999.

The amount of Section 179 claimed reduces the tax basis of the asset(s) by a like amount.

Once the amount of Section 179 expensing is determined, the remaining tax basis of depreciable asset(s) is depreciated using one of three standard cost recovery (depreciation) methods. MACRS-150 (Modified Accelerated Cost Recovery System-150) offers the most cost recovery in the early years of asset ownership. It is a declining balance method, with the percentage set at 150. It has the shortest recovery period allowable under current law. The recovery period is the years over which the entire cost of the asset is deductible as depreciation expense. This depreciation method is more complex than straight line because a different amount of depreciation will be claimed on the asset in each year of the recovery period.

There are two straight-line depreciation methods available. The MACRS-SL (Straight Line) has the same recovery period as MACRS-150 but it has less cost recovery allowable in the first years of the recovery period and more in the later years than MACRS-150. ADS (Alternative Depreciation System) is also a straight-line depreciation method with a longer recovery period than MACRS-SL method. In addition, capital purchases after October 1st may be subject to different depreciation rules in the year of purchase.

The entire cost of an income-producing asset will be claimed as an expense deduction using any of the cost recovery (depreciation) methods. The difference is the timing and the time required to obtain full recovery. You can select different methods for each class of assets that you have purchased. Select the one that is the most advantageous for your tax situation.

Example One

Your estimated taxable income for 1998 is \$55,000. Your average taxable income over the last several years was \$25,000 and you expect your taxable income will be \$25,000 in 1999. Using tax management techniques, you can prepay your property taxes (\$5000), incur other prepaid expense (fertilizer, seed, and feed) of \$4,700 and delay sales of 5 bull calves (\$300). This will move \$10,000 of taxable income from 1998 into 1999, and your estimated taxable income in 1999 will now be \$35,000. If you take these actions, will you have tax saving and how much are they?

Yes you will have tax savings because you will have shifted \$10,000 of income into a lower marginal tax bracket. The marginal tax rate at \$55,000 of income is approximately 48 percent (on Schedule F [self-employment] income) and the marginal tax rate at \$25,000 is approximately 35 percent. Therefore your tax saving will be \$1,300, the difference in the marginal rates (48 – 35 percent) times the \$10,000. In addition you will have \$3,500 in postponed taxes.

Example Two

You estimate your taxable income to be \$40,000 in 1998. Your average taxable income over the last several years was \$25,000 and you expect your taxable income will be \$25,000 in 1999. Using tax management techniques, you can prepay your property taxes (\$5000), incur other prepaid expense (fertilizer, seed, and feed) of \$4,700 and delay sales of 5 bull calves (\$300). This will move \$10,000 of taxable income from 1998 into 1999. If you take these actions, what are your tax savings?

Some people will answer, \$3500 ($\$10,000 \times 35\%$ [the marginal tax rate]). This is not correct. Your tax savings are zero because all the moved income will be in the same tax range-rate for the 1999 tax year. However, there is \$3500 of postponed taxes.

Postponing taxes is generally a good idea. However, postponing taxes can have consequences. In fact, one of the reasons many farmers maybe in higher tax brackets this year is that they have accelerated deductions in the past and those deduction are not available for them to use this year. Accordingly, don't confuse tax saving and postponed taxes.

Example Three

All forward shifts of taxable income will result in postponed taxes. However, some shifts of taxable income result in an increased tax burden. This is due to the collective nature of the three taxing units (state, federal, and social security).

Conclusion

First, estimate your taxable income for 1998 and compare it to recent years and your estimated income for 1999. Do this well before the end of 1998. If there appears to be fluctuations in your income, start planning for the income and expenses you wish to move.

Second, consult with your tax accountant as to which of these tax strategies are appropriate for your situation.

Lastly, do not forget to contribute to your IRA. If you wish, it is tax deductible.

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2. Breeding livestock, machinery, equipment, and buildings,
3. Only one dollar of depreciation can be claimed for each dollar of asset cost, therefore the cost basis of an asset must be reduced by the amount of Section 179 claimed before you place your assets on your "regular" depreciation schedule. Section 179 expensing can only be claimed on the boot price paid for assets purchased in the current tax year and the amount you can claim is reduced by one dollar for each dollar of asset purchases in excess of \$200,000 until zero deduction is available through Section 179. In addition, Section 179 deductions are limited to your taxable income from all trades or business - including employment income.