Agriculture Insights

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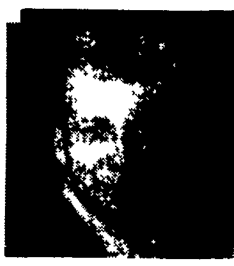

Pre-Year End Tax Planning

The end of the year is fast approaching, and do you know what your tax liabilities will be? To become better prepared for your tax liabilities and possibly help save you money in taxes, schedule a pre-year end tax planning meeting with your accountant.

It is advisable to meet with your accountant during the month of November to review your year-to-date financial records and project December's numbers in order to forecast your tax liability. This pre-year end meeting will allow enough time to make any final business transactions or plan other options to level your taxable income before the December 31 deadline.

With nearly all farmers on a cash basis accounting system, you pay taxes on the difference between your receipts and expenses. In farming there can be a large volatility from year to year on both your receipts as well as your expenses. A farmer's tax reporting process, (schedule F), is one of the most liberal in the business community. This can allow you to level out your taxable income over several years and remain in the same tax bracket, rather than pay a large amount in taxes one year and very little the next.

One strategy to take in leveling your income is to defer income to the next year and prepay expenses or show income early and defer expenses to the next year, depending on your financial situation. Planning allows you to manage which tax bracket you want your income taxed, and even allows income that otherwise would have been taxed to be sheltered if the income is pushed into a subsequent loss year. The following example illustrates how tax planning can benefit a farming operation:

Farmer Brown, a farm proprietor, has 2 children and files a joint tax return with his spouse. Their 2000 taxable income before tax planning is $54,000, and they expect their 2001 taxable income to be significantly less. Therefore, their tax planner advises them to defer income and prepay expenses of $10,000 to reduce their 2000 taxable income to $44,000, which is the top end of the 15% federal tax bracket. Without planning, the Brown's combined marginal tax rate would be 47% (28% federal, 4% PA and local, and 15% social security); therefore, by prepaying expenses or deferring income of $10,000, the Browns save approximately $4,700 of tax.

Those that don't plan claim that the profit gets taxed the following year, so why bother? First, the time value of money is an important item to remember. Having the tax money in your pocket to invest back into your operation or into a retirement plan (see below) instead of the government's pocket for one year is valuable. Second, if this year's profit is pushed into a lower bracket next year, the tax savings generated by the difference in tax brackets is permanent. Third, if you expect a loss next year, the profit pushed into next year is offset by the loss and never taxed.

The most common method of managing income is to delay or accelerate selling crops. In a dairy operation, delaying the receipt of a milk check is more of a challenge, especially if you have an automatic deposit feature. If you receive Commodity Credit Corporation (CCC) loans or crop damage insurance proceeds, there are some planning options available as to when this income is reported.

Another approach to managing taxable income would be to use a retirement planning option. This might involve placing money in a SIMPLE plan, IRA, 401K, or any other retirement planning tool. Be aware that a contribution to your own retirement plan saves income tax, but does not reduce your social security tax. However, this planning technique will help you secure and diversify your retirement wealth as well as reduce your taxable income.

Common methods of managing your expenses include prepaying or delaying payment of feed, supplies and fertilizer. There are limits on how much may be prepaid so consult with your accountant concerning these rules. Another available tool to avoid high taxes is first year depreciation or Section 179. With this special depreciation election, you may show an expense of up to $20,000 on equipment purchased. Another method is to pay your children, provided the labor and hourly wage is legitimate. No social security tax is due on wages paid by farmers operating as sole proprietorships to their children under age 18. In addition, children do not have to pay federal income tax on their first $4,400 of wages because of the standard deduction allowed on their tax returns, so it's a great way of sheltering income within the family.

As with any tax planning decision, be cautious to not leave the "tax cart" get in front of the "good business horse." In other words, consider whether the tax planning decisions you are making still make good business sense. For example, if you are considering prepaying feed and prices are high in December, and you can do much better economically buying feed next year when feed prices are anticipated to be lower, consider this as you make your year-end tax planning decisions.

If you do not already have a pre-year end meeting scheduled with your accountant, consider doing so this month. This not only allows enough time for tax planning but also will encourage you to maintain a better record keeping system and reduce the shock of your tax bill come February. If your time is limited this fall, it might be tempting to spend any extra time with the harvest fieldwork, but proper planning of your finances can save you far more money than the few extra bushels of grain you might harvest.

The Lancaster Chamber's 24th Annual Agriculture-Industry Banquet will be held on November 21 at the Lancaster Host Resort. For more information or to register for banquet tickets, visit www.lancaster-chamber.com, contact Brent Landis at (717) 397-3531 or e-mail blandis@lcci.com