



Ag Business Management

Informing farm families and ag businesses about management issues.

Ag Income Tax Update for Farm Families

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Introduction:

For tax years 2009 and 2010, there are a number of changes that have resulted from the passage of federal tax laws. These include changes in Section 179 allowance, reinstatement of bonus depreciation, depreciation year limits, tax rebates, taxation of CRP payments and much more. Farm business tax issues appear first, followed by individual tax issues.

Note: this information piece is offered as educational information only and not intended to be legal or financial advice. For questions specific to your farm business or individual situation, consult with your tax preparer.

Depreciation:

Section 179 depreciation: For the tax year 2008, the deduction limit was \$250,000 and the phase-out amount is \$800,000 - not indexed for inflation. Resulting from the American Recovery & Reconstruction Act of 2009, the Section 179 deduction limit for 2009 will be \$250,000 with a phase-out for qualifying property of \$800,000. For 2010, the amounts are reduced to a \$134,000 deduction and a \$530,000 investment limit.

Qualifying property for Section 179 includes breeding livestock, machinery, single purpose ag structures (hog confinement building), and drainage tile. Property can be new or used. Property eligible for Section 179 cannot be purchased from a related party (spouse, ancestors, or lineal descendant).

Modifying Section 179 Depreciation: Initially, Section 179 elections could be made only on the original tax return for a particular tax year and could not be

changed on an amended return. Thus, at a later time, if a change was desired through audit or discovery of an error, the taxpayer could not make or change the Section 179 election. Amending a tax return to change a Section 179 election, appears to be a gray area for 2008 and beyond. See your tax preparer.

Bonus depreciation: Bonus depreciation was reinstated for the 2008 tax year. Businesses were allowed to depreciate an additional 50% of the cost of certain property. Eligible property includes: tangible property that had a recovery period not exceeding 20 years, purchased computer software, water utility property, and qualified leasehold improvement property. **Only new assets qualify.**

The 2009 legislation extends bonus depreciation through 12/31/09 for new property (the original use of which commences with the taxpayer). First use priority is 3-20 year class life assets – includes barns and machine sheds.

The 2009 law also extends the bonus depreciation through the 2010 tax year (calendar year ending December 31, 2010) for property with a recovery period of 10 years or longer, transportation property, and certain aircraft (qualified long-production-period property).

Bonus depreciation will be allowed under the alternative minimum tax (AMT).

Minnesota law –Section 179 & Bonus depreciation: MN has not fully adopted the Section 179 provision as changed in federal tax law and is not expected to do so. Currently, Minnesota tax payers must add back 80 percent of the increased difference between the 179 expenses allowed federally and the amount that would

have been allowed under the IRC in effect prior to 2003. Minnesota's limitation for expensing newly acquired 179 assets is \$25,000 rather than the federal amount of \$250,000. The business investment limitation for Minnesota is \$200,000 rather than the \$800,000 federal amount. Taxpayers will have to re-compute federal Schedule 4562 for state purposes in order to figure the add-back amount. In each of the five years after the add-back is made, the taxpayer is allowed to subtract 20 percent of the remaining unclaimed amount.

This limitation applies to all business entities. In a partnership or S-corporation, the pass through to a partner or shareholder is first limited at the entity level. For example, a partnership has a Section 179 expense of \$100,000, the Minnesota flow through is limited to \$25,000.

Minnesota did not adopt the entire federal bonus depreciation rules and is not anticipated to do so. Currently, Minnesota taxpayers must add back 80% of the claimed bonus depreciation and then take a subtraction of 20% over the next five years. **Example:** Ralph took bonus depreciation of \$50,000 in 2009. For Minnesota, he must add back 80% or \$40,000 ($\$50,000 \times .8 = \$40,000$) on his Minnesota return. He will take a subtraction of \$8,000 each year ($\$40,000 \times .2$) over the next five years.

Five (5) year depreciation recovery period mandate for new farm machinery – federal rules: **New** farm machinery and equipment placed into service during 2009 must be depreciated over a 5 year period rather than 7 years. The 7 year depreciation period will still apply to used machinery and equipment placed into service in 2009.

Farm machinery and equipment subject to the 5 year Modified Accelerated Cost recovery System (MACRS) depreciation must meet the following requirements: **1)** the original use starts with the taxpayer after the date of December 31, 2008; **2)** the machinery/equipment is placed into service prior to January 1, 2010; and **3)** the items are not grain bins, fencing, or other land improvement or cotton-ginning assets.

If the producer does not want to be subject to the accelerated 5 year depreciation, they have two additional depreciation choices: **1)** elect to utilize straight-line depreciation method over the 5 year period General Depreciation System (GDS) or, **2)** elect to utilize the straight-line depreciation method over the 10 year Alternative Depreciation System (ADS). Nevertheless, any new machinery or equipment put into service in 2009 must be depreciated over the 5 year period.

Self-Employment Tax Items:

Self employment tax remains a split calculation as follows: 12.4% for social security and 2.9 % for Medicare for a total of 15.3%. The maximum income amount you will pay Social Security tax on is \$106,800 for 2009 and \$106,800 for 2010. There currently is no cap on the Medicare portion.

Annual earning limits on Self-Employment/Social Security Tax change each year. For individuals who are less than their Full Retirement Age (FRA), there is a limit on income of \$14,160 for 2009 and \$14,160 for 2010. In the year the individual reaches FRA, the income limit is \$37,680 for 2009 and \$37,680 for 2010. Beginning the month the individual reaches their FRA, there is no limit on income. **Note:** the FRA requirements change based upon an individual's birth date so check with your local Social Security office for these details or go to the following web site: www.socialsecurity.gov and search for Full Retirement Age Income Limits.

Self-Employment Tax on land, building, and facility rent: Land or building owners receiving rent from a business entity they are a part of, are exempt from SE tax on the rental payments **IF** the rent is fair and reasonable. **This is the current ruling ONLY in the 8th Circuit Court of Appeals which includes Minnesota, North Dakota, South Dakota, Iowa, Nebraska, Missouri, and Arkansas.** Please note that IRS continues to challenge this ruling, so make sure you check with your tax preparer to stay updated on this issue.

Alternative Minimum Tax (AMT) Issues:

On the federal level, AMT rules remain in effect. Changes in calculating the Alternative Minimum Taxable Income (AMTI) have made the AMT an issue of concern to farmers.

For individuals, the AMT exemption amounts have changed. If married and filing jointly or as a surviving spouse, the exemption is \$70,950 for 2009 and \$45,000 for 2010. If filing single or as head of household, the exemption is \$46,700 for 2009 and \$33,750 for 2010. If married filing separately, the AMT exemption is \$35,475 for 2009 and \$22,500 for 2010.

For Minnesota beginning in 2005, there are a number of items subtracted when calculating the income for computing AMT. Those items include: federal active duty military pay received by residents for services performed outside of Minnesota, compensation received for state

active duty service performed in Minnesota by National Guard members or Reservists, and certain costs incurred when donating all or part of a human organ. This is subject to change by legislative action.

AMT is a complex issue. Misinterpretation could increase taxes so check with your tax preparer.

Domestic Production Activities Deduction:

Domestic Production Activities Deduction provision is a tax deduction for employers with production activities within the United States. Agricultural production will qualify for this deduction. This provision allows for a deduction from taxable income for up to 3% of qualifying production income generated in the United States. The deduction will increase to 6% for taxable years beginning in 2007, 2008 and 2009, and to 9% for taxable years beginning after 2009.

The domestic production activities deduction for tax years beginning in 2007 to 2009 is limited to the smallest of:

- 1) 6 percent of qualified production activity income (QPAI).
- 2) 6 percent of the taxable income of a taxable entity or adjusted gross income of an individual taxpayer (computed without the I.R.C. Section 199 deduction), or
- 3) 50 percent of the Form W-2 wages paid by the taxpayer during the year.

This deduction is computed on Form 8903 and is taken on the front of the Form 1040 as an adjustment to income. Thus, the deduction is for adjusted gross income only and does not reduce earnings from self-employment.

Qualified Production Activities Income: Qualified production activities income, commonly referred to as QPAI, is equal to domestic production gross receipts (DPGR) minus the cost of goods sold, other deductions and expenses directly allocable to such receipts, and the share of other deductions and expenses not directly allocable to such receipts. For farmers, the qualifying activities include cultivating soil, raising livestock, and fishing, as well as storage, handling, and other processing (other than transportation activities) of agricultural products. For many farmers, their QPAI will be equal to the sum of net income reported on their Form 1040 Schedule F and net gain from the sale of raised livestock reported on Form 4797. However, as explained below, there are a number of possible exceptions to this guideline.

Domestic Production Gross Receipts: Domestic production gross receipts (DPGR) are generally the receipts from the sale of qualified production property. For cash basis farmers, this would be the receipts from the sales of livestock, produce, grains, and other products raised by the producer. DPGR includes the full sales price of livestock (like feeder livestock) and other products purchased for resale. Gains from the sale of raised draft, breeding, and dairy livestock reported on Form 4797 also qualify as DPGR.

Sales proceeds from livestock purchased for draft, breeding, or dairy purposes would probably not qualify unless the taxpayer had purchased the animals as young stock and had a significant role in raising them.

Government subsidies and payments not to produce are substitutes for gross receipts and do qualify as DPGR. Thus, subsidy payments that are directly linked to production, such as the loan deficiency payments (LDPs) and countercyclical payments, would qualify.

Direct payments under the Farm Bill are not a substitute for sales of a commodity and would not qualify as DPGR. Payments under the Conservation Reserve Program (CRP) are related to past production and are clearly a substitute for gross receipts. Crop and revenue insurance payments received for physical crop losses would also be included in DPGR.

Gains from the sale of land, machinery, and equipment are excluded from DPGR. Rent received from land is specifically excluded from DPGR. Custom hire income (e.g. combining, spraying, trucking etc.) reported on Schedule F is also excluded from DPGR. Government cost-sharing conservation payments and stewardship and incentive payments probably do not qualify. Because a custom livestock feeder does not have the benefits and burdens of ownership of the animals, the receipts would not qualify as DPGR.

If a taxpayer has less than 5% of his or her total gross receipts from items that are not DPGR, a safe harbor provision allows a taxpayer to treat all their gross receipts as DPGR. For example, a farmer has non-DPGR income of \$5,000 from planting the neighbor's no-till soybeans. As long as qualifying DPGR exceeds \$95,000, the farmer can include the \$5,000 as part of his or her DPGR and no cost allocations are necessary.

If qualifying DPGR is \$95,000 or less, then \$5,000 custom hire income must be kept separate and expenses allocated between DPGR and non-DPGR activities as discussed later. In computing the 5-percent limit, gross

receipts from the sale of assets used in a trade or business, such as machinery and equipment, livestock, and other business assets, are not reduced by the adjusted basis of business property. However, for assets held for investment purposes, only the net gain is included.

Computing QPAI: To determine QPAI, the farmer's DPGR is reduced by the appropriate costs. If items purchased for resale (like feeder livestock) are included in DPGR, the cost of these items is deducted. Directly allocable and indirectly allocable deductions, expenses, or losses related to the items included in DPGR are deducted. For a farmer whose entire crop sales receipts qualify as DPGR, QPAI would be computed by subtracting the allowable expenses, and QPAI would be equal to net farm income on Form 1040 Schedule F. If the farmer also had gains from the sale of raised livestock on Form 4797, QPAI would be the sum of net income from Form 1040 Schedule F and the livestock gain from Form 4797.

Domestic Activities Production is not treated as a business deduction for calculating a net operating loss (NOL).

Cooperative's DPAD distributed to patrons: New rule interpretation of cooperative DPAD distribution to patrons and the patron's handling of the deduction on their tax form results from I.R.C. § 199 (d)(3)(A)(ii).

"The member's deduction is the DPAD of the cooperative that is allocable to the following: 1) Patronage dividends paid to the patron (i.e., member) in money, in a qualified notice of allocation, or in other property (except a nonqualified written notice of allocation), 2) Per-unit retain allocations that are paid to the patron in qualified per-unit retain certificates I.R.C. § 199(d)(3)(A)(ii) requires the cooperative to designate the patron's portion of the income allocable to QPAI in a written notice mailed by the cooperative to the patron no later than the fifteenth day of the ninth month following the close of the tax year."¹

"Treas. Reg. § 1.199-6(1) states that "A qualified payment received by a patron of a cooperative is not taken into account by the patron for purposes of section 199." Therefore, patronage dividends are not included in a member's DPGR if they are paid in money, a qualified notice of allocation, or other property (except a nonqualified written notice of allocation) or in per-unit

retain allocations that are paid in qualified per-unit retain certificates.

This rule excludes the listed items from the member's DPGR whether or not the cooperative elects to pass part or all of its DPAD through to its members. Therefore, the cooperative's election to pass through (or not pass through) DPAD to its members has no effect on the members' DPGR."²

This is a complicated tax deduction so check with your tax preparer for information specific to your situation.

Federal Minimum Wage Increase:

An increase in the federal minimum wage becomes effective 60 days after the date of enactment and will take place in increments over a three year period. Each yearly increase is 70 cents per hour. The first increase took effect on July 24, 2007 with the minimum wage of \$5.85 per hour. The next increase to \$6.55 per hour was in July 2008 and the last increase to \$7.25 per hour occurred in July 2009.

Deferred Contract Sales and Alternative Minimum

Tax (AMT) Issues:

A farmer can sell grain and livestock in one year, sign a deferred payment contract or an installment contract, and postpone payment and recognition of that income into the following year. Tax on the income will be calculated for both regular and AMT tax in the following year.

However, there is one caution here. ". . . delaying payment increases the chances that the buyer may not pay for the commodity because of financial difficulties. Because the sale was not reported as income, a cash-basis farmer does not have a deductible loss if the buyer defaults on the deferred payments."³

"A qualified deferred-payment contract must avoid terms that result in the farmer's having constructive receipt of income. Thus, the contract should be in place before the grain or other commodity is delivered to the buyer, and it should specify that the seller has no right to any proceeds until the following year. I.R.C. § 483 and § 1274 generally require a buyer to pay interest on an installment-sale contract. However, I.R.C. § 483 and

¹ 2009 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 403

² Ibid., p. 404

³ Ibid., p. 380

§ 1274 do not apply to installment-sale contracts in two separate situations:

1. All payments are due within 6 months of the contract sale date [I.R.C. § 483(c)(1)(A) and 1274(c)(1)(B)].
2. The total sales price is \$3,000 or less [I.R.C. §§ 1274(c)(3)(C) and 483(d)(2)].”⁴

“If the buyer does not make the required deferred payment, the seller’s loss deduction is limited to the basis in the contract, which is generally the commodity’s basis. A farmer’s basis in a raised commodity is usually zero. Therefore, there is no deductible loss.”⁵

“The matching principle of accounting requires farmers who sell animals or other items that were purchased for resale to determine the profit or loss by subtracting the cost of the animal or other item from the amount received in the year of sale [Treas. Reg. § 1.61-4(a)].”⁶

Wind Generator Tax Issues:

“Most wind turbines are purchased, installed, and maintained by a power company, which needs access to the land on which towers for the turbines are built and access to land for power lines that collect electricity from the turbines and connect to the electrical power grid. The most common contractual arrangement between an energy company and landowners is the purchase of an easement. The contracts typically include three types of payments:

1. Purchase of the easement over the land.
2. Restitution for damage to crops during construction of the towers and power lines.
3. Annual rent payments based on the amount of electricity generated.

Each of these payments has income tax implications for the landowner.”⁷

Sale of Easement: : “Easements for wind-turbine towers or power lines from the turbines are subject to the same income tax rules that apply to the sale of any easement.

Because the landowner is selling only part of the rights to the property, the general rule in Treas. Reg. § 1.61-6(a) requires a basis allocation.

Two basis allocation issues arise from the sale of an easement:

1. The basis in the entire property must be allocated between the portion of the property that is affected by the easement and the portion of the property that is not affected by the easement.
2. The basis in the property that is affected by the easement must then be allocated between the rights that are sold (the easement) and the rights that are retained. However, if it is impossible to allocate basis between the partial interest that is sold and the partial interest that is retained, then the amount received for the easement can be compared with the entire basis in the affected property [Rev. Rul. 77-414, 1977-2 C.B. 299].”⁸

Payments for Crop Damage: “After buying an easement on crop land, the power company pays the owner of the crop for damage to the crop caused by construction or maintenance of the turbines or power lines. These payments sometimes go to a lessee who is raising a crop on the land. Crop damage payments are treated as proceeds from the sale of crops and are included on line 4 of Schedule F (Form 1040).”⁹

Rental Payments: “The annual payments to landowners that are based on the amount of electricity produced by the turbines are rental payments for land that is not used in agricultural production. The rent is not subject to SE tax [I.R.C. § 1402(a)], and it is reported on Schedule E (Form 1040), Supplemental Income and Loss. Landowners generally do not have any expenses to deduct on Schedule E (Form 1040).”¹⁰

Income Averaging:

Income averaging remains in effect **for farmers only**. Farmers can elect an amount of their current farm income to divide equally among the previous three years. The amount applied to the previous three years is added to the previous year’s taxable income. Savings result if the previous year’s income was taxed at a lower tax rate than the current year. This election applies to any income that is attributable to a farm business. Farm income includes

⁴ Ibid., p. 381

⁵ Ibid., p. 381

⁶ Ibid., p. 381

⁷ Ibid., p. 393

⁸ Ibid., p. 393

⁹ Ibid., p. 395

¹⁰ Ibid., p. 395

items of income, deduction, gain and loss attributable to the individual's farming business. This includes: **1)** net Schedule F income, **2)** an owner's share of net income from an S corporation, partnership, or limited liability company, **3)** wages received by an S corporation shareholder from the S corporation, and **4)** gain from the sale of assets used in the farming business and reported on Form 4797 and/or Schedule D (Form 1040) but not gain from the sale of land or timber.

Farmers are allowed to use a negative farm income for calculations in the base year. However, this loss carried from the base year to other years in the calculation, must be removed from the base year calculation to prevent a double tax benefit.

In addition, the tax payer will lose a portion of the benefit of the income averaging if the calculation reduces the regular tax liability below that calculated using the Alternative Minimum Tax (AMT) method.

If a farmer liquidates their farm business, the gain or loss is attributable to a farming business for income averaging only if the property is sold within a reasonable period of time. One year is considered a reasonable period of time.

Capital Gains Tax Changes:

Capital gain tax rates **for land and stock sales** are as follows:

- 10-15% federal tax bracket: capital gains rate of 5% (was 10% under previous law)
- 25% federal tax bracket or above: capital gains rate of 15% (was 20% under old law)

These rates went into affect for sales after May 5, 2003.

Note: the 5% rate will go to 0% for tax years 2008, 2009 and 2010 for taxpayers in the 10% and 15% federal tax bracket. The 0% rate applies **ONLY** to the capital gain portion, that when added to the individual's federal adjusted gross taxable income, raises the person's taxable income to the top of the 15% federal tax bracket which is \$67,900 in 2009 and \$68,000 in 2010 (Married Filing Joint). Any additional gain, in excess of the amount that raises the person's taxable income to the top of the 15% federal bracket, is taxed at the 15% rate.

Example: In 2009 Beatrice and her husband, George have a federal adjusted taxable income of \$37,900. Beatrice makes a capital sale resulting in a capital gain of \$60,000. Of that total gain, \$30,000 would be taxed at the 0% rate and would raise their taxable income to \$67,900

(\$37,900 + \$30,000 = \$67,900). The remaining gain of \$30,000 would then be taxed at the 15% federal rate because it exceeds the 15% federal tax bracket.

For sales of Section 1250 property (primarily refers to buildings and structures), any long-term capital gain attributable to depreciation (other than depreciation recapture as ordinary income) is taxed at a maximum rate of 25%. Generally, the un-recaptured Section 1250 gain is calculated as the smaller of (1) depreciation or (2) total gain less any recaptured depreciation that is taxed at ordinary rates (that is accelerated depreciation in excess of SL).¹¹

In Minnesota, capital gains are taxed as ordinary income. The Minnesota income tax rates range from 5.35% to 7.85%.

This is a critical issue and can be complicated, especially the 0% capital gain tax provision for the years 2008, 2009 & 2010. Be sure to check with your tax preparer for details.

Disaster Payments and Crop Insurance Indemnity Payments:

Any crop insurance proceeds you receive need to be included as income on your tax return. You generally include that income in the year received. Crop insurance includes the crop disaster payments received from the federal government as the result of destruction or damage to crops, or the inability to plant crops, because of drought, flood, or any other natural disaster.

You can postpone reporting crop insurance proceeds as income until the year following the year the damage occurred if you meet all the following conditions:

- a. You use the cash method of accounting.
- b. You receive the crop insurance proceeds in the same year the crops are damaged.
- c. You can show that under normal business practice you would have included income from the damaged crops in any tax year following the year the damage occurred.

Generally, farmers are able to establish their practice of reporting crop income in a following taxable year by reference to their prior year's sale records.

¹¹ Premium Quickfinder Handbook, 2008 Edition, Thomson Reuters, p. 7-4

In order for a payment to constitute insurance for the destruction of or damage to crops, the insured must suffer actual physical loss. Agreements with the insurance companies that provide for payments without regard to actual losses by the insured, such as payments in the event that county average yield is less than a specified amount, are not payments for the destruction of or damage to crops. Such payments do not qualify for deferral under I.R.C. § 451(d). Also payments made for a decline in the price of the commodity, rather than a physical loss, do not qualify for deferral.

Some farmers received compensation in 2008 & 2009 under Crop Revenue Coverage (CRC) policies they purchased from federal Crop Insurance Corporation. These payments are based on price as well as quantity and quality of the commodity produced. **Only the payment for destruction or damage (yield loss) is eligible for deferral.** A farmer who receives compensation from a CRC policy must determine the portion of the payment that is due to crop destruction or damage rather than due to a reduced market price.

A CRC policy guarantees a minimum amount of revenue per acre for the insured farmer. The policy provides a formula for computing the deemed revenue the insured received from the crop that was produced. Taken into account is price of the commodity at the time of harvest, the quantity the insured farmer harvested and the quality of the commodity harvested. This deemed revenue is compared with the guaranteed minimum revenue. The excess of the guaranteed minimum over the deemed revenue received is the amount paid to the insured farmer.

The insured farmer's deemed revenue (**calculated revenue**) is computed by multiplying two factors:

- 1) Production to Count: this equals the harvested and appraised production and includes a quality adjustment.
- 2) Harvest Price: is based on an appropriate futures contract price for the crop as defined in the insurance policy.

The guaranteed minimum amount of revenue (**final guarantee**) is computed by multiplying three factors:

- 1) Approved Yield Per Acre: is the historical average amount of production/acre of land covered by the policy.
- 2) The greater of:
 - a) Base Price: is based upon an appropriate futures

contract price for a period before the crop was planted as defined in the policy.

- b) Harvest Price: as defined earlier.

3) Coverage Level Percentage: the level of coverage the insured farmer chose when he/she purchased the policy. It is reasonable to allocate the payment by separately calculating the revenue loss due to destruction and damage and the revenue loss due to a reduced market price. The insurance proceeds can then be multiplied by the ratio of the revenue loss due to destruction to the total revenue loss.

EXAMPLE – CORN (harvest price less than base price):

Acres insured - - 1 acre
 Approved yield (APH) - - 140 bushels
 Base price - - \$4.06
 Harvest price - - \$3.58
 Coverage level - - 65% CRC
 Production to count - - 50 bushels

Calculation: CRC Payment

Final Guarantee:

Approved yield – bu./ac.		140	
Greater of base/harvest price	x	\$4.06	
Coverage level	x	<u>0.65</u>	
Final Guarantee (a)			\$369.46

Calculated Revenue:

Production to count – bu./ac.		50	
Harvest price	x	<u>\$3.58</u>	
Calculated Revenue (b)			\$179.00

Insurance Proceeds: (a-b) **\$190.46**

Yield loss:

Approved yield – bu./ac.		140	
Production to count – bu./ac.	-	<u>50</u>	
Damage loss – bu./ac.		90	
Harvest price	x	<u>\$3.58</u>	
Revenue loss from damage: (c)			\$322.20

Price loss:

Greater of base/harvest price		\$4.06	
Harvest price	-	<u>\$3.58</u>	
Price loss		<u>\$.48</u>	
Production to count bu./ac.	x	50	
Revenue loss from reduced price: (d)			<u>\$ 24.00</u>

Total Revenue Loss: (c+d) **\$346.20**

Amount Eligible for Deferral:

Physical Loss: $\$322.20 \div \$346.20 = 93.07\%$

Amount Eligible for Deferral:

$$.9307 \times \$190.46 = \underline{\underline{\$177.26 \text{ per acre}}}$$

The remaining \$13.20 is not eligible for possible deferral.

If the harvest price equals or exceeds the base price, the formula used in the previous example (harvest price less than base price) would end up allocating all of the CRC proceeds to destruction and damage (yield loss).

Prepaid Expenses:

If you use the cash method of accounting to report your income and expenses, your deduction for pre-paid farm expenses in the year you pay for them is limited to 50 percent of the other deductible farm expenses for the year (all Schedule F deductions minus pre-paid farm expenses). This limit does not apply if you meet all the exceptions described as follows.

Here's an example: During 2009, Alvin bought fertilizer (\$4,000), feed (\$1,000) and seed (\$500) for use on his farm in the following year. His total pre-paid farm expenses for 2008 are \$5,500. His other deductible farm expenses totaled \$10,000 (total schedule F expense minus pre-paid expenses) for 2009. Therefore, Alvin's deduction for pre-paid farm supplies cannot be more than \$5,000 (50 percent of \$10,000) for 2009. The excess pre-paid farm supplies expense of \$500 (\$5,500 - \$5,000) is deductible in the later tax year you use or consume the supplies

In recent years, farming has been a profitable enterprise. Many cash-basis tax filers utilize pre-paid expenses at year-end to balance expenses with income. This practice also allows farm producers to guarantee delivery and lock-in prices on crop inputs for the following year. However, there is a limit as to how much a farm operator may pre-pay.

There are a couple of exceptions: The limit on the deduction for pre-paid farm expenses does not apply if you are a farm related taxpayer and either of the following applies:

1. Your pre-paid farm expense is more than 50 percent of your other deductible farm expenses because of a change in the business operations caused by unusual circumstances.

2. Your total pre-paid farm expense for the preceding three tax years is less than 50 percent of your total other deductible farm expenses for those three years.

The maximum pre-paid amount is calculated each year based upon the final figures on the Schedule F. Fall applied fertilizer and lime does get treated differently. If fertilizer and lime are purchased late in 2009 and applied before January 1, 2010, the fertilizer and lime expense is not considered a pre-payment for tax purposes and thus is not subject to the 50 percent rule.

Net Operating Loss (NOL) Carry Back:

The American Recovery and Reinvestment Act of 2009 (signed into law February 17, 2009) allowed eligible small businesses (with average gross receipts of \$15 million or less) to elect to carry back net operating losses (NOLs) from 2008 for three, four or five years rather than the standard two years. The Worker, Homeownership, and Business Assistance Act of 2009 (signed into law November 6, 2009) provides a similar election to *all* U.S. businesses of every size to carry back NOLs up to five years but with a 50-percent income limit on NOL offsets in the fifth year. The new, expanded election is available for NOLs incurred in either 2008 or 2009, but not for both years. However, an eligible small business that elected under the 2009 Recovery Act to carry back 2008 NOLs may make the election for an additional year, enabling the qualified small business to carry back NOLs from both 2008 and 2009 for up to five years.¹²

A taxpayer must make the election by the extended due date for filing the return for its last tax year beginning in 2009. An election, once made, is irrevocable. [IRC §172(b)(1)(H)]¹³

These new expanded carry back rules do not prohibit a taxpayer from carrying the NOL forward utilizing the loss to offset future tax liability. A special election is required to carry a loss forward.

“If one spouse has an NOL and their joint income without the loss is lower than their average annual income, it may be advantageous to file separate returns in the NOL year. By filing separate returns, the NOL can be carried to

¹² CCH Tax Briefing: Worker, Homeownership, and Business Assistance Act of 2009, November 6, 2009. <http://tax.cchgroup.com/Legislation/default>

¹³ Small Business Quickfinder Handbook, 2009 Edition, Thomson Reuters, p. Q-6

another tax year to reduce income in a tax bracket higher than the joint income bracket of the NOL year.”¹⁴

“The passive activity loss rules are applied before the NOL rules. Therefore, only losses that are currently deductible under the passive loss rules can become a part of an NOL. A loss that is suspended by the passive loss rules becomes part of an NOL computation in the year it comes out of suspension. In that year, it is characterized as a business or non-business loss according to its origin.”¹⁵

“S corporations and partnerships cannot carry business losses to other tax years by deducting NOLs. Instead, the losses flow through to the shareholders or partners in the loss year and become a part of the shareholder’s or partner’s NOL calculation. These gains and losses are characterized as business or non-business according to their status inside the S corporation or partnership.”¹⁶

For a C corporation, NOL calculations differ from those of an individual, estate or trust. The corporation is allowed different deductions, modifications to the taxable income for carry-back/carry-forward must be made, and different forms are used.

The State of MN has enacted the federal rules addressing NOLs for farms in MN.

NOL calculations are complicated. To insure compliance with all rules and regulations make sure to discuss your specific situation with your accountant or tax professional.

Dairy Herd Retirement Program:

National Milk Production federation began a milk supply reduction program in 2003. The program, called CWT, assessed dairy producers 10¢ per hundredweight of milk marketed. The assessment was then used to pay dairy producers who agreed to send their entire dairy herd to slaughter.

The CWT program also added a bred heifer provision enabling producers who had their CWT bid accepted, to also be paid for slaughtering any bred heifers they had.

Assessment: “Both the assessments to fund the CWT program and the CWT payments received by farmers to liquidate their herd have tax consequences. The 10¢ per

hundredweight assessment is similar to other producer assessments for product-marketing programs. Because the payment is made to enhance the price the producers receive for their milk, it is a deductible business expense. As with other expenses that are deducted from a producer’s milk check, the CWT assessment should be reported separately as an expense on Schedule F (Form 1040) rather than netted out of the milk income reported on line 4 of Schedule F (Form 1040).”¹⁷

Retirement Program Payments: “Changes to the CWT Dairy Herd Retirement Program in 2009 require the producer and the premises to stay out of production for 12 months to receive the final 10% of the payment. Consequently, the IRS could take the position that if the total of the CWT payments and the amount received from sale on the slaughter market exceeds the *Agricultural Prices* value of the herd, then the excess must be reported on Schedule F (Form 1040) as ordinary income that is subject to SE income. Farmers who receive the CWT payment could argue that the amount reported as ordinary income should be limited to the 10% deferred payment because only that portion is subject to the staying-out-of-production requirement. It is unlikely that the IRS will require even the deferred 10% to be reported on Schedule F (Form 1040) if the total of the CWT payments and the amount received on the slaughter market is less than the *Agricultural Prices* value.”¹⁸ Because of the uncertainty of the IRS rules here, see your tax preparer.

Bred Heifer Option: “The amount received from the CWT for bred heifers is similar to the amount received for milking and dry cows, but the tax consequences are different. First, heifers that have been held for fewer than 24 months do not qualify for I.R.C. § 1231 treatment. Therefore, gain from the sale of heifers is ordinary income reported in Part II of Form 4797. It is *not* subject to SE tax. Second, it is less likely that the bred-heifer payments in excess of the *Agricultural Prices* value of the heifers will be treated as a replacement of milk income for the following reasons:

1. The bred-heifer payment is not based on past production.
2. Producers are not required to repay any of the bred-heifer payment if they do not stay out of dairy production for 12 months.
3. The heifers would not have produced milk until

¹⁴ 2009 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 59

¹⁵ Ibid., p. 60

¹⁶ Ibid., p. 60

¹⁷ Ibid., p. 407

¹⁸ Ibid., p. 408

they bore a calf, which could be up to 9 months into the 12-month period.

Business Sale or Liquidation:

“The tax impact of selling a business varies with the form of business ownership. Selling a business operated as a sole proprietorship can have different consequences than selling a business operated as a corporation. Taxpayers should consult with their tax advisor before disposing of a business so that the disposition can be structured to minimize the tax consequences.”¹⁹

When assets are sold, IRS code requires the aggregate sales price be allocated to one of seven asset classes for tax calculation purposes. Farm assets generally fall into two classes: Class IV-inventories, and Class V-equipment, buildings, land, vehicles, etc. Your tax preparer can assist you with this classification.

Once allocated to an asset class, the seller must calculate any gain or loss from the sale of the asset. “The character of the gain or loss is based on the nature of the asset:

1. Gain on accounts receivable is ordinary income.
2. Equipment is I.R.C. § 1231 property and is subject to the I.R.C. § 1245 ordinary income recapture provisions for depreciation allowed or allowable.
3. Gain on buildings is also I.R.C. § 1231 gain, generally subject to I.R.C. § 1250 depreciation recapture (none if straight-line depreciation was taken).
4. Gain or loss on intangible assets is typically a capital gain or loss unless the asset’s cost was depreciable or amortizable.”²⁰

Cancellation of Debt: “If a business fails or there is an economic slowdown, the debtor may negotiate debt reduction or forgiveness. Cancellation of debt is generally treated as gross income under I.R.C. § 61, but I.R.C. § 108(a) provides some exclusions. Cancellation of debt income (CODI) is not taxable in the following circumstances:

1. It occurs in a Title 11 (bankruptcy) case.

2. It occurs when the taxpayer is insolvent.
3. The debt is qualified farm indebtedness.
4. The debt is qualified real property business indebtedness, and the taxpayer is not a C corporation.
5. The debt is qualified principal residence indebtedness discharged during 2007–2012. I.R.C. § 108(e)(2) provides that income does not arise from the discharge of a debt to the extent that payment of the debt would give rise to a deduction. Thus, a cash-basis business that has not deducted its accounts payable does not have income if the creditors cancel or reduce those debts. An accrual-basis business that deducted the payables does have CODI if the debts are canceled or reduced.”²¹

“The American Recovery and Reinvestment Act of 2008 (ARRA), Pub. L. No. 111-5, permits CODI recognition to be deferred until 2014 if it arises from business debts that are restructured in 2009 or 2010. In 2014, the CODI begins to be recognized over a 5-year period.

When CODI is excluded from gross income, tax attributes generally must be reduced. The following attributes are reduced in the order they are listed:

1. Net operating losses (NOLs)
2. General business credit
3. Minimum tax credit
4. Capital loss carryovers
5. Basis in property
6. Passive-activity loss and credit carryovers
7. Foreign tax credit carryovers

The reduction for losses is dollar for dollar of excluded CODI. Credits are reduced 33¢ for each dollar of excluded CODI. A taxpayer may change the order of tax-attribute reductions by electing to reduce the basis of depreciable property first [I.R.C. §§ 108(e) and 1017]. The reduction is limited to the aggregate adjusted basis of depreciable property held by the taxpayer at the beginning of the tax year following the debt discharge tax year. These cancellation-of-debt rules apply to corporations and partnerships as well as sole proprietorships.”²²

¹⁹ Ibid., p. 163

²⁰ Ibid., pp. 165-166

²¹ Ibid., pp. 169-170

²² Ibid., p. 170

For additional information on this topic go to http://www.extension.umn.edu/distribution/business_management/DF7291.html and click on the publication titled “Tax Considerations in Liquidation and Reorganization (WW-7300).

The State of MN did not adopt this federal tax law provision. MN requires an addition for the amount of the deferred gain in the year it is realized. A subtraction will be allowed in the years in which the deferred gain is federally taxable.

This is a very complicated area of tax law so check with your tax preparer for details specific to your situation.

S Corporation Built-In Gains:

The 2009 Stimulus Package includes provisions for shortening, temporarily, from ten to seven years, the holding period for assets subject to the built-in gains tax imposed when a C corporation elects to become an S corporation. The provision applies to C corporations converting to S corporation status where the seventh taxable year (in the 10 year recognition period) preceded the taxable year 2009 or 2010.

This is a very technical issue so see your accountant for details specific to your situation.

Commodity Futures & Options Contracts:

“Farmers are increasingly using commodity futures and options contracts in their marketing programs and to secure inputs. Properly documenting futures positions is critical, because the tax consequences of hedging transaction and speculative transactions can be vastly different.

Farmers enter into hedges to protect against adverse price changes of commodities. The gain or loss on these futures or options contracts when they are closed is ordinary income or loss that is reported on Schedule F (Form 1040), Profit or Loss from Farming.

In contrast, a farmer may enter into a commodity futures or option contract with the intention of profiting from the transaction itself (i.e., speculating). Speculative transactions result in a capital gain or loss that is reported on Schedule D (Form 1040), Capital Gains and Losses. Speculative positions that are open at the end of a tax year are marked-to-market, and the owner pays income tax on the unrealized capital gain or loss. The contract’s basis is

then adjusted to determine the final gain or loss when the position is closed.”²³

A producer should never assume their broker will report their marketing transactions appropriately for tax purposes. Even though there may be separate hedging and speculative accounts, the producer should maintain appropriate records for tax purposes.

Standard Deduction & Personal Exemption:

The Federal standard deduction amounts for 2009 & 2010 are as follows:

	<u>2009</u>	<u>2010</u>
Married Filing Joint (MFJ)	\$11,400	\$11,400
Single	\$ 5,700	\$ 5,700
Head of Household (HOH)	\$ 8,350	\$ 8,400
Married Filing Separate (MFS)	\$ 5,700	\$ 5,700

Personal exemptions will be \$3,650 for each exemption 2009 and \$3,650 for exemption 2010. Personal exemptions for 2009 and 2010 begin to phase out when Adjusted Gross Income (AGI) is above the following amounts:

	<u>2009</u>	<u>2010</u>
Married Filing Jointly	\$250,200	NA
Single	\$166,800	NA
Head of Household	\$208,500	NA
Married Filing Separately	\$125,100	NA

Please note, an additional \$1,100 is added in 2009 and 2010, to each exemption for individuals who are over the age of 65 and/ blind/married. An additional \$1,400 is added to each exemption in 2009 and 2010 for individuals who are over the age of 65/blind/ unmarried/ or head of household.

Recent Minnesota legislation enacted April 3, 2009, adopts all of the federal tax provisions enacted between February 13 and December 31, 2009 with the exception of the federal deduction of educator expenses and the deduction for higher education tuition and fees (this excludes state treatment of Section 179 and Bonus depreciation – see depreciation section of this document).

The bill eliminates any need for Schedule M1NC, Federal Adjustments, and requires the two federal deductions to be added back to Minnesota taxable income on Schedule M1M, Income Additions and Subtractions, for tax year 2008.

²³ Ibid., p. 376

Because the 2008 Minnesota forms and instructions were printed before the state adopted the federal changes, some taxpayers may be required to file amended individual income tax returns.

Taxpayers affected by the recent law changes include those who included Schedule M1NC when they filed their 2008 Minnesota Form M1, Individual Tax Return.

For the 2008 tax year, the provisions of the Working Family Tax Relief Act of 2004 and the Tax Relief and Health Care Act of 2006. Minnesota married taxpayers who take the standard deduction are allowed to use the higher federal tax percentage rate to calculate their tax benefit. This provision is set to expire December 31, 2010.

Federal Child Tax Credit:

The new law increases the refundable portion of the child tax credit for 2009 and 2010. The agreement does so by setting the income threshold at \$3,000. The child tax credit currently gives individuals with dependent children under age 17 at the close of a calendar year a \$1,000 per child credit through 2010. The Emergency Economic Stabilization Act of 2008 (EESA) enhanced the credit for 2008. Taxpayers in 2008 were eligible for a refundable credit equal to 15 percent of their earned income in excess of a \$8,500 threshold up to the child credit amount if the total amount of their allowable credit exceeds their total tax liability (regular and AMT).

Federal Mileage Deduction:

Mileage deductions per mile are as follows:

	<u>2009</u>	<u>2010</u>
Business Miles	55.0¢	50¢
Medical/Move Miles	24¢	16.5¢
Charitable Miles	14¢	14¢

Annual Exclusion for Gifts:

The annual exclusion for gifts is \$13,000 per donor/per recipient/per year for 2009 and 2010. For married couples gifting assets owned jointly, the couple can elect to treat all gifts as if one-half was given from each spouse. The amount gifted can then be doubled to \$26,000. However, if one spouse owns the asset being given as if belonging to both spouse, the donor spouse technically needs to complete IRS Form 709 if the fair market value of the gift is in excess of the annual exclusion amount of \$13,000.

This can be a complicated issue so check with your tax preparer.

Kiddie Tax:

“When parents and grandparents transfer property to minor children under the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA), the subsequent income from the transferred property is taxable to the child.”²⁴

“The kiddie tax that subjects a child’s investment income to tax at the parents’ marginal rate originally applied only to children under age 14. The age limit was increased twice previously (through age 17 and then age 18), and beginning with the 2008 tax year, it can affect full-time students until they are age 24.”²⁵

“Since 1986, individuals who can be claimed as dependents on another taxpayer’s return cannot deduct an exemption amount on their own returns, regardless of their age. They are allowed a standard deduction that varies with the amount and type of income the dependent received. The following rules apply for 2009 to dependents that are not entitled to claim any of the additions to the basic standard deduction:

1. A dependent is generally not required to file a federal income tax return if his or her gross income does not exceed \$950, including both earned income and investment income. (Exceptions apply if other taxes are due, such as self-employment tax or the penalty for an early distribution from a retirement fund.)
2. If a dependent’s income exceeds \$950 and includes more than \$300 of investment income, the dependent must file a return.
3. If all of a dependent’s income is earned income, filing is not required until the income exceeds \$5,700 (the standard deduction amount for individuals who are single or married filing separately).”²⁶

“Dependency is not a factor when considering whether the kiddie tax applies to a minor child’s income. When a child’s investment income exceeds \$1,900 (twice the basic standard deduction for a dependent, even if the

²⁴ Ibid., p. 137

²⁵ Ibid., p. 137

²⁶ Ibid., p. 137

child is not a dependent), the kiddie tax must be considered.”²⁷

“The age of the child partially determines the degree of exposure.

1. The kiddie tax applies to any child who is younger than age 18.
2. The kiddie tax applies to an 18-year-old unless his or her earned income exceeds 50% of his or her total support, whether or not the income is spent for the support and whether or not the 18-year-old is a student.
3. The kiddie tax applies to full-time students, ages 19–23, unless the student’s earned income exceeds 50% of his or her total support, whether or not the income is spent for the support.

A child who meets the above criteria is nevertheless exempt from the kiddie tax in two circumstances:

1. If both parents are deceased, the kiddie tax is not applicable.
2. If a child is married and files a joint return, the kiddie tax is not applicable. (It does apply to a married child’s income if the child files a separate return.)”²⁸

Investment income for the kiddie tax calculation includes such things as taxable interest income, dividends, rents, royalties, taxable pension payments, distributable net income from trusts, etc.

Making Work Pay Credit:

The 2009 Stimulus Package includes a new taxpayer credit against individual income tax in an amount equal to the lesser of 6.2% of the individual’s earned income or \$400 (\$800 for MFJ). The credit is retroactive to Jan. 1, 2009 and extends through 2010. The credit applies to employers and self-employed individuals. There are new 2009 income tax withholding tables (effective April 1, 2009). This applies to Modified Adjusted Gross Income less than \$75,000 (single) or \$150,000 (MFJ). Incomes above those amounts are subject to phase outs.

Note that the 2009 credit is reduced by the amount of any economic stimulus payments received by the taxpayer.

These include payments to railroad retirees, VA, SSA and the \$250 refundable credit for government retirees.

This credit is claimed by filing IRS Form Schedule M.

Economic Recovery Payment:

The 2009 legislation provides for a one-time payment of \$250 to individuals on fixed incomes such as Social Security recipients, railroad retirees, disabled veterans and retired government employees. Payments will reduce any “Making Work Pay Credit” the individual may have qualified for.

The payment is to arrive within 120 days after the date of enactment of the law (enactment date Feb. 17, 2009). Payments are issued by the Treasury Department, not IRS. The payment amount is not included as gross income when calculating federal income taxes.

First-Time Home Buyer Tax Credit:

In Phase 1, “For 2008, a first-time homebuyer was allowed a refundable tax credit equal to the lesser of \$7,500 (\$3,750 for a married individual filing separately) or 10% of the purchase price of a *principal residence* acquired from an *unrelated person* on or after April 9, 2008, and before July 1, 2009. **A first-time homebuyer is an individual who had no ownership interest in a principal residence in the United States during the prior 3-year period ending on the date of purchase of the qualifying home.**

The 2008 credit must be repaid ratably over 15 years (without interest) beginning in the second tax year after the year of purchase. For example, if the taxpayer purchased a home in 2008, the credit was allowed on the 2008 tax return, and repayments are to commence with the 2010 tax return. The repayment is shown as an additional tax on the return for each repayment year.

If the taxpayer sells the home (or if it ceases to be used as the taxpayer’s principal residence) prior to complete repayment of the credit, the balance of the credit is recaptured as a tax due on the tax return for that year. However, if the home is sold to an unrelated person, the recapture amount is limited to the gain from that sale. In determining gain for this purpose, the home’s basis is reduced by the outstanding balance of the credit.

Taxpayers who purchased a home during the first 6 months of 2009 could elect to treat it as purchased on December 31, 2008, to claim the credit on the 2008 tax return and to establish the beginning of the recapture

²⁷ Ibid., p. 137

²⁸ Ibid., p. 138

period. They claim the credit on Form 5405, First-Time Homebuyer Credit.

For Phase 2, the homebuyer credit applies to qualifying home purchases in 2009 before December 1, 2009, and the maximum credit amount is \$8,000 (\$4,000 for a married individual filing separately). The 15-year recapture provision does not apply to qualifying home purchases made after December 31, 2008, and before December 1, 2009. However, the entire amount of the credit must be recaptured if the taxpayer disposes of the home (or if it is no longer used as the taxpayer's principal residence) within 36 months from the date of purchase. The repayment is treated as an additional tax on the return for the year the home ceased to be the taxpayer's principal residence.”²⁹

Phase 3, enacted on Nov. 6, 2009 continues the first-time homebuyer tax provision. Rules dictate the taxpayer must identify a house by April 30, 2010 and close on the transaction no later than June 30, 2010. The home cannot be valued over \$850,000 and the buyer must be 18 years of age or older.

Check with your tax preparer for details specific to your situation.

Earned Income Credit (EIC):

The 2009 law increases the earned income credit for 2009 and 2010 to 45 percent of the first \$12,750 of earned income for taxpayers with three or more qualified children or \$5,657. The phase-out is adjusted upward from \$1,880 to \$5,000 for joint filers to eliminate any marriage penalty.

Eligibility requirements for Minnesota's Working Family Credit (WFC) are based upon Federal EIC. However, MN did not legislate and adopt the federal changes to the EIC threshold and percentage amounts. Therefore, some MN taxpayers might qualify for the federal EIC but not qualify for the MN WFC.

Health Saving Accounts:

The rules for Health Saving Accounts remain in effect. A Health Saving Account (HSA) is a tax-exempt custodial account that must be used in conjunction with a high-deductible health plan. The contributions are treated much like a traditional IRA.

In order to qualify for a Health Saving Account, you must be enrolled in a "High-Deductible Health Plan". The minimum annual deductible amounts are \$1,150 per individual and \$2,300 for a family in 2009. These amounts are \$1,200 and \$2,400 for 2010. Maximum annual out-of-pocket expense amounts are \$5,800 for an individual and \$11,600 for a family in 2009. For 2010 the amounts are \$5,950 and \$11,900. Additional requirements include not having any other health insurance coverage, not being entitled to Medicare benefits, and you cannot be claimed as a dependent on someone else's return.

Several key points on Health Saving Accounts include:

- contributions made by employer may be excluded from gross income,
- contributions remain in account year to year,
- interest/earnings from account are tax free,
- distributions may be tax free if you pay qualified medical expenses, and
- portable – stays with you if you switch jobs or leave the work force.

The contribution limits for a Health Saving Account are:

	<u>2009</u>	<u>2010</u>
• Single	\$3,000	\$3,050
• Family	\$5,950	\$6,150

An additional \$1,000 can be added to the 2009 and 2010 amounts, if the individual or individuals are age 55 or over.

Taxation of CRP Payments:

Taxation of CRP payments has been an ongoing issue. The issue of discussion is whether or not the CRP payment is subject to Self-Employment (SE) tax.

Recent Farm Bill legislation states that CRP payments made to individuals receiving Social Security retirement, survivor, or disability payments are not subject to SE tax. Any other individuals receiving CRP payments would be subject to SE tax on those payments.

New Car Deduction:

The 2009 law allows for an above-the-line deduction for purchases of new (not used) vehicles on or after Feb. 17, 2009, for state and local sales taxes or excise taxes paid on the purchase.

²⁹ Ibid., p. 511

The deduction is limited to the tax on vehicle expense up to \$49,500 and there is a phase-out beginning at \$125,000 for single filers and \$250,000 for MFJ.

The deduction applies to domestic and foreign automobiles, SUVs, light trucks, motor homes, and motorcycles weighing not more than 8,500 pounds gross weight. Taxes on a lease agreement do not qualify.

Cash For Clunkers:

“The Consumer Assistance to Recycle and Save Act (CARS), Pub. L. No. 111-32, enacted June 24, 2009, was a voluntary program to help consumers pay for a more fuel-efficient new car or truck when they trade in a less fuel-efficient car or truck. Fuel-efficiency was based on EPA ratings.

Consumers received credits of \$3,500–\$4,500 toward the purchase price of the new vehicle, but the trade-in value of the old vehicle (i.e., the clunker) was only its salvage value because it was required to be crushed or otherwise destroyed. The credit (i.e., the “cash”) came from the National Highway Traffic Safety Administration (NHTSA) in the form of a grant paid directly to the dealership that sold the new car or truck.

The act specifically states that the credit is not income to the purchaser [CARS § 1302(h)]. Because a trade-in was required, the like-kind exchange rules apply to determine the purchaser’s basis in the new car or truck.”³⁰

Taxpayers itemizing deductions for federal tax purposes and have included in that list sales tax for the purchase of a motor vehicle, the State of MN requires the sales tax amount be added to taxable income for MN tax purposes .

Dividend Income Tax Procedures:

Effective January 1, 2003 through December 31, 2008, dividend income will be taxed at capital gain rates.

The AMT calculation applies and the rates are the same as regular rates.

The new rule does not apply to dividends that are really interest or income from REITs. There is a 60 day holding period requirement. Dividends no longer offset investment interest unless election to have the income taxed at regular rates is made.

Farm Family Tax & Retirement Provisions:

Individual Retirement Accounts (IRA): For the traditional IRA, the maximum contribution you may make is \$5,000 in 2009 and 2010, if the taxpayer is covered by an employer plan or if the taxpayer is not but their spouse is. If the taxpayer is age 50 or older, the maximum catch-up contribution amount \$1,000 for 2009 and 2010.

Roth IRAs: Roth IRAs are subject to the same contribution amounts and rules as the traditional IRA mentioned above.

Education IRAs (Coverdell ESA): The maximum contribution is \$2,000 for 2009 and 2010. The contribution limit phases out for single individuals when AGI is between \$95,000 and \$110,000. Phase out occurs for married taxpayers filing a joint return when AGI is between \$190,000 and \$220,000.

Contributions are treated as made in the calendar year if completed by April 15 of the following year. Qualified expenses are expanded to include tuition, fees, academic tutoring, books, supplies, room and board, and computers and other equipment necessary in connection with the enrollment or attendance at a public, private or religious school. Education IRA’s can be used at nearly any school that provides elementary or secondary education (K-12) or institution or college of higher education.

Hope Scholarship Credit: It is a non-refundable credit that reduces the taxes paid by parents of certain post high school students. The allowable credit is \$3,600 per eligible student in 2009 (2010 NA as of this writing) for mfj, s, hh or qw – no credit for mfs. The credit can be claimed by a taxpayer for expenses incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent claimed on the tax return.

To be eligible, the student must be enrolled in a degree, certificate, or other program leading to recognized educational credentialing. The law also extends the credit to all four years of college and adds course materials to qualified expenses. The student must be at least a half-time student and never have been convicted of a felony consisting of the possession or distribution of a controlled substance.

The income phase-out level begins at \$48,000 (s, hh, or qw) and \$100,000 (MFJ) for 2009 (2010 NA at time of writing). For 2009 the credit maximum is \$1,800 per

³⁰ Ibid., p. 492

eligible student for their qualified expenses, to be calculated as 100% of the first \$1,200 and 50% of the next \$1,200 of qualified tuition and related educational expenses.

American Opportunity Credit: “The American Opportunity credit is a new version of the Hope credit for tax years beginning in 2009 or 2010. It covers the first 4 years of postsecondary education and is allowed for 4 taxable years for each student.

The maximum credit is \$2,500 (100% of the first \$2,000 of qualified expenses plus 25% of the next \$2,000).

The AGI phase-out range is higher [\$80,000–\$90,000 for most taxpayers and \$160,000–\$180,000 for married taxpayers filing a joint return (MFJ)].

Up to \$1,000 (40% × \$2,500) of the American Opportunity credit is refundable unless the taxpayer is a child with unearned income who is subject to the kiddie tax.

Eligible expenses include not only tuition and fees but also course materials. Course materials are the books, supplies, and equipment that are needed for a course of study whether or not they are purchased from the educational institution as a condition of enrollment or attendance. Otherwise, the Hope credit eligibility rules apply, including the at least half-time attendance requirement.

The nonrefundable Hope credit is still an option for students attending an eligible educational institution in the mid-western disaster area. It is a \$3,600 maximum, calculated as 100% of the first \$2,400 of qualified expenses and 50% of the next \$2,400 of qualified expenses. A taxpayer who is otherwise eligible for both credits may choose to claim either the American Opportunity credit or the Hope credit for an eligible student. All of the education credits are claimed on Form 8863, Education Credits (American Opportunity, Hope, and Lifetime Learning Credits).

Because the American Opportunity credit is available only for tax years beginning in 2009 and 2010, the effect of the change making taxpayers eligible for the credit for 4 years is that taxpayers who claimed the Hope credit in 2 previous years can claim the American Opportunity credit in 2009 and 2010 if they meet the other requirements.”³¹

Lifetime Learning Credit: This educational credit provides a non-refundable credit against federal income taxes equal to 20 percent of qualified tuition fees incurred during a tax year up to \$10,000 of eligible expenses.

The credit can be claimed on behalf of the taxpayer, the taxpayer's spouse or any dependent. The maximum credit per tax return (not per student) is \$2,000 for 2009 and 2010. The credit is phased out for high-income tax payer categories mfj, s, hh, or qw, amounts the same as for the Hope Credit shown above. There is no credit for mfs.

The credit can be claimed for an unlimited number of taxable years and for any course of instruction at an eligible educational institution for the purpose of acquiring or improving job skills.

Student loan interest is deductible on educational loans. Individuals who pay interest on qualified educational loans may claim a deduction for such interest expenses. The maximum deduction allowed is \$2,500 for 2009 and 2010.

The deduction is allowed on payments made on a qualified educational loan on which interest payments are required. There is currently no time limitation. The deduction is an "above the line" deduction, which means that it will be a deduction on the front page of the Form 1040 and you do not have to itemize deductions to claim this credit.

This deduction is phased out depending upon your tax status. Check with your tax preparer.

Section 529 savings plans: tax law exempts earnings in Sec.529 plans from federal income taxes. There are two types:

- prepaid tuition plans
- college savings plans

Under the 2009 law, distributions to beneficiaries to pay qualifying educational expenses from Qualified Tuition Programs, such as 529, are tax free federally. Other distributions are included in the beneficiary's income and subject to penalty.

For 2009 and 2010 the new law allows beneficiaries of qualified tuition programs to use tax-free distributions to purchase computers and computer technology, including Internet access.

³¹ Ibid., pp. 505-506

Appendix

FEDERAL TAX RATES FOR 2009:

TABLE 1: SECTION 1(a): MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

If Taxable Income Is: The Tax Is:

Not over \$16,700	10% of the taxable income
Over \$16,700 but not over \$67,900	\$1,670 plus 15% of the excess over \$16,700
Over \$67,900 but not over \$137,050	\$9,350 plus 25% of the excess over \$67,900
Over \$137,050 but not over \$208,850	\$26,637.50 plus 28% of the excess over \$137,050
Over \$208,850 but not over \$372,950	\$46,741.50 plus 33% of the excess over \$208,850
Over \$372,950	\$100,894.50 plus 35% of the excess over \$372,950

TABLE 2: SECTION 1(b); HEADS OF HOUSEHOLDS

If Taxable Income Is: The Tax Is:

Not over \$11,950	10% of the taxable income
Over \$11,950 but not over \$45,500	\$1,195 plus 15% of the excess over \$11,950
Over \$45,500 but not over \$117,450	\$6,227.50 plus 25% of the excess over \$45,500
Over \$117,450 but not over \$190,200	\$24,215 plus 28% of the excess over \$117,450
Over \$190,200 but not over \$372,950	\$44,585 plus 33% of the excess over \$190,200
Over \$372,950	\$104,892.50 plus 35% of the excess over \$372,950

TABLE 3: SECTION 1(c): SINGLE INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)

If Taxable Income Is: The Tax Is:

Not over \$8,350	10% of the taxable income
Over \$8,350 but not over \$33,950	\$835 plus 15% of the excess over \$8,350
Over \$33,950 but not over \$82,250	\$4,675 plus 25% of the excess over \$33,950
Over \$82,250 but not over \$171,550	\$16,750 plus 28% of the excess over \$82,250
Over \$171,550 but not over \$372,950	\$41,754 plus 33% of the excess over \$171,550
Over \$372,950	\$108,216 plus 35% of the excess over \$372,950

TABLE 4: SECTION 1(d): MARRIED INDIVIDUALS FILING SEPARATE RETURNS

If Taxable Income Is: The Tax Is:

Not over \$8,350	10% of the taxable income
Over \$8,350 but not over \$33,950	\$835 plus 15% of the excess over \$8,350
Over \$33,950 but not over \$68,525	\$4,675 plus 25% of the excess over \$33,950
Over \$68,525 but not over \$104,425	\$13,318.75 plus 28% of the excess over \$68,525
Over \$104,425 but not over \$186,475	\$23,370.75 plus 33% of the excess over \$104,425
Over \$186,475	\$50,447.25 plus 35% of the excess over \$186,475

FEDERAL TAX RATES FOR 2010:

TABLE 1: SECTION 1(a): MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

If Taxable Income Is: The Tax Is:

Not over \$16,750	10% of the taxable income
Over \$16,750 but not over \$68,000	\$1,675 plus 15% of the excess over \$16,750
Over \$68,000 but not over \$137,300	\$9,362.50 plus 25% of the excess over \$68,000
Over \$137,300 but not over \$209,250	\$26,687.50 plus 28% of the excess over \$137,300
Over \$209,250 but not over \$373,650	\$46,833.50 plus 33% of the excess over \$209,250
Over \$373,650	\$101,085.50 plus 35% of the excess over \$373,650

TABLE 2: SECTION 1(b); HEADS OF HOUSEHOLDS

If Taxable Income Is: The Tax Is:

Not over \$11,950	10% of the taxable income
Over \$11,950 but not over \$45,550	\$1,195 plus 15% of the excess over \$11,950
Over \$45,500 but not over \$117,650	\$6,235 plus 25% of the excess over \$45,500
Over \$117,650 but not over \$190,550	\$24,260 plus 28% of the excess over \$117,650
Over \$190,550 but not over \$373,650	\$44,672 plus 33% of the excess over \$190,550
Over \$373,650	\$105,095 plus 35% of the excess over \$373,650

TABLE 3: SECTION 1(c): SINGLE INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)

If Taxable Income Is: The Tax Is:

Not over \$8,375	10% of the taxable income
Over \$8,375 but not over \$34,000	\$837.50 plus 15% of the excess over \$8,375
Over \$34,000 but not over \$82,400	\$4,681.25 plus 25% of the excess over \$34,000
Over \$82,400 but not over \$171,850	\$16,781.25 plus 28% of the excess over \$82,400
Over \$171,850 but not over \$373,650	\$41,827.25 plus 33% of the excess over \$171,850
Over \$373,650	\$108,421.25 plus 35% of the excess over \$373,650

TABLE 4: SECTION 1(d): MARRIED INDIVIDUALS FILING SEPARATE RETURNS

If Taxable Income Is: The Tax Is:

Not over \$8,375	10% of the taxable income
Over \$8,375 but not over \$34,000	\$837.50 plus 15% of the excess over \$8,375
Over \$34,000 but not over \$68,650	\$4,681.25 plus 25% of the excess over \$34,000
Over \$68,650 but not over \$104,625	\$13,343.75 plus 28% of the excess over \$68,650
Over \$104,625 but not over \$186,825	\$23,416.75 plus 33% of the excess over \$104,625
Over \$186,825	\$50,542.75 plus 35% of the excess over \$186,825

MINNESOTA STATE TAX RATES FOR 2010:

	<u>Tax Rate</u>		
	<u>5.35%</u>	<u>7.05%</u>	<u>7.85%</u>
Single	\$0 - \$22,770	\$22,771 - \$74,780	\$74,781 +
Head of Household	\$0 - \$28,030	\$28,031 - \$112,620	\$112,621 +
Married Filing Jointly	\$0 - \$33,280	\$33,281 - \$132,220	\$132,221 +
Married Filing Separate	\$0 - \$16,640	\$16,641 - \$66,110	\$66,111 +

ESTATES AND TRUSTS - 2009:

If Taxable Income Is:

Not over \$2,300
 Over \$2,300 but not over \$5,350
 Over \$5,350 but not over \$8,200
 Over \$8,200 but not over \$11,150
 Over \$11,150

The Tax Is:

15% of the taxable income
 \$345 plus 25% of the excess over \$2,300
 \$1,107.50 plus 28% of the excess over \$5,350
 \$1,905.50 plus 33% of the excess over \$8,200
 \$2,879 plus 35% of the excess over \$11,150

ESTATES AND TRUSTS - 2010:

If Taxable Income Is:

Not over \$2,300
 Over \$2,300 but not over \$5,350
 Over \$5,350 but not over \$8,200
 Over \$8,200 but not over \$11,200
 Over \$11,200

The Tax Is:

15% of the taxable income
 \$345 plus 25% of the excess over \$2,300
 \$1,107.50 plus 28% of the excess over \$5,350
 \$1,905.50 plus 33% of the excess over \$8,200
 \$2,895.50 plus 35% of the excess over \$11,200

CAPITAL GAIN RATES (Non-corporate Taxpayers):

Category of Gain:

	<u>Tax Rate:</u>	
	<u>2009</u>	<u>2010</u>
Gain on Collectables	28%	28%
I.R.C. § 1202 gain	28%	28%
Un-recaptured I.R.C. § 1250 gain	25%	25%
Net long-term capital gain	15%	15%
Reduced long-term gain rate if ordinary tax rate 10% or 15%	0%	0%

OTHER INFORMATION:

	<u>2008</u>	<u>2009</u>	<u>2010</u>
<u>Form 706—U.S. Estate (and Generation-Skipping Transfer) Tax Return:</u>			
Estate Tax Applicable Exclusion Amount:	\$2,000,000	\$3,500,000	No Estate Tax No Stepped-up Basis
Special-use valuation reduction limit:	\$960,000	\$1,000,000	\$1,000,000
Generation-skipping transfer Exemption (GST):	\$2,000,000	\$3,500,000	NA
Estate value qualifying for 2% interest for installment payments:	\$1,280,000	\$1,330,000	\$1,340,000

	<u>2008</u>	<u>2009</u>	<u>2010</u>
<u>Form 709—U.S. Gift (and Generation-Skipping Transfer) Tax Return:</u>			
Life-time Gift Tax Applicable Exclusion Amount:	\$1,000,000	\$1,000,000	\$1,000,000
Annual exclusion for gifts:	\$12,000	\$13,000	\$13,000
<u>Form 1040—U.S. Individual Income Tax Return Standard Deductions:</u>			
Joint or qualifying widow(er):	\$10,900	\$11,400	\$11,400
Single:	\$5,450	\$5,700	\$5,700
Head of household:	\$8,000	\$8,350	\$8,400
Married filing separately:	\$5,450	\$5,700	\$5,700
Additional for elderly/blind—married:	\$1,050	\$1,100	\$1,100
Additional for elderly/blind—unmarried or head of household:	\$1,350	\$1,400	\$1,400
Taxpayer claimed as dependent (or \$300 + earned income not exceeding standard deduction or \$300 in 2006):	\$900	\$950	\$950
<u>Beginning of Itemized Deduction Phase-out Range Based on AGI:</u>			
Joint, single, head of household:	\$159,950	\$166,800	NA
Married filing separately:	\$79,975	\$83,400	NA
<u>Exemption deductions:</u>			
Personal and dependent:	\$3,500	\$3,650	\$3,650
Estate:	\$600	\$600	\$600
Simple trust:	\$300	\$300	\$300
Complex trust:	\$100	\$100	\$100
<u>Form 4562—Depreciation & Amortization:</u>			
Section 179 Deduction:	\$250,000	\$250,000	\$134,000
Phase-out begins at new investment of:	\$500,000	\$800,000	\$530,000
<u>Form 6251—Alternative Minimum Tax—Individuals AMT Exemption Amount:</u>			
Married, filing joint return:	\$69,950	\$70,950	\$45,000
Single, qualifying widow(er), head of household:	\$46,200	\$46,700	\$33,750
Married, filing separately:	\$34,975	\$35,475	\$22,500
Kiddie tax:	\$6,400	\$6,700	\$6,700
<u>Earnings Ceiling for Social Security:</u>			
Below full retirement age (FRA):	\$13,560	\$14,160	\$14,160
Monthly maximum earnings before FRA for full benefits:	\$3,010	\$3,140	\$3,140
Above full retirement age:	Unlimited	Unlimited	Unlimited
Earnings Required to Earn One Quarter of Social Security Coverage:	\$1,050	\$1,090	\$1,120

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CCH Editorial Staff Publication
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CES Paper No. 368-W, December 2009
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