

# Ag Income Tax Update for Farm Families

## Agricultural Business Management

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### Introduction:

As a result of several recent pieces of Congressional tax legislation, many tax provisions affecting farm families have changed. This information piece summarizes many of these changes.

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

### Depreciation:

**Section 179 depreciation:** For calendar year 2011 the maximum section 179 deduction is \$500,000. The investment limit (for qualifying property) is a \$2 million maximum. Qualifying property includes: breeding livestock, machinery, single-purpose agricultural structures (hog confinement buildings), and drainage tile. Property cannot be purchased from a related party (spouse, ancestors, or lineal descendants).<sup>1</sup>

**Modifying Section 179 Depreciation:** The Section 179 election is made on an item-by-item basis for qualifying property by completing Part I of Form 4562. A taxpayer can make or revoke the expensing election on a timely filed amended return. Once the election is revoked, however, it cannot be remade.

A section 179 election made on an amended return must specify the item of Section 179 property to which the election applies and the portion of the cost of each item to be expensed. If a taxpayer elected to expense only a portion of the cost of an item for a particular taxable year (or did not elect to expense any portion of the item), the

taxpayer may file an amended return and expense any portion of the item not previously expensed. Any increase in the amount expensed under Section 179 is not treated as a revocation of the prior election for that year.<sup>2</sup>

See your tax preparer for details specific to your situation.

**Bonus depreciation:** New legislation passed in 2010 created a 100% bonus depreciation (also known as additional first year depreciation) available for property purchased after September 8, 2010 and before January 1, 2012. Under this provision only new assets qualify (the language specifically says, "first use"). Generally, qualifying assets include tangible property not exceeding 20 years life (which includes barns and machine sheds which are not eligible for section 179). Certain long-lived property and transportation property is eligible for 100% expensing if it is placed into service before January 1, 2013. Eligible property also includes: purchased computer software, water utility property, and qualified leaseholder improvement 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 Internal Revenue Code (IRC) in effect prior to 2003. Minnesota's limitation for expensing newly acquired 179 assets is \$25,000 rather than the federal amount of \$500,000 in 2011.

<sup>1</sup>Quickfinder Legislative Update: Small Business Jobs Act of 2010. p. 1.

<sup>2</sup>2010 Quickfinder, 1040 Edition. p. 10-10

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:** Buddy took bonus depreciation of \$50,000 in 2011. 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.

The five (5) year depreciation recovery period mandate for new farm machinery expired at the end of 2009. **New** farm machinery and equipment placed into service during 2010 and 2011 should be depreciated over a 7 year period.

### **Residual Fertilizer:**

The issue of deducting residual fertilizer has surfaced as a tax issue in the upper Midwest over the past few years. The question on this issue is whether a farmer purchasing additional property can deduct residual fertilizer left over from the individual he or she purchased the property from. Since 2004, net farm income has steadily increased. In fact we have seen record profitability for several years. This increased profitability has resulted in higher land rents and of course, much higher land prices. The motivation behind this idea of deducting residual fertilizer is to garner additional farm expense rather than allocating all of the purchase cost to the basis of the farm.

First and foremost, there is NOT an established IRS Revenue Procedure that states deducting residual fertilizer is okay. By the same token, there is not an IRS Revenue Procedure that says you

can't. This argument is based on examination of current accepted business practices in conjunction with an aging technical advice memorandum.

It is a generally accepted practice that upon the purchase of additional land a portion of the purchase price may be allocated to buildings, fences, and tile (cost segregation). Proponents of this procedure advocate that upon purchase the farmer should be able to allocate a portion of the purchase price to existing soil fertility (with the intention of depreciating the identified soil fertility). Many of these proponents have also advocated that this soil fertility may be identified as a flat percentage of the purchase cost. This practice has resulted in large unsubstantiated deductions that have gained the attention of both Internal Revenue Service and the Minnesota Department of Revenue and have triggered numerous audits.

Currently, Minnesota Department of Revenue is examining a very high percentage of returns that show this type of transaction.

While no IRS Revenue Procedure exists for this issue, taxpayers and tax professionals alike can be referred to a Technical Advice Memorandum from 1992 (TAM 9211007). A TAM does not carry the same weight as a Revenue Procedure or IRS Code, but in this case it does provide the greatest amount of guidance available.

The guidelines of the TAM state:<sup>3</sup>

- Taxpayer must be the owner of the fertilizer supply,
- Taxpayer must establish the extent of the fertilizer supply,
- Taxpayer must establish cost basis and
- Taxpayer must show depletion and rate of decline

One of the keys to making this situation work is that the purchaser of the land must hire an agronomist or some type of licensed soil scientist. The agronomist or soil scientist must conduct soil tests to certify fertility levels.

Taking a flat percentage of the initial purchase cost will not be accepted by Internal Revenue Service or Minnesota Department of Revenue.

<sup>3</sup> 2011 National Income Tax Workbook. Land Grant University Tax Education Foundation. [www.Taxworkbook.com](http://www.Taxworkbook.com)

The purchasing individual must provide scientific evidence demonstrating the existence of residual soil fertility.

An additional issue that is being looked at by examining authorities is the consistency and character of the income and expense on both sides of the transaction. The seller is motivated to have all of the income from the sale treated as long-term capital gain. The buyer on the other hand desires ordinary expense that may be deducted via depreciation. Examining authorities are looking for consistency on both ends of the transaction. If there is residual soil fertility present in the property that is sold, then the seller should report that portion of the sale as ordinary income rather than capital gains. In order for this to happen in the real world any residual soil fertility should be identified at the time the transaction takes place (and detailed in the sales agreement).

Again, the authors need to convey very strongly that current guidance from IRS does not exist. Minnesota Department of Revenue is aggressively auditing returns on this issue. In the long run, this procedure may work. The initial recommendations are to adhere to the 1992 TAM, recognize that the character of income and expense on both ends of the transaction should be consistent, and an agronomist or soil scientist must be hired in order to certify fertility levels. Ultimately this issue is going to be clarified either through a court case or through an Internal Revenue Service Revenue ruling.

### **1099 Repeal Bill:**

On April 14, 2011, President Obama signed H.R. 4 to repeal the controversial expanded information reporting on form 1099 for certain business payments and rental property expense payments. The Senate passed H.R. 4 on April 5, 2011. The House approved the bill on March 3, 2011. To offset cost of repeal, H.R. 4 increases the amount of the over-payment of the health insurance premium assistance credit that is subject to recapture. Since both the House and Senate passed identical bills, the legislation did not go to conference committee.<sup>4</sup>

<sup>4</sup>CCH Tax Briefing. 1099 Taxpayer Protection Act of 2011. [tax.cchgroup.com/downloads/files/pdfs/.../repeal1099reporting.pdf](http://tax.cchgroup.com/downloads/files/pdfs/.../repeal1099reporting.pdf). pp. 1-2.

Repeal means that the former 1099 reporting rules for business payments continue unchanged. In particular, businesses must continue to issue form 1099s for payments of \$600 or more to service providers. Additionally, repeal means that the long-standing exception to required information reporting for payments made to corporations remains intact (except payments to attorneys).<sup>5</sup>

### **Self-Employment Tax Items:**

On December 23, 2011, President Obama signed the Temporary Payroll Tax Continuation Act of 2011. The new law continues the 2011 calendar year employee-side payroll tax cut for the first two months of 2012. The new law also includes a recapture provision. The recapture provision applies only to those individuals who receive more than \$18,350 during the two-month period (the Social Security wage base for 2012 is \$110,100 and \$18,350 represents two months of the full-year amount). This provision imposes an additional income tax on these individuals.<sup>6</sup>

The House and Senate are negotiating an extension of the employee-side payroll tax cut holiday through the end of 2012. Under the new law, the employee-share of OASDI tax is 4.2 percent for the first two months of 2012 (10.4 percent for self-employment income).<sup>7</sup>

**Note:** the reduction does not apply to the employer's share of the tax on wages, which remains 6.2% of wages up to a maximum of \$110,100.<sup>8</sup> 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 2011 and \$14,460 for 2012. In the year the individual reaches FRA, the income limit is \$37,680 for 2011 and \$38,800 for 2012. 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

<sup>5</sup> Ibid. p. 2

<sup>6</sup> CCH Tax Briefing. 2011 Tax Year-In-Review. <http://tax.cchgroup.com/downloads/files/pdfs/legislation/2011yearend.pdfpp.1-2>.

<sup>7</sup> Ibid. p. 2

<sup>8</sup> Quickfinder Legislative Update: Small Business Jobs Act of 2010. p. 5.

with your local Social Security office for these details or go to the following web site:

[www.socialsecurity.gov](http://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 8<sup>th</sup> 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):**

Alternative minimum tax has been in existence since 1969. AMT was enacted after Congress learned of 155 taxpayers with Adjusted Gross Income (AGI) of \$200,000 or more in 1966 and paid no federal income tax. The purpose of AMT was to prevent high income taxpayers from exploiting the regular income tax system benefits available to lower income taxpayers.<sup>9</sup> Alternative Minimum Tax (AMT) is a rather complicated calculation. In essence, there are two tax calculations that occur on each and every tax return. First there is the calculation for regular tax. Then there is a calculation for alternative minimum tax. The taxpayer is obligated to pay the higher of the two calculations. The calculation for AMT operates under a different set of rules than the regular or standard income tax calculation. There are numerous adjustments and preference items that make up the alternative minimum tax calculation. Alternative minimum tax is reported on form 6251. Form 6251 addresses 27 lines of preference items and adjustments that differ from the conventional income tax calculations.

The typical criteria that will trigger alternative minimum tax includes: high income, large number of dependents, large miscellaneous itemized deductions, and substantial capital gains.

#### **Domestic Production Activities Deduction (DPAD):**

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 allowed for a deduction from taxable income for up to 3% of qualifying production income generated in the United States. The deduction increased to 6% for taxable years beginning in 2007, 2008 and 2009, and increased to 9% for taxable years beginning after 2009.

The domestic production activities deduction for tax years beginning in 2010 is limited to the smallest of:

- 1) 9 percent of qualified production activity income (QPAI), **or**
- 2) 9 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 (QPAI):**

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 a number of possible exceptions to this guideline.

#### **Domestic Production Gross Receipts (DPGR):**

Domestic Production Gross Receipts are generally the receipts from the sale of qualified production property. For cash basis farmers, this would be the

<sup>9</sup> 2004 University of Illinois Income Tax Workbook, p. 243

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."<sup>10</sup>

<sup>10</sup> 2009 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 403

“Treas. Reg. § 1.199-6(l) 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.”<sup>11</sup>

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

### **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.”<sup>12</sup>

“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 § 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)].”<sup>13</sup>

“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.”<sup>14</sup>

“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)].”<sup>15</sup>

### **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.”<sup>16</sup>

<sup>11</sup> Ibid., p. 404

<sup>12</sup> 2009 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 380

<sup>13</sup> Ibid., p. 381

<sup>14</sup> 2009 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 381

<sup>15</sup> Ibid., p. 381

<sup>16</sup> Ibid., p. 393

**Sale of Easement:** Any temporary easement with a lifespan of 30 years or greater is considered a sale.

“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].”<sup>17</sup>

**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).”<sup>18</sup>

**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).”<sup>19</sup>

### **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 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 taxpayer 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)

<sup>17</sup>2009 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 393

<sup>18</sup> Ibid., p. 395

<sup>19</sup> Ibid., p. 395

**Note: the 5% rate will go to 0% for tax years 2011 and 2012 only 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 \$69,000 in 2011 & \$70,700 for 2012 (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 2011 Beatrice and her husband, George has a federal adjusted taxable income of \$39,000. 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 \$69,000 (\$39,000 + \$30,000 = \$69,000). 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).<sup>20</sup>

In Minnesota, capital gains are taxed as ordinary income. The Minnesota income tax rates are 5.35%, 7.05% and 7.85%.

This is a critical issue and can be complicated, especially the 0% capital gain tax provision for the years 2011 & 2012. Be sure to check with your tax preparer for details.

### **Estate Tax, Gift Tax, and Generation Skipping Tax:**

**Federal Tax:** For tax years 2011 & 2012 only, the federal estate tax applicable exclusion (amount each person can pass through their estate without federal estate tax) has been increased to

\$5,000,000 (2011) and \$5,120,000 (2012) per person. The federal estate tax rate for 2011 and 2012 only, has been reduced to 35%. Congress needs to act on these numbers for 2013 and beyond.

The federal lifetime gift tax exclusion (amount each person can gift in their lifetime without federal gift tax) has been increased to \$5,000,000 (2011) and \$5,120,000 (2012) per person. The increase is for 2011 and 2012 only. Gifts up to the exclusion amount requires filing an IRS 709 gift tax form but no tax is due while the donor is living. Gifts in excess of the exclusion amount would be taxed at 35% and the tax would be due immediately. Congress will need to act on these numbers for 2013 and beyond.

The federal annual gift exclusion (amount each person can gift to as many persons they want in one year without federal gift tax) remains at \$13,000 per recipient. If spouses own the gifted asset jointly, they can double up on the exclusion amount and gift \$26,000 to as many recipients as they want without a gift tax. Gifts in excess of the exclusion amount must be reported on IRS Form 709. No tax is due unless the accumulated gifts exceed the lifetime exclusions listed above. Tax may be due at time of death depending upon the size of the decedent's estate.

For the Federal Generation Skipping Tax, the 2010 Tax Relief Act provides a \$5,000,000 exemption amount for 2011 and \$5,120,000 for 2012 only. The tax rate for amounts over the exemption is 35%. Congress must act on these numbers for 2013 and beyond.

**Minnesota Tax:** For Minnesota, the estate applicable exclusion amount remains at \$1,000,000 per person. The tax rate for estate amounts in excess of the exclusion, range from 41% to 9.96%. The first \$75,000 above the \$1,000,000 exclusion is taxed at 41% and the last \$50,000 of the amount over the exclusion is taxed at 9.96%.<sup>21</sup>

**Qualified Small Business Property & Qualified Farm Property Exclusion (MN only):** With the signing of the Minnesota Legislative Special Session Budget Bill in July 2011, there is a new

<sup>20</sup> Premium Quickfinder Handbook, 2008 Edition, Thomson Reuters, p. 7-4

<sup>21</sup> 2011 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 673.

additional estate tax exclusion amount for qualifying small business and farm property owners only. The exclusion is limited to decedents dying after June 30, 2011. The additional exclusion is \$4,000,000 on top of the \$1,000,000 exclusion mentioned earlier.

#### Qualified Farm Property Exclusion (MN only):

To qualify, the property value must have been included in the decedent's federal adjusted taxable estate after deductions. Property must meet the definition of a farm according to Minnesota Statute (MS) 500.24. Property was classified as the homestead of the decedent or decedent's spouse and classified as Class 2a property. The decedent continuously owned the property for three years ending at their death. The family member inheriting the property must continuously use the property in the operation of the trade or business for three years following the decedent's death.

#### Qualified Small Business Property Exclusion (MN only):

Qualified small business property has to comply with the same rules as does the qualifying farm property. There is one additional rule in that the small business cannot have had gross annual sales in excess of \$10 million during the last taxable year that ended before the decedent's death.

For both qualified farm and small business property, a qualified heir includes: decedent's ancestors such as parents, grandparents, etc.; decedent's spouse; a linear descendent such as a child, grandchild, etc. of the decedent, of the decedent's spouse, or of the decedent's parents; or spouse of any lineal descendent described previously.

If the qualified heir disposes of the any interest in the qualified property other than to another qualified heir or a family member ceases to use the qualified property in the operation of the trade or business, the heir is subject to a recapture tax of 16% of the amount excluded. The tax is due to the Minnesota Department of Revenue within six months of the disqualifying disposition or cessation of use.

To claim the exclusion, you would file Schedule M706Q, Election to Claim the Qualified Small Business and Farm Property Exclusion when filing the MN estate Tax return.

There are many unanswered questions about the new exclusion so check with your tax preparer if you are going to elect this exclusion.

#### 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. 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.

An indemnity payment from a Revenue Protection (RP) policy is 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 RP policy must determine

the portion of the payment that is due to crop destruction or damage rather than due to a reduced market price.

An insurance payment received from a prevented planting policy does qualify for crop insurance deferral (assuming the taxpayer meets all other requirements for deferral). This provision is addressed specifically in IRS code section 451 (D).

A RP 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.

### **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.

**Example:** During 2011, 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 2011 are \$5,500. His other deductible farm expenses totaled \$10,000 (total schedule F expense minus pre-paid expenses) for 2011. Therefore, Alvin's deduction for pre-paid farm supplies cannot be more than \$5,000 (50 percent of \$10,000) for 2011. 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 2011 and applied before January 1, 2011, the fertilizer and lime expense is not considered a pre-payment for tax purposes and thus is not subject to the 50 percent rule.<sup>22</sup>

### **Net Operating Loss (NOL) Carry Back:**

When business deductions exceed business income, a net operating loss (NOL) may occur. A NOL may be caused by deductions from a trade or business, from working as an employee, or from casualty and theft losses, moving expenses or rental property.<sup>23</sup>

Taxpayers with NOLs generally must carry them back to preceding years before carrying them forward. However, IRC section 172 (b) (3) allows a taxpayer to make an irrevocable election to relinquish the carry back and carry the NOL deduction only to future years. The election must be made by attaching a statement to the timely filed return for the loss year.<sup>24</sup>

An NOL generally is carried back two years and then forward 20 years. The following elections are

<sup>22</sup> 2010 Farmers Tax Guide. Publication 225. [www.irs.gov](http://www.irs.gov).

<sup>23</sup> 2010 Quickfinder, 1040 Edition. P.6-14.

<sup>24</sup> 2010 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 238

rear revocable and must be made on a timely filed return (including extensions) for the NOL year.

- Election to waive the carry back period
- Election to disregard five-year carry back treatment

Taxpayers could elect two, three, four or five year carry back periods for an NOL incurred during 2008 or 2009.<sup>25</sup> “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.”<sup>26</sup>

“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.”<sup>27</sup>

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.

### **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.”<sup>28</sup>

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.”<sup>29</sup>

**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.

<sup>25</sup> 2010 Quickfinder, 1040 Edition. pp. 6-14 and 6-15.

<sup>26</sup> 2009 National Income Tax Workbook, Land Grant University Tax Education Foundations, Inc. P. 59.

<sup>27</sup> 2009 National Income Tax Workbook, Land Grant University Tax Education Foundations, Inc. p. 60

<sup>28</sup> Ibid., p. 163

<sup>29</sup> 2009 National Income Tax Workbook, Land Grant University Tax Education Foundations, Inc. pp. 165-166

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.”<sup>30</sup>

“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.”<sup>31</sup>

For additional information on this topic go to <http://www.extension.umn.edu/distribution/businessmanagement/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:**

Beginning in 2011, a C Corporation that elects to be taxed as an S Corporation is taxed at the highest corporate rate on all built-in gains that are recognized during the recognition period. The recognition period is reduced from the corporations first seven years following the S election and to its first five years following the Selection.<sup>32</sup>

For tax years beginning in 2009 and 2010, the recognition period was the first 7 years after the S election.

### **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.,

<sup>30</sup> Ibid., pp. 169-170

<sup>31</sup> Ibid. p. 170

<sup>32</sup>CCH Tax Briefing. Small Business Jobs Act of 2010.<http://www.cchgroup.com/opencms/opencms/web/TAA/PDFs/legislation/Small-Business-Jobs-Act-7-23-10.pdf>. p. 3

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.”<sup>33</sup>

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 are as follows:

	<u>2011</u>	<u>2012</u>
Married Filing Joint (MFJ)	\$11,600	\$11,900
Single	\$ 5,800	\$ 5,950
Head of Household (HOH)	\$ 8,500	\$ 8,700
Married Filing Separate (MFS)	\$ 5,800	\$ 5,950

Personal exemptions will be \$3,700 for each exemption 2011 and \$3,00 for exemption 2012.

An additional \$1,150 is added in 2011, to each exemption for individuals who are 65 and another \$1,450 is added if the individual is blind (only for Married Filing Joint, Qualifying Widow(er), or Married Filing Single Status). An additional \$1,450 is added to each exemption in 2011 for individuals who are 65 and/or if the individual is blind (only for Single and Head of Household filing status).<sup>34</sup>

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).

<sup>33</sup>2009 National Income Tax Workbook, Land Grant University Tax Education Foundations, Inc. p. 376.

<sup>34</sup> 2011 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 688.

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.

### **Federal Child Tax Credit:**

The 2010 Tax Relief Act extends the child tax credit through 2011 and 2012. Taxpayers with one or more qualifying children may be able to claim a child tax credit of up to \$1,000 per qualifying child. The child tax credit is generally a nonrefundable credit that is limited to regular tax liability plus alternative minimum tax (AMT) liability. Qualifying children for the Federal Child Tax Credit must meet the following criteria:

- Child must be under the age of 17.
- Child must be a U.S. citizen, resident alien or national (being a resident of Canada or Mexico is not sufficient).

The child tax credit is phased out by \$50 for each \$1,000 (or fraction thereof) of adjusted gross income (AGI) above the beginning phase-out amount. The AGI where the credit is completely phased out depends on the number of qualifying children.<sup>35</sup>

Taxpayers who have more than \$3,000 of earned income (for 2011) may be eligible for the Additional Child Tax Credit. Federal Form 8812 is used to calculate the Additional Child Tax Credit.<sup>36</sup>

Please see your tax professional for calculations involving your individual situation.

### **Federal Mileage Deduction:**

Mileage deductions per mile are as follows:

	2011 prior to <u>July 1</u>	2011 on or after <u>July 1</u>	<u>2012</u>
Business Miles	51.0¢	55.5¢	55.5¢
Medical/Move Miles	19.0¢	23.5¢	23.0¢
Charitable Miles	14.0¢	14.0¢	14.0¢

<sup>35</sup> 2010 Quickfinder, 1040 Edition. p. 12-5

<sup>36</sup> 2010 Quickfinder, 1040 Edition. p. 12-6

### 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.”<sup>37</sup>

Children who have investment income greater than \$1,900 may be subject to tax based on their parent’s income. In other words the child’s income will be taxed at parent’s marginal tax rate.<sup>38</sup>

Kiddie tax rules apply for tax year 2011 if:

1. At the end of 2011, the child is either **(a)** under age 18, or **(b)** age 18 (or a full-time student age 19-23) and the income is less than or equal to half the student’s support. For the 2011 age test, the age of the child with January 1 birthday is determined as of January 1, 2011. For the support test support includes amount spent for the child’s food, lodging, clothing, education, medical care, recreation, transportation and similar necessities. The scholarship a child receives is not considered support if the child is a full-time student.
2. The child has more than \$1,900 of investment income for the year,
3. Either parent was alive on December 31, 2011 and
4. The child does not file a joint return for the tax year.<sup>39</sup>

### Earned Income Credit (EIC):

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended existing earned income credit rules into tax years 2011 and 2012.

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 \$1,200 per individual and \$2,400 for a family in 2011. These amounts are \$1,200 and \$2,400 for 2012. Maximum annual out-of-pocket expense amounts are \$5,950 for an individual and \$11,900 for a family in 2011. For 2012 the amounts are \$6,050 and \$12,100. 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.<sup>40</sup>

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>2011</u>	<u>2012</u>
• Single	\$3,050	\$3,100
• Family	\$6,150	\$6,250

An additional \$1,000 can be added to the 2011 and 2012 amounts, if the individual or individuals are age 55 or over.

<sup>37</sup> 2009 National Income Tax Workbook, Land Grant University Tax Education Foundations, Inc. p. 137

<sup>38</sup> 2010 Quickfinder, 1040 Edition. p. 13-1

<sup>39</sup> 2011 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 156.

<sup>40</sup> Ibid. p. 686.

### 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.

### Dividend Income Tax Procedures:

For 2011 and 2012 only, qualified dividends are taxed the same as long-term capital gains (0% tax rate for taxpayers in the 10% and 15% federal tax brackets, and 15% for taxpayers in the 25% and above federal tax brackets).<sup>41</sup>

To qualify for the reduced rate, a dividend must be received on a stock held for at least 61 days.<sup>42</sup> 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 2011 and 2012, 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 2011 and 2012.

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 2011 and 2012. 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.<sup>43</sup>

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 post-secondary education and is allowed for 4 taxable years for each student. The American Opportunity credit was scheduled to expire at the end of 2010. However, new legislation extended the American Opportunity Credit through tax year 2012."<sup>44</sup>

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 a level of \$160,000-\$180,000 for married taxpayers filing a joint return (MFJ)].

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.<sup>45</sup>

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 2011 and 2012. The credit is

<sup>41</sup> Ibid. p. 5-23

<sup>42</sup> Ibid. p. 5-23

<sup>43</sup> 2010 Quickfinder, 1040 Edition. p. 12-1

<sup>44</sup> Ibid. p. 12-1

<sup>45</sup> Ibid. p. 12-8

phased out for high-income tax payer categories MFJ, Single, Heads of Household, or Qualifying Widow(er), 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.<sup>46</sup>

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 2011 and 2012.

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 (ESAs): tax law exempts earnings in Sec. 529 plans from federal income taxes. There are two types:

- prepaid tuition plans
- college savings plans

Under the 2010 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. Current ESA rules allow beneficiaries of qualified tuition programs to use tax-free distributions to purchase computers, computer technology, and Internet access.<sup>47</sup>

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<sup>46</sup> Ibid. p. 12-8

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<sup>47</sup> Internal Revenue Service Website. IRS.GOV



**APPENDIX**

**FEDERAL TAX RATES FOR 2011:**

**TABLE 1: MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES**

**If Taxable Income Is: The Tax Is:**

Not over \$17,000	10% of the taxable income
Over \$17,000 but not over \$69,000	\$1,700 plus 15% of the excess over \$17,000
Over \$69,000 but not over \$139,350	\$9,500 plus 25% of the excess over \$69,000
Over \$139,350 but not over \$212,300	\$27,087.50 plus 28% of the excess over \$139,350
Over \$212,300 but not over \$379,150	\$47,513.50 plus 33% of the excess over \$212,300
Over \$379,150	\$102,574 plus 35% of the excess over \$379,150 <sup>48</sup>

**TABLE 2: HEADS OF HOUSEHOLD**

**If Taxable Income Is: The Tax Is:**

Not over \$12,150	10% of the taxable income
Over \$12,150 but not over \$46,250	\$1,215 plus 15% of the excess over \$12,150
Over \$46,250 but not over \$119,400	\$6,330 plus 25% of the excess over \$46,250
Over \$119,400 but not over \$193,350	\$24,617.50 plus 28% of the excess over \$119,400
Over \$193,350 but not over \$379,150	\$45,323.50 plus 33% of the excess over \$193,350
Over \$379,150	\$106,637.50 plus 35% of the excess over \$379,150

**TABLE 3: SINGLE INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)**

**If Taxable Income Is: The Tax Is:**

Not over \$8,500	10% of the taxable income
Over \$8,500 but not over \$34,500	\$850 plus 15% of the excess over \$8,500
Over \$34,500 but not over \$83,600	\$4,750 plus 25% of the excess over \$34,500
Over \$83,600 but not over \$174,400	\$17,025 plus 28% of the excess over \$83,600
Over \$174,400 but not over \$379,150	\$42,449 plus 33% of the excess over \$174,400
Over \$379,150	\$110,016.50 plus 35% of the excess over \$379,150 <sup>49</sup>

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

**If Taxable Income Is: The Tax Is:**

Not over \$8,500	10% of the taxable income
Over \$8,500 but not over \$34,500	\$850 plus 15% of the excess over \$8,500
Over \$34,500 but not over \$69,675	\$4,750 plus 25% of the excess over \$34,500
Over \$69,675 but not over \$106,150	\$13,543.75 plus 28% of the excess over \$69,675
Over \$106,150 but not over \$189,575	\$23,756.75 plus 33% of the excess over \$106,150
Over \$189,575	\$51,287 plus 35% of the excess over \$189,575

<sup>48</sup>2011 National Income Tax Workbook, Land Grant University Tax Education Foundation. p. 671.

<sup>49</sup> Ibid., p. 672

## **FEDERAL TAX RATES FOR 2012:**

### **TABLE 1: MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES**

**If Taxable Income Is: The Tax Is:**

Not over \$17,400	10% of the taxable income
Over \$17,400 but not over \$70,700	\$1,740 plus 15% of the excess over \$17,400
Over \$70,700 but not over \$142,700	\$9,735 plus 25% of the excess over \$70,700
Over \$142,700 but not over \$217,450	\$27,735 plus 28% of the excess over \$142,700
Over \$217,450 but not over \$388,350	\$48,665 plus 33% of the excess over \$217,450
Over \$388,350	\$105,062 plus 35% of the excess over \$388,350 <sup>50</sup>

### **TABLE 2: HEADS OF HOUSEHOLD**

**If Taxable Income Is: The Tax Is:**

Not over \$12,400	10% of the taxable income
Over \$12,400 but not over \$47,350	\$1,240 plus 15% of the excess over \$12,400
Over \$47,350 but not over \$122,300	\$6,482.50 plus 25% of the excess over \$47,350
Over \$122,300 but not over \$198,050	\$25,220 plus 28% of the excess over \$122,300
Over \$198,050 but not over \$388,350	\$46,430 plus 33% of the excess over \$198,050
Over \$388,350	\$109,229 plus 35% of the excess over \$388,350

### **TABLE 3: SINGLE INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)**

**If Taxable Income Is: The Tax Is:**

Not over \$8,700	10% of the taxable income
Over \$8,700 but not over \$35,350	\$870 plus 15% of the excess over \$8,700
Over \$35,350 but not over \$85,650	\$4,867.50 plus 25% of the excess over \$35,350
Over \$85,650 but not over \$178,650	\$17,442.50 plus 28% of the excess over \$85,650
Over \$178,650 but not over \$388,350	\$43,482.50 plus 33% of the excess over \$178,650
Over \$388,350	\$112,683.50 plus 35% of the excess over \$388,350

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

**If Taxable Income Is: The Tax Is:**

Not over \$8,700	10% of the taxable income
Over \$8,700 but not over \$35,350	\$870 plus 15% of the excess over \$8,700
Over \$35,350 but not over \$71,350	\$4,867.50 plus 25% of the excess over \$35,350
Over \$71,350 but not over \$108,725	\$13,867.50 plus 28% of the excess over \$71,350
Over \$108,725 but not over \$194,175	\$24,332.50 plus 33% of the excess over \$108,725
Over \$194,175	\$52,531 plus 35% of the excess over \$194,175

<sup>50</sup>2011 National Income Tax Workbook, Land Grant University Tax Education Foundation. p. 673.

**MINNESOTA STATE TAX RATES FOR 2012:**

	<u>Tax Rate</u>		
	<u>5.35%</u>	<u>7.05%</u>	<u>7.85%</u>
<b>Single</b>	\$0 - \$23,100	\$23,101 - \$75,890	\$75,891 +
<b>Head of Household</b>	\$0 - \$28,440	\$28,441 - \$114,290	\$114,291 +
<b>Married Filing Jointly</b>	\$0 - \$33,770	\$33,771 - \$134,170	\$134,171 +
<b>Married Filing Separate</b>	\$0 - \$16,890	\$16,891 - \$67,090	\$67,091 +

**ESTATES AND TRUSTS - 2011:**

**If Taxable Income Is:**

Not over \$2,300  
 Over \$2,300 but not over \$5,450  
 Over \$5,450 but not over \$8,300  
 Over \$8,300 but not over \$11,350  
 Over \$11,350

**The Tax Is:**

15% of the taxable income  
 \$345 plus 25% of the excess over \$2,300  
 \$1,132.50 plus 28% of the excess over \$5,450  
 \$1,930.50 plus 33% of the excess over \$8,300  
 \$2,937 plus 35% of the excess over \$11,350

**ESTATES AND TRUSTS - 2012:**

**If Taxable Income Is:**

Not over \$2,400  
 Over \$2,400 but not over \$5,600  
 Over \$5,600 but not over \$8,500  
 Over \$8,500 but not over \$11,650  
 Over \$11,650

**The Tax Is:**

15% of the taxable income  
 \$360 plus 25% of the excess over \$2,400  
 \$1,160 plus 28% of the excess over \$5,600  
 \$1,972 plus 33% of the excess over \$8,500  
 \$3,011.50 plus 35% of the excess over \$11,650<sup>51</sup>

**CAPITAL GAIN RATES (Non-corporate Taxpayers):**

**Category of Gain:**

	<b>Tax Rate:</b>		
	<u>2010</u>	<u>2011</u>	<u>2012</u>
Gain on Collectables	28%	28%	28%
I.R.C. § 1202 gain	28%	28%	28%
Un-recaptured I.R.C. § 1250 gain	25%	25%	25%
Net long-term capital gain	15%	15%	15%
Reduced long-term gain rate if ordinary tax rate 10% or 15%	0%	0% <sup>52</sup>	0%

<sup>51</sup> 2011 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 672

<sup>52</sup> 2011 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 674

**OTHER INFORMATION:**

	<u>2010</u>	<u>2011</u>	<u>2012</u>
<b><u>Form 706—U.S. Estate/Generation-Skipping Tax:</u></b>			
Estate Tax Applicable Exclusion Amount:	(a) No Estate Tax No Stepped-up Basis Carryover Basis	\$5,000,000 Stepped-up Basis	\$5,120,000 Stepped-up Basis
	<b>OR</b> (b) \$5,000,000 Stepped-up Basis		
Federal Estate Tax Applicable Credit Amount	\$1,730,800	\$1,730,800	\$1,772,800
Special-use valuation reduction limit:	\$1,000,000	\$1,020,000	\$1,040,000
Generation-skipping transfer Exemption (GST):	\$5,000,000	\$5,000,000	\$5,120,000
Estate value qualifying for 2% interest for installment payments:	\$1,340,000	\$1,360,000	\$1,390,000 <sup>53</sup>
<b><u>Form 709—U.S. Gift/Generation Skipping Tax:</u></b>			
Life-time Gift Tax Applicable Exclusion Amount:	\$1,000,000	\$5,000,000	\$5,120,000
Annual exclusion for gifts:	\$13,000	\$13,000	\$13,000
<b><u>Form 1040—U.S. Individual Income Tax Return Standard Deductions:</u></b>			
Joint or qualifying widow(er):	\$11,400	\$11,600	\$11,900
Single:	\$5,700	\$5,800	\$5,950
Head of household:	\$8,400	\$8,500	\$8,700
Married filing separately	\$5,700	\$5,800	\$5,950
Additional for elderly/blind—married:	\$1,100	\$1,150	\$1,150
Additional for elderly/blind—unmarried or head of household:	\$1,400	\$1,450	\$1,450
Taxpayer claimed as dependent (or \$300 + earned income not exceeding standard deduction or \$300 in 2006):	\$950	\$950	\$950 <sup>54</sup>
<b><u>Beginning of Itemized Deduction Phase-out Range Based on AGI:</u></b>			
Joint or qualified widow(er):	NA	NA	NA
Single	NA	NA	NA
Head of Household	NA	NA	NA
Married filing separately:	NA	NA	NA <sup>55</sup>
<b><u>Exemption deductions:</u></b>			
Personal and dependent:	\$3,650	\$3,700	\$3,800
Estate:	\$600	\$600	\$600
Simple trust:	\$300	\$300	\$300
Complex trust:	\$100	\$100	\$100 <sup>56</sup>

<sup>53</sup>2011 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 683.

<sup>54</sup>2011 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 688.

<sup>55</sup>Ibid. p. 688.

<sup>56</sup> 2011 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 684.

	<u>2010</u>	<u>2011</u>	<u>2012</u>
<b><u>Form 4562—Depreciation &amp; Amortization:</u></b>			
Section 179 Deduction:	\$500,000	\$500,000	\$139,000
Phase-out begins at new investment of:	\$2,000,000	\$2,000,000	\$560,000 <sup>57</sup>
<b><u>Form 6251—Alternative Minimum Tax—Individuals AMT Exemption Amount:</u></b>			
Married, filing joint return or qualified widow(er):	\$45,000	\$74,450	\$45,000
Single or head of household:	\$33,750	\$48,450	\$33,750
Married, filing separately:	\$22,500	\$37,225	\$22,500
Kiddie tax:	\$6,700	\$6,800	\$6,950 <sup>58</sup>
<b><u>Earnings Ceiling for Social Security:</u></b>			
Below full retirement age (FRA):	\$13,560	\$14,160	\$14,460
Monthly maximum earnings before FRA for full benefits:	\$3,010	\$3,140	\$3,240
Above full retirement age:	Unlimited	Unlimited	Unlimited
Earnings Required to Earn One Quarter of Social Security Coverage:	\$1,050	\$1,090	\$1,130
OASDI tax maximum earnings	\$106,800	\$106,800	\$110,100

<sup>57</sup>2011 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 678.

<sup>58</sup>2011 National Income Tax Workbook, Land Grant University Tax Education Foundation, Inc. p. 688.

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