Tax Management: Income Averaging

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This information can change... often.

This is educational information, not tax or legal advice. Information is based on material from LGUTEF, Ruraltax.org, and IRS. Please be a good consumer of professional services.
Source Acknowledgement

Land Grant University
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IRS
Department of the Treasury
Internal Revenue Service

RuralTax.org

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Tax Management

• Not How to get out of paying taxes!
• But Should be....
• How do I maximize my after-tax net income
Tax Management: Multiple methods of tax management!

- Should meet with your tax professional at least 6-8 weeks before year-end to review where the farm is and what options may be available.
- Multiple strategies to consider.
  - Are there any Net Operating Losses (NOLs) available to use?
  - Are Pre-Pays, pre-paying farm supplies/inputs an option or a need?
  - Various Depreciation methods are available; GDS vs. ADS, Sec. 179, Bonus, etc.
  - Pre-tax funding of retirement, investment, and or medical accounts?
  - Income Averaging, can be done following the conclusion of the tax year.
Income Averaging

- Added as I.R.C. §1031 by TRA 1997
- Still Underutilized
- 2004 study showed average savings of $4,434 by 50,800 farmers – 23% savings, this has continued with more recent reviews as well.
- More recent data continues to show that it is still underutilized and a tax liability payment savings.
- Averages the tax rates that apply to current year farm income using tax brackets from 3 prior years.
- This is **NOT** the same as **Amending** a return.
Crop share landlords

- Crop share landlords may qualify for farm income averaging.
- Written agreement and timing are crucial.
- Written agreement must be signed *before* tenant begins significant activities on the land.
- Landlord need not materially participate.
- Fixed rent is **NOT** a crop share and does not qualify.
- Cash rent does not qualify.
Definitions

• **Election year** – year of the election
• **Base years** – 3 prior years
• **Electible farm income** – reduced by NOLs, includes farm asset sales (except land) and S corp shareholder wages
• **Elected farm income** – amount taxed at base-year rates
• **Farming business** – trade or business under I.R.C. §263A(e)(4)
Income Averaging

• Filed on Schedule J
• Allows taxpayers to utilize unused tax brackets from previous 3 years
Income Averaging

• Only farm income qualifies
• Does not affect:
  • Taxable income
  • Self-employment income
  • Amount of self-employment tax
The dollar values are taxable farming income only.

In this example we are taking $30,000 from 2022 and it is divided by three and each 1/3rd is applied to each of the base (2019 - 2021) years.

- $78,950 is Top of the 12%
- $72,000 applied to 2019
- $80,250 is Top of the 12%
- $65,000 applied to 2020
- $81,050 is Top of the 12%
- $70,000 applied to 2021
- $83,550 is Top of the 12%
- $10,000 applied to 2021
- $110,000.00

2022 Income above the 12% into the 22% by $26,450

This will lower the income in the 2022 year to $80,000 just under the 22% bracket.
Tax Planning Example – part 1

• Jo Jones, Married Filing Joint return, and Standard Deduction ($27,700)
• Net Farm Income = $ 125,000
• Taxable Income = $ 97,300
  • Federal Tax = $ 12,021
  • Self-Employment Tax = $ 19,125
  • Total Tax = $ 31,146
• Marginal Tax Rate = 22%
• Effective Tax Rate = 9.6% (Does not include SE tax)
2023 INCOME TAX RATES (MFJ)

Developed by Mr. Rob Holcomb, University of Minnesota

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Tax Planning Example – part 2

• Jo Jones, Married Filing Joint return, and Standard Deduction ($27,700)
• To reduce tax bite, purchase additional inputs of $20,000
• Net Farm Income = $105,000 ($125,000 – $20,000)
• Taxable Income = $77,300
  • Federal Tax = $8,836
  • Self-Employment Tax = $16,065
  • Total Tax = $24,901 ($6,245 tax savings)
• Marginal Tax Rate = 12%
• Effective Tax Rate = 8.4% (Does not include SE tax)
Notes:

• Income Averaging should be considered even if it will not provide an immediate benefit in the current year.
  • It can create opportunities for future years income.
    • Move income to prior years for lower base years in the future.

• You may amend prior years returns to income average to create lower base years.

• “Full” base years drop off after 3 years.
Common Questions

• Who can use Income Averaging?
  • You must be engaged in farming, ranching, or commercial fishing. The IRS states that “income from your trade or business of farming or fishing”. There are some additional limitations so please refer to the below link.
  • Entity Types: This typically will occur at the individual level for pass through entities. Income Averaging is allowed for Sole Proprietorship, Partnership, Single and Multi-member LLC taxed as either a partnership or Sub Chapter S Corporation, and Sub Chapter S-Corporations. It cannot be used by multi-member LLC taxed as a C-Corp, C-corps, Estate or Trusts.

• The sale of Breeding Cows is includable in farm income for income averaging. Only the income from the sale of animals that are considered to be a part of a farming activity considered in farm income. Typically, animals that are being raised for meat, milk, wool, draft, or sporting purposes are typically considered farming activities and income derived from these activities may be counted as farm income for income averaging purposes.

• Typically, most government payments are considered as farm income unless it has been specifically excluded legislatively.

References and Resources

• IRS Publication 225 “Farmer’s Tax Guide”
  • https://www.irs.gov/forms-pubs/about-publication-225

• Rural Tax website for farm related tax information:
  • ruraltax.org

• USDA Farmer’s.Gov website tax information
  • farmers.gov/taxes
Thank You!
Contact Information

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