

A Penny Saved:
Business Planning and Wealth Preservation for Farmers
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CHAPTER ONE

You Wouldn't Use Sandbags to Stop a Tornado and You Wouldn't Hide in the Basement to Escape Flooding, So Why Are You Using a Sole-Proprietorship or a General Partnership to Run Your Farm Instead of a Limited Liability Company?

Indiana farmers in the central and southern parts of the state are struggling this season against flooding, and, as a result, farm profits are literally being [swept away](#). Although, what many Hoosier farmers do not realize is that while natural disasters may be costly, the government is second to none at sweeping away profits, and, much like acts of God, taxation cannot be avoided entirely, but its effects can certainly be mitigated through careful planning.

Farms face numerous calamities: wild fires, swarming insect populations, floods, tornadoes, and the list goes on. Similarly, farmers are subject to a number of different taxes: income and self-employment tax, property tax, gift and estate tax, and unfortunately this list goes on as well. But fortunately there are tools for confronting almost every adversity faced by farmers, including taxes. In this post I will summarize the various tools available for minimizing tax, and in future posts I will provide a more thorough explanation as to the way in which each technique is to be implemented.

The amount of income tax due can be lowered by utilizing the most advantageous accounting method, postponing income, and taking all applicable exclusions, deductions, exemptions, and credits. And as to the related topic of self-employment tax, the principal method for lowering this burden is to minimize the amount of net earnings from self-employment, which can be accomplished through intelligent business structuring.

Property tax has been a source of enmity in the Hoosier state for the last several years, and the debate has lost none of its initial virulence. While a challenge to the assessed value of property is a possibility, the first line of attack should be diligence in assuring that all applicable credits and deductions are received.

Gift and estate taxes can be a significant hurdle for family farmers who wish to provide for the continuing involvement of their children. But there are methods for successfully transferring management and ownership of the family farm from the present generation on to the next. These include: special use valuation, installment payments, creation of conservation easements, implementation of various types of trusts, life-time gifting, organization of limited liability companies, and execution of buy-sell agreements.

Please join me next time for: **A Short Explanation of the Income Tax System or A Day Trip Through Dante's Inferno.**

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CHAPTER TWO

A SHORT EXPLANATION OF THE INCOME TAX SYSTEM OR A DAY TRIP THROUGH DANTE'S INFERNO

According to Will Rogers the income tax system is excruciatingly simple: "If you make any money, the government shoves you in the creek once a year with it in your pockets, and all that don't get wet you can keep." However there are steps that can be taken to minimize the amount of money that gets "wet." I will elaborate on these steps in subsequent posts, but before I do that, I think a short description of how the income tax system works would be appropriate.

First, Gross Income must be determined by computing "all income from whatever source derived," less certain postponed and excluded items, such as gifts received, amounts contributed to 401(k) accounts, and proceeds from life insurance. Second, above the line deductions must be taken to determine the Adjusted Gross Income. Above the line deductions include (among other items): trade and business expenses of self-employed individuals, contributions to Individual Retirement Accounts, and contributions made by self-employed individuals to pension, profit-sharing, and annuity plans. And third, below the line deductions, which will be either itemized deductions or the standard deduction, must be taken along with personal and dependent exemptions to finally arrive at Taxable Income.

Also, it is important to bear in mind the difference between items excluded from gross income and above the line deductions on the one hand and below the line deductions on the other. This distinction is critical for the reason that all items in the former will reduce Taxable Income, but the same cannot always be said of the latter. This is because below the line deductions require the taxpayer to make a choice between two mutually exclusive alternatives: either receive the standard deduction or take itemized deductions. In other words, a taxpayer will always be able to reduce his or her Taxable Income by amounts contributed to 401(k) accounts and Individual Retirement Accounts, but if he or she receives the standard deduction then itemized deductions must be foregone, or, alternatively, if he or she takes itemized deductions then the standard deduction will be unavailable.

After Taxable Income has been calculated, then the taxpayer's obligation is determined based upon calculations performed in accordance with the marginal rates. However, even after this initial calculation of the tax amount, a taxpayer may still be able to lower his or her ultimate tax liability by subtracting credits. Credits reduce tax on a dollar-for-dollar basis because they are applied directly against the tax due, as opposed to deductions and exemptions which are applied against the taxpayer's income. There are two main types of credits: non-refundable and refundable. Non-refundable credits can reduce a taxpayer's obligation to zero, but cannot reduce it below zero. Refundable credits, on the other hand, can reduce a taxpayer's obligation below zero, and, as a result, can cause a taxpayer to receive a refund. Several of the more commonly used credits

include the non-refundable credit for the elderly and the permanently and totally disabled, the partially refundable child tax credit, and the refundable credit for tax withheld on wages.

And, in addition to the Federal income tax, Indiana imposes a State income tax of 3.4%, which is determined by reference to the taxpayer's Federal adjusted gross income along with a few quirks. Also, there is a county income tax due, the percentage of which varies depending upon the county of residence from .01% to 2.08%.

Please join me next time for: **How to Minimize Income Tax or I Wear a Barrel Because Uncle Sam Took My Slacks.**

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CHAPTER THREE

How to Minimize Income Tax or I Wear a Barrel Because Uncle Sam Took My Slacks

As I have mentioned in my previous posts, there are methods through which income tax obligations can be lowered. Robert A. Heinlein has warned: "Be wary of strong drink. It can make you shoot at tax collectors... and miss." But I am hopeful that in this post I may be able to provide a few hints regarding the minimization of income taxes, which do not involve taxpayers cooling their heels in the gray bar hotel. Chief among these are utilizing the most advantageous accounting method; postponing income; and taking all applicable exclusions, deductions, exemptions, and credits.

Operating under the cash method of accounting can be an effective way of postponing income. There are two methods of accounting: the accrual method and the cash method. Under the accrual method income is included in the year that it is earned and expenses are deducted as incurred, whereas under the cash method income is included in the year in which it is received and expenses are deducted as paid. Most farmers are permitted to utilize the cash method of accounting, and can achieve significant tax savings through structuring transactions in an optimum manner.

At its most rudimentary, appropriate structuring under the cash method involves delaying the receipt of cash and accelerating the payment of expenses. This will result in decreasing Taxable Income in the present year at the expense of increasing Taxable Income in the next year, which is normally desirable for the reason that a dollar today is preferable over a dollar tomorrow. Although, a farmer who anticipates that next year will be significantly more profitable than this year may be well advised to accelerate his or her receipt of cash in the present year and delay his or her expenses until next year, as this would allow him or her to enjoy the benefit of lower marginal rates in the present year.

Postponing income means that the taxpayer will not pay tax on that income in the current tax year, but that he or she will be required to do so in the future. There are several ways in which income can be postponed (and, in fact, utilization of the cash method could be thought of as way of postponing income).

Section 1031 allows for the exchange of real property, such as farm ground, for "property of a like kind," and instead of requiring the recognition of capital gain, the taxpayer is permitted to assign the basis of the old property to the new property. This means that the capital gain will have to be recognized at some point in the future when the new property is sold. Similarly, amounts contributed on behalf of a taxpayer to a 401(k) account (including SIMPLE 401(k) plans) are not treated as income until distributed. In 2008, a taxpayer may elect to defer up to \$15,500 for this purpose.

The other method by which a taxpayer's obligation may be reduced is by taking full advantage of all applicable exclusions, deductions, exemptions, and credits. One

popular method for increasing deductions is depositing funds into an Individual Retirement Account (IRA). The maximum contribution amount eligible for deduction in 2008 is \$5,000. Additionally, there are, of course, an abundance of other available exclusions, deductions, exemptions, and credits, but the trick here is to work with an accountant who can ferret all of these out.

Please join me next time for: **The Self-Employment Tax or All These Taxes Are Taxing My Patience.**

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CHAPTER FOUR

The Self-Employment Tax or All These Taxes Are Taxing My Patience

In today's post we will consider the workings of the self-employment tax, along with methods for its reduction.

IRC 1401 imposes a tax on the self-employment income of every individual, which is known as the Self-Employment Contributions Act (SECA) tax. This tax is analogous to the Federal Insurance Contributions Act (FICA) tax, which is imposed on those who are employed by others. There is, however, one significant difference, half of the FICA tax is paid by the employee and the other half is paid by the employer, whereas the self-employed individual must pay both halves. The SECA tax is made up of two parts: a Social Security tax of 12.4%, which in 2008 is applied against self-employment income up to \$102,000; and a Medicare tax of 2.9%, which is applied against all self-employment income.

When performing the calculation to determine the SECA tax obligation, it must be remembered that, again, even in the case of self-employed individuals conceptually there is still an employee's portion and an employer's portion. The first step in the calculation is to multiply net earnings from self-employment by 7.65%, which represents the employer's portion of the SECA tax. The second step is to subtract the product of this computation from self-employment net earnings. These first two steps function to ensure that self-employed individuals are not required to count amounts paid regarding the employer's portion as net earnings from self-employment when determining the amount of SECA tax due. The third step is to multiply the resulting amount by the applicable rates (15.3% on the first \$102,000, 2.9% on everything above that) to determine the SECA tax obligation. However, one-half of this amount can be taken as an above the line deduction, which ensures that the self-employed individual will not be required to pay income tax on the employer portion of the SECA tax.

There are several effective methods for reducing the amount of the SECA tax obligation which revolve around the concept of transforming income from self-employment income to income which is excluded from self-employment income. IRC 1402 lists numerous sources of income that are to be excluded from self-employment income. Among these the more typically utilized are real estate rent, dividends, capital gains, and distributions related to limited partnership interests.

There are several techniques which may be of benefit to farmers. A farm business can be bifurcated into two limited liability companies: one company to own the land, and the other to conduct the farming operations. The operating company would then pay reasonable rent to the land owning company. The effect of this is to transform income that would otherwise be a part of net earnings from self-employment to income which is excluded. Of course, either way the farmer would still be responsible for paying

income tax on this income, but to the extent that the income is received as rental income the farmer is not responsible for paying SECA tax.

Another method for increasing the amount of excluded income is to organize the farm as an S Corporation and pay out reasonable salaries and make distributions. S Corporations are taxed as pass-through entities (similar to partnerships), which means that the shareholder or shareholders are taxed on the income produced by the business but that the corporation itself does not pay any tax (as would a C Corporation). After the farm has been organized as an S Corporation it can then pay a reasonable salary to the farmer or farmers, to which salary the FICA tax would apply. Why FICA and not SECA? Because an individual who is employed by a corporation is not self-employed (for tax purposes), even if that individual owns 100% of the corporation that employs him or her. Any amounts remaining after the payment of reasonable salaries could then be distributed free of any FICA or SECA tax obligations, although, of course, these amounts would still be subject to income tax.

Finally, I would be remiss if I failed to mention that there are also various ways of dividing ownership interests in limited liability companies between active and passive that have been used to reduce SECA taxes. In 1997, the IRS issued proposed regulations in an attempt to clarify SECA tax treatment as applied to limited liability companies. But due to controversy, the proposed regulations were never adopted, and, as a result, application of the SECA tax to limited liability companies remains ambiguous. However, it is unlikely that the IRS would challenge a taxpayer proceeding in conformity with the proposed regulations, and, if caution is exercised, this is a strategy that some farmers may find to be of benefit.

Please join me next time for: **Indiana Property Tax Reform or Indiana Property Tax Fiasco.**

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CHAPTER FIVE

Indiana Property Tax Reform or Indiana Property Tax Fiasco

In December 1998, the Indiana Supreme Court determined that Indiana's then-existing property tax scheme was unconstitutional. *State Bd. of Tax Com'rs v. Town of St. John*, 702 N.E.2d 1034 (Ind. 1998). In the following years, the system was revised in an attempt to bring it into conformity with Indiana's Constitution. This attempt has been met with significant distress, as those who formerly paid low property taxes have either been (a) forced to finally start paying their fair share, or (b) unfairly targeted for excessive property tax hikes, which determination is largely based upon whether or not the property taxes of the one making the determination have recently increased. But those folks who have been unfairly targeted for excessive property tax hikes should not despair as there are a few avenues for addressing that concern.

One possible means of lowering the property tax liability is to dispute the assessed value of the property. The assessed value is multiplied by the property tax rate (which varies from place to place), and, accordingly, a decrease in the assessed value will result in a decrease in the amount of property tax owed. The assessed value can be disputed by first filing an appeal with the local official responsible for the assessment, who will then forward the appeal on to the County Property Tax Assessment Board of Appeals. If the taxpayer is not satisfied with the determination made by the County Property Tax Assessment Board, then he or she may file an appeal with the Indiana Board of Tax Review. And if the Indiana Board of Tax Review's final determination is not to the taxpayer's liking, then he or she may either petition for rehearing or request judicial review.

But before considering an appeal of the assessed value, the prudent taxpayer would be well advised to be certain that all property credits and deductions are received. Available credits and deductions each fall under one of several categories: those relating to homesteads and mortgages, those relating to alternative energy sources, those relating to age and disability, and those relating to veteran status.

The Homestead Standard Deduction allows each homeowner to deduct from the assessed value the lesser of 60% of the assessed value or \$45,000. Additionally, the Homestead Credit and the Supplemental Homestead Deduction may be available to certain taxpayers. And the Mortgage Deduction allows the homeowner to deduct the lesser of the balance of the mortgage on the property, one-half of the assessed value of the property, or \$3,000.

Homeowners owning property that has been improved by the addition of certain alternative energy contraptions are entitled to a deduction in the amount of the value of the contraption. In other words, for purposes of determining the assessed value of the property, the doohickey is disregarded. The following are eligible for this favored

treatment: Solar Energy Heating or Cooling Systems, Wind Power Devices, Hydroelectric Power Devices, and Geothermal Devices.

Homeowners who are over the age of 65 are entitled to a \$12,480 deduction, although this deduction may not be taken in addition to any other deductions except the Homestead Deduction and the Mortgage Deduction. Also, the Over 65 Circuit Breaker Credit may be available to certain taxpayers. Homeowners who are blind or disabled are entitled to a \$12,480 deduction.

Disabled veterans are entitled to a \$12,480 deduction against the assessed value of the property. Veterans with service connected disabilities are entitled to a \$24,960 deduction against the assessed value of the property. And World War I veterans and their surviving spouses are entitled to \$18,720 deduction against the assessed value of the property.

In addition to the foregoing, real property owners will be receiving some relief as a result of the passage of House Bill 1001. HB 1001 entitles those who pay property taxes in 2009 to receive a credit that is the amount by which the person's property tax liability attributable to the person's: (1) homestead exceeds one and five-tenths percent (1.5%); (2) residential property exceeds two and five-tenths percent (2.5%); (3) long term care property exceeds two and five-tenths percent (2.5%); (4) agricultural land exceeds two and five-tenths percent (2.5%); (5) nonresidential real property exceeds three and five-tenths percent (3.5%); or (6) personal property exceeds three and five-tenths percent (3.5%); of the gross assessed value of the property that is the basis for determination of property taxes for that calendar year. This effectively caps the property tax at these percentages of assessed value. And, in 2010, the point at which the credit (cap) kicks in will drop by half a percent.

Please join me next time for: **Gift and Estate Taxed or Bilked, Bamboozled, and Bushwhacked.**

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CHAPTER SIX

Gift and Estate Taxed or Bilked, Bamboozled, and Bushwacked

Benjamin Franklin once observed that “Nothing in life is certain except death and taxes.” But what about death taxes? Farmers more than others have reason to fear the estate tax for the reason that their estates frequently consists of large and illiquid assets such as land, machinery, and equipment. In today’s post I will outline the Gift and Estate Tax system and next time I will discuss a few of the techniques available for reducing or otherwise addressing the gift and estate tax obligation.

The gift tax is a tax that is levied upon gifts made during life. Each year every taxpayer is allowed to gift an amount up to the then-applicable annual exclusion to an unlimited number of individuals. In 2008, the amount of the annual exclusion is \$12,000. This means that in 2008, a taxpayer may give up to \$12,000, in cash or other property, to any number of people that he or she desires, and each couple may give up to \$24,000 to any number of people.

In addition to the annual exclusion, each taxpayer is allowed a \$1 Million lifetime gift tax credit. This means that in any given year, if gifts exceed the applicable annual exclusion amount (which again, is \$12,000 in 2008), then that excess will function to reduce the available amount of the gift tax credit. And the gift tax credit is tied to the estate tax credit - the Unified Gift and Estate Tax Credit. As a result, the estate tax credit is diminished to the extent that the gift tax credit is utilized. In other words, the gift tax credit could be thought of as lifetime usage of the estate tax credit.

The estate tax credit is currently set at \$2 Million; however, the estate tax scheme is currently in a state of transition and the eventual outcome is still uncertain. IRC 2010 provides for an applicable credit amount against estate taxes of \$2 Million in 2008 and \$3.5 Million in 2009, after which in 2010 there will be no estate tax, but then in 2011, it will return with a \$1 Million applicable credit. Although, the consensus among experts in the field is that Congress will not allow the 2010 phase-out to occur, but will rather set the applicable credit amount to remain at the \$3.5 Million figure for the foreseeable future.

The Federal Estate Tax is calculated by first determining the size of the Gross Estate, which requires an understanding of what is includable in the Gross Estate and what is not. IRC 2031 states “The value of the gross estate of the decedent shall be determined by including . . . the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.” And IRC 2033 goes on to state that “The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.” Which is to say that not only

does the Gross Estate include all assets held by the deceased at death, but it also includes several types of assets not held by the deceased at death, such as: dower or curtesy interests held by the surviving spouse, certain gifts made three years prior to the decedent's death, property regarding which the decedent held a life estate, property transferring upon the death of the decedent, property transferred subject to the decedent's power to revoke, annuities receivable by a beneficiary as a result of the decedent's death, certain joint interests, property over which the decedent held a general power of appointment, life insurance proceeds from policies regarding which the decedent possessed any of the incidents of ownership.

After the Gross Estate has been calculated various deductions must be taken to arrive at the Taxable Estate. Deductions are allowed for the following items, among others: funeral expenses, administration expenses, claims against the estate, charitable contributions, and property left to the surviving spouse. If the Taxable Estate is less than the Unified Gift and Estate Tax Credit as reduced by lifetime gifts, then no Federal Estate Tax is due. If, however, the Taxable Estate is greater than the Unified Gift and Estate Tax Credit as reduced by lifetime gifts, then Federal Estate Tax will be due. And, in the event that Federal Estate Tax is due, the size of the obligation can be determined by multiplying the amount by which the Taxable Estate exceeds the Unified Gift and Tax Credit by the applicable rate, which in 2008 is 45%.

Please join me next time for: **Don't Pay Any More Than You Have to or How to Stick It to the (Tax) Man.**

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CHAPTER SEVEN

Don't Pay Any More Than You Have to or How to Stick It to the (Tax) Man

John Marshall, the fourth Chief Justice of the United States Supreme Court, once noted that “The power to tax involves the power to destroy.” But now that we understand how the gift and estate tax regime operates we can turn to a discussion of the various strategies available to prevent those taxes from “destroying” your estate. Methods for confronting the estate tax revolve around several differing approaches, which include minimizing the size of the Taxable Estate, stretching out the time period in which the estate tax obligation may be met, and providing the funds necessary to meet this obligation without incurring additional estate tax in the process.

There are several ways in which the size of the Taxable Estate can be reduced. The easiest big way to accomplish this is by not failing to take advantage of the Estate Tax Credit. While this may seem obvious, many people nonetheless fail in this regard. Why? Because they do not engage in any tax planning prior to the death of the first spouse, and instead leave all property to the survivor. As a result, an opportunity to pass an amount up to the exemption equivalent (\$2 Million in 2008) without incurring any estate tax is lost.

Another method for reducing the Taxable Estate is to make lifetime gifts. As we discussed last time, every year a taxpayer may gift an amount of up to \$12,000 to each person that he or she desires without incurring any gift tax. For those with a moderately sized estate this can be a powerful tool, if used properly. Almost any type of present interest may be gifted, but some assets are more advantageous from a tax perspective than others. In general, if an asset has a relatively low basis, then it will be better to hold on to that asset and dispose of it at death so that the recipient will receive a step up in basis, which will result in a lower capital gain being attributed to him or her if he or she should decide to sell that asset.

Granting conservation easements is another way of lowering the size of the Taxable Estate, and also of receiving income tax deductions. Oftentimes a conservation easement is granted that will prevent development of the land, but which allows the landowner to otherwise use and enjoy the property exclusively just as he or she had before. Conservation easements reduce Estate Taxes in two ways: first, to the extent that a valuable interest in land has been given up, the value of that land for determining the size of the estate is reduced, and, second, IRC 2031(c) provides an additional exclusion regarding land upon which a conservation easement has been given. And, for my Indiana readers, I would recommend visiting <http://indianalandtrusts.org/> to find out more about local opportunities for granting conservation easements.

Another method available to farmers for lowering the Taxable Estate is utilization of IRC 2032A Special Use Valuation. Special Use Valuation may be elected by the decedent's estate if certain criteria are met, and allows for farmland to be appraised based upon its value in its use as farmland as opposed to being appraised based upon its fair market value. This can be a very effective strategy if farming operations will be continued for the foreseeable future. Although, the aggregate decrease in value of qualified real property resulting from the application of IRC 2032A may not exceed \$960,000 for those dying in 2008.

But if it is not possible to get the Taxable Estate below the exemption equivalent, there are still options. The first option is to make funds available to meet the Estate Tax obligation without incurring additional estate taxes. And the second option, if all else fails, is to stretch out the time in which the Estate Tax obligation may be fulfilled.

Life insurance can be used to provide the cash necessary to pay off the Estate Tax obligation, but the problem with life insurance is that any policy owned by the decedent is includible in his or her estate and thus increases the amount of tax due. There is, however, a way around this dilemma. By establishing an Irrevocable Life Insurance Trust (ILIT), it is possible to make cash available without triggering an increase in the amount of tax due. There are two tricks to making an ILIT function properly. The first is to prevent the Trustmaker from having any incidents of ownership. This is done by naming an irrevocable trust as the owner and beneficiary of the policy. The second is to structure the premium payments on that life insurance policy so that those payments constitute a gift of a present interest. In order to make this happen it is necessary that the beneficiary of the trust have an opportunity to withdraw the funds set aside for premium payments for some specified number of days (frequently thirty) after which this right may lapse. Failure as to either of these may result in undesirable estate tax consequences.

Finally, if it has not been possible to reduce the Taxable Estate to a point where no tax is due and if funds are not available to pay off the Estate Tax obligation, then it may be possible to stretch out the payments. IRC 6166 states that in situations where an interest in closely held business, such as a family farm, makes up more than 35% of the value of the adjusted gross estate of a decedent who was a citizen or resident of the United States, the executor may elect to pay the tax in ten annual installments of equal amounts. Additionally, the executor may delay making the first annual installment for up to five years, during which time only interest payments will be due. Of course, there are several drawbacks to this strategy: interest will be incurred, the IRS may require a bond or lien, final distribution will be delayed, and if a payment is six months late, then the IRS can accelerate the estate's payment obligation.

Please join me next time for: **Indiana Inheritance Tax or One More Reason to Move to Florida.**