CHAPTER 2

OVERVIEW OF TAXES

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Introduction

Farmers, as well as other taxpayers, pay a wide variety of taxes to federal, state and local governments. This chapter provides a brief overview of those taxes to help you understand the context of the tax planning discussed in the chapters that follow.

Property Taxes

Property taxes are imposed on the value of the property you own. The most common property tax is the real property tax imposed by local governments. This tax is generally the principal source of revenue for local governments. Some jurisdictions also impose a property tax on the value of certain personal property, such as motor vehicles licensed for use on public roads and equipment used in a business.

In most jurisdictions, property tax is computed annually by multiplying the assessed value of the property by that year's tax rate. The local government sends a tax bill to each property owner that details how the tax is calculated and when the payment or payments are due.

A failure to pay property taxes results in a tax lien on the property. The lien allows the local government to foreclose on the property, sell it at a public auction, and apply the sales proceeds to the unpaid taxes.

Local governments typically set the tax rate by dividing their approved budgets by the total assessed value of the real property subject to the tax. Therefore, the tax you pay depends on the assessed values of your property relative to the assessed values of all the other property in the local government's jurisdiction. If the assessed value of all property in a jurisdiction increases by 10% but the government's budget does not change, the amount of tax due on each property stays the same because the tax rate decreases by the same 10%.

In some states, land used for farming purposes is assessed at it use value rather than at its fair market value. The use value reflects the value of the property to a farming business rather than the amount a buyer would pay for it for an alternative use, such as recreation or development. The formula for computing the use value of farm land is typically based on commodity prices, farm land rental rates, or other measures of the ability of the land to produce income in a farming business. The threshold requirements for use valuation vary by state, but they generally involve evidence of agricultural use, such as planting crops or grazing livestock.

Planning Pointer

Satisfy Use-Value Requirements

In some cases, a small change in your use of land may make it eligible for use valuation and a reduction in property taxes. Changes that cost you less than the taxes you save increase your after-tax income.

Sales Taxes

Most state governments and many local governments impose a sales tax on purchases of goods and some services. The sales tax is collected at the point of purchase by the vendor, who then remits the taxes to the government.

A number of goods are exempt from sales taxes for a variety of reasons. The most common exemption is food purchased in grocery store. Goods purchased as an input for manufacturing are exempt because sales tax will be collected when the final product is sold. Most states have a sales tax exemption list of farm inputs, such as equipment, seeds, feed, fertilizer, lubricants, animal bedding, and livestock drugs. To qualify for a sales tax exemption that is based on the buyer's use of the good, the buyer generally must provide the seller an exemption certificate or other evidence that the purchase is sales tax-exempt.

In most states, farmers who regularly sell goods that are subject to sales tax must obtain a seller's permit and an identification number, and they must collect the sales tax at the point of sale. The collected sales taxes must be remitted to the government periodically with a tax return that reports the taxable sales.

Sellers are not required to collect sales tax on goods shipped to out-of-state buyers if the seller does not have a sufficient physical presence in the buyer's state to be treated as doing business in that state.

Use Taxes

Purchases that would be subject to a state or local sales tax if the seller had a physical presence in the buyer's state are subject to an equivalent tax called the use tax. Buyers are responsible for self-reporting and paying use tax, generally when they file their state income tax returns. Unlike sales tax, use tax is not collected at the point of sale, and unlike property tax, the government does not send a use-tax bill.

Example 2.1 Use Tax

Seth Shapiro bought a computer from an out-of-state seller that had no retail location in Seth's state. The seller was not required to collect—and did not collect—sales tax on Seth's purchase. If Seth purchased the computer from a seller in his own state, the seller would collect a 6% sales tax from Seth and remit it to the state government. Seth must report the purchase to his state government and pay a 6% use tax.

Excise Taxes

Like sales taxes, excise taxes are usually collected by the seller from the buyer at the point of sale. However, an excise tax differs from a sales tax in three ways:

1. An excise tax applies to a narrow range of products, such as tobacco products. A sales tax applies to most goods and some services.
2. An excise tax is based on the number of units purchased, such as cartons of cigarettes or gallons of gasoline. A sales tax is based on the amount paid.
3. An excise tax is usually a much greater proportion of the total sales price than a sales tax.

Fuels used in farming are not subject to the federal excise tax that is collected on fuels used in vehicles driven on public roads. Farmers can claim a credit on their federal income tax returns for the excise taxes they paid when they purchased the gasoline if they use the gasoline for a farming purpose. If farmers purchase diesel fuel and use it for a farming purpose, they can either claim a credit on their federal income tax returns or file a refund claim for the excise taxes paid on the diesel fuel.

Cross-Reference

See Chapter 14 of IRS Publication 225, *Farmer's Tax Guide (for 2010)*, for more details on the excise taxes on gasoline and diesel fuel.

Gift Taxes

A gift tax is imposed on the value of gifts made during the donor's life. The federal government and several states collect a gift tax. The amounts that can be given tax-free and the gift tax rates vary from state to state. This brief overview discusses only the federal gift tax.

✔ **Note**

Rules are More Complex

The rules for computing the gift tax are more complex than this summary indicates; this summary focuses on the effect of those tax rules. See IRS Publication 950, *Introduction to Estate and Gift Taxes*, and the instructions to IRS Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for more information on gift taxes.

Annual Exclusion

The federal gift tax rules include an annual exclusion. For 2011, donors may exclude from the gift tax the first $13,000 given to each of any number of individuals. The $13,000 amount is adjusted for inflation, so it may be a different amount in future years, but it will always be an even multiple of $1,000. In addition to the $13,000 (as adjusted for inflation), payments for the benefit of another individual are excluded from taxable gifts if they are made directly to an institution of higher learning or to a person or entity that provides medical care to the individual.

Example 2.2 Gift Tax Annual Exclusion

Guaming Yang gave $113,000 to each of her three children in 2011. Guaming's taxable gifts for 2011 total $300,000, because the first $13,000 transferred to each child is excluded from taxable gifts.

Gifts Between Spouses

Gifts of any amount to the donor's spouse are excluded from taxable gifts. Therefore, spouses can give as much as they want to give to each other and they will not be subject to the federal gift tax on those gifts.

Gifts to Charity

Gifts of any amount to qualified charities are excluded from taxable gifts. Therefore, an individual can reduce his or her taxable estate without paying any gift tax by making donations to qualified charities.

Federal Gift Tax Rate

The effective federal gift tax rate for taxable gifts in 2011 and 2012 is 35%. That rate is scheduled to increase for cumulative taxable gifts exceeding $500,000 in 2013 and later years. The rate is scheduled to be progressively higher for gifts in higher brackets until it reaches 55% for cumulative taxable gifts exceeding $3,000,000.

Applicable Exclusion Amount

An applicable credit amount offsets the federal gift tax on the first $5,000,000 of taxable gifts in 2011 and 2012. The applicable exclusion amount was $1,000,000 for gifts in 2002 through 2010 and it is scheduled to revert to the $1,000,000 amounts for gifts after 2012. Unlike the annual exclusion, each donor has only one applicable exclusion amount for cumulative taxable gifts made to all donees. The applicable exclusion amount for gifts in any tax year is reduced by the donor's prior taxable gifts that were tax-free because of the gift tax applicable exclusion amount in effect at the time of the prior gifts.

Example 2.3 Gift Tax Applicable Exclusion Amount

John James made no taxable gifts before 1999, when he gave each of his three children $210,000. The 1999 annual exclusion was $10,000, which reduced each taxable gift to $200,000, for a total of $600,000 of taxable gifts. The $650,000 gift tax applicable exclusion amount for 1999 resulted in no gift tax on the $600,000 taxable gifts.

In 2011, John gave his children another $500,000 in taxable gifts. The $1,000,000 gift tax applicable exclusion amount for 2011 is reduced by the $600,000 taxable gift that was tax-free in 1999. Therefore, only the first $400,000 ($1,000,000 – $600,000) of John's $500,000 taxable gifts in 2011 is tax-free. The gift tax on the remaining $100,000 is $35,000 (35% × $100,000).

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If John's taxable gift in 1999 had been $700,000 (or any amount over $650,000), the 1999 $650,000 gift tax applicable exclusion amount would have allowed only the first $650,000 to pass tax-free. Therefore, the 2011 $1,000,000 gift tax applicable exclusion amount would be reduced by the $650,000 gift that was tax-free in 1999. Only $350,000 of John's $500,000 2011 taxable gift would then be tax-free. The gift tax on the remaining $150,000 would be $52,500 (35% × $150,000).

Planning Pointer

Opportunity in 2011 and 2012

Taxpayers may want to make gifts in 2011 and 2012 to take advantage of the $5,000,000 applicable exclusion amount. Congress could increase the applicable exclusion amount for 2013 and later years, but the increase, if any, might not raise the applicable exclusion amount to the current $5,000,000.

Estate Taxes

An estate tax is imposed on the value of a decedent's taxable estate. The federal government and several states collect an estate tax. The amounts that can be passed tax-free and the estate tax rates vary from state to state. This brief overview discusses only the federal estate tax.

✔ **Note**

Rules are More Complex

The rules for computing the estate tax are more complex than this summary indicates; but this summary explains the effect of those tax rules. See IRS Publication 950, *Introduction to Estate and Gift Taxes*, and IRS Publication 559, *Survivors, Executors, and Administrators*, for more information on estate taxes.

Gross Estate

For purposes of the federal estate tax, a decedent's gross estate includes the value of all property the decedent owned—directly or indirectly—at the time of death. In addition to the decedent's tangible assets (such as cash, bank accounts, personal property, and real estate), the gross estate includes intangible assets (such as life insurance owned by the decedent) and annuities payable to the decedent or the decedent's heirs.

✔ **Note**

Probate Estate Is Different

Some assets that are excluded from a decedent's probate estate are included in the decedent's federal estate tax gross estate. For example, if the decedent owned a life insurance policy on his or her life and the proceeds are payable to a beneficiary other than the decedent's estate, the policy is excluded from the probate estate but it is included in the federal estate tax gross estate.

Taxable Estate

A decedent's taxable estate is the gross estate reduced by deductions for debts owed by the decedent, funeral expenses, amounts that pass to the decedent's spouse, amounts going to a charity, and state death taxes.

Applicable Exclusion Amount

An applicable credit amount offsets the federal estate tax on the first $5,000,000 of the taxable estate for deaths in 2011 and 2012. The applicable exclusion amount is scheduled to be $1,000,000 for deaths after 2012. The applicable exclusion amount is reduced by the donor's taxable gifts that were tax-free because of the gift tax applicable exclusion amount in effect at the time of the gifts.

Example 2.4 Estate Tax Applicable Exclusion Amount

Rhonda Rodriguez made no taxable gifts before giving her children $500,000 of taxable gifts in 2008. The $1,000,000 gift tax applicable exclusion amount for 2008 resulted in no gift tax on the $500,000. Rhonda died in 2011, leaving her entire $6,000,000 estate to her children.

The 2011 estate tax $5,000,000 applicable exclusion amount is reduced by the $500,000 taxable gift that was tax-free in 2008 because of the 2008 gift tax applicable exclusion amount. Therefore, the first $4,500,000 of Rhonda's estate is tax-free. The estate tax on the remaining $1,500,000 is $525,000 (35% of $1,500,000).

If Rhonda's taxable gift in 2008 had been $1,200,000 (or any amount over $1,000,000), the $1,000,000 gift tax applicable exclusion amount would have allowed $1,000,000 to pass tax-free. Therefore, upon Rhonda's death in 2011, the 2011 $5,000,000 estate tax applicable exclusion amount is reduced by the $1,000,000 gift that was tax-free in 2008, and $4,000,000 of Rhonda's estate is tax-free. The estate tax on the remaining $2,000,000 is $700,000 (35% of $2,000,000).

Inheritance Taxes

An inheritance tax is imposed on a person who inherits property. There is no federal inheritance tax, but some states impose an inheritance tax on the value of money and other property that is inherited from a decedent.

Inheritance tax rules vary from state to state, but most states have an exemption amount that is not taxed and tax rates that increase as the amount that is inherited increases. Exemptions and rates often vary by the relationship of the heir or beneficiary to the decedent. An inheritance from a spouse might not be taxed, and an inheritance by a child might have a large exemption amount and low tax rates on the amount above the exemption amount. The exemption amount might decrease and the tax rates increase for inheritances from more distant relatives, with the lowest exemption amount and the highest tax rates applying to an inheritance from an unrelated decedent.

Income Taxes

An income tax imposes a tax on the taxpayer's income. The federal government, most state governments, and some local governments collect an income tax. Many state and local income taxes are based on the federal income tax rules, with varying adjustments. This brief overview discusses only the federal income tax.

Figure 2.1 summarizes the income tax computation by outlining the steps taxpayers follow on Form 1040, U.S. Individual Income Tax Return.

FIGURE 2.1 Outline of Federal Income Tax Calculation

Gross Income
– Above-the-line deductions
= Adjusted gross income
– Standard deduction or itemized deductions
– Personal and dependent exemptions deduction
= Taxable income
× Income tax rates
= Income tax
– Credits
+ Other taxes
= Total tax
– Tax payments during the tax year
= Tax due with return or tax refund

Gross Income

The Sixteenth Amendment to the United States Constitution gives Congress the power to collect taxes on income. Congress used that power by defining gross income as "all income from whatever source derived." Because of that broad definition, an increase in wealth is included in taxable income unless it is specifically excluded. For example, Congress excludes an increase in the value of property from gross income until there is a taxable event, such as a sale.

Form 1040 provides separate lines to report several categories of income, such as wages, interest, dividends, refunds, alimony, distributions from retirement plans, unemployment compensation, and social security benefits.

An individual's gross income from a sole proprietorship is reported on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship); Schedule E (Form 1040), Supplemental Income and Loss; or Schedule F (Form 1040), Profit or Loss From Farming. The related business expenses, which are some of the above-the-line deductions, are also reported on those forms. Only the net business income is reported on Form 1040.

Similarly, proceeds from selling assets that qualify for capital gain treatment are reported on Schedule D (Form 1040), Capital Gains and Losses. The income tax bases of those assets are also reported on Schedule D (Form 1040 and subtracted from the sale proceeds before the net amount is carried to Form 1040.

An individual's share of income from flow-through entities—such as partnerships, S corporations, and trusts—is reported first on Schedule E (Form 1040) and then carried to Form 1040.

Gross income that does not fall within any category on the itemized lines on Form 1040 is reported on a line called "Other income" (line 21 on the 2010 form).

Because deductions are subtracted from business income before it is reported on Form 1040, an individual's total gross income does not show up in any one place on the income tax return, and there is no line labeled "gross income." The sum of the income and losses that are reported in the income section of Form 1040 (line 22 of the 2010 form) is appropriately labeled "total income."

Adjusted Gross Income

Adjusted gross income (AGI) is an important number in the income tax calculation because it is used as a base for some other calculations. For example, medical expenses can be deducted only to the extent they exceed 7.5% of AGI. Most miscellaneous itemized deductions reduce taxable income only to the extent the total exceeds 2% of AGI.

AGI is calculated by subtracting any remaining above-the-line deductions from total income (business expenses and the bases of assets were already deducted on other schedules). The remaining above-the-line deductions include educator expenses, health savings account contributions, moving expenses, one-half of self-employment taxes, the cost of self-employed health insurance, certain retirement plan contributions, alimony, interest paid on student loans, deductible tuition and fees, and the domestic production activities deduction.

Including a deduction in the above-the-line category, rather than as an itemized deduction, has three effects on tax liability:

1. Above-the-line deductions can be claimed even if the taxpayer claims the standard deduction instead of itemizing deductions.
2. Above-the-line deductions are not subject to the floors that reduce some itemized deductions.
3. Above-the-line deductions reduce AGI, which affects other tax calculations as described earlier.

Standard Deduction

If a taxpayer does not elect to itemize deductions, he or she subtracts the standard deduction from AGI. Standard deductions vary by filing status, dependency status, and the taxpayer's age, and are increased for taxpayers who are legally blind.

Cross-Reference

See Figure 13.1 in Chapter 13 of this guide for a list of the 2011 standard deductions.

Itemized Deductions

Itemized deductions are personal expenses for which Congress specifically allows a deduction. They include medical and dental expenses (to the extent the total exceeds 7.5% of AGI); state and local taxes; interest on a home mortgage; gifts to charities; casualty and theft losses of property used for personal (rather than business) purposes; employee business expenses; investment expenses; and tax preparation expenses.

In most cases, taxpayers should elect to itemize their deductions if the total exceeds their standard deduction. However, a married person who files separately cannot itemize his or her deductions if his or her spouse claims the standard deduction.

Personal and Dependent Exemptions Deduction

Congress allows a set amount ($3,700 for 2011) to be deducted from AGI for each taxpayer filing the tax return and the dependents of those taxpayers. For example, a married couple with three children who file a joint income tax return can claim two personal exemptions and three dependent exemptions. For 2011, their personal and dependent exemptions deduction is $18,500 (5 × $3,700).

Taxable Income, Income Tax Rates, and Income Tax

Taxable income is the remainder after itemized deductions or the standard deduction and the personal and dependent exceptions deduction are subtracted from AGI. It is the base to which the tax rates are applied to compute income tax liability.

The income tax rates are graduated, which means that a higher tax rate applies to higher levels of income. The higher rates apply only to the income above the threshold for each rate and not to the income below that threshold.

Example 2.5 Income Tax Rates

Victor and Maria Gomez reported $50,000 of taxable income on their 2011 joint income tax return. For 2011, the joint return tax rate on the first $17,000 of taxable income is 10% and the tax rate for the next $52,000 is 15%. Therefore, the Gomezes' 2011 income tax is $6,650, as shown in Figure 2.2.

FIGURE 2.2 Gomez's 2011 Income Tax

Tax on first $17,000 of taxable income ($17,000 × 10%)		$1,700
Tax on amount over $17,000		
Amount over $17,000 ($50,000 – $17,000)	$33,000	
Tax rate	× .15	
Tax on $33,000		4,950
Total tax		$6,650

The federal income tax rate on long-term capital gains and qualified dividends is the lesser of the ordinary income tax rate or the tax rate for long-term capital gain. For 2011, the tax rate for most long-term capital gains is 0% for eligible gains and dividends included in total taxable income that does not exceed the 10% and 15% ordinary income tax brackets. It is 15% for eligible long-term capital gains and dividends included in income that would be taxed in the 25% or higher ordinary income tax brackets.

Example 2.6 Tax Rates for Capital Gain

Victor and Maria Gomez, from Example 2.5, have $25,000 of long-term capital gains in addition to their $50,000 of ordinary income. Because the 15% ordinary income tax bracket for married filing jointly ends at $69,000 for 2011, $19,000 ($69,000 – $50,000) of their $25,000 long-term capital gain falls within the 15% tax bracket when it is added to their ordinary income. That $19,000 of long-term capital gain is taxed at the 0% capital gain rate.

The remaining $6,000 ($25,000 – $19,000) of long-term capital gain falls within the 25% ordinary income tax bracket and is taxed at the 15% capital gains rate. With the addition of the $25,000 long-term capital gain, the Gomezes' 2011 income tax is $7,550, as shown in Figure 2.3.

FIGURE 2.3 Gomez's 2011 Income Tax

Tax on first $17,000 of ordinary taxable income ($17,000 × 10%)		$1,700
Tax on ordinary income over $17,000		
Amount over $17,000 ($50,000 – $17,000)	$33,000	
Tax rate	× .15	
Tax on $33,000		4,950
Tax on first $19,000 of capital gain ($19,000 × 0%)		0
Tax on capital gain over $19,000		
Amount over $19,000 ($25,000 – $19,000)	$ 6,000	
Tax rate	× .15	
Tax on $6,000		900
Total tax		$7,550

Credits

If the alternative minimum tax (see Chapter 9 of this guide) is owed, it is added to the income tax liability before nonrefundable credits are subtracted. These credits include the foreign tax credit; the credit for child and dependent care expenses; education credits, such as the Hope credit and the lifetime learning credit; the retirement savings contribution credit; the child tax credit; residential energy credits; and others.

The order in which credits are subtracted is important because some credits are refundable and some are not. If the amount of tax due before a refundable credit is applied is less than the refundable credit, the excess amount of the credit can be received as a refund. By contrast, if a nonrefundable credit exceeds the amount of tax due, the credit can be used only to reduce the tax to zero. The excess is not refundable.

Observation

Benefit of Credits

Because tax credits offset tax liability, the benefit of a credit is the same for both high- and low-bracket taxpayers if there is a tax liability for the credit to offset or if the credit is refundable. By contrast, the benefit of a tax deduction depends on the tax bracket of the taxpayer. A $100 deductions from income in the 35% bracket saves the taxpayer $35 of taxes. A $100 deduction from income in the 15% bracket saves the taxpayer $15 of taxes.

Other Taxes

Taxes that cannot be reduced by nonrefundable credits are added to the net tax due after the credits are subtracted. These taxes include the self-employment tax; social security and Medicare taxes that were not already paid on tips and wages; and other taxes.

Total Tax, Tax Payments, and Tax Due

Payments include withholding and estimated payments and refundable credits. They are subtracted from the total tax liability to arrive at the tax balance that is due with the return or the tax refund that the IRS will send to the taxpayer.

Employment Taxes

Most wages paid to employees are subject to Federal Income Contributions Act (FICA) taxes and Federal Unemployment Tax Act (FUTA) taxes.

Cross-Reference

See Chapter 13 of IRS Publication 225, *Farmer's Tax Guide (for 2010)*, for more information on FICA and FUTA taxes.

FICA Taxes

Both the employer and the employee must pay FICA taxes on the employee's wages.

The FICA tax is comprised of two taxes. One is the social security tax (also called old-age, survivors, and disability insurance), which funds social security benefits, including disability, retirement, and survivor benefits. Since 1990, the social security tax rate has been 6.2% for both the employer and the employee. For wages paid in 2011, the social security tax rate for employees is temporarily reduced to 4.2%. The social security tax applies only up to an inflation-adjusted wage base, which is $106,800 for wages paid in 2011.

The second tax included in FICA taxes is the Medicare tax (also called hospital insurance), which funds Medicare payments. Since 1986, the Medicare tax rate has been 1.45% for both employers and employees. Unlike the social security tax, there is no wage limit for the Medicare tax. Employers and employees owe this tax on all wages.

Combined, the social security tax and the Medicare tax impose a 7.65% tax on both employers and employees (5.65% for employees on wages paid in 2011) for the first $106,800 (for 2011) of wages and a 1.45% tax on wages over $106,800 (for 2011).

Employers must withhold the employee's share of FICA taxes from wages and remit both the employee's share and the employer's share to the United States Treasury. Employers then report the wages and taxes on employment tax returns filed with the IRS.

FUTA Taxes

Famers must pay FUTA taxes if they meet either of the following tests:

1. They pay $20,000 or more to farmworkers in any calendar quarter during the current or preceding calendar year, or
2. They employ 10 or more farmworkers for some part of at least 1 day during any 20 or more different calendar weeks during the current or preceding calendar year.

Noncash Wages

Noncash wages paid to farmworkers are not subject to FICA or FUTA taxes. Noncash wages include food, lodging, clothing, transportation passes, commodities, and other goods and services.

Planning Pointer

Social Security Benefits

Paying noncash wages to farmworkers saves FICA taxes for both the employer and the employee and saves FUTA taxes for the employer. However, noncash wages are not counted as earned income for calculating social security benefits. Therefore, employers and employees should compare the FICA and FUTA taxes saved with the social security benefits lost by paying noncash wages.

Self-Employment Taxes

Instead of paying FICA taxes on wages, self-employed individuals pay self-employment tax on their self-employment income. Like the FICA tax, the self-employment tax is comprised of the social security tax and the Medicare tax. The social security and Medicare tax rates equal the sum of the rates paid by the employer and the employee on wages. Therefore, the self-employment tax rate is 12.4% (10.4% in 2011) and the Medicare tax rate is 2.9%.

The wage base that limits the social security tax to the first $106,800 (for 2011) of wages also limits the social security component of the self-employment tax to the first $106,800 (for 2011) of self-employment income. If a taxpayer receives both wages and self-employment income, the base for self-employment taxes is reduced by the wages he or she receives.

Cross-Reference

See Chapter 12 of IRS Publication 225, *Farmer's Tax Guide (for 2010)*, for more information on the self-employment tax.

Summary

Farmers must pay several different taxes that vary in their complexity and the way they are collected. Effective farm management includes minimizing taxes. However, some taxes are easier to manage than others.