



KENTUCKY FARM BUSINESS MANAGEMENT PROGRAM STATE NEWSLETTER

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ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001 AND OTHER INCOME TAX ISSUES

by Craig D. Gibson

The Economic Growth and Tax Relief Reconciliation Act of 2001 is viewed as the largest tax reduction legislation since 1981. A wide range of provisions affecting individual taxpayers are found. However, many provisions involve “phase-in” rules with some benefits of the changes not realized until five or even ten years from enactment.

A major concern of this legislation lies with the automatic “sunset” provision. Without additional legislation, all of the changes resulting from this legislation disappear at the end of 2010. The rules in effect prior to this legislation will then be reinstated.

For planning purposes, we will provide some changes that will result from the 2001 legislation. We have tried to keep our summary of the new law as brief as possible with emphasis in areas that relate to agriculture. However, most of the changes relate to individual taxpayers.

The Limit on Itemized Deductions is Repealed

For tax years beginning after 2009, the limitation on deductions for higher-income individuals is repealed. The repeal is phased in over a five-year period beginning in 2006. Taxpayers affected are married taxpayers filing jointly, surviving spouses, single individuals, and heads of households with adjusted gross incomes more than \$132,950, and married taxpayers filing jointly with adjusted gross incomes more than \$66,475. These threshold amounts are for 2001 and are adjusted for inflation annually.

The Personal Exemption Phase Out for High-Income Taxpayers

For tax years beginning after 2009, reduction in the personal exemption deduction due to higher-incomes is repealed. The repeal is phased in over a five-year period beginning in 2006. The threshold amounts by which the reduction in the personal exemption deduction takes place are adjusted gross income amounts greater than \$199,450 (for a joint return or surviving spouse), \$166,200 (for head of household), \$132,950 (for an unmarried taxpayer that is neither a surviving spouse nor head of household), and \$99,725 (for married taxpayers filing separately). These threshold amounts are for 2001 and are adjusted for inflation annually.

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Marriage Penalty Relief

The standard deduction for married taxpayers filing jointly will increase beginning in 2005. Over a five-year period, the standard deduction will increase such that the standard deduction will eventually equal twice the amount applicable to a single taxpayer.

The size of the 15% tax-rate bracket for married taxpayers filing jointly will gradually increase beginning in 2005. Over a four-year period, the range of income taxed at 15% will gradually increase until it reaches twice the size of the 15% bracket applicable to a single taxpayer.

Tax Credits

Beginning in 2002, Earned Income Credit (EIC) is simplified. Earned income, for purposes of EIC, is defined as only taxable income and does not include nontaxable employee compensation. EIC is calculated based on the taxpayer's adjusted gross income. The beginning and the end of the phase out range for joint filers are increased by \$1,000 for tax years beginning in 2002, 2003, 2004.

The Child Tax Credit (CTC) will gradually be doubled from the 2000 level of \$500-per-child, reaching \$1,000 in 2010. For 2001, the credit will equal \$600 per child and will continue at that level through the 2004 tax year.

The Dependent Care Credit, where a tax credit is given based on employment-related expenses, is changed for tax years beginning after 2002. The maximum percentage credit is increased from 30 percent to 35. The maximum amount of eligible employment-related expenses is increased from \$2,400 to \$3,000 if there is one qualifying child or dependent, and from \$4,800 to \$6,000 if there are two or more. The income threshold for reduction of the credit is increased to \$15,000 from \$10,000. For taxpayers with an adjusted gross income more than \$43,000, the credit percentage is limited to 20 percent.

Individual Retirement Accounts (IRAs)

The maximum amount of tax-favored contributions to IRAs will gradually increase from the current \$2,000 limit to \$5,000 in 2008, and will then be adjusted for inflation. Individuals who have attained age 50 will be permitted to make additional "catch up" contributions to their IRAs. The following shows the maximum dollar contribution limits for tax years beginning in 2002 and after.

Other limitations related to IRAs that have not changed, but are significant, include: Individuals can only make contributions to an IRA if they have earned income. Contribution limits are the lesser of earned income or the amounts showed above. Deductible traditional IRA contributions continue to be limited when individuals are active participants in an employer-sponsored retirement

Table 1: Maximum dollar contributions for IRAs

For Tax Years Beginning:	Contribution limits for taxpayers age 50 and over	Contribution limits for taxpayers under age 50
2002-2004	\$3,500	\$3,000
2005	\$4,500	\$4,000
2006-2007	\$5,000	\$4,000
2008 and after	\$6,000	\$5,000

plan. The contribution to a Roth IRA is limited for single individuals where the adjusted gross income is greater than \$95,000 (with the full phase-out occurring at \$110,000). For married individuals filing a joint return, the adjusted gross income threshold is \$150,000 (with the full phase-out occurring at \$160,000).

Pension Contributions

The new law increases the dollar limits on certain retirement and income deferral plans. In addition, for individuals who are at least age 50 before the end of the plan year, the current dollar limits on elective deferrals are increased for Code Sec. 401(k) qualified cash or deferred arrangement plans, Code Sec. 408(p) tax-sheltered annuities, Code Sec. 408(k) SEPs, Code Sec. 408(b) SIMPLEs, and certain other elective deferrals.

Tax Credit for Elective Deferrals and IRA Contributions

To encourage low- and middle-income taxpayers to establish or maintain private savings accounts for retirement, a temporary non refundable tax credit for contributions or deferrals to retirement savings plans is established. This credit is in addition to the dollar amount exclusion from gross income in calculating income tax. The maximum credit is 50 percent of the savings contribution to a qualified retirement savings plan (not to exceed \$2,000 in contribution or a \$1,000 credit). To attain the maximum credit, adjusted gross incomes must be less than or equal to \$30,000 (joint returns), \$22,500 (head of household), or \$15,000 (all other cases). The credit decreases as adjusted gross incomes become greater. There is no credit when adjusted gross incomes equal \$50,000 (joint returns), \$37,500 (head of household), or \$25,000 (all other cases). To be eligible, the taxpayer must be 18 years of age and is not claimed as a dependent on another income tax return. Provisions become available in tax years after 2001 and expire in tax years after December 31, 2006.

Alternative Minimum Tax (AMT)

The AMT exemption amounts will increase for tax years 2001 through 2004 by \$4,000 for joint filers and surviving spouses, and by \$2,000 for other individual taxpayers. However, the increase in the AMT exemption amount ceases to apply in tax years beginning in 2005 or later. The following illustrates the exemption amounts by tax period.

Table 2: AMT exemption amounts

Tax Years	Single, Other Than Surviving Spouse	Married, Separate Return	Estates and Trusts	Married, Joint Return
2001-2005	\$35,750	\$24,500	\$22,500	\$49,000
2005-	\$35,750	\$22,500	\$22,500	\$45,000

Other Income Tax Issues

It seems that tax certain issues are annually brought forth by the experts. This year is no exception. Although these issues are not necessarily directly related to the 2001 tax legislation, they do have relevance to taxpayers and are noted in the following.

Income Averaging

Income averaging was made available to farmers for the 1998 tax year. Initially, the averaging calculations did not allow negative taxable income in base years (i.e., the three years prior to the tax year being averaged). New interpretation now allows negative taxable income in the base years. Therefore, any farmer that had negative taxable income in base years may wish to amend the income tax return(s) affected by the new interpretation. Amended returns can be filed for 1998, 1999, and 2000. Farmers may look for a Schedule J in their income tax return to see if income averaging was used in any of the three preceding tax years.

Prepaid Expenses: Change of plans

Farmers are allowed to deduct the cost of supplies even if the supplies are used in the following tax year. But two sets of rules must be met. These rules are familiar to most producers and are as follows:

Rule 1:

C The expenditure must be a payment for the supply rather than a deposit.

C The prepayment must be made for a business purpose and not tax avoidance.

C The deduction must not result in a material distortion of income.

Rule 2:

C Prepaid expenses shall not exceed 50% of deductible expenses other than the prepaid expenses unless the taxpayer is a "qualified farm-related taxpayer."

A change of plans may create the situation whereby the purchased supplies are not used and a credit balance results

with the vendor from whom the supplies were purchased. In the situation that the vendor reimburses the credit balance, careful documentation is necessary to

show that the vendor is reimbursing a credit balance that represents an unused quantity at the same per unit price as originally paid. Failure to document such suggests a reimbursement of a "deposit". Deposits to a vendor are not the same as the purchase of supplies and risk being disallowed as a deduction in the year the deposit is made.

Promissory Notes to Suppliers

A farmer that pays for farm inputs by giving the vendor a promissory note cannot claim a deduction for the inputs. Instead, the deduction is allowed in the tax year the promissory note is paid. In contrast, if farm inputs are paid with loan proceeds from a third party, the deduction for the inputs is allowed in the tax year the inputs are paid. A lending subsidiary of the vendor from whom farm inputs is purchased may not be considered a "third party" in the eyes of Internal Revenue Service.

In year-end tax planning, farmers must take special care in the last two items mentioned. Cash basis farmers are able to effectively "plan" their tax liabilities. It must be done properly!

CHANGES IN ESTATE AND GIFT TAX

by Rush Midkiff

The Economic Growth and Tax Relief Reconciliation act of 2001 made major changes to Estate and Gift Taxes.

Repeal of estate and generation-skipping transfer tax

Effective for decedents dying after December 31, 2009, the estate and generation-skipping tax will be repealed. **Only** the gift tax will be in effect after December 31, 2009.

Reductions of estate and gift tax rates for 2002

Effective for estates of decedents dying, and gifts made, after December 31, 2001, the top marginal estate and gift tax rate is reduced to 50 percent, applicable to amounts in excess of \$2.5 million. The new law provides for additional rate reductions in the maximum rate for future years. See Table 3.

Increase in estate tax applicable exclusion amounts

The applicable exclusion amount for estate (but not gift) tax purposes will gradually increase to \$3.5 million by 2009 (the year prior to repeal of the estate and generation-skipping transfer taxes). The exclusion amounts for years prior to 2009 are in Table 3.

Increase in gift tax applicable exclusion amounts

The applicable exclusion amount for gift tax purposes will increase to \$1 million in 2002 and remain at that level. This amount will not be indexed for inflation.

Qualified Family-Owned Business Deduction Repealed

The Taxpayer Relief Act of 1997 made available a new exclusion from the gross estates of individuals holding certain family-owned business interests. This exclusion is repealed for the estates of decedents dying after December 31, 2003.

Phase Out of State Death Tax Credit

The state death tax credit now available will be reduced beginning in 2002 and will continue to decrease until it is repealed entirely in 2005. Beginning in 2005, the credit for state death taxes will be replaced by a deduction for the same. In other words, state death taxes will become a deduction from the gross estate value in calculating federal estate taxes.

New carryover basis rules

For property acquired from a decedent dying after December 31, 2009, the income tax basis of property acquired from a decedent will generally be “carried over” or passed from the decedent. The recipient of the property will receive a basis equal to the lessor of the adjusted basis of the property in the hands of the decedent, or the fair market value of the property on the date of the decedent’s death. However, the new law grants the executor of a decedent’s estate the

Table 3: Important Changes to the Estate and Gift Tax Based on the Economic Growth and Tax Relief Reconciliation Act of 2001

Year	Estate Tax Exemption Amount	Gift Tax Exemption Amount	Generation Skipping Transfer Tax Exemption Amount	Maximum Estate and Gift Tax Rates
2001	675,000	675,000	1,000,000	0.55
2002	1,000,000	1,000,000	1,000,000	0.5
2003	1,000,000	1,000,000	1,000,000	0.49
2004	1,500,000	1,000,000	1,500,000	0.48
2005	1,500,000	1,000,000	1,500,000	0.47
2006	2,000,000	1,000,000	2,000,000	0.46
2007	2,000,000	1,000,000	2,000,000	0.45
2008	2,000,000	1,000,000	2,000,000	0.45
2009	3,500,000	1,000,000	3,500,000	0.45
2010	Repealed	1,000,000	Repealed	0.35

- C Beginning 2010, Property passing through a Decedent’s Estate will have carryover basis as opposed to “Stepped Up” or fair market value basis, subject to the following exceptions: (1) Each estate will have \$1,300,000 of basis to be allocated to property; (2) Estates will be allowed an additional \$3 million of basis, to be allocated among the assets passing to a surviving spouse; (3) Property must be owned by a Decedent for three years prior to death to obtain basis increase.
- C Repeal of the Family Owned Business Interest Deduction after 2003.
- C Gradual elimination of the State Death Tax Credit.
- C Income Tax Home Sale Exclusion available for Estates after 2009.
- C Tax Law changes may be amended or repealed at any time by future legislation. After 2010, laws may revert to 2001 levels unless amended or extended by 2010.

authority to increase the basis of assets (up to \$1.3 million, or \$3 million in the case of property passing to a surviving spouse) from their carryover value to a stepped-up, date of death value. Special provisions and rules are required for the increase in basis features.

Property acquired within three years of death

The basis increase provisions of the new modified carryover basis at death rules do not apply to property acquired by a decedent within three years of death under certain situations.

Repeal or Changes at any time by Future Legislation

After 2010, laws may revert to 2001 level unless amended or extended by 2010.

Conclusions

The new law gives business owners opportunity to leave assets to heirs with little or no estate tax. The details of making the transfer of assets to heirs both on farm and off farm is a very personal decision. However, planning for the transfer of assets to the next generation can save future generations a sizable sum of money. For help with getting started talk to your Area Farm Management Specialist.

SOCIAL SECURITY COVERAGE

by David Heisterberg

Over the last several years most of you should have received a report from the Social Security Administration explaining the amount of benefits that you would be eligible for. It contains a detailed report of the amount of earnings that have been credited to your account for each year in your employment history, and the number of quarters that you have earned. This report is scheduled to be updated and sent to you every two years.

It is very important that you review this report. It is not uncommon to find errors, particularly for people that are self-employed. The most common error and an easy edit for you to perform, is to look for any years that show zero earnings. While you may have had a loss for that year, it is also likely that Social Security Administration missed inputting that year. A popular misconception is that only the highest five years count for retirement. Another myth is that earnings from a long time ago won't make a difference as they were low relative to current income. Retirement benefits are calculated using the highest 35 years, with all years indexed to the year prior to retirement. So it is important that all years be reported accurately

The second item to check is how many quarters of coverage you have earned and if are you either "fully insured" or "currently insured". There are three different benefit programs that you may be covered for under Social Security. They are retirement benefits, survivor benefits, and disability benefits. While Social Security benefits are probably not sufficient enough to provide for you or your family under any of the three programs, they can be an important supplement to other coverage and should not be overlooked. To be eligible for benefits, you must either be fully insured or currently insured. To be fully insured requires 40 quarters of coverage. To be currently insured you must have 20 quarters of coverage in the most recent 10 years. There are several exceptions for people under age 31, but they are too detailed to go into in this newsletter.

To earn a quarter of coverage in 2001, you must have \$830 of earned income. Therefore, to get four quarters it takes \$3320 of income. This amount has been increasing steadily in the past few years. For those of you with off-farm employment or with consistent positive farm income, you are probably accumulating adequate quarters of coverage. However, it is becoming increasingly difficult for those with low earnings to accumulate quarters. One of the options available for those with losses, is to use the farm-optional method, whereby you can report and pay self-employment tax on \$1600 of deemed income. However, you will only get one quarter of coverage for this in 2001. In years past you could have received up to four quarters for this election.

Another option is to use excellent tax planning to try and avoid showing losses. This may be difficult to do in bad years, but in years with a small loss it may be possible to time some expenses or income so as to show a small profit. This may have some other tax benefits as well such as not losing the benefit of your personal exemptions and standard deduction, and may qualify you for the earned income credit.

One other area to consider is the spouse who is not working off the farm. It is probably just as important to make sure they are covered for disability and survivor benefits as the working spouse. One idea to consider is paying the spouse for work done on the farm. In order to earn four quarters of coverage the annual salary would need to be \$3320 or larger. Please remember this needs to be for legitimate farm employment and proper reporting needs to take place for all payroll taxes. It would be good to have an employment agreement detailing the work to be performed and the pay rate.

If you are in doubt about your status or unsure what you need to do after you review these SSA reports, don't hesitate to call Social Security, or consult with your tax preparer. This coverage may only be supplemental, but after an accident or death is not the time to discover you were not covered.

TAX SAVINGS MAKE EDUCATION MORE AFFORDABLE

by Darwin Foley

With the advent of the Economic Growth and Tax Reconciliation Act of 2001 there are many ways to save taxes in order to make education more affordable. Options are briefly summarized below and followed by some thoughts on strategies you should use.

Hope Credit and Lifetime Learning Credit: These two credits are based on education expenses paid for the taxpayer, spouse and dependents. Both credits may be claimed on the same tax return, but only one of them can be claimed for each student. Qualified expenses do not include room and board, or other personal expenses. Qualified expenses for both credits are tuition and fees at an accredited college, university, vocational school, or post secondary educational institution eligible for financial aid. The education credit is reduced starting at \$40,00 for single taxpayers and at \$80,000 for married filing jointly.

The Hope Credit can be claimed for only two tax years for each eligible and the maximum credit is \$1,500 for each eligible student (100% of the first \$1,000 of qualified expenses and 50% of the next \$1,000 of such expenses). The Lifetime Learning Credit is 20% of the first \$5,000 of

qualified expenses paid for all students in the family, for a maximum of \$1,000 per tax return. Classes may be taken for credit toward a degree or to acquire or improve job skills.

Student Loan Interest Deduction: Up to \$2,500 in student loan interest paid in 2001 can be deducted on 2001 income tax returns, up from \$2,000 in 2000. This is an adjustment to gross income, but the deduction begins to phase out for single filers at adjusted gross income of \$40,00 and \$60,000 for joint filers. The loan must be used strictly for college expenses and only the person legally liable for the loan can claim the deduction. A student who borrows money and is claimed as a dependent on the parent's return is not eligible for the deduction. The student loan deduction can be claimed for the first 60 months that interest payments are required on the loan.

Deduction for Higher Education Expenses: For taxable years beginning after 2001 you'll be able to deduct up to \$3,000 in tuition payments in 2002 and 2003. That's for couples with incomes under \$130,000 and singles under \$65,000. Qualified higher education expenses for this deduction are defined in the same manner as for purposes of the Hope Credit (tuition and academic fees).

Taxpayers are not eligible to claim the deduction and a Hope or Lifetime Learning Credit in the same year with respect to the same student. However a taxpayer can claim an exclusion for distributions from a qualified tuition plan, Education IRA, or interest on education savings bonds, as long as both a deduction and an exclusion are not claimed for the same expenses.

Educational IRAs: For tax years beginning after 2001 the annual contribution limit to Education IRAs is increased from \$500 to \$2,000 on behalf of any particular beneficiary. Under the old law the funds had to be used for higher education. The new law allows expenditures for qualified elementary and secondary school expenses. In addition to tuition, fees, books and supplies, room and board, uniforms, transportation, and supplementary items also qualify. The unused balances can be rolled over tax-free into Education IRAs for other family members. Balances are considered distributed once a beneficiary reaches age 30 or within 30 days of the death of a beneficiary.

Qualified Tuition Programs: For tax years beginning after 2001, these programs, often referred to as College 529 plans and run by states, will be expanded to include private educational institutions. Also, first cousins of the original beneficiary are eligible family members. Kentucky's two plans are the Kentucky Education Saving Plan Trust and Kentucky's Affordable Prepaid Tuition plan. You can invest up to \$250,000 per child.

A taxpayer is allowed to claim a Hope Credit or Life time Learning Credit and exclude income from distributions from a qualified plan as long as the distribution is not used for the same expenses for which the credit was claimed.

Accounts open at least eight years with a resident beneficiary lock in resident tuition rates at Kentucky public institutions even if the beneficiary subsequently moves out of state

Education Savings Bonds: Series I and Series EE savings bonds are increasingly being used to fund college expenses because of the interest exclusion available. The bonds must be purchased after 1989 and must be registered in the name of the taxpayer and the taxpayer must be at least 24 years old before the issue date of the bond. Qualified education expenses are limited to tuition and fees. The taxpayer is prevented from excluding the savings bond interest and taking the Hope or Lifetime Learning Credit for the same expenses. The taxpayer must use both the principal and interest from the bonds cashed during the year to pay for tuition and fees of the student. Form 8815 must be filed for the exclusion.

Uniform Transfers: Gifts to minor children can also be used as a college savings vehicle. The parent gifts money to a minor child and the money is invested in the child's name with the child's social security number on the account. These accounts are referred to as UTMA or UGMA accounts and are subject to the "kiddie tax". If the child's investment income is under \$750 and the child has no earned income the income will not be taxed, but if the child was under age 14 at the end of the tax year and had investment income in excess of \$1,500 part of the child's investment income may be taxed at the parent's highest marginal tax rate. The tax computation can be rather complicated.

Tax Free Graduate Tuition: Effective January 1, 2002, employers can provide up to \$5,250 per year of tax free graduate tuition to employees. Graduate tuition provided by employers before January 1, 2002 will be subject to taxation.

Summary: The best way to save for college depends on your income. High income tax payers lose the benefit of credits and deductions but can invest up to \$250,000 in a college 529 plan. Those who are not affected by income limitations have many options, but must do careful planning to receive the most tax benefit from the options they have available. Don't forget that the Lifetime Learning Credit can be used for improving job skills and the Educational IRAs can now be used for grade school and high school.

Upcoming Annual Association Meetings

Ohio Valley: November 29th, at the Daviess Co. Ext. Office in Owensboro, Keith Rogers will be the guest speaker.

Lincoln Trail: December 6th at Marks Feed Store in Elizabethtown, Dr. Jack McAllister will be the guest speaker.

Pennyroyal: January 11th at the Hopkinsville Convention Center, Dr. Bernie Earvin will be the guest speaker.

Suzy Martin, Editor
Ohio Valley Farm Analysis

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