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1980 FARM INCOME TAX MANAGEMENT

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An unusual hot, dry summer, hail damage for some and higher cost of production will result in below average income for many Oklahoma farmers. In addition, many stocker and feeder cattle operators had a bad year. A few farmers, however, harvested good crops before the summer drought and a few had oil income which will result in average or above taxable income. Thus tax management is an individual affair and each person must estimate and project his yearly income before many tax management decisions can be made.

Tax Changes

There are a few tax changes this year and they are discussed in O.S.U. Current Report, "Windfall Profit Tax of 1980 and Other Tax Changes." The primary changes include the crude oil excise tax, credit for alcohol fuels, added energy credit for homeowners, added energy credit for business, repeal of the carryover basis, and larger dividend exclusions next year.

Use Zero Bracket Amounts and Exemptions

If a self-employed person has a bad year financially he is likely to give little thought to tax management. Failure to do so, however, may mean increased taxes next year. For example, a couple filing a joint return with two children may have up to $7400 income before they pay any tax. Therefore, if adjustments can be made to delay some expenses to next year and make some sales that normally might be carried over to next year it may result in lower taxes next year. Tax estimates should be made in November or December in order that tax management decisions can be made prior to the end of the year. Forms for making such estimates are available from Area Farm Management Agents and the Agriculture Economics Department at Oklahoma State University.

Drought Sales of Livestock

If property is involuntarily converted, you may under certain circumstances postpone paying tax on any gain. Two types of livestock may be affected, (1) livestock held for draft, breeding and dairy and (2) livestock held for sale. They will be discussed separately.

(a) Livestock held for draft, breeding or dairy. Only livestock sold in excess of the number you normally sell under usual business conditions will be considered involuntarily converted. For example, if you normally sell ten cull cows but this year due to drought you sell twenty, the gain from ten would be an involuntary conversion.

When excess qualified livestock are sold because of drought your tax return for the year sold should contain the following information.

1. Evidence of the drought that forced the sale of livestock.

2. Computation of the gain.
3. Number and kind of livestock sold.
4. Number and kind that would normally have been sold in the absence of a drought.

The replacement period ends two years after the close of the first taxable year in which the gain is realized. The return for the year in which the livestock are replaced should show the following information:

1. Date replacements were purchased.
2. Number, kind and cost of replacement livestock.

(b) Drought sales of livestock held for sale. You may elect to defer for one year reporting the sales proceeds from this type of livestock if the sale was due to drought conditions. This could be raised or purchased stocker cattle, sheep or hogs. You must meet the following conditions.

1. Use the cash method of accounting.
2. You must establish that under usual business practices, the sale would not have occurred except for drought conditions.
3. The drought conditions have resulted in your area being designated as eligible for assistance by the Federal Government.

See the Farmers Tax Guide for details on how to make the election.

Regardless of the kind of livestock sold, the wise taxpayer will consider the alternative of paying tax the year the drought sales are held as compared to postponing the tax. Often a farmers income is low in the year of a drought because of low crop yields and increased costs of purchasing hay and grain. Therefore, just because you are eligible to postpone the tax doesn't mean you should automatically do so.

Strategy for Series E Bonds

The Treasury Department will stop paying interest on some old Series E Bonds effective in May 1981. Maturity dates will no longer be extended beyond present limits. The term of the bonds range from 40 years in 1941 down to 25 years in 1969. This means a fully matured bond will no longer earn interest.

What alternatives does an investor have who is holding old bonds about to mature? He may cash some this year and the rest next year before May 1981 if his income tax situation permits. Selling in two different years will avoid income bunching. The other alternative is to convert the bonds tax free to Series H or HH. The untaxed interest in the E Bond will be reflected in the H or HH Bond but won't be included in income until the converted bonds mature or are redeemed. Bonds issued between May 1941 and April 1952 will mature between May 1981 and April 1992. Bonds issued later will have later maturing dates.

One should also consider cashing the matured bonds, paying the tax and investing in other alternatives paying a higher rate of interest.

Net Operating Losses (NOL)

Farmers who have net operating losses this year may carry the loss back three years, or if they so desire, they may relinquish the entire carry-back period and carry it forward. The election to forego the carry-back must be made by the due date and a statement attached to the return stating the election is being made under section 172(b)(3)(c) of the code.

Form 1040X should be used to obtain refund. A quick refund of prior year taxes may be obtained by filing form 1045 for a tentative adjustment.

Five modifications may be necessary for NOL: (A) Any deduction for a net operating loss carry-over or carry-back from any other year must be eliminated. (B) No non-business capital loss deduction in excess of non-business capital gains is allowed. (C) The deduction for 60 percent of the excess of long term capital gains over capital losses must be eliminated. (D) Deduction for personal exemption and dependents. (E) Excess of non-business deduction over non-business income.

A net operating loss carry-back may affect the following items reported in the carry-back years:

1. Income averaging
2. Minimum tax
3. Investment credit
4. Foreign tax credit
5. Retirement income credit

If investment credit has been used to off-set income tax liability in carry-over years, the effect of carrying back the net operating loss is to "free up" some or all of the investment credit used.

Thus the computation of net operating losses on some returns can be complex and experienced tax assistance may be necessary. A detailed example is shown in the Farmers Tax Guide.

Earned Income Credit

Due to the lower incomes due to drought, more farmers will likely qualify for the earned income credit. If earnings from self employment on Line 13 of Schedule S.E. (form 1040) and Line 31 form 1040 are under $10,000 you may be able to claim this credit. Earned income means wages and salaries and net earning from self employment.

You must maintain a household which is your principal residence for the entire year for you and your child who is under 19 years of age or a student. A disabled child over 19, for whom you claim as a dependent may qualify.

Married individuals must file jointly to be eligible. They qualify for one credit with their combined income. Losses from self-employed income reduce earned income. The earned income credit may be as low as $3 or as much as $500. If you owe no tax you may qualify for a refund.

Capital Gains

Only forty percent of the gains from the sale of long term capital asset is taxable. Sixty percent is excluded.

The holding periods to qualify for capital gains, including Section 1231 assets, are: 12 months for breeding swine and sheep; 24 months for breeding cattle; and 12 months for assets such as land, machinery and stocks. Farm commodity future contracts will continue to be eligible for capital gains after holding for six months.

The way to analyze your capital gains and losses is as follows: (1) Total your long term gains, (2) Add up all long term losses. Add the two together which gives your net "Long term gain or loss", (3) In the same manner total your short term gains and losses to get your net short term gain or loss. Compare the long term gains and short term gains, (4) If there is a gain in both, treat each separately. The short term gain is added to ordinary income and only forty percent of the long term capital gain will be taxable. (5) If you have more net long term gain than net short term loss, off-set and treat the net as long term capital gain. (6) If the net short term gain exceeds the net long term loss, treat the net as short term capital gain. Your short or long term loss offsets ordinary income up to $3,000. It will take $6,000 of long term losses to off-set $3,000 of ordinary income since it takes $2 of long term loss to offset $1 of ordinary income.

Usually losses on Section 1231 assets used in the business such as machinery and breeding cattle are fully deductible as ordinary losses unless offset by gains.

General strategy - use long term losses to offset short term gain if possible. If you have long term gains use as much long term loss as possible to offset the gains. Three thousand of net short term losses can be used to offset ordinary income.

Investment Credit

Wise use of investment credit will reduce tax liability more than any other item. It reduces tax liability dollar for dollar.

Single purpose livestock structures and under certain conditions rehabilitated buildings of at least 20 years old may now qualify for investment credit. Also certain energy property may qualify for both energy credit and investment credit. Since the requirements are detailed and specific, refer to IRS publication 572 on investment credit or seek reputable tax counsel. Fences, machinery, groves, storage facilities and breeding cattle are the most common qualifying property.

Alternative Minimum Tax

The alternative minimum tax was effective in 1979 and may be triggered by tax preference items such as capital gains exclusions and excess itemized deductions. A number of Oklahoma farmers had to pay the alternative minimum tax for the 1979 tax year because the use of investment credit lowered their regular tax to the extent that the alternative minimum tax was due.

For a detailed discussion see Current Report 742 "Alternative Minimum Tax and Investment Credit". The use of the installment sale is a good strategy to use if capital gains exclusion results in alternative minimum tax.

Income Averaging

When a taxpayer has an above average tax income, he should estimate the tax saving by income averaging. The income for the current year must exceed 120 percent of your average income for the preceding four years by more than $3,000.

Selling Home or Farm

Any homeowner who is at least fifty-five years old can elect to exclude up to $100,000 of gain on the sale of a principal residence sold after July 26, 1978. The homeowner must have lived in the home for at least three of the last five years prior to the sale.

Homeowners continue to be one of the most tax favored groups. They are allowed to deduct mortgage interest payments and taxes. Homeowners can postpone tax when they sell a home for a gain by purchasing or building a new home equal to or at a greater price.

Farmers and ranchers should allocate the part of the sales price to the home and part to the land when they sell a farm on which their home is located.

Installment Sales

If a major sale will result in an unusually large taxable income, always consider the installment sale. The installment sale permits a person to report the gain in the year it is received. Congress recently passed legislation which changes many of the requirements for installment sales. The president is expected to sign the law. The law changes many of the requirements and some are retroactive to January 1, 1980. Watch for details.

Trades

When a farm is sold, a tax has to be paid on the gain. Different rules apply if a proper election is made as to proceeds received on an involuntary conversion of farm equipment or property.

A farm, however, may be traded for another. In the case of a trade for like kind property, all or part of the tax liability is postponed. Unless "boot" is received in the form of cash or unlike property, no gain is recognized. The tax on any gain realized is postponed until the property you received is sold or traded in a taxable exchange. There are strict limitations on nontaxable exchanges. See The Farmers Tax Guide for further details.

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