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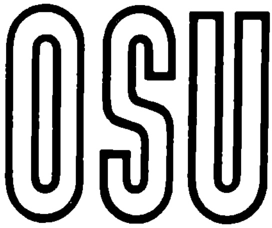

Current Report

Cooperative Extension Service • Division of Agriculture • Oklahoma State University

1983 Farm Income and Social Security Tax Management

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Plan your farm business transactions to maximize your after tax income. Many Oklahoma farmers and ranchers will have relative low income due to low farm prices and reduced production, however a number will still have considerable taxable income.

Tax Changes

The 1982 Tax Equity and Fiscal Responsibility Act contains many changes which are effective for the 1983 calendar tax year. These changes plus those in the 1981 act effective in 1983 will be discussed in another current report.

Tax rate decrease: The final 10% decrease in tax rates went into effect July 1, 1983. Since this decrease comes half way through the year, the full effect will not be reflected until 1984.

Special Use Valuation Limit Increased: The limit on reduction in fair market value of qualified real property used for agricultural production increased from $700,000 to $750,000, in 1983.

Alternative Minimum Tax

Alternative minimum tax (AMT) is effective for tax years beginning after December 31, 1982. The new alternative minimum tax replaces both the old alternative minimum tax and the add-on minimum tax and effects individuals, estates, and trusts. Generally the new (AMT) will reduce the liability for some middle-income taxpayers and increases it for higher income taxpayers.

Alternative minimum taxable income is adjusted gross income (AGI) plus tax preference items, (listed below) less some itemized deductions, less the (AMT) net operating loss, less the (AMT) exemption.

Alternative minimum tax = [(adjusted gross income + Tax Preference Items) - (AMT) itemized deductions - (AMT) net operating loss - (AMT) exemption] x Tax rate.

The new (AMT) law retains the following tax preference items:
--Capital gain deduction;
--Accelerated depreciation on real property;
--Accelerated depreciation on leased personal property;
--Amortization of certified pollution control facilities in excess of normal depreciation;
--Percentage depletion in excess of adjusted basis; and
--Intangible drilling costs.

In addition, these new tax preference items are added:
--Dividends excluded by the $100 ($200 joint return) dividend--received exclusion that begins in 1985.
--Interest excluded by the All-Savers Certificate and the net interest exclusion that begins in 1985.

--Bargain element on exercise of an incentive stock option, unless there is an early disposition of stock so acquired.
--Rapid writeoffs, to the extent they exceed the amount allowable had the expenditure been capitalized and deducted ratably over 10 years, for the following: Circulation expense; Research and experimental costs; Mining development and exploration expenses.

(AMT) itemized deductions include medical expenses in excess of 10% AGI, casualty losses in excess of 10% floor, charitable contributions, estate tax deductions, housing interest, other interest to the extent that net investment income is included in alternative minimum taxable income, allowable wagering losses.

Alternative minimum taxable income can be reduced by alternative minimum tax net operating losses (NOL). All pre 1983 regular tax (NOL's) may be carried forward as minimum tax (NOL). For tax years beginning 12-31-82, the alternative minimum tax net operating loss is calculated like a regular (NOL) except that tax preference item for that year are added back to taxable income, and only the new alternative minimum tax itemized deductions can be used.

The (AMT) tax exemption allows single filers a $30,000 exemption, while joint filers and surviving spouses receive a $40,000 exemption. Married taxpayer filing separately receive a $20,000 exemption. The (AMT) tax rate is a flat 20%.

Caution: Nonrefundable credits like investment credit, WIN credit, child care credit, and residential energy credit, cannot be taken as a credit against the alternative minimum tax. A taxpayer that pays little or no regular tax due to investment credit, may owe an alternative minimum tax liability independent of tax preference items.

Basis Reduced by 50% of Investment Credit - Taxpayers will generally have to reduce the basis of assets by 50% of the regular and energy investment credit for assets placed in service after 1982. For example, a $60,000 tractor is purchased. The investment credit is $6,000. Half of $6,000 is $3,000. The $3,000 must be subtracted from the $60,000 leaving $57,000, the basis used for depreciation.

A taxpayer not needing the investment credit can elect to reduce his investment credit and not the basis for depreciation. For five year recovery property, the taxpayer can elect to claim 8% instead of 10% investment credit and not reduce the basis for depreciation. For three year recovery property the taxpayer can reduce the investment credit from 6% to 4% and not reduce the depreciable basis.

For recapture purposes the basis reduction is considered as recovery writeoff and may be recaptured. If the disposition triggers recapture of the credit, there will be an upward adjustment of basis, immediately before the disposition, of half the amount of the credit that's recaptured.

Limitation on Investment Credit

The investment credit allowed for 1983 is limited to your tax liability. If the tax liability is more than $25,000, the limit on the credit is $25,000 plus 85% of the excess for 1983. The limit is reduced from 90 to 85%. Credit which can't be used because of the limit can be carried back three years and forward 15 years.

1983 Social Security Act Effective in 1984.

The new Social Security Reform Act of 1983 has direct impact on you and your farm as an employee, farm operator or recipient of benefits. Payroll tax rates will increase, employer payments that have been exempt until now will be taxed, younger workers must work longer to receive retirement benefits, and some social security benefits will be subject to income tax.

Self-employment tax rates will increase from 9.35% in 1983 to 14% in 1984. A 2.7% credit will be allowed in 1984. The credit drops to 2.3% in 1985 and thereafter will be 2%. The Employee Social Security rate will increase to 7.0% in 1984. However, a .3% credit is allowed.

Employer social security tax rate is 7.0% in 1984 with no credit allowed. The taxable wage base for both social security and self-employment tax increased from 35,700 in 1983 to 37,800 in 1984.

A self-employed taxpayer filing a joint return with 4 exemptions can have taxable income of $35,000 and pay as much self-employment tax as income tax. Traditional management strategies to minimize regular income tax must be adjusted to consider the increased cost of self-employment tax.

Changes effective in 1984 require that employer amounts paid to a tax sheltered annuity must be included in the social security wage base. Social security taxes can be reduced by providing employee's meals, lodging, milk, or meat in lieu of wages. Also no social security tax is paid on temporary workers paid less than $150 per year or those who work for cash wages for less than 20 days during the year. Family members under 21 require no social security tax payments.

Some social security benefits will be subject to income tax. Up to 50% of the social security benefits may be taxed. Benefits taxed equals the lesser of one-half the benefits received or one-half the excess of the sum of the taxpayers adjusted gross income (AGI) plus, interest on tax exempt obligations plus half the social security benefits over the base amount. Base amounts are $32,000 for marrieds filing jointly, $25,000 for other individuals, and zero for marrieds filing separately who lived with their spouse part of the year.

For example John and Jane Public are both over 65 and has adjusted gross income of $40,000 and social security benefits of 15,000, in 1984.

1. Benefits taxed = 1/2 [(AGI + interest on tax exempt + 1/2 benefits) - Base amount]

or

2. One-half social security benefits, 7,500.

Benefits taxed = 1/2 [(40,000 + 7,500) - 32,000] = 7750.

John and Jane Public must include $7,500 in taxable income for 1984.

Net Operating Losses (NOL)

Farmers who have net operating losses this year may carry the loss back three years and forward up to fifteen 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 a 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 resulting from low prices received, 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 32 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.

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.

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. The installment sale should also be considered when the alternative minimum tax results in more tax due to large capital gains exclusions. For details see OSU Facts 700, "Tax Consideration in Selling a Farm Business".

End-of-Year Tax Management

Most businessmen have some flexibility in management of income and expenses. This opportunity should be used to help avoid wide variations in income from year to year. Tax rates are graduated, and exemptions and deductions cannot be carried forward. Ways to reduce taxable income and ways to increase taxable income to offset all of your exemptions and deductions are listed below:

To Reduce Taxable Income

1. Make additional purchases
2. Use maximum initial depreciation
3. Delay sales
4. Pay current accounts
5. Use income averaging
6. Do extra conservation work
7. Make needed repairs
8. Establish retirement fund

To Increase Taxable Income

1. Change to slower depreciation
2. Postpone payments of current accounts
3. Sell crops and livestock
4. Collect accounts receivable
5. Do additional custom work

Tax Savings Strategies and Ideas

1. Dividend deferral on utility Stock - An individual may defer dividends up to $750 and up to $1,500 for couples filing jointly. The new shares will

have a zero cost basis but will qualify for capital gains if held for at least 12 months. Thus in essence a taxpayer is converting regular tax dividends into tax favored capital gains.

2. For the tax years beginning in 1982 the first $100 of dividends is exempt for an individual and $200 for a joint return. Money market funds and other interest do not qualify. Taxpayers who do not own stock should consider buying at least enough to utilize the dividend exclusion.

3. Income from compensation and investments are both taxed at the maximum rate of 50% in 1982. Investment income had been subject to a top rate of 70%.

4. IRA's - Money put into an IRA is subtracted from your taxable income before computing tax. The tax on the interest is not taxable until the money from IRA is withdrawn. Interest is earned on interest that otherwise would be taxed. IRA's can be purchased by anyone employed even though they have another retirement plan or a Keogh. A IRA can be obtained for a non-working spouse with a combined amount of $2,250 to both accounts.

Depreciation

Generally, in a high income year the most rapid depreciation choice is used. Conversely in a low income year a reduced first year depreciation is selected. Those farmers with low incomes may want to select the straight line ACRS method rather than the regular ACRS. For details see OSU Facts 748, "Depreciation and Investment Credit."

Investment Credit Choices

Investment credit is a very important tax management tool. Wise choices increase the effectiveness. This applies to both the original choice and matters relative to recapture.

Beginning in 1982 and in 1983 farmers will hve an option to expense up to $5000 on purchases of tangible personal property such as machinery. This amount is then deducted from the cost to determine the remaining amount eligible for depreciation. Also and more important investment credit is not allowed on the amount expensed. Thus, if a $50,000 tractor is purchased and $5,000 is expensed, only $45,000 remains to be depreciated and eligible for investment credit. Thus $500 of investment credit is lost. Unless a farmer has an exceptionally high income year he should carefully consider foregoing the expensing option.

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 non-taxable exchanges. See the FARMER'S TAX GUIDE for further details.

Other Tax Considerations

Prior to the end of the tax year, consider how the following may effect your 1983 taxes:

1. Conservation expenses up to 25% of gross farm income may be incurred and deducted.

2. Land Clearing expenses up to $5,000 or 25% of net farm profit, whichever is smaller, may be deducted.

3. If you bought a farm during 1983 costs should be allocated to growing crops, depreciable improvements, dwelling, and land.

4. Remember, if you customarily hold crops harvested in one year for sale in the next, you may elect to report crop insurance proceeds the following year.

5. Don't overlook involuntary conversions. In the case of condemnations of farm property, the replacement period begins on the earliest date of the threat or imminence of condemnation and ends two years after the close of the first tax year in which you realized any part of the gain on the involuntary conversion.

6. Only 50% of an individuals long-term capital losses may be used to offset ordinary income up to a $3,000 limit. Short-term capital losses can be deducted from ordinary income, but are also limited to $3,000 per year.

7. Reasonable wages may be paid to your children for farm work as long as there is a true employer-employee relationship. They should be assigned regular duties and responsibilities and paid regularly as non-related employees.

8. Gifts of raised grain or livestock are not included in the income tax return of the donor (person making gift). See FARMER'S TAX GUIDE for details.

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