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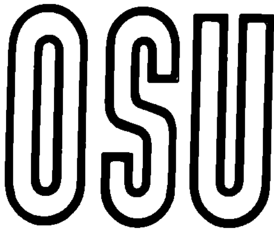

Current Report

Cooperative Extension Service • Division of Agriculture • Oklahoma State University

1984 Self-Employment and Farm Income Tax Management

by

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Because of low farm prices, adverse weather conditions, and reduced production, some Oklahoma farmers and ranchers may have little or no taxable income. Since net operating losses can be carried back or forward to claim a refund or reduce tax in a future year, it is important to consider the tax aspects of each management decision and to select tax management options that yield the greatest after tax income.

The Tax Reform Act of 1984 contains delays or repeals of many of the tax reductions that were scheduled to take effect in 1984 and later years. The act is a collection of hundreds of separate tax changes. Some of the more important will be presented. Contact your accountant, Tax Practitioner, or Farm Management Specialist to learn how the Tax Reform Act of 1984 may influence your individual business.

Tax Reform Act of 1984

Interest on Deferred Payments

Generally, there will be unstated or imputed interest on a deferred (or installment) sale contract if the stated interest rate is below 110 percent of the federal rate (adequate stated interest.) The federal rate is set for the six-month periods beginning January 1 and July 1 or each year. You may qualify for one of the many exceptions to this general rule. Details will be available in future publications.

Loans With Below Market Rates of Interest

Generally, the Tax Reform Act of 1984 treats low or no interest loans as arm's length transactions. Interest, at the federal rate is treated as income received by the lender and expense paid by the borrower. The new rules apply to gift loans, compensation-related loans, corporate-shareholder loans, tax avoidance loans and certain other types of loans where interest is charged at lower than the applicable federal interest rate. The applicable federal rate for this purpose for 1984 is 10 percent compounded semi-annually. This 10% rate will continue through June 30, 1985.

Investment Tax Credit and Depreciation

The $125,000 limit on used property eligible for investment tax credit was scheduled to go to $150,000 in 1985. The $125,000 limit continues through 1987. Buildings and other depreciable property not eligible for investment tax credit (other than low income housing) are now depreciable over an 18 year period instead of a 15 year period. This generally applies to property placed in service after March 15, 1984.

The expensing election limitation under Sec. 179 of $5000 is retained for 1984, 1985, 1986 and 1987. It was scheduled to increase to $7500 in 1984 and 1985 and $10,000 in 1986 and later years.

Investment tax credit and accelerated depreciation under ACRS may not be taken on passenger automobiles, any other property used as a means of transportation, any property of a type generally used for purposes of entertainment, recreation or amusement, or any computer unless used more than 50 percent on an annual basis in a trade or business. Limits were also placed on investment tax credit and depreciation deductions for qualifying passenger automobiles. This provision generally applies to property placed in service after June 18, 1984.

Installment Sales

On any installment sale a taxpayer must recognize any recaptured depreciation as payments are received. The law required all ordinary income to be recognized prior to the recognition of any capital gain. Tax Reform Act of 1984 requires all recapture gain to be recognized in the year of sale, even if no principal payments are received in that year.

This provision applies to sales after June 6, 1984 unless the sale was pursuant to a contract which was binding as of March 22, 1984, and at all times thereafter.

Capital Gain Holding Period

The "more than 12 month" holding period is reduced to "more than 6 months", for machinery and equipment, farmland, and depreciable improvements. The holding period for livestock is unchanged. The new rules apply to assets acquired after June 22, 1984 and before January 1, 1988.

Income Averaging

For 1984 and later years, averageable income is the amount the taxable income for the current year exceeds 140% (instead of 120%) of the average base period income. The base period is shortened from the 4 to 3 prior years and the averaging formula is changed so that it widens the tax brackets by a factor of four instead of five. Income averaging for 1984 and later years will produce a smaller benefit. Many individuals who qualified for income averaging in prior years will not qualify in 1984.

Alternate Valuation

For estates of decedents who die after July 18, 1984, the election to use the alternate valuation procedure can be made only if there is a decrease in both the value of the gross estate and the amount of tax, reduced by credits allowable against the tax.

Property Distributed In Kind By An Estate or Trust

Under pre-Tax Reform Act-1984 law, if a trust or estate had distributable net income (DNI) and distributed property in kind, the gain or loss was entirely exempt from tax. For distributions after July 18, 1984, distributions of property in kind will result in gain or loss as though the property had been sold to the beneficiary. However, the trustee or executor has the election to recognize the gain or loss.

If no election to recognize gain is made the distribution is treated as carrying out DNI only to the extent of the lessor of the property's basis or its fair market value at the time of distribution. If no election is made, the basis in the hands of the beneficiary is the same as the trust's or estate's and the beneficiary will recognize gain or loss on a taxable transaction. If an election to recognize dain is made, the distributed property is taken into account by the trust or estate at its fair market value.

Prior Year's Law Effective in 1984

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 when full investment tax credit is claimed. 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.

1983 Social Security Act Effective in 1984

The 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 effective rate in 1984 is 11.3 percent. 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].
Benefits taxed = 1/2 [(40,000 + 7,500) - 32,000] = 7750.

or

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

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
6. Capital gains & losses

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 in Line 13 of Schedule S.E. (form 1040) and Line 32 form 1040 are under $11,000 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. If you owe no tax you may qualify for a refund, up to a maximum of $550.

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 and expensing option
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

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."

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 1984 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 1984 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 form ordinary income, but are also limited to $3,000 per year.
7. Reasonable wages may be paid to your children or spouse 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. Withholding of social security or (FICA) is not required for your children or spouse.
8. Gifts of raised grain or livestock are not included in the income tax return of the donor (person making gift).

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