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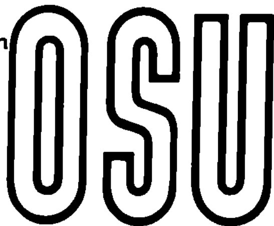

# Current Report

Cooperative Extension Service • Division of Agriculture • Oklahoma State University

# 1986 FARM INCOME TAX MANAGEMENT

by

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Declining farm exports, falling product prices, weather conditions, and reduced production, have all contributed to critical economic conditions in agriculture. While many Oklahoma farmers and ranchers have little or no taxable income, it is extremely important to consider the tax aspects of each management decision and choose those options that yield the most after tax income. Be aware of significant income tax consequences from forced sales, repossessions, and debt forgiveness.

## 1986 Tax Reform Act

The sweeping revision of the tax code passed by the House and Senate tax writers is virtually unprecedented in the 73-year history of the nation's income tax law. This broad based law will in some way touch the lives of every American taxpayer. The general rules of the past will no longer apply to everyone. Tax planning strategy will be unique to each individual situation. Individuals, businesses, and corporations alike must rethink past and future decisions based on a radically different tax environment. The number of tax rates have been reduced from 14 to two and more than six million low income taxpayers will pay no tax. However, those taxpayers who must file returns will face many new requirements and complex transition rules lasting up to 5 years. Some of the more important tax law changes will be presented. Contact your account, tax preparer, or farm management specialist for specific information on how the 1986 Tax Reform Act will impact your individual situation.

## Effective in 1986

Some of the provisions of this law are retroactive back to January 1st 1986, while others phase in over the next 5 years. The following provisions specifically affect agriculture.

### Investment Tax Credit

The investment tax credit of 6% for 3 year property and 10% for 5 year property reduced the after tax cost of investment in capital assets like cattle, machinery, and equipment. This credit has been repealed effective January 1st, 1986. No investment tax credit is available this year. Investment tax credits carried forward from a previous year will be reduced 17.5% or limited to 82.5% of the total in 1987. Transition property or a non-calandar tax year may require up to a 35% reduction.

### Land Clearing Expenses

Beginning January 1st, 1986, land clearing expenditures are not deductible or depreciable. These expenses must be added to the basis or cost of the land.

### Prepayment of Expenses

If prepaid farming expenses of a farmer using the cash method of accounting exceed 50% of total non-prepaid farm expenses such as feed, seed, fertilizer, and other farm expenses, then, these excess expenses may be deducted only as such items are actually consumed. Non-prepaid expenses are those expenses paid and consumed or used during the tax year. Prepaid expenses are those expenses that are paid but not used or consumed during the tax year. This provision applied to expenses that would be allowed as a deduction after March 1, 1986.

### Discharge of Indebtedness Income

When a creditor forgives all or a portion of a debt, the general rule treats the amount of debt forgiven as taxable income. Exceptions to this rule include insolvency (debts exceed market value of assets), bankruptcy, discharge of trade or business indebtedness and some solvent farmers.

In 1986, if a solvent taxpayer receives income from discharge of trade or business indebtedness, the taxpayer may exclude the income if an election to reduce basis in depreciable property is made. If the amount of debt forgiven is greater than the taxpayer's basis, the amount greater is taxable income. Starting in 1987 this deduction is not allowed. Discharge of indebtedness will be recognized as income in the situation. However, the new law makes a special exception for qualifying farmers.

If an insolvent taxpayer has debt forgiveness income, it can be excluded up to the amount of insolvency. The taxpayer's tax attributes (net operating loss and investment tax credit carryovers) and basis in property are reduced by the amount of the excluded income. However, if the debt forgiveness income exceeds the taxpayer's tax attributes and basis, tax on the excess is forgiven.

Under the new law, income arising from debt forgiveness owed by a qualified farmer to an unrelated lender is treated as taxable income of an insolvent taxpayer, even if the farmer is solvent. The debt must have been incurred in the trade or business of farming, or debt is secured by farmland or farm equipment used in such trade or business. A qualified farmer is defined as having received 50% or more of average annual gross receipts for the last 3 years from farming. Thus, the debt forgiveness income is excluded from taxable income after reduction of tax attributes and basis (including basis in farmland). Effective date is April 9, 1986.

## Effective 1987 and Later

### Soil and Water Conservation Expenditures

Beginning in 1987, soil and water conservation expenditures are deductible only if they relate to improvements that are consistent with a conservation plan approved by the U.S. Department of Agriculture or, by a comparable state agency.

### Preproductive Period Expenses

Under the current law, expenses for raising dairy or beef replacement heifers for breeding purposes, have been deducted as a current expense for that tax year. If held for breeding purposes for more than 2 years, the income from the sale of these animals was eligible for capital gain. The 1986 Tax Reform Act allows two options:

1. Farmers must allocate the expenses of growing these replacement heifers to a capital account and depreciate these costs over the productive life of the animal.

2. Farmers can elect to deduct these expenses in the current tax year. However, under this election, farmers must use nonincentive or longer term depreciation for all farm assets. Also, farmers must recapture these costs as ordinary taxable income when the animal is sold.

### Capital Gain Deduction Eliminated

Farmland, breeding livestock, and most machinery and equipment qualify for capital gain treatment. Capital gain is the sales price minus the assets cost or basis. The capital gain deduction, under current law, excludes 60% of the gain from taxable income. The remaining 40% is included in taxable income. This provision reduces the tax liability for sales of these assets.

The 1986 Tax Reform Act repeals the capital gain deduction effective for 1987. All of the gain, 100%, will be included in taxable income.

### Income Averaging Repealed

If taxable income is more than 140% above the average of the previous 3 years, taxpayers could use income averaging for the last time in 1986. Income averaging is repealed after the 1986 tax year. However, the net operating loss provisions have not changed. Losses can be carried back 3 years to obtain a refund, or, carried forward 15 years to offset taxable income in the future.

### Depreciation Deduction Reduced

Beginning in 1987, autos and light trucks will change from a 3 year life to 5 years. Most machinery and equipment that had been depreciated over a 5 year life will increase to 7 years. Special purpose agricultural production facilities will increase from 5 years to 7 years. The depreciation deduction will be stretched out over a longer time period.

## Prior Year's Law Effective in 1986

### Social Security & Self Employment

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 14.1% in 1985 to 14.3% in 1986. A 2% credit will be allowed in 1985. The effective rate in 1985 is 11.8%.The effective rate for 1986 will be 12.3%. The credit drops to 2.0% in 1986. The Employee Social Security rate will increse to 7.05% in 1985.

Employer social security tax rate is 7.05% in 1985 with no credit allowed. The taxable wage base for both social security and self-employment tax increased from 39,600 in 1985 to 42,000 in 1986.

Social Security changes 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 have adjusted gross income of $40,000 and social security benefits of 15,000, in 1986.

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] = 7,750.

or

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

John and Jane Public must include $7,500 in taxable income for 1986.

## 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. Reitrement income credit
6. Capital gains and 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 Farmer's 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.

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, 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 (1986 last year)
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 acccounts
3. Sell crops and livestock
4. Collect accounts receivable
5. Do additional custom work

## IRA'S

Money put into an IRA is subtracted form 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. An IRA can be obtained for a non-working spouse with a combined amount of $2,250 to both accounts. Beginning in 1987, IRA's are not deductible if covered by another retirement and joint income is above $50,000.

## 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. The 1986 Tax Reform Act modifies ACRS by increasing the life and changing depreciation methods. For details see OSU Facts, "Depreciation Methods."

## 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 ot the end of the tax year, consider how the following may effect your 1986 taxes:

1. Conservation expenses up to 25% of gross farm income may be incurred and deducted.
2. No investment tax credit is allowed for 1986.
3. Land clearing expense must be capitalized and depreciated, beginning January 1, 1986.
4. 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 converstion.
5. Consider sales of items eligible for capital gain this year (capital gain deduction is repealed January 1, 1987).
6. Consider accelerating installment sale payments to take advantage of capital gain (repealed January 1, 1987).
7. Only 50% of an individual's long-term capital losses may be used to offset ordinary income up to a $3,000 limit. Starting in 1987, 100% of an individual's long-term capital losses will 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.
8. If you bought a farm during 1986, costs should be allocated to growing crops, depreciable improvements, dwelling, and land.
9. 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.
10. Resonable 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 responsibilites and paid regularly as non-related employees. Withholding of social security or (FICA) is not required for your children or spouse.
11. Gifts of raised grain or livestock are not included in the income tax return of the donor (person making gift).

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