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INSOLVENT FARMERS RECEIVE ALTERNATIVE MINIMUM TAX RELIEF

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Farmers who are dealing with financial crisis have enough to think about without worrying about income taxes. Unfortunately, taxes may significantly reduce the sales proceeds available for repayment of debt. Forgiveness of debt may result in taxable income and alternative minimum tax (AMT) be due for farmers who otherwise would have no tax liability. Given current economic conditions, a large number of farmers are facing some financial distress. Congress has included an amendment in the Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA) that provides some tax relief for insolvent farmers who dispose of farmland to reduce their indebtedness. The effective date of this change is January 1, 1982. If you have disposed of land or are planning a disposition, first, determine if you paid alternative minimum tax, and second, determine if you qualify for a tax refund. Please contact an area extension farm management specialist, farm management association fieldman, or tax preparer, for more information.

Alternative Minimum Tax Example

For a complete discussion of alternative minimum tax, tax preference items and alternative minimum tax calculations, please see the last page. The following example shows how alternative minimum tax can impact farmers: John Farmer and his wife filed a joint federal income tax return for the calendar year 1984. During that year they sold a portion of their farm land, under threat of foreclosure, for $200,000. The Farmers had owned the land for many years and had an adjusted basis in the land of $75,000. Immediately before the sale, their liabilities exceeded the fair-market value of their assets by $50,000. The Farmers received other income of $20,000 and claimed a deduction from the business of farming of $70,000. Given the situation, the Farmers incurred no regular income tax liability for 1984. Also, they had received 50% or more of their average annual gross income for the previous three years from the business of their family farm.

Regular tax liability is calculated as follows:

Example I

$200,000		Amount realized on sale of land
-$75,000		Adjusted basis of land
	$125,000	Net long term capital gain on sale of land
	+20,000	Other income
	$145,000	Gross Income
$75,000		Capital Gain Deduction
$70,000		Business deduction
	$145,000	Total deduction from gross income
	-0-	Adjusted gross income.

Alternative minimum tax is calculated as follows:

The $75,000 capital gain deduction is subject to alternative minimum tax. Since the Farmers filed a joint return they are allowed a $40,000 exclusion. Alternative minimum tax is $35,000 X 20% equals $7,000. Since the $7,000 alternative minimum tax is greater than the regular tax liability, which is zero, the Farmers must pay alternative minimum tax.

Consolidated Omnibus Budget Re-conciliation Act 1986

This legislation was signed by the President in April 1986. This new law contains a provision to ease the potential tax burden of alternative minimum tax for persons who disposed of farmland to reduce their indebtedness. In general, it allows taxpayers to reduce the amount of capital gain deduction included as alternative minimum taxable income. This reduction is limited to the amount that the taxpayer was insolvent immediately before the land was transferred.

To qualify for this alternative minimum tax reduction, a farmer must have transferred or deeded farmland to a creditor in cancellation of indebtedness or sold (exchanged) farmland under a threat of foreclosure. Second, the taxpayer must be a farmer by having received 50% or more of the average annual gross income for the 3 previous years from a farm business. The business of farming includes cultivating the soil and raising or harvesting any agricultural commodity. Third, the taxpayer must have been insolvent immediately before the land transfer. Insolvency is the amount that the taxpayer's liabilities exceed the fair market value of assets. This provision is retroactive to January 1, 1982. However, a claim for refund must be filed within 3 years after the due date of the return. For 1982 amended returns, Congress passed a provision that allows amended returns for 1982 to be filed until April 15, 1987. Be aware that the deadline for 1983 amended returns is also April 15, 1987, with no exceptions.

Back to the example, John Farmer and his wife owed $7,000 of alternative minimum tax for 1984. Example II shows the effect of this new law on the Farmer's tax liability.

Example II

COBRA	PRE-COBRA	
-0-	-0-	1984 Adjusted gross income
+25,000	+75,000	Capital gains tax preference items
25,000	75,000	Alternative minimum taxable income
-40,000	-40,000	Exemption amount
-0-	35,000	Income subject to tax
	x .20	Alternative minimum tax rate
	7,000	Alternative Minimum Tax
	-0-	Regular tax
	4,000	1984 Alternative minimum tax liability

Because of the COBRA provisions, their tax will be reduced. The Farmers paid $75,000 for land they sold under threat of foreclosure for $200,000. The gain or difference is $125,000. The 60% capital gain exclusion is $75,000. This is a tax preference item subject to alternative minimum tax. The Farmers were insolvent before the sale by $50,000. This leaves $25,000. The Farmers filed a joint return and received a $40,000 exemption. Thus, the new provision reduces the Farmer's alternative minimum tax liability from $7,000 to zero.

Now assume that the situation is the same, except that the sale takes place in 1985 and the amount by which the Farmer's liabilities exceed the fair-market value or their assets is $20,000. In the previous example, the Farmer's pre-cobra alternative minimum tax liability was reduced from $7,000 to zero because of the cobra amendment. In this Example III, the $75,000 capital gain deduction which is a tax preference item can be reduced only by the amount of insolvency $20,000. Thus, $55,000 subject to alternative minimum tax less the $40,000 exemption for joint filers equals $15,000 X 20% tax rate or $3,000 alternative minimum tax even considering the effects of the cobra amendment.

Example III

COBRA	PRE-COBRA	
-0-	-0-	1985 Adjusted gross income
	+75,000	Capital gains tax preference items
55,000	75,000	Alternative minimum taxable income
-40,000	-40,000	Exemption amount
15,000	35,000	Income subject to tax
x .20	x .20	Alternative minimum tax rate
3,000	7,000	Alternative Minimum Tax
-0-	-0-	Regular tax
3,000	7,000	1984 Alternative minimum tax liability

In another example, Mr. and Mrs. Jones file a joint federal income tax return for the calendar year 1985. During 1985, they sold a part of their land (parcel one), under threat of foreclosure for $150,000. The Jones had an adjusted basis in the land of $50,000. Another portion of their land (parcel two) was also sold under threat of foreclosure. Parcel two was sold for $150,000 but the Jones adjusted basis in parcel two was $175,000. Immediately before the sale, their liabilities exceeded the fair-market value of their assets by $50,000. In addition, other income of $20,000 was received and $50,000 of business deductions from farming were claimed. In this situation, no regular income tax liability was owed. Mr. and Mrs. Jones met the farm income requirement by having more that 50% of their gross income from farming.

In this example, the $25,000 loss from parcel two can offset part of the $100,000 gain on parcel one. Thus, the $75,000 net gain times the 60% yields the $45,000 capital gain deduction which is an alternative minimum tax preference item as shown in Example IV.

Example IV

COBRA	PRE-COBRA	
-0-	-0-	1985 Adjusted gross income
	+45,000	Capital gains tax preference item
	45,000	Alternative minimum taxable income
	-40,000	Exemption amount
	5,000	Income subject to tax
	x .20	Alternative minimum tax rate
	1,000	Alternative Minimum Tax
	-0-	Regular tax
	1,000	1984 Alternative minimum tax liability

The $45,000 alternative minimum tax liability can be reduced by the amount that the Jones were insolvent, $50,000. Thus, under the Cobra Amendment, the Jones are not liable for regular or alternative minimum taxes for 1985.

Alternative minimum tax is a very complex problem for farmers who have disposed of farmland under threat of foreclosure or to reduce debt. Not all taxpayers pay alternative minimum tax in this situation. Also, not all taxpayers who pay alternative minimum tax are eligible for a refund under these new provisions. If you have disposed of farmland since 1982, for more information, contact your area extension economist, farm management association fieldman, or tax preparer to see if these new provisions apply to you.

Alternative Minimum Tax

The tax law allows special treatment of certain kinds of income and provides special deductions for certain expenses. To be sure that taxpayers who benefit from these laws will pay at least a minimum amount of tax, two different taxes have beed passed. The minimum tax applies only to corporations. Alternative minimum tax (AMT) applies to individuals, estates, and trusts. Before 1983, individual estates, and trusts also were subject to the minimum tax.

The alternative minimum tax is figured on benefits received in the form of deductions, lower tax rates, and exclusions from tax. These benefits are classified as "tax preference items." These tax preferences result because of preferential treatment given in the tax law. However, only the amount of the benefit received or used to save tax, minus the benefit that would otherwise be allowed is the actual tax preference item. In other words, you may reduce the total of your tax preference items by any amount that does not actually serve to reduce your income subject to tax. To figure the amount that your tax preference items reduce your income, and thereby provide you a tax benefit, you must first use all your other deductions to reduce taxable income, then use your tax preference items that are needed to reduce your taxable income to zero.

Tax Preference Items

The following are the tax preference items for alternative minimum tax:

1. The dividend exclusion
2. Capital gain deduction
3. Accelerated depreciation on real property
4. Accelerated depreciation on leased property
5. Depletion
6. Intangible drilling and development costs
7. Amortization of certified pollution control facilities
8. Mining exploration and development costs
9. Circulation costs
10. Research and experimentation costs
11. Incentive stock options

Capital gains deduction is the tax preference item that most often creates an alternative minimum tax liability for farmers. Current law allows capital gain treatment on the gain from the sales proceeds of certain assets that have been held for an appropriate time. Gain is the sales proceeds minus the asset's basis. The holding period for breeding livestock other than cattle and horses is 12 months or 1 year. Breeding cattle and horses must be held 2 years or 24 months. For other capital assets purchased after June 23, 1984, the holding period is 6 months, while other capital assets purchased before that time must be held 1 year or 12 months.

Capital gain treatment provides for the exclusion from taxable income of 60% of the gain (sales proceeds - basis). The remaining 40% is taxed at ordinary income tax rates. The excluded 60% or capital gain deduction, is a tax preference item. Farmer Jones sold 20 acres of land he purchased in 1940 for $50 per acre. Sales price is $500 per acre. Gain is (500 - 50) = $450 per acre. Capital gain deduction is ($450 X 60%) = $270. The $270 per acre is a tax preference item subject to alternative minimum tax. One hundred eighty dollars per acre is taxed at ordinary income rates. Total regular taxable income is $3,600 ($180 per acre X 20 acres). Alternative taxable income from this sale is $5,400 ($270 per acre X 20 acres).

Alternative Minimum Tax Calculation

The first step is to determine alternative minimum taxable income as follows:

1. Start with your adjusted gross income without deducting any net operating loss.
2. Add to this, the total of all your tax preference items.

3. Subtract the amount allowable for the following itemized deductions (your alternative tax itemized deductions), whether or not you use these amounts to figure your regular taxable income:

   Casualty losses
   Gambling losses to the extent of gambling gains
   Charitable contributions
   Medical expenses (you may subtract 10% of AGI)
   Home mortgage interest
   Other interest up to net investment income

4. Subtract amounts paid to you from a trust.
5. Subtract income from alcohol fuel credit.
6. Subtract alternative tax net operating loss deduction.

The second step is to subtract the amount that is exempt from the alternative minimum tax. This amount depends on your filing status.

Filing Status	Exempted Amount
Married Filing Separate	$20,000
Single, Head of Household	$30,000
Joint, Qualifying Widow or Widower	$40,000

Gross alternative minimum tax is 20% of the amount computed in Step 2. Alternative minimum tax is due only if this tax is larger than the regular tax liability.

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