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FARM INCOME TAX MANAGEMENT FOR 1976

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Tax planning is much more difficult when new tax laws are retroactive. For example, several provisions of the 1975 Tax Reduction Act were applicable to the 1975 tax year only. It was unknown as to whether some of the provisions would be reinstated in future legislation. The Tax Reform Act of 1976, passed in September 1976, contains many changes retroactive to January 1, 1976. In effect this nullifies some tax planning for 1976, however, many of the main principles of tax management can still be used.

Tax management may involve the timing of sales, farm business organization, financing the business, and strategies in operating the business. A farmer should be sufficiently aware of the principles of tax management and have enough knowledge of the tax laws to know when to consult a tax specialist.

The tax manager should, if possible, have enough farm income in a given year to offset all of his exemptions and deductions. The $35 deduction against tax liability for each dependency exemption or 2% of first $9,000 of taxable income, whichever is larger, should not be overlooked for the 1976 and 1977 tax years. See O.S.U. Current Report, "Tax Reform Act of 1976," for the filing requirements in 1976.

Persons in the higher tax bracket should be aware of the graduated tax rates. The rates are 14 percent for taxable income under $1,000 to 25 percent when it reaches $12,000 and 50 percent when it reaches $44,000.

Investment Credit

The wise tax manager takes advantage of investment credit especially during high tax years. The 10 percent investment credit is good through the year 1980. The investment credit is deducted directly from tax liability, thus, it is much more valuable than depreciation. A farmer purchasing a $40,000 tractor and establishing a 7 year life would be able to deduct $4,000 from his tax liability. Most farmers, therefore, make more purchases that qualify for investment credit in high income years. For further information, see O.S.U. Facts "Investment Credit Highlights and Depreciation Guidelines.

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. In the year of sale, the down payment and subsequent payments must not exceed 30 percent of the selling price. There are other strict requirements that must be met. See O.S.U. Facts 700, "Tax Considerations in Selling a Farm Business.

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 excced 120% of your average income for the preceding 4 years by more than $3,000.

Capital Gains

Everything you own is, for income tax purposes, either a capital asset or a noncapital (ordinary) asset. If your net long-term capital gains exceed your net short-term capital losses, you claim a deduction equal to 50% of the excess. This is the reason why it is often stated that we only pay tax on one-half of our capital gains. Therefore, it is an advantage to any taxpayer to qualify as much gain as possible for long-term capital gains.

To qualify, different assets have to be held for specified periods of time. For example, land has to be held at least 6 months, breeding swine for 12 months, and breeding cattle for 24 months. Therefore, it is usually good tax management to hold an asset for a few months longer if such a period of time qualifies it for capital gains.

Beginning in 1977, the holding period for capital gains will be increased from 6 to 9 months and to 12 months in 1978 and later years. Farm commodity futures contracts will continue to be eligible for capital gains after 6 months.

Long-Term Capital Losses

If you have held a capital asset for 6 months or less, the gain or loss is short-term. Short-term gain is taxed as ordinary income. Capital losses must be used to offset capital gains. After 1970, net long-term losses may offset up to $1,000 of ordinary income on a $2 for $1 basis. That is, it takes $2,000 of long-term loss to offset $1,000 ordinary income. The excess long-term loss may be carried forward indefinitely. Thus, it is usually good strategy to consider the following, remembering that net after taxes should be the objective of most business decisions:

Take capital losses up to 100% of gains. Avoid if possible taking long-term losses in excess of gains. Remember, losses on property used in your trade or business (Sec. 1231 Assets), unless offset by gains, are fully deductible as ordinary losses.

One should also keep in mind that the amount of ordinary income against which capital losses can be deducted will increase to $2,000 in 1977 and $3,000 in 1978 and thereafter.

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. Table 2 illustrates the consequences of selling 2 years' farm income in 1 year. Note that both families had the same average income but the Smiths' had to pay $1,069 in taxes while the Jones' paid none.

Table 3 lists ways to reduce taxable income and ways to increase taxable income. Some of them are limited or restricted in their application.

To get a deduction for prepaid feed bills, a cash basis farmer must show that the expenditure is a payment and not a deposit, the prepayment has a business purpose, and income isn't distorted. If the contract includes a provision for a refund, the prepayment will be disallowed. Acceptable business purposes include guaranteeing prices and/or securing supply. The I.R.S. will look for the following with respect to the distortion of income.

(1) Was the prepaid feed expense customary in the past?

(2) Was the prepayment in proportion to past

Table 2.

Smiths' and 2 Children			
First Year	Second Year	Average Income	Tax
--0--	$12,200	$6,100	$1,069

Jones' and 2 Children			
First Year	Second Year	Average Income	Tax[A/]
$6,100	$6,100	$6,100	--0--

[A/] The Jones' would also qualify for earned income credit and the Smiths' would not.

years' prepayment?
(3) Did the taxpayer wait until the end of the year to make the prepayment? If the test isn't met, I.R.S. will defer deductions for prepayments to taxable years in which the feed is actually consumed.

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 FARMER'S TAX GUIDE for further details.

Depreciation Suggestions

Some pertinent facts and principles regarding the use of depreciation follows:

(1) Taking the additional first year depreciation, plus the declining balance should be considered in high income years. When the annual income becomes lower than normal, switch from the declining balance to straight line. A taxpayer may switch from the declining method to straight line without permission from the Internal Revenue Service.

(2) Generally, if a taxpayer is having to borrow money and has to pay income taxes, a rather rapid rate of depreciation is best. Rapid depreciation results in postponing tax rather than reducing it. It allows the taxpayer use of the money before he gives it up in taxes. The value of a dollar in hand today is worth more than one to be received in the future. A young man who doesn't have enough income to use up his exemptions and deductions would, of course, benefit from a slow recovery of depreciation.

(3) Depreciation is not optional. If not claimed, the depreciation that would have been allowable must be subtracted from the cost to determine the adjusted cost and the

Table 3.

TO REDUCE TAXABLE INCOME	TO INCREASE TAXABLE INCOME
Make Additional Purchases	Change to Slower Depreciation
Use Maximum Initial Depreciation	Postpone Payments of Current Accounts
Delay Sales	Sell Crops and Livestock
Pay Current Accounts	Collect Accounts Receivable
Use Income Averaging	Do Additional Custom Work
Do Extra Conservation Work	
Make Needed Repairs	
Establish Retirement Fund	

resulting gain. If a taxpayer fails to take depreciation when due, he is not allowed to recover the lost depreciation in a later year.

See the FARMER'S TAX GUIDE for details and comparisons of the different methods of depreciation.

The Importance of Good Records

Taxpayers are required to keep sufficient records to accurately prepare an income tax return. In addition to the record of income and expenses, a record of all capital purchases should be made. Records to substantiate the depreciation schedule as well as records of nondepreciable assets should be kept. Permanent records should be kept of capital expenditures made on the farm home as they will be needed to determine the basis in case it is sold at some later date. The date of purchase and date of disposition should be kept of all items on which investment credit has been taken. Farm Home Account Books suitable for adequate tax records are available at your local O.S.U. County Extension Center.

Net Operating Loss

If a farmer has a net operating loss, it may be used to reduce net farm income of other years. Generally, the loss is carried back 3 years and applied against taxable income of that year. If the income is not sufficient in that year, the remaining loss is carried to the second preceding year. If necessary, it may be carried back 3 and forward 7 to use up all the loss. Under the new law, taxpayers presently entitled to carryback periods for operating losses may elect to forego the entire carryback period for a net operating loss in any tax period.

Oil Production and Bonus Leases

Money received from oil production has had a 7% gross production tax taken out. Small producers are entitled to a depletion allowance of 22%. The example below shows how to compute depletion.

$930 oil checks received for the past year
$930 ÷ .93 = $1000 value of oil sold last year
$1000 x 22% = 220 depletion allowed
$930 - 220 = $710 taxable income

Percentage depletion is no longer permitted for a recipient of a lease bonus in connection with oil and gas. Recipients of lease bonuses are limited to cost depletion.

Other Tax Considerations

Prior to the end of the tax year, consider how the following may affect your 1976 taxes:

1. Conservation expenses up to 25% of gross farm income may be incurred and deducted.
2. Land clearing expenses up to $5000 or 25% of net farm profit, whichever is smaller, may be deducted.
3. If you bought a farm during 1976, 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 and disaster payments 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 2 years after the close of the first tax year in which you realized any part of the gain on the involuntary conversion. The replacement period is changed from 2 to 3 years for real property with respect to which any condemnation proceedings begins on or after the date of the enactment of '76 Tax Reform Act.
6. Commodity credit loans may, at your election, be included in income for the year in which the proceeds of the loan are actually received. Once you report on this basis, you must continue unless permission from the IRS to change is received. Bank loans may not be treated as income.

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