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FARM INCOME TAX MANAGEMENT FOR 1977

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The objective of a wise farm manager should be to maximize income after taxes. Most major management decisions have income tax implications. Therefore, it is important that a modern manager have a good understanding of income tax management. He should have sufficient knowledge about tax management to know when to obtain the advice and opinions of tax specialists.

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 as well as exemption for age and blindness or 2 percent of first $9,000 of taxable income, whichever is larger, should not be overlooked for the 1977 and 1978 tax years. See O.S.U. Current Report, "Tax Reduction and Simplification Act of 1977".

Strategy Change

Prior to the change in the 1976 estate tax laws, it was good tax strategy for cash basis farmers to let their heirs inherit a large farm inventory. For example, if a cash basis farmer died having large inventories of grain and raised cattle with a zero income tax basis, his heirs received a new basis at his death. Generally, the new basis for the heirs was the value appraised for estate tax purposes.

All this has been changed under the 1976 Tax Reform Act. Crops raised after 1976 and livestock born after 1976 will all have a zero basis for the heirs. For example, if Mr. Farmer dies in 1977 and leaves crops and livestock of $100,000, it will not only be included in his estate for estate taxes at this value, but his estate or heirs will have to pay income tax on it when it is sold.

Inventory items, machinery and land held prior to 1977 may qualify for a stepped up basis as of December 31, 1976. See O.S.U. Facts 728, "Major Federal Estate and Gift Tax Changes".

As a result of this change, it became more important to sell zero basis inventory items during low income years.

Earned Income Credit

Due to low grain prices, more farmers will be eligible for the earned income credit. If your earned income or adjusted gross income is less than $8,000, you

Table 1

Smiths' and 2 Children			
First Year	Second year	Average Income	Tax
--0--	$14,460	$7,200	$1,275
Jones' and 2 Children			
First Year	Second Year	Average Income	Tax[A/]
$7,200	$7,200	$7,200	--0--

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

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 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.

Investment Credit

The 10 percent investment credit is good through the year 1980.

Net Operating Leases (NOL)

Farmers who have net operating losses this year may carry the loss back three years, or if they so desire, they may relinquish the entire carry-back period and carry it forward.

Form 1040X should be used to obtain 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 50 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.

Table 2

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	

may claim the 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 years of age, for whom you claim as a dependent, may qualify.

The earned income credit is 10 percent of the first $4,000 of earned income or a maximum of $400. The credit is reduced by 10 percent by which your adjusted gross income or earned income exceeds $4,000. Earned income means wages and salaries and net earnings from self-employment. 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.

Commodity Credit Loans

Commodity Credit Loans may, at your election, be included in income for the year in which the proceeds of the loan are actually received, instead of the year the commodity is finally sold. You need not obtain permission from the Internal Revenue Service to adopt this method of reporting Commodity Credit Loans, even though you may have reported those received in prior years as taxable income in the year the crop was sold. Once you have reported on this basis, however, you must report all such succeeding loans as income in the year received, unless you obtain the permission of the Internal Revenue Service to change to a different method. You make the election by including (in Schedule F) the amount of the loan as income in the year you receive it. You should attach a statement to your return indicating that the election is made and showing the amount of the loan, the year the loan was received, the commodity on which the loan was received, and the quantity of the commodity.

If you report Commodity Credit Loans as income in the year received, then you must treat any amount received in excess of the loan as additional income in the year the commodity is sold.

Loans on your wheat received from a bank cannot be treated as income for income tax purposes. Thus, if you need a loan for all of your wheat and want to pay income taxes on only part of it this year, you may want to obtain a loan on part of it at a bank.

Capital Gains

There is considerable discussion about terminating capital gains tax next year. If this happens, farmers will pay considerable more tax. At the present time, if your net long-term capital gains exceed your net short-term capital losses, you claim a deduction of 50 percent of the excess. This is why it is often stated that we only pay tax on one-half of our capital gains.

Beginning in 1977, the holding period to qualify for capital gains is 9 months, 12 months for breeding swine and sheep and 24 months for breeding cattle. Farm commodity futures contracts will continue to be eligible after 6 months.

Although it is uncertain as to whether capital gains will be terminated next year, if you have items that qualify for capital gains which will be sold in the near future, it may be wise to closely watch proposed legislation. Beginning in 1978, capital assets will have to be held for 12 months to qualify for capital gains.

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 1 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 $1,275 in taxes while the Jones' paid none.

Table 2 lists ways to reduce taxable income and ways to increase taxable income. Some of them are limited or restricted in their application.

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.

Installment Sales

If a major sale will result in an unusually large taxable income, aways 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.

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.

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

Other Tax Considerations

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 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 whichever condemnation proceedings begin on or after the date of the enactment of '76 Tax Reform Act.

6. 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.

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