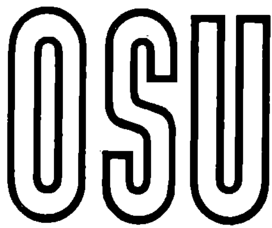

Current Report

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1978 FARM INCOME TAX MANAGEMENT

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What should your tax strategy be for 1978? Do you want an average taxable income year? Do you need to delay or accelerate taxable income for the rest of the year to reach your objectives?

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.

Capital Gains and Losses

Last year there was discussion in Congress to do away with capital gains tax. This, in effect, would have increased taxes from capital gains. This year the tax climate is different. It appears there will be a reduction in the capital gains tax in the 1978 tax legislation, however, at this time we do not know when it will be effective.

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. Capital gains are a tax preference item and subject to the minimum tax.

The holding periods to qualify for capital gains, including Section 1231 assets, are: 12 months for breeding swine and sheep, 24 months for breeding cattle, and, 12 months for assets such as land and machinery. Farm commodity futures contracts will continue to be eligible for capital gains after holding for six months.

Therefore, if you have a capital asset that you plan to sell (stocks for example), which would result in a gain, try to hold it long enough to qualify for capital gains. On the other hand, if you have a capital asset which, if sold, would result in a loss, sell it while it is a short-term capital loss. Net short-term capital losses are deducted dollar for dollar from taxable income, whereas, it takes two dollars of long-term capital losses to offset one dollar of ordinary income.

As a general rule, take capital losses up to 100% of capital gain. Avoid, if possible, taking long-term losses in excess of gains. Remember, losses on property used in your trade or business (Section 1231 assets), unless offset by gains, are fully deductible as ordinary losses. A maximum of $3,000 net long-term capital loss may be deducted in one year. The remainder, if any, must be carried forward.

$3,000 Annual Gift Tax Exclusion

Don't forget to take advantage of the $3,000 gift tax exclusion for the first $3,000 in gifts to each donee. The gift may be increased to $6,000 if your spouse consents to have the gift treated as being one-half from each of you. This is true even if only one spouse owns the property. This procedure is allowed under both federal and Oklahoma gift tax laws. Gift tax returns have to be filed under this

latter provision.

Gifts of Raised Farm Produce

Gifts of raised grain or livestock are not included in the tax return of the donor (person making gift). Inventories have to be adjusted for those on the accrual basis making such a gift. The cost of producing the items must be deducted from the donor's production costs on his tax return. When the donee (receiver of the gift) sells the farm produce, he must report the income on his return. The basis of the gift in the hands of the donee is the same as the donor's.

Crop Shares Received as Rent

Crop shares received as rent must be included in the gross income of the donor, even though they are given as a gift. Warehouse receipts of such crop shares would be treated the same. Grain received as rent is treated differently than raised grain when given as a gift.

Tax Shelters

Do you want to adopt a tax sheltered retirement plan this year? It should be established prior to the end of the year if it is a new plan. Payments may be made up to the date of a timely filed tax return, if the plan has been previously established. See OSU Facts No. 121, *Tax Shelters for Farmers*, for further information about tax shelters.

Oil and Gas Production and Cash Bonus Leases

A twenty-two percent depletion allowance is allowed on Oklahoma returns for both oil and gas production and cash lease bonuses.

Small producers may take a twenty-two percent depletion for oil and gas production on the federal return*. Percentage depletion is no longer allowed for a lease bonus on a federal return.

Checks received for oil and gas production have had a seven percent gross production tax deducted. Since a depletion allowance of twenty-two percent is allowed, the taxable income should be recomputed as illustrated in the example below.

$9,300 oil checks received for the past year

$9,300 ÷ .93 = $10,000 value of oil sold last year.
$10,000 X 22% = $2,200 depletion allowed.
$9,300 - 2,200 = $7,100 taxable 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.

*In 1978, the depletable oil quantity was 1,200 barrels per day and the natural gas was 7,200,000 cubic feet. The rate and amounts are to be reduced in later years.

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.

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 two years' farm income in one year. Note that both families had the same average income but the Smiths had to pay $1,275 in taxes while the Joneses 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.

If possible, always have enough income to offset all of your exemptions and deductions. In 1978, the allowable deductions amount to $7,200 for a family of four before any income tax is due.

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 downpayment and subsequent payments must not exceed 30 percent of the selling price. There are other strict requirements that must be met.

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

Table 1

First Year	Second Year	Average Income	Tax
Smiths and 2 Children			
--0--	$14,400	$7,200	$1,275
Joneses and 2 Children			
$7,200	$7,200	7,200	--0--

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	

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 four years by more than $3,000.

Children As Employees

Reasonable wages may be paid your children for farm work as long as there is a true employer-employee relationship. They should be assigned definite duties and responsibilities and wages should be paid regularly, as if paid to non-related employees. The parents can receive an exemption for the child as a dependent as long as they provide over one-half of the child's support. This applies to children under 19 years of age or those qualifying as full-time students regularly enrolled in school five or more months in the year. The child must file and pay tax if his income exceeds $2,950. If the dependent child has unearned income, the unused zero bracket amount must be added to his other income to arrive at the tax table income. Do not pay Social Security tax on your children under 21 years of age.

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 1978, 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. Deficiency payments are not disaster payments.

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 thr years after the close of the first tax year in which you realized any part of the gain on the involuntary conversion.

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 balance method to straight line without permission from the Internal Revenue Service.

> The Revenue Act of 1978 was still being debated in Congress at the time this was written. Most of the provisions are effective after 12-31-78.

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