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FACT SHEET

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The Why and How of Farm Income Tax Management

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BASIS FOR INCOME TAX MANAGEMENT

Income tax management opportunities arise from four situations: (1) not all income is taxable, (2) tax rates vary with the amount of taxable income, (3) income, particularly that of farmers and ranchers, may vary widely from year to year, and (4) tax regulations provide optional methods of reporting certain income and costs.

Income tax rates range from 14 percent on the lowest taxable income to 70 percent on the highest. Tax savings are possible by shifting deductions to unusually high income years where they will be deducted from income subject to higher tax rates. Further savings are realized by increasing the proportion of non-taxable income. (See figure page 3.)

Personal deductions and exemptions exclude some income from taxation. Other non-taxable income comes from capital gains, dividend exclusions, depletion allowances, retirement income credits, tax-free bond credits, non-taxable exchanges, self-employed retirement plan deductions and non-recognized gains on contributions. Careful planning can increase the proportion of non-taxable income.

Deductions, whether business expenses or personal deductions, reduce taxes more in high income years than in low income years. For example, consider the farmer whose highest tax rate on his usual taxable income of $4,000 would be 17 percent. However, in some years because of little or no taxable income his tax rate might be zero. If this farmer has extra income from an oil lease or property sales and good yields and prices for his crops, all of which result in $12,000 taxable income for the year, his highest tax rate would be 22 percent. Thus, any deduction moved from a lower to a higher income year reduces the tax rate on the amount of the deduction shifted between years. In this example, savings would be the difference between 17 and 22 percent or, possibly, zero and 22 percent if the next year showed no taxable income.

REDUCING TAXABLE INCOME

Claim All Allowable Deductions

Carefully report all allowable deductions, both business and personal, from a complete and accurate financial record. Deductions easily omitted include the cost of business travel and entertainment; protective clothing; subscriptions to farm magazines and professional publications; the business share of costs that are partly business and partly personal such as water wells and pumps, fire arms used to protect crops and control predators, dogs and dog food used in livestock production, and horses used in the farm or ranch business; travel expenses and lodging in behalf of a church or charitable organization and the fair market value of assets given such organizations.

Capital Gain Income

Only half of the profit on eligible capital sales may be taxable and at a maximum rate of 50 percent. Farmers and ranchers frequently include the sale of breeding, draft and dairy livestock with the sale of calves, pigs and lambs. All profits from livestock purchased or raised for sale are reported as ordinary income on Schedule F and subject to taxation. However, breeding, draft and dairy livestock held for income production whether raised or purchased, are reported as capital sales on Schedule D and may be eligible for the capital gain treatment.

Livestock systems can be managed to produce a higher proportion of capital sales by raising herd replacements, as opposed to purchasing replacements. Particularly important are the overall profits from each system, as well as any existing tax advantages. Factors to consider include the producer's income tax bracket, cost of raising replacements, desirable replacements available for purchase and disease control.

Improvement Deductions

Farm and ranch operators can deduct soil and water conservation, brush control and timber clearing costs as ordinary expenses, with certain

restrictions, or capitalize them (add them to the original cost of the property) to be recovered when the property is sold at some later date. These costs are lost when capitalized if the property is transferred to heirs through an estate. If the costs are capitalized and the property is later sold, profits (usually capital gains) are reduced by the amount of the costs capitalized. However, if these costs are deducted, they reduce ordinary income by that amount.

Actual soil and water conservation and brush control costs can be deducted by up to 25 percent of the *gross* farm income in the year incurred. If these costs exceed the 25 percent limitation, they may be carried forward and deducted by up to 25 percent of each following years' gross farm income until the total costs have been claimed. Once the taxpayer elects to either deduct or capitalize these costs, he cannot change without permission from the Internal Revenue Service.

Timber clearing costs to make land suitable for farming may be deducted by up to the lesser of 25 percent of the *taxable* farm income or $5,000 in the year incurred. Costs exceeding the limitation must be capitalized. The election to deduct or capitalize timber clearing costs can be made each year they are incurred.

Non-taxable Exchanges, Involuntary Conversions

When a farm or business is relocated or the type of business is changed, business property may be traded for *like* business property in a non-taxable exchange. Whereas, if business property is voluntarily sold, any profit is taxable income without regard to how the proceeds are used. The cost, for tax purposes, of property received in a non-taxable trade is the cost of the property traded plus any "boot" paid. The amount of any boot received is taxable income. Non-taxable exchanges are limited to exchanges of certain business and investment property.

Gain from the sale of a personal residence is non-taxable gain if a replacement residence is acquired within 1 year from the date of sale at a cost as much or more than the proceeds from the residence sold. Home construction started within 1 year and occupied within 18 months also meets the time period requirement. A taxpayer 65 years or older before the date of sale can exclude the entire gain up to $20,000 adjusted sale price, provided he *owned and used* the residence for at least 5 years out of the last 8 years preceding the date of sale. Only one such exclusion of gain may be made during a taxpayer's life.

Involuntary conversions occur when compensation is received for property destroyed by casualty, stolen or condemned for public use. Gain from an involuntary conversion is non-taxable if replacement property is acquired within 1 year from the end of the tax year in which any gain is realized.

Replacement property must cost as much or more than the net proceeds from the conversion for the total gain to be non-taxable. Involuntary conversions can result from casualties, such as an auto accident, shipwreck, airplane crash, wind, hurricane, flood, lightning, freezing, drouth and fire or from theft for which insurance proceeds are received. Payments for property condemned by public authority are also involuntary conversions.

Itemized Personal Deductions

If itemized deductions exceed the standard deduction, taxable income may be reduced by contributing property or assets to churches and charitable organizations rather than cash. Taxpayers can claim the fair market value of assets contributed to qualifying organizations as a contribution. For example, if a taxpayer sells an asset that costs $400 for $1,000 and contributes the proceeds to a qualifying organization, he has a $600 taxable gain and a $1,000 deductible contribution. If, however, he contributes the asset, he may deduct the $1,000 contribution and no taxable gain is realized. Farm expenses cannot include the costs of purchasing and/or raising livestock, crops or produce contributed to qualifying organizations.

Other Deductions

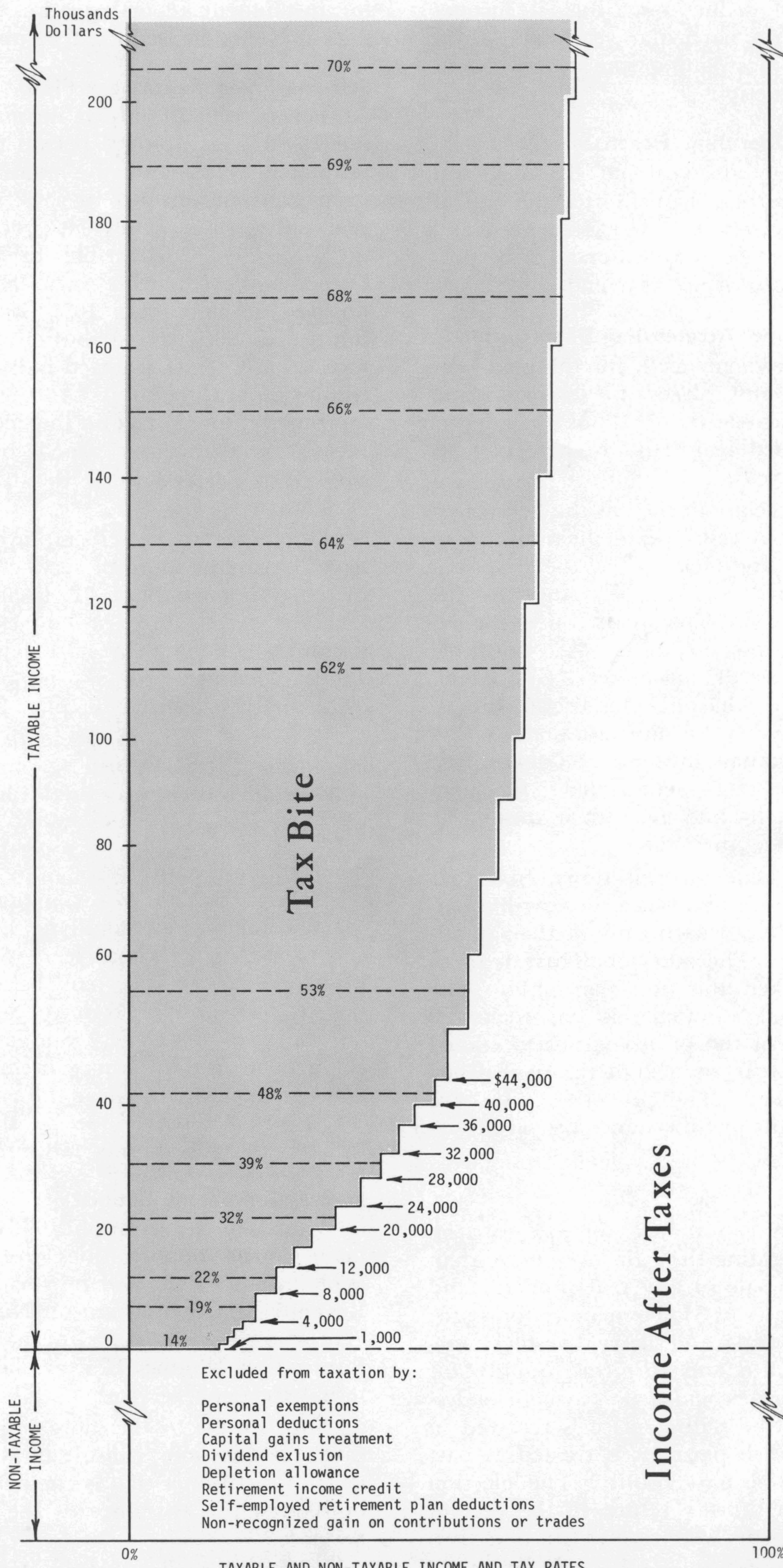
Deductions not deliberately planned should not be overlooked, such as casualty and theft losses, child care costs, extra exemptions for age or blindness, exemptions for students living away from home and income averaging where applicable.

Investment credit, oil and mineral depletion allowances, retirement income credit, foreign tax credit, tax-free covenant bond credit and dividend exclusion are additional deductions on qualifying income and expenditures.

For taxpayers filing a joint return in a community property state, which includes Texas, the capital loss deduction is limited to $1,000 or the combined taxable income, without regard to capital gains and losses and exemptions, whichever is smaller. However, husband and wife may claim a capital loss deduction of $1,000 each if they file separate returns.

INCOME LEVELING

Income leveling does not attempt to reduce taxable income or to increase the total amount of deductions. These were covered in the preceding section. Income leveling deals with shifting a portion of income and/or deductions between years for maximum benefits resulting from high and low tax brackets. If taxable income is fairly constant from year to year, little can be gained by



TAXABLE AND NON-TAXABLE INCOME AND TAX RATES

FOR MARRIED TAXPAYERS FILING A JOINT RETURN

shifting income and deductions. But, if income is unusually high in a particular year, total taxes can be reduced by postponing some income and advancing some deductions.

Ordinary Income, Operating Expenses

In high income years, year-end livestock and crop sales can be postponed until after the end of the tax year. Conversely, fertilizer, seed, feed and supplies required for the next season may be purchased before the current tax year ends.

Capital Purchases and Accelerated Depreciation

Anticipated equipment needs for the next year may be purchased and placed in service before the end of a "high income" year. Thus some depreciation can be claimed against the higher tax rates of the high income year.

Accelerated depreciation, such as the "declining balance method," can result in deductions up to twice the "straight line method" in the first year an asset is depreciated, and can be changed to the straight line method in later years when the accelerated method is not advantageous. Breeding, draft and dairy livestock, machinery, equipment, buildings and fences that have a useful life of 3 years or more qualify for the fast depreciation methods. This election must be made the first year a qualifying asset is depreciated. Once an asset is on the straight line method, it cannot be changed to any other method.

Taxpayers may claim an additional first year 20 percent depreciation allowance on tangible personal property that has a useful life in their hands of 6 years or more. The additional first year allowance can be taken the first year only. The maximum additional allowance is limited to 20 percent of the cost of the property, not to exceed $20,000 in any one year, on a joint return ($10,000 on a separate return). The property must have been purchased. Gift or inheritance property does not qualify.

Installment Sales

Installment sales can reduce the tax rate on capital sales by spreading the gain over more than one tax year. The sale of any real property and personal property sales of $1,000 or more for assets, such as breeding, draft and dairy livestock, machinery, personal auto and furniture qualify for installment reporting, *provided* no payment or less than 30 percent of the selling price is received in the year of sale. Each payment is treated as part recovery of costs and part profit. The election should be made on the tax return in the year of sale even if no payments were received in that year.

Property held primarily for sale or which would have been included in inventories does not qualify for installment reporting. Losses on installment sales may not be deducted in installments.

Self-Employed Retirement Plan

Ten percent of earned income can be contributed by a self-employed person to a self-employed retirement plan and the contribution deducted from gross income up to a $2,500 maximum for years after 1967. Only 50% of the contribution up to $1,250 is deductible for years before 1968. Owner-employees who own an unincorporated business or more than 10% of a partnership are limited to $2,500 contribution annually in their own behalf. Self-employed individuals not owner-employees are not subject to the $2,500 limitation on contributions. Tax on the deduction from gross income and income earned by the retirement fund is postponed until the fund is distributed at maturity.

Employees of the self-employed individual who have 3 years or more of service must be included in the retirement plan. Retirement plan benefits may not start before age 59½ except for death or disability and must be started not later than age 70½. Tax penalties are imposed for ineligible distribution of retirement plan funds.

Generally, persons presently subject to self-employment tax, ministers, commission salesmen and certain others may establish self-employed retirement plans.

Itemized Deduction

In high income years, a portion of the next year's contributions could be made prior to the end of the high income year. Some personal and property taxes may be paid before the end of one tax year or postponed into the next, depending on the tax advantage. Similarly, some interest charges, medical insurance premiums and medical expenses may be due near the end of the tax year. These offer opportunities to shift deductions to the year of greatest tax advantage.

Secure Competent Council

Most regulations applicable to the income tax management opportunities discussed herein are explained in *"Your Federal Income Tax,"* Internal Revenue Service Publication Number 17, and the *"Farmers' Tax Guide,"* Internal Revenue Service Publication Number 225, available from your Internal Revenue Service.

For answers to the more important or complicated tax questions, consult an attorney, accountant or tax practitioner that is competent in tax matters or request the assistance of the Internal Revenue Service.

In any case, plan before you act. Dertimental action, tax wise, usually cannot be corrected.

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