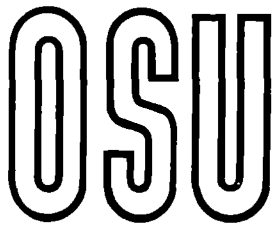

Current Report

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TAX MANAGEMENT FOR 1975

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Tax management decisions in 1975 will be more difficult in some respects than in previous years. This is due to several provisions of the 1975 Tax Reduction Act which, at the present time, affects the tax year 1975 only. It is uncertain at this time whether some or all of these provisions will be extended to the tax year 1976.

For example, the increased standard deduction, the higher low income allowance, and the $30 deduction per exemption from actual tax liability is effective for the 1975 tax year only. Thus under present law, income taxes for many will be lower for 1975 than they will be for the year 1976.

One should still use the main principles of tax management however. A taxpayer should make sufficient sales to use up all of his exemptions and deductions, including the $30 deduction from tax liability for each exemption.

In Table 1, note that taxpayers with four exemptions can have up to $4,900 and not be taxed. If he used the $30 deduction from tax liability per exemption, he could have up to $5,750 and not owe any taxes. The $30 per exemption excludes those for being blind and over age 65.

If a person is in a higher bracket and uses the standard deduction, the amount is 16% of the adjusted gross income up to $2,600 for a joint return.

Another factor in tax management is the graduated tax rates. The rates are 14% for taxable income under $1,000 to 25% when it reaches $12,000 and 50% when it reaches $44,000.

Eligible property acquired and placed in service after January 21, 1975 and before January 1, 1977 qualifies for 10% investment credit. Seven percent investment credit is allowed for the period January 1, 1975 to January 21, 1975.

Installment Sale

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% of the selling price. There are other strict requirements that must be met.

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.

Capital Gains

Everything you own is, for income tax purposes, either a capital asset or a noncapital (ordinary) asset. If your net long-

Table 1. Non-Taxable Amount in 1975[A/]

Exemptions	Non-Taxable Amt.	Exemptions	Non-Taxable Amt.
1	$2,350	5	$5,650
2	3,400	6	6,400
3	4,150	7	7,150
4	4,900	8	7,900

[A/]According to the tax tables and based on a joint return where 2 or more exemptions are indicated. The $30 deduction per exemptions from tax liability is in addition to the amounts indicated for 1975.

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.

Decisions Which May Have Major Tax Implications

A good tax manager will seek competent tax counsel prior to making decisions which may have major tax implications. A good tax expert can estimate the tax consequences prior to making the decision. Some of the major decision areas in farming and ranching are as follows:

(1) When a change in the form of business organization is being made. When a sole proprietor changes to a partnership or corporation, a lack of tax knowledge can be costly. The wrong choice may result in immediate, additional taxes, while an alternative choice will result in no additional taxes. Also, a change in business organization will result in establishment of certain tax records which must be maintained throughout the life of the new organization. Some alternative choices will result in the recapture of investment credit.

(2) When purchasing major equipment. The tax consequences should be analyzed prior to making purchases of large equipment. Investment credit implications and depreciation must be weighed against the consequences of hiring custom work or perhaps renting some piece of equipment or machinery.

(3) When planning major expansions. Usually, a major expansion involves capital investment in both depreciable and non-depreciable capital assets. How the expansion will affect cash flows and how potential future capital gains can be created should be explored.

(4) When planning for retirement. Farmers approaching retirement may reduce taxes significantly by sound tax planning. For example, upon coming eligible for social security it may be advantageous to cash or crop rent their land rather than continue farming. Also, investing in approved retirement plans must be analyzed relative to investing the funds in the business.

(5) Comparing farm to off-farm investments. Successful farmers with money to invest should weigh the advantages and disadvantages of investing in stocks, bonds, and non-farm real estate compared to additional farm investments. Growth, capital gain, and inflation may effect the tax consequences.

(6) In estate planning. Not only estate taxes but income taxes must be considered in estate planning. For example, in making gifts of property the donee's basis will be the same as the donor's plus any gift taxes paid. Generally, it is best

to let children inherit property with a low basis if they intend to later sell it. Unless income tax consequences are considered, some actions in estate planning may result in more income taxes being paid than estate taxes being saved.

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 two years' farm income in one year. Note that both families had the same average income but the Smiths' had to pay $786 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. See the section on "Prepaid Feed Expenses."

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 non-taxable exchanges. See the FARMER'S TAX GUIDE for further details.

Table 2.

Smiths' and 2 Children			
First Year	Second Year	Average Income	Tax[1]
---0---	$9,800	$4,900	$786

Jones' and 2 Children			
First Year	Second Year	Average Income	Tax
$4,900	$4,900	$4,900	--0--

[1] The tax will be reduced $30 per exemption for the 1975 tax year.

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	

Prepaid Feed Expenses

The Internal Revenue Service has republished and will enforce a prepaid feed expense deductibility test. This test was originally published in 1973 but was held up by litigation until October 4, 1974. See Revenue Ruling 75-152 for the complete ruling.

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.

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 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.

Other Tax Considerations

Prior to the end of the tax year, consider how the following may effect your 1975 taxes:

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 1975, 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 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 two years after the close of the first tax year in which you realized any part of the gain on the involuntary conversion.
6. Only 50% of an individual's long-term capital losses may be used to offset ordinary income up to a $1,000 limit. Short-term capital losses can be deducted from ordinary income.

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