Tax Planning and Management Considerations for Farmers in 1992

George Patrick

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Tax Planning and Management Considerations for Farmers in 1992
Tax Planning

and

Management Considerations

for Farmers in 1992

by

George F. Patrick
Extension Agricultural Economist
Purdue University
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TAX PLANNING AND MANAGEMENT CONSIDERATIONS FOR FARMERS IN 1992

by George F. Patrick, Extension Economist, Purdue University

The economy has been the focus of considerable tax legislation in 1992. Early in 1992, Congress passed Tax Fairness and Economic Growth Bill of 1992, which was vetoed by President Bush. A number of tax provisions, including the medical deduction for self-employed individuals, were extended to June 30, 1992 as part of the bill to extend unemployment benefits. Later, the House-Senate compromise versions of the Comprehensive National Energy Policy Bill (H.R. 776) and the Revenue Bill of 1992 (H.R. 11) were passed by both the House and Senate before adjournment. These bills would have broadened Individual Retirement Accounts (IRA), established enterprise zones for job creation through deductible investments, and brought about many other changes. The Revenue Bill of 1992 was vetoed by President Bush.

IRS continues to make rulings and regulations. Farmers should be aware that IRS is taking an aggressive position with respect to noncash wages and other efforts to reduce self-employment taxes. The original H.R. 11 bill would have also eliminated the exclusion from social security taxes for noncash wages, other than housing and meals, for agricultural workers. This provision was not included in the compromise version.

The Comprehensive National Energy Policy Bill of 1992 had a number of energy-related and revenue-affecting provisions. One provision which affects farmers indirectly through its impact on the demand for corn is the extension of the partial excise tax exemption to 5.7 and 7.7 percent alcohol gasoline blends. Another provision which may affect some farmers is seller-financed deduction of home mortgage interest. A farmer who is buying a farm (including the farm home) on contract or seller-financed mortgage will be required to report the seller’s taxpayer identification number. This would be in addition to the name and address of the seller as currently required, and would be effective for 1992 and later years.

TAX ITEMS OF INTEREST

This section discusses a number of topics which may be of interest to farmers in 1992.

Avoiding Net Operating Losses

Because of reduced yields in 1991, farmers who carried their grain over may find that their 1992 taxable income is lower than expected. Although most farmers do not enjoy paying taxes, very few want to incur a loss to avoid taxes. A net operating loss (NOL) can be especially painful as some tax benefits are also lost. A NOL is not simply receipts minus expenses on Schedule F. Income from other sources such as sales of business assets reported on Form 4797, salary, wages, interest, dividends, rents, retirement distributions and the taxable portion of social security benefits is included. Only if the total income is negative does one have a NOL.

* Appreciation is expressed to Gerald Harrison, John Kadlec and Bob Taylor for helpful comments on an earlier version.
Tax planning may allow farmers to avoid having an NOL year and the complications it causes. An analysis of receipts and expenses will provide an idea of taxable income while there is still time to make adjustments. Some farmers may be better off to sell commodities in 1992 and avoid a loss. Their after-tax income might be higher than if they sold commodities for a higher price in 1993. Adjustments can also be made on the expense side. Purchases and payments may be deferred until 1993 to increase 1992 income for tax purposes.

If you have a NOL, the loss can be carried back to offset income from three years ago. For 1992 returns, that would be 1989. Adjustments which must be made and which may reduce the size of the NOL include:

a. Nonbusiness deductions (IRA or Keogh contributions, standard deduction) are allowed only to the extent of nonbusiness income (interest, dividends, and pensions).

b. Capital losses are allowed only to the extent of capital gains.

Although a NOL may reduce income tax liability in a prior year, there is no effect on self-employment taxes paid. Thus, in many instances, the tax benefits of a NOL may be wasted if there were other tax benefits in the carryback year.

An individual may elect to forego the NOL carryback and carry the NOL forward only. This election must be made by the due date of the return for the NOL. A statement to that effect is attached to the tax return. The election is made on a year by year basis, but once made for any year, it is irrevocable for that year.

If no planning is done before year-end, one should at least compare the carryback and carryforward options. The time value of money reduces the value of tax savings in the future which would be associated with the carryforward election. However, if the year 1989 was a low income year, the benefits from a carryback of a NOL may be very limited.

**Deductibility of Tax Preparation Fees**

Rev. Ruling 92-29 says that sole proprietors, farmers and other individual taxpayers with business, royalty or rental income may deduct part of the tax preparation fee. Likewise, individuals may also deduct expenses involved in an audit of the business or income production side of their tax return on the related business return.

**Example:** A farmer pays $450 for preparation of the entire 1991 tax return. Of the $450, $400 is for the preparation of Schedule F, Form 4797, Form 4562 and other business related returns. This $400 charge is deductible on the 1992 Schedule F. The $50 charge for preparation of the personal Form 1040 would be deductible only as an itemized miscellaneous deduction subject to the two percent floor.

This is a reversal of the previous IRS position. In 1991 (LTR-9126014) IRS took the position that the costs of preparing a Schedule C or F were only deductible as miscellaneous
itemized deductions subject to the two percent floor. If farmers did not deduct the allowable tax preparation fee, they might file amended returns.

Cooperative Distributions

Many farmers are members of cooperatives and may receive various distributions which are reported on 1099PATR. Proper reporting can avoid IRS inquiries and later adjustments. The total patronage dividends and per unit retainer should be reported on Line 5a of Schedule F.

Patronage dividends are an allocation of a cooperative’s income based on the farmer’s purchases of farm supplies and equipment or sales of commodities through the co-op. Only a portion, generally 20 percent, of the patronage dividend is paid in cash. The remainder is retained by the co-op as working capital and paid out at a later date or at the patron’s death.

The entire patronage dividend (both cash and noncash portions) is taxable in the year the qualified written notice of allocation is received. The future receipt of the noncash retained portion would not be taxable because it has already been reported as income. However, several adjustments may be necessary to properly reflect the taxable portion of the distribution.

a. Dividends received for the purchase of depreciable property are not reported as income, instead the asset’s basis for depreciation is reduced. For example, $10,000 of watering and feeding equipment was purchased from a co-op and a 1 percent ($100) patronage dividend was received. The basis for depreciation of the equipment would be $9,900. The $100 on the 1099 PATR would be reported on Line 5a, with a $0 on Line 5b of Schedule F as the taxable portion.

b. Dividends received for the purchase of items for personal use or the personal use portion are not taxable. Examples would include home heating oil and the personal use portion of gasoline purchases. Again, the gross amount of the 1099PATR would be reported on Line 5a, with only the taxable portion included on Line 5b of Schedule F.

c. Dividends for purchases made by a tenant and reimbursed by the landlord are not taxable. The portion of the patronage dividend attributable to purchases on behalf of the landlord, if passed through, would not be included in taxable income of the tenant.

Per units retainer are written notices of income allocations from a cooperative based on marketings, not earnings of the co-op. Like patronage dividends, the per unit retainer are reported on Lines 5a and 5b of Schedule F.

Co-op equity losses may result in a deduction for the farmer for the tax year in which a write-down occurs. If a co-op issues a statement indicating the patron’s equity account is permanently reduced, the write-down amount is deductible on Schedule F.
A deductible loss also occurs if a cooperative obligation is redeemed or sold for less than the face amount which was previously reported in income. For example, a farmer received a $250 patronage dividend in 1991, $50 in cash and a $200 certificate of indebtedness. If the certificate was sold for $120 in 1992, then the $80 loss would be reported as negative income on Line 10 (other income) of Schedule F in 1992.

DEPRECIATION AND EXPENSING

Form 4562 (Depreciation) is not required for 1990 and later years unless you add depreciable assets to the business during the year or use "listed property," like a pick-up truck, in the business. Depreciation for assets acquired in previous years would be entered on Schedule F based on the supporting depreciation schedule.

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) affected both the class life of some assets acquired after 1988 and the rate of depreciation for property used in farming. Although the system continues to be called MACRS (Modified Accelerated Cost Recovery System), different rates of depreciation apply for property acquired in the 1987-88 and after 1988 periods. Recent regulations have changed the final quarter limitation test and Section 179 expensing.

Class Lives and Depreciation Rates

Three-year MACRS property includes breeding hogs and the tractor units of semitrailers for over-the-road use.

Five-year MACRS property includes cattle held for breeding or dairy purposes, computers and some construction equipment. Congress specifically included automobiles, pickups and other trucks in the 5-year class. Special depreciation limitations and recordkeeping requirements apply to vehicles.

Seven-year MACRS property includes most agricultural machinery and equipment. Grain bins, fences and general office equipment are also included in this 7-year class. Single-purpose agricultural and horticultural structures placed in service prior to 1989 are also in this category.

Ten-year MACRS property includes single-purpose agricultural and horticultural structures placed in service after 1988, fruit trees and vineyards. For orchards and vineyards placed in service after 1988, depreciation is on the straight line method.

Allowable depreciation for these pre-1989 assets is calculated using the double declining balance (200 percent declining balance) method, shifting to straight line to maximize depreciation. For machinery and equipment used in farming and acquired after 1988, depreciation is slowed. The 150-percent declining balance instead of 200 percent declining balance will be used. Deductions by year, as a percentage of the depreciable basis, for assets acquired in the 1987-88 and after 1988 periods are shown in Table 1.
Table 1. MACRS Percentages for Property Used in Farming by Type of MACRS Property and When Acquired.

<table>
<thead>
<tr>
<th>Recovery Year</th>
<th>Type of MACRS Property</th>
<th>3-Year</th>
<th>5-Year</th>
<th>7-Year</th>
<th>10-Year</th>
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<tr>
<td>1</td>
<td>33.33</td>
<td>20.00</td>
<td>14.29</td>
<td>7.50</td>
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<tr>
<td>2</td>
<td>44.45</td>
<td>32.00</td>
<td>24.49</td>
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<tr>
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<td>19.20</td>
<td>17.49</td>
<td>11.79</td>
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<tr>
<td>4</td>
<td>7.41</td>
<td>11.52</td>
<td>12.49</td>
<td>10.02</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>--</td>
<td>11.52</td>
<td>8.93</td>
<td>8.74</td>
<td></td>
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<tr>
<td>6</td>
<td>--</td>
<td>5.76</td>
<td>8.92</td>
<td>8.74</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>--</td>
<td>--</td>
<td>8.93</td>
<td>8.74</td>
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<td>4.46</td>
<td>8.74</td>
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<td>11</td>
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<td>--</td>
<td>--</td>
<td>4.37</td>
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These MACRS percentages have built-in the "half-year convention" for the year of purchase. The equivalent of six months depreciation is allowed whether an asset is placed in service on January 1 or December 31. If a $100,000 asset were purchased in 1992, the depreciation allowed would generally be $25,000, $15,000, $10,710 or $7,500 if the asset was 3, 5, 7, or 10-year MACRS property, respectively. The "half-year" convention is also used for the year of disposition. For example, if a tractor acquired in 1988 is traded in 1992, the fifth recovery year, depreciation taken for 1992 would have been one-half of the 8.93 percent in the table.

Depreciable land improvements, such as field tiling, are assets in the 15-year MACRS class. Farm buildings, such as general purpose barns and machinery sheds, are 20-year MACRS property. The 150 percent declining balance method with a shift to straight line depreciation is used for property in the 15 and 20-year MACRS classes.
Rental houses and apartment buildings acquired in 1987 and later years will have a 27.5-year life. Non-residential real property such as office buildings, factories and stores will have a 31.5-year life. The 31.5-year life would be extended to 40 years by proposed legislation. Straight line depreciation is used for both the 27.5 and 31.5-year MACRS classes.

Final Quarter Limitation

A special limitation on depreciation applies if more than 40 percent of depreciable property acquired in a year is placed in service during the last 3 months of the year. This final quarter limitation affects all assets acquired that year and may substantially reduce the amount of depreciation allowed, especially on the near end-of-the-year purchases.

Example. If a $100,000 combine were the only asset acquired during 1992 and it was placed in service after October 1, then only 1.5 months of depreciation would be allowed. Instead of deducting $10,710 of the "half-year" depreciation, one could deduct depreciation for only 1.5 months or $2,680. The depreciation not allowed in the year of purchase would be taken in later years. For example, 20.85 percent would be allowed in the second year for an asset subject to the final quarter limitation in the year of purchase. For further details see IRS Publication 534, Depreciation, Table 18, page 51. This publication has tables which can be used to determine the appropriate percentage for each situation of depreciation.

Determination of whether the final quarter limitation applies is made after any Section 179 expensing. This is a different interpretation than in some previous years and is based on regulations adopted by the IRS. Whether Section 179 expensing is elected and which assets are selected for expensing may have a considerable impact on the depreciation for the year.

Example. Assume a farmer acquired a $25,000 machine in the first quarter, a $30,000 machine in the second quarter, and a $45,000 machine in the last quarter of the year. If there was no Section 179 expensing, the final quarter limitation would apply and a "mid-quarter convention" applies to all assets purchased that year. Each asset is treated as if it had been acquired on the mid-point of the quarter it was placed in service. Depreciation would be computed, using percentages from IRS Pub. 534 Tables 15, 16, and 17, as:

\[
\begin{align*}
$25,000 \times 18.75\% &= $4,687.50 \\
$30,000 \times 13.39\% &= $4,017.00 \\
$45,000 \times 2.68\% &= $1,206.00 \\
\text{TOTAL} &= \$9,910.50
\end{align*}
\]

Example. If the farmer elected $10,000 Section 179 expensing on the $45,000 machine acquired in the last quarter, then only $90,000 of qualifying property would have been acquired. The 40 percent test would not be satisfied, and the mid-year convention would apply to all of the purchases. Depreciation would be computed using the percentages from Table 1 above as:
In this instance, the total depreciation and expensing deduction would be $19,639.

**Property Purchased and Disposed of in the Same Year**

A few farmers have been trading combines every year. They have been aided by machinery company sales promotion programs of interest waivers from the time of purchases until September. In some instances, farmers have been acquiring a combine and trading it in before the end of the tax year. Several farmers and tax practitioners have had questions with respect to the amount of depreciation allowed.

The general depreciation regulations allow one-half year's depreciation in the year of acquisition (unless the final quarter limitation applies) and one-half year of depreciation in the year of disposition. Farmers would like this to imply that one gets a full year of depreciation if one purchases and disposes of a combine within the year. The new regulations indicate that if one purchases and disposes of an asset within a tax year, the transaction occurs on the same day, and one receives NO depreciation on that asset. Furthermore, in a like-kind exchange (trading back the combine used one season), no gain or loss is recognized. Thus, no loss can be deducted and the basis of the combine just keeps increasing.

**Example 1:** A farmer purchases a $100,000 combine on January 15 and a $10,000 planter on September 1. The combine is traded in December, but the replacement has not been received by December 31.

Only the planter is considered for the 40 percent test. The 40 percent test is not satisfied, and the planter is depreciated using the half year convention. There is no depreciation deduction on the combine.

**Example 2:** A farmer purchases a combine, #1, for $100,000 on January 15. On July 15th, the combine is traded for another combine, #2, and $10,000 boot is paid. These are the only assets acquired during the year.

The 40 percent test is not satisfied by combine #2, thus the mid-year convention applies. There is no depreciation on combine #1 because it was acquired and disposed of during the same tax year. Combine #2 has a tax basis of $110,000, and it qualifies for a half year of depreciation. This would be 10.71 percent of $110,000 or $11,781.

**Example 3:** The same as example 2, except the trade for combine #2 occurs on December 15. Combine #2 is delivered by December 31.
Combine #1 is not considered in the 40 percent test and gets no depreciation. Combine #2 does satisfy the 40 percent test, thus the mid-quarter convention applies. The basis of combine #2 is $110,000 and it is depreciated for 1.5 months, 2.68 percent, or $2,948. Section 179 expensing could be taken on combine #2.

Depreciation Alternatives

Farmers may elect to use other methods of depreciation. These alternatives all provide slower depreciation than is available with the MACRS 150 percent declining balance method. An election to use slower depreciation would apply to all assets in a specific MACRS class acquired in a given year. A farmer who made a major purchase in early 1992 and who has a lower than expected income might wish to use slower depreciation.

The straight line method of depreciation over the class life of the asset is one alternative. The straight line method is also subject to the "half-year convention." Thus depreciation on a 5-year MACRS asset would be 10 percent in the year of acquisition, 20 percent in the second through fifth years and 10 percent in the sixth year.

Farmers may also elect the straight line method over a longer period of time. This longer time period is called the Asset Depreciation Range midpoint and is ten years for most agricultural machinery and equipment, fences and grain bins. Cars, cattle and computers have a five-year ADR midpoint. Single-purpose agricultural and horticultural structures use 15 years.

A third method is 150 percent declining balance over the alternative MACRS life. The alternative MACRS life is generally the same as the ADR midpoint discussed above. This is the method which is used for alternative minimum tax (AMT) purposes. For further information see IRS Publication 534, Depreciation.

Section 179 Expensing

Farmers and others in an active trade or business can annually elect to treat the cost of up to $10,000 of qualifying property purchased during the year as an expense rather than as a depreciable capital expenditure. Tangible personal property used in a trade or business qualifies if it would have been eligible for investment tax credit. (The rules changed slightly; now reference is made to Section 1245 property which includes horses.) Purchased new or used property can be expensed. However, only the "boot" portion paid on trades is eligible for expensing. Inherited property or property acquired from a spouse, ancestors and lineal descendants is not eligible for Section 179 expensing.

The entire Section 179 expensing deduction can be taken on one large item, reducing the basis for cost recovery. Alternatively, several small items can be completely written off in the year of purchase. Less than the full $10,000 expensing deduction can also be used. The amounts expensed are treated the same as depreciation when the property is sold or traded, and for depreciation recapture purposes.
The expensing deduction is phased out on a dollar for dollar basis if over $200,000 of qualified property is placed in service during a tax year. For example, if a farmer buys $205,000 of machinery in one year, the maximum Section 179 expensing allowed would be $5,000 that year. Only the boot is considered for the $200,000 limit.

Recent IRS regulations indicate an employee receiving salary and wages is considered to be engaged in a trade or business. A farmer’s and/or spouse’s off-farm wage income could be combined with Schedule F loss so that aggregate taxable income would be positive. This would permit a Section 179 expense for an asset acquired by the farm business. Gain or loss from the sale of livestock, machinery and business assets reported on Form 4797 is also included in taxable income for Section 179 purposes.

The expensing deduction is also limited to the taxable income from any active trade or business before any Section 179 expensing. For example, a farmer with a net income from active trades and businesses of $2,600 would be limited to a Section 179 deduction of $2,600. If more than $2,600 of qualifying property had been purchased in 1992, the excess could be carried over to 1993 or later years. The amount carried over to 1993 could be deducted, assuming sufficient taxable income, even if no qualifying property has been purchased in 1993. However, the total Section 179 expensing cannot exceed $10,000 in a year, even with carryovers.

Example. Assume that $10,000 of qualifying assets has been purchased in 1991, but taxable income was only $3,100. Thus, only $3,100 would be allowed as Section 179 expensing in 1991, and $6,900 would be carried to 1992. In 1992, taxable income is $12,000 and $5,000 of Section 179 qualifying property is purchased. The 1992 Section 179 would be limited to $10,000 ($6,900 carryover plus $3,100 of new purchases). The remaining $1,900 of 1992 purchases ($5,000 minus $3,100) could be carried to 1993.

NOTE: Reducing taxable income to $0 as in the example above is generally not good tax management. Reducing income subject to tax below the personal exemptions and standard deduction by Section 179 expensing "wastes" future depreciation deductions.

With Section 179 expensing there is a trade-off between the tax deductions for income and self-employment tax purposes in one year versus tax savings spread over several years. Expensing a 7-year MACRS class asset gains the tax savings in one year rather than over the eight years of the recovery period. The time value of money and expected future income are important in making the expensing decision. The present value of tax benefits from expensing are generally higher for assets with longer MACRS lives, like drainage tile. However, expensing may not reduce taxes for the farmer who expects income to increase and the marginal tax rate to be higher in the future. Both income and SE taxes should be considered.

Lease vs. Purchase

If a farmer leases machinery under a true lease, the entire lease payment is a deductible expense. If machinery is purchased, only depreciation and interest on the loan are deductible. Some "leases" with an option to buy are considered conditional sales contracts (installment sale
by the seller) and treated as a purchased machine. There is no clear-cut definition of the
difference between a true lease with an option to buy and a conditional sales contract.
Furthermore, "farm finance leases" were sales by the guidelines below which, before 1988, were
treated as a lease for federal tax purposes.

Whether a lease is a lease or a purchase can be important to a farmer faced with the final
quarter limitation on depreciation. The question is also important to a retiring farmer who sells
the farm under an installment sale contract and leases machinery to buyer (often a family
member) to avoid depreciation recapture (discussed later). The substance of the transaction is
more important than the form of the agreement as far as the IRS is concerned. However, the
agreement must resemble a lease to be treated as a lease. The intent of the parties involved is
important. If the lessor records payments as "rental" and takes depreciation, it indicates that the
lessee is treating it as a lease.

If the "lessee" acquires title to the property after a specified number of payments, the
agreement will be treated as a sale. No part of the payments should be designated as interest,
nor should part of the payment be "easy to recognize as interest." If the payments made exceed
the fair rental value of the equipment, a sale is indicated. This is also the case if the rental
payments over a short period of time are a large part of what you would have to pay to buy the
equipment. The rental value should reflect depreciation, risk of obsolescence and costs of
dealing with returned equipment. The lessor should be in a position of not losing money if the
equipment is returned. A rental payment based on hours of use or another measure unrelated
to purchase price indicates a lease rather than a sale.

Having an option to buy the equipment does not automatically make an agreement a sale.
However, if the option price is nominal relative to the value of the equipment at the time the
option is exercised, this suggests a sale. Whether the option price is nominal is judged by
factors as they were when the agreement was originally made. Later, unforeseen changes in
market conditions have no effect. For example, the lease agreement may allow the lessee to buy
the equipment for $1 after five years. This would probably be considered nominal and thus a
sale. However, if the option price had been established at 30 percent of the original purchase
price, it would probably not be considered nominal. A doubling of machinery prices during the
five years should have no effect on the determination.

For agreements involving related parties, it may be helpful to have appraisals to help
establish the initial rental value and later the purchase price, if the lessee does exercise the
purchase option. These appraisals could be done by an expert or qualified individual such as
an equipment dealer.

Some farmers trade-in a used piece of equipment on a lease. This would be considered
as a taxable disposition of the old equipment -- a sale for the value of the reduced lease
payments. For example, a farmer may trade in an old tractor and not make the normal lease
payment of $15,000 per year for the first two years of the lease. Presumably the "sales price"
of $30,000 would be reported on Form 4797. The lease payment, including the value of the
trade-in, $15,000 annually in this example, would be deducted on Schedule F.
SELF-EMPLOYMENT AND SOCIAL SECURITY TAXES

Self-employment (SE) taxes are larger than income taxes for many farmers. The SE tax applies to the first dollars of earnings from self-employment, and the tax rate is higher than the income tax rate. Both the SE and social security taxes have two parts. Of the 7.65 percent social security tax rate which both employees and employers pay, 6.2 percent is social security and 1.45 percent is for the medicare hospital insurance tax. For the SE tax, the corresponding rates are 12.4 percent for social security and 2.9 percent for medicare. The maximum earnings subject to SE or social security taxes is $55,500 in 1992, and the medicare hospital insurance tax applies to the first $130,200. For 1993, the tax rates remain the same, but the maximum earnings increase to $57,600 for SE taxes and $135,000 for medicare hospital insurance tax. Thus, the maximum SE tax increases from $10,657.80 in 1992 to $11,057.40 in 1993.

Social Security Benefits

The Social Security system provides benefits in addition to retirement benefit for self-employed individuals. If an individual becomes disabled, a covered individual becomes eligible for disability payments. Benefits may also be provided to surviving spouses and to dependent children under 18 years of age.

Because social security coverage provides benefits in addition to retirement pensions, many farmers want to ensure that they are covered for these other benefits. Payments under the optional method will contribute toward an individual's "currently insured" status. For survivor benefits, an individual must have been covered for six of the twelve quarters preceding the quarter of death. To be "fully insured" an individual needs one quarter of coverage for each year since 1951 or turning 21, whichever is later. Once 40 quarters of coverage are obtained, an individual is fully insured permanently, even if the person was not covered for six of the last twelve quarters.

Farmers who have SE earnings of less than $400 and more than $2,400 gross income from farming may elect to pay SE tax on $1,600 of earnings under an optional method. These farmers receive credit for three quarters, not four quarters, in determining social security benefits. Payments under the optional method will increase earnings for calculation of the earned income credit. In some situations, this may result in, or increase, the earned income credit for a family and thereby reduce the net cost of qualifying for social security coverage.

Pension benefits paid under social security will increase 3.0 percent in 1993, the smallest increase in six years, reflecting lower inflation. The average retired worker's monthly benefit will increase from about $624 in 1992 to $653 in 1993. Supplemental security income payments to the disabled will also increase 3.0 percent from a maximum of about $422 in 1992 to about $434 in 1993.

The amount which an individual receiving social security benefits may earn without a reduction in benefits also increases in 1993. The maximum earnings without pension reductions are indicated below:
<table>
<thead>
<tr>
<th>AGE</th>
<th>1992</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 65</td>
<td>$7,440</td>
<td>$7,660</td>
</tr>
<tr>
<td>65 to 70</td>
<td>$10,200</td>
<td>$10,500</td>
</tr>
<tr>
<td>70 or over</td>
<td>No limit</td>
<td>No limit</td>
</tr>
</tbody>
</table>

Pension benefits are reduced by $1 for every $2 earned over the maximum earnings limit if under age 65 and $1 for every $3 earned if between 65 and 70.

SE Tax Reduction Techniques

There are four major ways in which farm families have attempted to reduce the amount of earnings for SE tax purposes. These include:

a. Noncash wages to spouse
b. Rent to a spouse
c. Gifts of commodities.
d. New business arrangements

IRS is challenging these techniques, often successfully, when the transactions lack economic substance or independent significance aside from tax avoidance.

Legislation was passed by the House in 1992 which would have eliminated the exclusion of noncash wages, other than housing and meals, from social security taxes.

Noncash Wages to Spouse and Employees

For farm workers, unlike non-agricultural employees, only their cash wages are subject to social security. The value of noncash items provided by the employer is not taxable for social security purposes (IRC Sec 3121(a)(8)(A)). However, as indicated by the recent Letter Ruling 9136001 (May 14, 1991), the IRS is going to take a firm position in this manner. Furthermore, the Indianapolis District of IRS is taking the position that any noncash wage payments, other than de minimus amounts, will be challenged on audit.

There have been some cautions to be observed when making payments in commodities to avoid having them be considered as the equivalent of cash. First, the employment contract of the employee should specify payment in a physical quantity of the commodity, not a dollar amount. Second, it is critical that the employee have "dominion and control" of the commodity. A number of rulings against farmers have occurred when the commodity is transferred to the employee after it has left the farm. Transfer of the commodity to the employee should be clearly separate from marketing. Third, the employee should pay rent for use of the employer's facilities and/or equipment (such as storage and trucking) or be treated as having additional noncash compensation. Fourth, the proceeds should not be deposited in a joint account and used in the farm business. Finally, all of the required W-2, W-3 and Form 943s should be filed with the income and expense being consistently reported on the individuals' tax returns. If one did not follow these cautions very carefully, the IRS is likely to consider these payments as cash wages, imposing penalties and interest.
Rent to a Spouse

On many farms, the real estate may be owned jointly by the farmer and spouse. For example, Jim and Sarah own 320 acres as joint tenants. If Jim pays Sarah cash rent for her share of the joint tenancy property, he may claim the payment as an expense on Schedule F and reduce his earnings for self-employment. Sarah would report the rent on Schedule E and claim her portion of real estate taxes, interest and insurance on that form. This arrangement would reduce self-employment tax only, not income tax. However, IRS has successfully attacked the payment of rent to a spouse in a recent letter ruling (LTR-9206008) where there was not consistent treatment of the expenses. The IRS does have substantial authority under IRC Sec. 482 to recharacterize payments among related parties designed solely to avoid tax.

Payment of rent to a spouse would have more economic substance if the property is not jointly owned by the spouse. There should be a written lease between farm operator and landlord/spouse with reasonable rental payments at least annually. The landlord/spouse should receive rent payment and make tax, insurance, and interest payments from a separate account which is not used for the farm business. The farm operator should issue a Form 1099-MISC for the rent payments which are reported on the landlord/spouse’s Schedule E. If there is a mortgage on the property, it should be in the landlord/spouse’s name, although the farm operator could guarantee the loan. Finally, the landlord/spouse should avoid material participation in the farming business. A spouse receiving both rent and wage compensation might lead to recharacterization of the farm operation as a partnership by IRS.

Gifts of Commodities

In some instances, farm operators have made gifts of commodities with the idea of reducing SE tax. Gifts may be made to spouses, other family members, or charitable organizations. If the gift is made during the year in which the commodity is produced, expenses on Schedule F should be reduced by an amount representing cost of donated commodity. Although income is not reported, expenses are reduced and there is little tax benefit to the gift.

If the gift is made in the year after the commodities are produced, no adjustment of expenses is generally made and the tax savings would be considerably higher. However, Rev. Ruling 55-531 is not unambiguous on whether an adjustment of expenses must be made.

Charitable contributions of commodities may reduce taxes for cash basis farmers, especially those who cannot itemize deductions. Donation of a commodity produced in a prior year results in the deduction of costs in the prior year and no income in the year of gift. It is important that the commodity be transferred to the charity and not merely sold on the charity’s behalf. Transfer of the commodity to the charity should be separate from the sale of the commodity. If delivered to an elevator, the warehouse or storage receipt should be made out to the charity. The receipt should be sent to the charity with a cover letter indicating they can treat the commodity as they see fit. The check should not be issued until the elevator receives instructions from the charity. It does not appear that Form 8283, Noncash Charity Contributions, would need to be filed because no charitable contribution deduction will be taken by the farmer.
Example: On February 1993, a cash basis farmer delivers 1,000 bushels of corn with a market value of $2,500 to the local elevator and sends the storage receipt to the church with a letter indicating the church may use the grain as they like. If the farmer had sold the grain for $2,500 and paid the taxes, how much would be left to contribute to the church?

\[
\begin{align*}
\text{SE tax} & \quad 15.3\% \times \$2,500 \quad = \quad 382.50 \\
\text{Federal tax} & \quad 15\% \times \$2,500 \quad = \quad 375 \\
\text{State and local tax} & \quad 4\% \times \$2,500 \quad = \quad 100 \\
\text{Total taxes} & \quad = \quad 857.50 \\
\text{Proceeds} & \quad = \quad \$2,500 - 857.50 = \$1,642.50
\end{align*}
\]

If the gift was made in 1992 and Schedule F expenses were reduced by the direct costs of producing the corn, say $1.20 per bushel, adjusted gross income would increase by $1,200. The additional taxes (34.3 percent) would be $411.60, less than half the taxes which would be paid if the corn were sold and the proceeds denoted to charity.

Gifts to Spouse to avoid SE tax have been successfully attacked. In LTR-9210002 a husband and wife jointly owned land, and the husband rented additional land. The wife said her involvement in the farm was limited to monthly bookkeeping. Soybeans were delivered to elevator in June by the husband and half were sold. The rest were stored with husband’s name listed as patron and wife’s name written below. Soybeans were transferred to wife in July by a notarized statement with stipulation they could be sold any time prior to September 1. The soybeans were sold after September 1 and the check made out to wife was deposited in joint account by the husband. Later the wife transferred funds to her account.

Gifts to a spouse are not likely to be recognized as gifts for tax purposes if the spouse participated in the farm operation in any way (or owned property). Deposit of proceeds in a joint bank account, even if not the farm account, is likely to be fatal to the gift. Providing any guidance in the gifting agreement about disposition of commodity or not having sales documentation with spouse as seller also causes problems.

Gifts to Other Family Members have a higher probability of surviving IRS examination than gifts to spouses, but they also may be examined carefully. If the family members are employed or involved in the business, the gift may be viewed as compensation. The gift commodity should be a prior year’s production and not have any sale commitments. Transfer of the commodity must be clearly distinguished from the sale, with the donee bearing the risk of any loss and having control of the use of proceeds.

New Business Arrangements

Many farmers have developed new business arrangements, often involving incorporation of all or part of the farm business. Generally these arrangements have a variety of objectives such as estate planning, limiting liability and bringing others into the business. In addition, these new arrangements may allow individuals greater control of the amount which is considered as earnings for SE or social security tax purposes. For example, the operating portion of the business may be incorporated, pay a salary to the farm operator and rent to the operator and spouse as owners of the real estate. Only the salary would be earnings for social security tax purposes, but the salary should be reasonable compensation.
Example: John and Mary are married with no dependents and own 160 acres of land and livestock facilities jointly. An additional 480 acres is share leased. In 1992, they had $45,000 earnings from self-employment and an adjusted gross income of $48,000. They paid $6,358 in SE tax and $5,818 in federal income tax.

Situation A: John and Mary ask their tax practitioner to calculate what their taxes would be if they formed an S-corporation to operate the farm. The corporation will pay John a salary of $23,000 and rent the land and livestock facilities from John and Mary for $15,000. The operating corporation has a profit of $10,000, which "passes through" to John and Mary. They would pay $3,519 in social security tax on John's salary and $5,818 in federal income tax. The S corporation pays no tax. This is a savings of $2,839 in taxes.

Situation B: John and Mary ask their tax practitioner to calculate what their taxes would be if they formed a regular or C corporation to operate the farm. John is paid $23,000 salary and they receive $15,000 rent from the corporation. The corporation has a profit of $10,000 and pays a corporate income tax of $1,500. (Corporate tax rates are 15 percent on the first $50,000, 25 percent on the next $25,000, 34 percent on income from $75,000 to $100,000, and 39 percent on income between $100,000 and $335,000 before dropping back to 34 percent.) John and Mary would pay $3,519 social security tax and $4,110 in federal income tax. Taxes would total $9,129. This is a savings of $3,047 relative to their present situation and $208 relative to the S-corporation.

There are a number of differences in what S and C corporations can do with respect to losses, provision of fringe benefits and property distributions. The initial tax saving potential is only one of the factors which should be considered.

New business arrangements should be explored with caution. Circumstances of individual farms differ, and arrangements should be "custom made" rather than "off the rack." Both current and future objectives should be considered. Competent advice is essential before making changes. Like marriage, getting into a new business arrangement is generally much easier than getting out of it.

HEALTH INSURANCE - TAX DEDUCTIBILITY

There are two different income tax provisions which provide some benefit to farmers with respect to health insurance. One allows a deduction of 25 percent of the cost of health insurance, and the other allows a 100 percent deduction. The second may provide the larger tax saving, but is more difficult to qualify for.

25 Percent Deductibility: A self-employed individual, like a non-incorporated farmer, is allowed to deduct 25 percent of the cost of health insurance for a policy which covers the individual, spouse and dependents. To qualify, a farmer may NOT be eligible to participate in any subsidized health plan maintained by an employer of the farmer or the farmer's spouse. Second, the deduction is limited to the earned income derived by the taxpayer from the trade or business for which the deduction is being claimed. (This is a narrower definition than the Section 179 expensing, but broader than earnings for self-employment taxes.) The deduction
is taken on Line 26 of Form 1040 as an adjustment to income. Thus, the deduction does not reduce self-employment income nor self-employment taxes. The remaining 75 percent of the cost of health insurance can be included with other medical expenses, and, to the extent they exceed 7.5 percent of adjusted gross income, they may be deducted as an itemized deduction on Schedule A.

**NOTE:** At the current time, it appears that costs of insurance coverage through June 30, 1992 only will be deductible.

**100 Percent Deductibility:** Section 105 allows employees to exclude from income the value of employer-provided health and/or accident insurance benefits for themselves, their spouse and their dependents. Employers are allowed by Section 162 (a) (1) to deduct the cost of providing these benefits to employees.

If a farmer has a *bona fide* employer-employee relationship with his or her spouse in the farm business, these Sections allow the farmer to purchase family health insurance with before-tax dollars. As an employer, the farmer can provide health insurance for his or her employee and the employee's family, which includes the farmer. The cost is deducted as a Schedule F expense, and the value of the insurance does not need to be included in income.

Farmers must be very careful to comply with all of the requirements to avoid (or survive) a challenge by the IRS. First, there must be a true employer-employee relationship, with the employee providing services to the farm business. Second, the expenditure must be a necessary expense and not a gratuity. Third, there must be an agreement, oral is acceptable, to pay compensation. Having a true employer-employee relationship with a written employment agreement which specifies the duties of the employee and the form and amount of compensation will help demonstrate that the spousal employment relationship exists. Fourth, the wages must actually be paid to be deductible. The wages should be taken out of a business account and set aside for the employee-spouse. Again, written records will help document the employer-employee relationship. Fifth, the compensation should be reasonable for the services performed. In determining the amount of compensation, the value of the insurance as well as wages will be included.

The farmer’s spouse must be treated as an employee. The farmer must have an employer identification number and file the Form 943, W-2 and W-3 each year. The amounts paid for the employee’s insurance are deducted on Schedule F, but are not reported as wages for the employee for income and social security tax purposes. However, the spouse’s cash wages are subject to social security taxes and income tax withholding.

Farmers may provide health and accident insurance purchased from a third party to the employee-spouse and are not required to provide insurance for other farm employees. No intermediary is necessary between the farmer and the insurance company. There is no nondiscrimination requirement for the third party health insurance coverage. A farmer may provide health insurance to one employee but not another. However, if insurance is provided only to those employees who are family members, then IRS might argue that the benefits are a disguised distribution of profits and deny the business deduction.
Medical reimbursement plans which reimburse deductibles and medical expenses which are not covered by insurance must be in writing and must meet the nondiscrimination rules. In general, employees who have worked less than three years, are less than 25 years of age, work less than 25 hours per week, or work under seven months per year may be excluded.

GOVERNMENT AGRICULTURAL PROGRAM PAYMENTS

This section reviews crop insurance and disaster assistance payment, soil and water conservation expenditures, and CCC crop reporting options.

Crop Insurance and Disaster Assistance

Farmers generally must report crop insurance proceeds and disaster assistance payments as income for the year in which they are received. If disaster assistance payments for losses to 1991 crops were received in 1992, the income would be reported for 1992.

Qualifying farmers may elect to postpone reporting crop insurance proceeds and disaster assistance payments from the year in which crops were damaged to the following year. To qualify, a farmer must be able to show that, under normal business practice, income from the crop for which payment was received would have been reported in a year following the receipt of payment. The election to postpone payments as income covers all crops for which disaster or insurance payments were received.

The election to postpone reporting the payment as income must be attached to the return (or amended return) and include the following information:

a. Name and address of taxpayer
b. Declaration that taxpayer is making an election under Section 451 (d)
c. Identification of the specific crop or crops destroyed
d. A declaration that, under normal business practice, the income from the crops which were destroyed or damaged would have been included in gross income for a taxable year following the year of loss
e. The cause of destruction or damage and the date or dates it occurred
f. Total amount of payment received from insurance carriers, itemized with respect to each specific crop and date payment was received
g. Name(s) of insurance carrier or carriers from whom payments were received
Soil and Water Conservation Expenditures

Most farmers elect to deduct the cost of improvements made for soil and water conservation purposes, such as terracing and earthen dams. Deductibility is limited to 25 percent of the gross income from farming. Any excess may be carried forward to another tax year. To be deductible, expenditures must be consistent with an approved conservation plan. Furthermore, a Form 8645, Soil and Water Conservation Plan Certification, must be filed with Schedule F for expenses to be deductible.

Many expenditures which farmers make to control soil erosion are not subject to the special limitations on soil and water conservation expenditures. For example, purchase of conservation tillage equipment is depreciated in the same way as other machinery and equipment. Expenditures for depreciable soil and water conservation assets (i.e., pipe, tile or wooden, masonry, metal or concrete structure) do not qualify as soil and water conservation expenditures, and the investment are recovered through depreciation. Expenditures to maintain soil and water conservation structures, such as open ditches, are considered ordinary business expenses, not as soil and water conservation expenses.

CCC Loan Reporting Options

Farmers who treat Commodity Credit Corporation (CCC) loans as loans report no income at the time the loan is received. If the loan is not repaid and the grain is later forfeited to the CCC, then the amount of the loan is included as income in the forfeiture year (Line 7b of the 1992 Schedule F). Alternatively, the loan (plus interest, which may be deducted as an expense) can be repaid and the grain redeemed. If the redeemed grain is sold, the sale proceeds would be reported as income when received. If the redeemed grain is fed, there would be no grain income to report, nor any feed expense deduction.

Some farmers elect to treat CCC loans as a grain sale to the CCC and report the loan as income (Line 7a of the 1992 Schedule F). If the grain is forfeited, there is no further income to report. If the loan is repaid, the farmer has a tax basis in the redeemed grain. The grain’s tax basis will be the amount of the loan reported as income, if redeemed with cash. Any interest paid would be deductible in the year paid. Gain or loss on the sale of the redeemed grain is calculated with respect to the tax basis of the redeemed grain. If the redeemed grain is fed, a feed deduction equal to the amount reported in income may be claimed.

Once a CCC loan has been treated as income, a Section 77 election, then all subsequent loans must also be treated as income. The election to treat loans as income applies to all loans received during the year of the election.

Transfer of grain from the nine-month CCC loan program to the longer Farmer Owned Reserve (FOR) program does not change the tax status of the loan.
TAXES AND MARKETING CONCERNS

Farmers and others continue to develop innovative ways of marketing and pricing of agricultural products as well as sharing market risk. These arrangements often accomplish what was originally intended, but often they may also be used for other objectives as well. Although these arrangements provide marketing flexibility, the arrangements may place farmers in positions considered as speculation by the IRS. Farmers do not want to be considered speculators for tax purposes because of the $3,000 deduction limitation on net capital losses.

Hedging vs. Speculating

The IRS recognizes that commodity futures and options contracts can be used by producers to reduce the risk of unfavorable price fluctuations. Any gain or loss from a closed hedging transaction is reported on Schedule F and considered farm-related for both income and SE tax purposes. For the cash basis farmer, open hedges are not considered at year-end. Unlike speculative activities, true hedges are not subject to the year-end "mark-to-market" rule.

The key elements in identifying a hedge are:

1. An opposite and equal position in a futures contract offsets a position in the cash market. Examples include a corn and soybean producer who sells corn and soybean futures. The cattle feeder who buys corn futures is also hedging feed needs. A cattle feeder who buys cattle futures would generally be speculating unless futures were for feeder cattle to lock-in replacement feeder cattle prices.

2. Quantity traded should not exceed anticipated production (or expected usage by a feeder). Trading outside that range is speculation.

3. Timing should correspond to activities in the cash market. A person becomes a spectator if she/he fails to lift a hedge after selling in the cash market.

The burden of proof that commodity futures or options transactions are hedging is on the taxpayer. If a hedging transaction is made, it must be identified as such on the taxpayer's books before the close of business that day. Some individuals made the "integral part of the business" argument for a broader definition of hedging. However, in 1988, the Supreme Court rejected that argument in the Arkansas Best case. Thus, anything other an "opposite and equal" position is likely to be challenged by the IRS.

Some farmers sell grain at harvest and buy futures contracts to "store on paper." Such transactions are speculative for IRS purposes. In other instances, farmers may consider themselves in a marketing plan which may involve puts and calls for the same commodity. Such plans are speculating rather than hedging to the IRS. Such speculative transactions are treated for tax purposes as if they had been closed out on the last trading day of the year under the "mark-to-market" rules. Any gain (loss) is considered to be 40 percent short-term capital gain (loss) and 60 percent long-term capital gain (loss) on Form 6781. Although gains are not earnings for SE taxes, deductibility of net capital losses is limited to $3,000 per year.
Minimum Price and Basis Contracts

Farmers may enter into deferred pricing contracts in which the price the farmer will receive is not known when the commodity is delivered. A minimum price contract establishes a minimum price, one below the current local price, a farmer will receive. A basis contract establishes the spread between the amount the farmer will receive for the commodity from the local elevator and a specified commodity futures price, but no minimum price.

If no money is received at the time of the delivery, there is no income to report. If the grain is priced and the proceeds received before the end of the farmer’s tax year, the income would be reported for this tax year. If the grain was not priced until the following tax year, then no income would be reported this year from the sale of the commodity. In some cases, the farmer may receive a portion of the anticipated price at the time of delivery. In this situation, that income would be included in this year’s income. Any additional income received when the commodity is priced would be reported as income at that time.

Deferred Payment Contracts

Farmers commonly sell grain before the end of the year and request that payment not be made until the following year. It is important that a valid deferred payment contract be executed in these situations. A deferred payment contract does not allow a farmer to sell, assign, transfer, pledge or convey the contract or any rights in the contract.

It has been argued that farmers should be sure that arrangements delaying payment until the next tax year be in place before the grain is delivered. Typical elevator practice is to pay for grain upon delivery. Deciding to wait until next year for payment after the grain is delivered could be construed as "constructive receipt" of the proceeds by the farmer. However, under the 1980 Installment Sales Revision Act, when one or more payments are received after the year of sale, income is reported when received unless one elects out of installment reporting.

Because the grain is held for sale in the ordinary course of business by a farmer, it cannot be reported on the installment method for alternative minimum tax (AMT) purposes. A situation could arise in which a farmer sold $50,000 of corn in 1991 and postponed getting the check until 1993. The $50,000 would be included in 1992 income for AMT purposes, but 1993 for regular tax purposes. Having a valid deferred payment contract will avert this possible problem.

IRS has not recognized deferred payment arrangements for livestock where the purchaser acts an agent of the farmer. For example, a stockyard, auction barn or consignment broker acts as an agent of the farmer, and receipt of income by the agent is considered to be receipt by the farmer. Direct sale to a packer, buying station or other buyer where the title passes to the purchaser would avoid an agent and would allow for a valid deferred payment contract.
TAX CONCERNS OF CASH RENT LANDLORDS

Retired or retiring farmers often become cash rent landlords to avoid potential problems with the Social Security Administration with respect to their material participation in farming. Although being a cash rent landlord should avoid problems with Social Security, other problems may arise because a cash rent landlord is not considered to be in the trade or business of farming. First, estimated tax payments must be made to avoid penalties and interest if one does not qualify as a farmer with two-thirds of gross income from farming. Cash rent is not considered farm income for the two-thirds test. There is a one-year grace period, so if one qualified as a farmer in 1991, one would not be subject to estimated tax penalties in 1992.

Second, a cash rent landowner does not qualify for the Section 175 deduction of soil and water conservation expenditures. For example, if a cash rent landlord builds a wascrob (water and sediment control basin), the cost is not deductible but must be added to the basis of the property. Furthermore, any cost sharing payment received from ASCS must be included in income, unless the landowner qualifies for a Section 126 cost-sharing exclusion. To qualify for the Section 126 exclusion, the cost-sharing must be received under a qualifying program such as the Indiana Critical Erosion Cost-Share Program. The calculation of the excludable amount is complex. A rule of thumb for an improvement which was totally conservation oriented would be about 125 percent of the annual rent per acre multiplied by the number of affected acres as the excludable amount.

Third, a cash rent landlord does not qualify for the Section 179 expensing deduction. Investments in depreciable assets would be recovered through normal depreciation. For example, a cash rent landlord who invested $10,000 in tile drainage would not be able to use the $10,000 Section 179 expensing election but would be required to recover the cost over the 15-year MACRS life.

TAX CONSIDERATIONS FOR RETIRING FARMERS

Farmers considering retirement are often looking for ways to transfer assets to other family members or use their farm assets for retirement income. This is an area in which careful planning before assets are transferred can be very helpful.

If machinery and equipment is sold for more than its adjusted basis (remaining book value) the gain is taxable. The difference between the adjusted basis and original cost basis is depreciation recapture and taxed as ordinary income. Only the gain in excess of the original cost basis is taxed as capital gain. For example, if a tractor purchased for $25,000 in 1976 is fully depreciated (an adjusted basis of $0), then the first $25,000 of the sales price is ordinary income and only the amount received in excess of $25,000 would be capital gain income.

To avoid a large tax bill in the year of sale, some farmers may consider an installment sale of machinery and equipment. However, under the installment sales rules, the entire amount of depreciation recapture is taxable in the year of sale regardless of the amount of sale proceeds received. For example, a farmer sells a line of machinery with an adjusted basis of $75,000 on an installment sale for $250,000 and receives a $50,000 down payment. A gain of $175,000
($250,000 sale price - $75,000 basis) is reported as taxable in the year of sale, although only $50,000 was received.

When land is sold on an installment sale, only the proportion of the gain actually received is reported as taxable gain. For example, 80 acres of bare land which a farmer had purchased for $900 per acre was sold for $1,200 per acre. The $300 per acre gain represents 25 percent of the $1,200 per acre sales price, thus 25 percent of each payment received, excluding interest, is taxable income. Depreciation recapture may be involved if the sale of real estate involves fences, grain storage, single purpose agricultural facilities and other depreciable assets. Previously deducted soil and water conservation expenditures may also be recaptured if the land has been owned for less than ten years.

Leasing of machinery and equipment with an option to buy, especially to family members, is commonly suggested to reduce or avoid the depreciation recapture associated with its sale. If done carefully (see earlier discussion), this can avoid being treated as an installment sale. Rental of personal property, such as machinery, should be reported on Schedule C, not Schedule E, according to IRS instructions. Income reported on Schedule C is considered as income from a trade or business and subject to self-employment taxes. Income reported on Schedule E is rental income and not subject to self-employment taxes. If real estate, machinery and equipment are rented jointly, the income and expenses are reported on Form 4835 if a share rental or Schedule E if a cash rental and not subject to self-employment tax.

The installment sale of farm real estate may be very useful from an income tax planning standpoint, but may have some disadvantage for estate planning, especially if family members are involved. First, the installment sale prior to death results in the fair market value of the note being included in the estate, subject to federal estate tax and Indiana inheritance tax. The basis of the obligation is not "stepped-up", and gains continue to be reported as income by the estate or beneficiaries. Second, if the buyer and seller are related parties, the gift or cancellation of an installment obligation is income to the seller. In a worst case type scenario, if the buyer (son) is unable to make the payments and the seller (father) forgives the debt, the seller is treated as if he had received payment in full. Third, if the installment contract is canceled by the seller's will, the gain is recognized by the estate in its final return. It should be noted that the "disadvantages" in some situations may be "advantages" in special circumstances.

OTHER TAX TOPICS

There are many other tax provisions which can affect individuals and businesses. Farmers may be affected by the changes in standard deduction and personal exemptions as well as the change in rate schedule as the result of inflation.

Tax Brackets

To prevent "bracket creep" caused by inflation rather than real increases in income, the tax brackets are adjusted annually. The tax brackets and rates for the married, filing jointly situation are indicated below for 1992 and 1993.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Pay</th>
<th>% on Excess</th>
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<td></td>
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<tr>
<td>$0-35,800</td>
<td>$0</td>
<td>15%</td>
<td>$0</td>
</tr>
<tr>
<td>$35,800-86,500</td>
<td>$5,370</td>
<td>28%</td>
<td>$35,800</td>
</tr>
<tr>
<td>$86,500 and over</td>
<td>$19,566</td>
<td>31%</td>
<td>$86,500</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1993</td>
<td></td>
</tr>
<tr>
<td>$0-$36,900</td>
<td>$0</td>
<td>15%</td>
<td>$0</td>
</tr>
<tr>
<td>$36,900-89,150</td>
<td>$5,535</td>
<td>28%</td>
<td>$36,900</td>
</tr>
<tr>
<td>$89,150 and over</td>
<td>$20,165</td>
<td>31%</td>
<td>$89,150</td>
</tr>
</tbody>
</table>

Standard Deduction and Personal Exemptions

The standard deductions and personal exemptions are also adjusted annually for cost of living changes. The 1992 and 1993 standard deductions are indicated below:

Standard Deduction

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>1992</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint</td>
<td>$6,000</td>
<td>$6,200</td>
</tr>
<tr>
<td>Single</td>
<td>$3,600</td>
<td>$3,700</td>
</tr>
<tr>
<td>Head of household</td>
<td>$5,250</td>
<td>$5,450</td>
</tr>
</tbody>
</table>

The basic standard deduction for an individual who can be claimed as a dependent on another's return is limited to $600 or the individual's earned income, whichever is greater. This is the same for 1992 and 1993.

Married individuals who are over 65 or blind receive an additional standard deduction of $700 in 1992 and 1993. Single individuals who are over 65 or blind will receive an additional standard deduction of $900 in 1992 and 1993.

The personal exemption for an individual and qualifying dependents is $2,300 in 1992 and $2,350 in 1993. Thus, a married couple with two dependents might have an income of $15,200 before they begin to pay federal income tax. That will increase to $15,600 in 1993.
TAX MANAGEMENT

Recent tax law changes have made compliance with tax law more difficult. However, tax considerations have become relatively less important in many management decisions. Economic profitability is of increasing importance, especially for investors who were "farming the tax code." Elimination of tax breaks (tax savings opportunities, if you could take advantage of them) has complicated recordkeeping for all farmers.

One's tax management goal should be maximizing after-tax income over time, not minimizing taxes in any one year. Some people get so concerned about saving a few dollars in taxes this year that they miss the big picture. Because of low income many farmers may simply assume that they will not have a tax problem, instead of viewing that as a tax planning opportunity. This year may be such an opportunity for some farmers.

Keeping taxable income relatively stable year-to-year has been a key to effective income tax management in the past because of the progressive tax rates. With only three tax rates and much wider tax brackets, the benefits from keeping income even year-to-year are reduced. However, wide swings in taxable income are still likely to result in higher taxes. The amount of income which is "tax-free" because of personal exemptions and the standard deduction has increased sharply. One should plan to have at least this "tax-free" amount of income each year. Self-employment taxes are larger than income taxes, for most farmers, and may be more difficult to manage.

Deferral of income and income taxes can still be effective tax management. If income taxes are deferred, even for a year, this is an interest-free loan from the government. Although estimated tax payments required to avoid penalties have been increased to 90 percent of the tax liability, farmers continue to have an exception. If two-thirds or more of gross income is from farming, farmers can pay the tax due by March 1 and avoid estimated tax penalties. Although farmers must pay by March 1, the due date of their return for many other purposes, such as retirement plan contributions, is April 15.

Tax implications of major decisions should still be considered before the decision is final. Installment sales and deferred payment contracts often have tax benefits. Tax-free exchanges such as involved with the trade-in of machinery and equipment may reduce taxes, but need to be analyzed carefully.
REFERENCES

This article draws heavily on the following references:


Bock, C. Allen, "Update on Agricultural Taxation," Ag Law Update Teleconference, June 2 and 4, 1992, program materials.


Copies of IRS publications may be obtained by calling 1-800-424-FORM.

A useful introduction to farm corporations is: NCR11-The Farm Corporation, Revised April 1991.

This is available at a cost of $2.00 from:

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