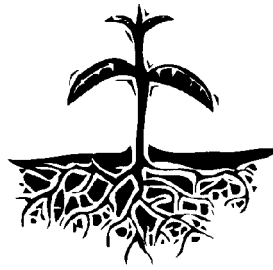


FEDERAL INCOME TAX MANAGEMENT FOR FARMERS AND RANCHERS

By *Gayle S. Willett, Larry K. Bond, and Norman Dalsted**

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*The authors are Extension Economists specializing in farm business management. Gayle Willett is with the Department of Agricultural Economics, Washington State University; Larry Bond is in the Department of Economics, Utah State University; Norman Dalsted is a member of the Department of Agricultural and Resource Economics, Colorado State University.

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INTRODUCTION

Anyone who owns a business can benefit from income tax management. Tax management, like other money management issues, should not be completely delegated to someone else. While farm and ranch managers need not be tax experts, they will benefit substantially from recognizing a tax problem or opportunity. Most, if not all, major business adjustments have income tax implications. Examples include change in business form, business expansion, major capital expenditures, sale or exchange of capital items, pay packages, employee benefits, retirement planning, estate planning, as well as major ongoing, day-to-day transactions of buying and selling.

Effective tax management can often lead to large savings in taxes with a small investment of time and money at little risk. The objective of good tax management is to maximize income after taxes over time, not to minimize taxes. While it may seem that a dollar saved in taxes means an increase in after tax income, it is not always true. Tax decisions should be made while considering the impact upon the entire operations through time. Poor decisions may result if only tax savings are considered. Buying unneeded machinery will increase depreciation and thus reduce taxes, but the result may be lower net income. Postponing sales to shift revenue to the next accounting period in the face of declining prices is another example of a poor management decision based only on tax considerations.

Good tax planning is based on selecting a proper accounting period, the appropriate accounting method

(that is, cash versus accrual), and a good accounting system. Additionally, understanding the general tax law provisions, recognizing the benefits from effective tax decision making, seeking competent professional help at appropriate times, and knowing when and how to use basic tax management strategies are necessary.

The objective of this publication is to review selected federal income tax management principles and strategies relevant to the farm and ranch business. The discussion will focus on two basic categories of tax management opportunities:

- (1) controlling the flow of income between tax years and tax entities, and
- (2) deferring income and taxes. In addition, tips will be offered for other tax management opportunities including trading versus selling machinery, wages paid in kind, gifts in lieu of wages, buying or selling a farm, and livestock sales in a drought year.

The discussion is based on the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1993. Cash basis (as opposed to accrual, tax accounting and individual (as opposed to corporate) taxation is assumed. Since the presentation is limited to the more basic aspects of income tax management, you are urged to seek professional counsel when you desire more detail or interpretation. Also you will find the *Farmer's Tax Guide* published annually by the Internal Revenue Service and available at no expense, helpful in obtaining additional background on commonly encountered income tax matters.

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MANAGING THE INCOME FLOW

REDUCING YEAR-TO-YEAR VARIATION IN INCOME

Because of our progressive tax (that is, higher incomes are taxed at a higher rate), an income that fluctuates from one year to the next carries a greater tax liability than a stable one. This fact is illustrated by Example 1, considering a married couple filing a joint return and 1994 tax rates. The marginal tax rate (MTR) appearing in the table below is the rate at which additional income is taxed. To illustrate, the tax

on \$44,900 (see below) is \$5,700 + 28% (\$44,900 - \$38,000) or \$7,775. The 28% is the MTR applying to taxable income between \$38,000 and \$91,850. Taxable income below \$38,000 and above \$91,850 has an MTR of 15% and 31% respectively. The taxable income brackets corresponding to various MTRs vary with your filing status and are indexed annually to reflect the impact of inflation.

Example 1. Federal Income Tax Liability with Fluctuating and Stable Income.

Year	Taxable Income	Marginal Tax Rate	Federal Income Tax
Fluctuating Income:			
19X1	\$44,900	28%	\$ 7,775
19X2	28,900	15%	4,335
Total	\$73,800	xxx	\$12,110
Stable Income:			
19X1	\$36,900	15%	\$ 5,535
19X2	36,900	15%	5,535
Total	\$73,800	xxx	\$11,070

In the example, a stable income results in \$1,040 less federal income tax (\$12,110-\$11,070) over a two-year period than a fluctuating one, even though total taxable incomes (\$73,800) are equal.

Reducing year-to-year taxable income variation offers a major opportunity for you to increase your after tax income. This opportunity was strengthened by 1993 tax legislation, which added two new tax brackets to the existing three brackets, resulting in five tax rates for individual taxpayers. The principle for managing year-to-year income flows is to shift income across years until MTRs are equalized. Check the applicable current federal tax table to determine the income levels associated with various MTRs.

Two general strategies can be used to equalize marginal tax rates:

- (1) shift taxable revenue from the higher tax bracket year to the lower tax bracket year.
- (2) shift tax deductible expenses from the lower tax bracket year to the higher tax bracket year.

Effective use of these two strategies depends heavily on projecting the taxable incomes (and marginal tax rates) for the current and upcoming years. Of course, this projection should be made far enough in advance of the ends of the current year to allow sufficient time to utilize the appropriate tax management strategies.

MARGINAL TAX RATE 19X1 IS GREATER THAN MARGINAL TAX RATE 19X2

When a near year-end projection of taxable income indicates the MTR for the current year (19X1) is likely to exceed the MTR for the following year (19X2), you should consider shifting taxable revenue from 19X1 to 19X2 and tax deductible expenses from 19X2 to 19X1. In Example 1, shifting \$8,000 of taxable income from 19X1 to 19X2 saved \$1,040 in taxes. This is the result of taxing the \$8,000 at a 15% rather than a 28% MTR. You should explore using the following specific courses of action when the MTR for 19X1 is projected to be greater than the MTR for 19X2:

1. Delay sales.

By delaying commodity sales until the next tax year, income is moved into next year's lower tax bracket, resulting in a tax savings. Of course, the opportunity farmers have to use this strategy depends on the perishability of the product. For example, dairy farmers have little chance to delay milk sales, but have some discretion in timing of cull cow and calf sales. Also, grain and hay producers can postpone the sale of these harvested commodities for several months. However, producers should be aware that added storage costs and a potential decline in commodity price during the postponement period may more than offset income tax benefits.

You can delay sales without assuming the risk of product price reversals by selling the product at a specified price prior to the end of the year, but deferring payment until after the first of the year. However, in pursuing this strategy, you should be aware of the constructive receipt rule. Income is constructively received and, therefore, taxable if the seller has the right to collect payment after commodity delivery, even though no money has actually been received. Further, money is constructively received by the farmer when an agent of the farmer collects the money. For example, if a farmer delivers a crop to an elevator with instructions to sell the crop and hold the proceeds until the following tax year, the farmer has constructively received payment because the elevator company is an agent of the producer. To prevent constructive receipt, you should have a written deferred payment contract stating

payment will be made the following year. Moreover, if you want security while waiting for payment, you should arrange for a letter of credit from the buyer's bank. Letters of credit (and other third-party guarantees) are not taxable income.

2. Accelerate operating expenses.

By purchasing and paying for operating inputs (for example, feed, seed, fertilizer, chemicals, fuel, etc.) prior to the end of the tax year, rather than after the first of the year, expenses are deducted from income in a higher tax bracket. This reduces taxes, since a dollar of expenses is worth more in tax savings when moved to a higher tax bracket. However, tax savings should be compared to such added costs as:

- (1) the additional interest associated with an earlier departure of funds to buy operating inputs, and
- (2) higher input prices if they are trending downward.

Advance purchase of supplies needs to be done according to IRS rules. The IRS says three criteria must be met:

- (1) there must have been an actual payment for the supplies, not just a deposit;
- (2) there must have been a valid business purpose for advancing purchases; and
- (3) the prepayment must not materially distort income.

To meet these criteria, you should:

- (1) have a binding sales contract with the supplier, stating that the prepayment is nonrefundable;
- (2) make purchases that are reasonable in light of short-term needs; and
- (3) build a case for purchasing early so as to guarantee an adequate supply or to get a price break.

Certain expenses cannot be deducted when prepaid; instead, they must be prorated over the period the input is used. This restriction includes interest and, generally speaking, rent and insurance. An additional restriction

applies to inputs prepaid by a taxpayer who is not a “qualified farm-related person.” This rule restricts prepaid expense deductions to 50% of the expenses that were actually used in the current year. To be a farm-related person and therefore exempt from the 50% restriction, the taxpayer must either live on the farm, have a principal occupation of farming, or be a member of a family who meets these requirements.

3. Accelerate depreciation.

There are two basic strategies for shifting depreciation deductions to the current higher MTR year from the following year(s) with lower MTRs. An obvious first strategy is to shift the purchase of depreciable assets from the following year to the current year. Purchases of depreciable property made late in the year generally qualify for one-half year of depreciation. However, if more than 40% of the total basis of depreciable property placed in service during the current tax year is placed in service during the last three months of that year, it is necessary to use the mid-quarter convention. This means depreciation on all property placed in service that year is computed from the midpoint of the quarter the property was placed in service, thus reducing allowable depreciation for that year. A second strategy is to use accelerated depreciation on assets purchased during the current year. This shifts depreciation deductions from later years in the asset recovery period to the earlier years, which are assumed to have a higher MTR.

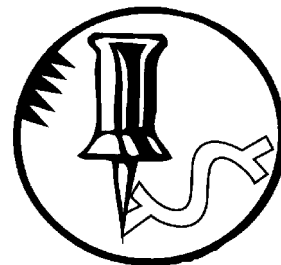
Under current depreciation rules, you have considerable flexibility in choosing how fast to depreciate property. The modified accelerated cost recovery system (MACRS) generally in effect for property placed in service after 1986 is comprised of two systems. The first and main system is termed the General Depreciation System (GDS). The second is referred to as the Alternative Depreciation System (ADS). They differ in the length of the recovery period and the choice of depreciation method used to calculate the annual deduction.

The fastest depreciation policy is MACRS-GDS, 150% declining balance method (with a switch to straight line), and the shortest recovery period. A slower policy is MACRS-GDS, straight-line method, and the shortest recovery period. The slowest policy is

MACRS-ADS, which uses a straight-line method and generally longer recovery periods.

Various restrictions apply to the selection of the above depreciation methods. If you elect to use the straight-line method for a particular item in a property class, this method must be used on all items in that class placed in service in the tax year of the election. However, you may make the election each year for each property class. For example, you may choose straight line on machinery (seven-year property class) placed in service in 19X1 and declining balance on machinery placed in service in 19X2. However, once the straight-line election has been made on a particular property, you cannot later use declining balance on that same property. Further, cars and pickup trucks have annual limits on depreciation (and expensing) deductions. Also, if you elect not to use the uniform capitalization rules on plants produced in your business, you must use MACRS-ADS on all property placed in service while the election is in effect.

An illustration of the difference in first-year depreciation, coupled with the Section 179 expensing option (to be discussed next), between the fastest and slowest methods appears in Example 2.



Example 2. Impact of Depreciation Method and Section 179 Deduction on First-Year Tax Deduction.

Accelerated Method:

\$ 50,000	Cost basis
- 17,500	Section 179 deduction
= 32,500	Adjusted cost basis
x 0.1071	19X1 depreciation factor with MACRS-GDS, 150% declining balance, seven-year recovery period.
= \$ 3,481	19X1 deduction
+ \$ 17,500	Section 179 deduction
= \$ 20,981	Maximum 19X1 deduction

Straight-Line Method:

\$ 50,000	Cost basis
x 0.05	19X1 depreciation factor MACRS-ADS, straight-line, ten-year recovery period
= \$ 2,500	19X1 deduction

Thus, there is a difference of \$18,481 (= \$20,981 - \$2,500) in the 19X1 deduction allowed by the fastest (accelerated) and slowest (straight-line) methods.

4. Expense rather than capitalize.

Certain expenditures may be either expensed or capitalized. If expensed, you get the tax deduction in the current year. A capitalized expenditure is depreciated; that is, you get the tax deduction through depreciation over a period of several years. By opting to expense expenditures made in a higher tax bracket year, you move tax deductions from later years with lower MTRs to the current year with a higher MTR, thereby saving taxes. Selected situations where you have an opportunity to expense or capitalize include the Section 179 deduction, certain repairs, small tools, soil and water conservation expenses, and development costs for fruit and nut crops.

Section 179 Deduction

Under the Section 179 deduction, you have the option to expense up to \$17,500 per year of the cost of new or used depreciable tangible personal property (for example, machinery, purchased breeding animals, and equipment) and single purpose structures. The basis eligible for MACRS depreciation must be reduced by the Section 179 deduction, however. Further, the \$17,500 annual limit applies to single and married

taxpayers filing a joint return (\$8,750 married, filing a separate return). Also, a partnership is limited to a pass-through of \$17,500 per year to all partners, not to each partner. The deduction may not exceed the current year's taxable income, although the unused portion may be carried to subsequent years. In a trade or exchange, only the cash paid in addition to the trade-in value qualifies for the deduction. Example 2 illustrates how the Section 179 deduction, combined with the depreciation policy, can affect first-year deductions. The deduction may be used with either fast or slow depreciation methods.

Improvements or Repairs

You also have some latitude in classifying expenditures for the repair and maintenance of depreciable property as improvements or repairs. Generally speaking, improvements should be capitalized, while repairs are fully deductible when paid. An improvement occurs when the expenditure has substantially prolonged the properties' life, increased its value, or changed its use. Since these events are not always clear-cut, you may want to adopt a liberal interpretation in favor of repair treatment in a higher tax bracket year. For example, when is a tractor engine

overhaul minor and deductible as a repair, or major and capitalized?

Small Tools

Small capital items with a useful life in excess of one year are depreciable. However, if the amounts are sufficiently small and recurring to make their addition to a depreciation schedule impractical, they may be expensed as a supply item. While consistency of treatment is an issue, some flexibility likely exists. If you are in a higher tax bracket year, the incentive is to expense rather than capitalize small capital items. Larger operations have more flexibility on this issue than a smaller one, since a small expenditure by a large business is less visible and not as likely to be challenged.

Soil and Water Conservation Expenses

You have the option of either expensing or capitalizing certain soil and water conservation expenditures. If capitalized, the expenditure is added to the cost basis of the land and is deductible upon the disposal of the land.

To qualify for expensing, the expenditure must be for land that you or your tenant are using, or have used in the past, for farming. Further, expensing requires the expenditure to be consistent with a plan approved by the Natural Resources Conservation Service (NRCS), or with the plan offered by a similar state agency if no NRCS plan exists. You must file Form 8645 to certify consistency with an approved conservation plan.



Examples of expenditures you may either expense or capitalize include:

- movement or treatment of earth (leveling, grading, terracing, contour furrowing, and restoration of fertility)
- construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, and ponds
- eradication of brush
- planting windbreaks

Expenditures for items that are depreciable (for example, concrete, pipe, tile, wooden dams, water wells, etc.) must be depreciated. Also, no more than 25% of your gross farm income can be deducted as a soil and water expense in any given year. However, unused deductions can be deducted in later years.

You should also be aware of the rules applying when you have had previous soil and water expenditures. If you capitalized these expenditures in previous years and want to expense current year outlays, you will need the permission of the District Director of the Internal Revenue Service to change your reporting method. However, if this is the first year you've made these expenditures, no prior approval is required to either expense or capitalize.

Preproductive Period Expenses for Fruit and Nut Crops

The uniform capitalization rules apply to crops produced in a farming business if the crop has a preproductive period of more than two years. Thus, if you are producing tree fruit and/or nut crops, these rules are probably applicable. Under these rules, effective after 1986, all direct and most indirect costs incurred during the preproductive period for these crops must be capitalized. This means rather than deducting the costs in the year incurred, they must be accumulated through the preproductive period and then deducted as depreciation over the IRS-defined recovery period. The preproductive period starts when you first plant or acquire the seed or plant and ends when the plant becomes productive in marketable quantities.

However, subject to certain exceptions, producers can elect out of the uniform capitalization rules. Under this election, preproductive period costs may be deducted in the year incurred rather than depreciated. You cannot elect out of the rules for citrus or almond groves or if you are a corporation, partnership, or tax shelter required to use an accrual accounting method. If the preproductive years are in a higher tax bracket than the productive period, tax savings will be realized by electing out of the rules. This follows from the deductions saving more taxes through expensing rather than depreciation. The election is made the first year you grow crops subject to the uniform capitalization rules. Once the election out is made, you must have IRS consent to change back to the uniform capitalization rules. Also, those who opt not to have the rules apply must use a MACRS-ADS to depreciate all property used predominately in the business, including property not used to produce the fruit or nut crop. This requirement applies to all property placed in service in any tax year the election is in effect.

5. Postpone taxation of crop insurance proceeds.

Crop insurance and federal disaster payments are taxable income, generally for the year they are received. However, if you received these payments in the year of the crop failure and you would have normally marketed the crop in the following year, you have the option of declaring the payments as income for the following year. If the current year is the year of both a crop failure and a higher tax bracket (perhaps because of feed shortages and forced sales of livestock), you will realize tax savings by postponing the taxation of insurance proceeds until the following year. A discussion of the tax management options you have for drought induced sale of livestock appears on pages 23-24.



6. Postpone taxation of Commodity Credit Corporation (CCC) loans.

You have the option of treating an initial CCC loan as income in the year the loan is received or in the subsequent year when the grain is either forfeited or reclaimed and sold. By electing to have the income taxed in the year following receipt of the loan, income is shifted to a lower tax bracket, resulting in less taxes paid. However, if you previously treated a CCC loan as income in the year the loan was received, it is necessary to obtain IRS approval to declare it as income in the following year.

7. Accelerate itemized personal deductions .

You have the choice of itemizing personal deductions or using the standard deduction, and will logically select the larger of the two. In a higher tax bracket year, you may want to consider moving selected itemized deductions normally paid the following year to the current year, so that total deductions in the current year exceed the standard deduction. The standard deduction could then be used in the following year. This strategy moves personal deductions to a higher tax bracket year, resulting in additional income tax savings. Medical expenses and contributions are examples of personal deductions that may be readily advanced to the current tax year.

8. Trade, don't sell, capital items with taxable gains.

If machinery, equipment, or vehicles are sold at a price above their undepreciated basis, that gain (depreciation recapture and perhaps, capital gain) is taxable in the year the sale proceeds are received. However, that same gain on a trade reduces the basis on the replacement item, resulting in less depreciation deductions in later years. Thus, by opting to trade rather than sell (and purchase a replacement the following tax year), taxable income is shifted from the current, high tax bracket year to later years with lower tax brackets, thereby saving taxes. Also, using tax-free exchanges rather than selling real estate with capital gains provides an opportunity to shift taxable income to later, perhaps lower tax bracket year(s).

MARGINAL TAX RATE 19X2 IS GREATER THAN MARGINAL TAX RATE 19X1

If a projection of taxable income suggests the MTR for 19X2 (next year) is likely to exceed the MTR for 19X1 (current year), you should consider shifting taxable revenue from 19X2 to 19X1 and tax deductible expenses from 19X1 to 19X2. These strategies may include the following:

1. Advance commodity sales to the current tax year.

Shifting commodity sales from the high tax bracket year (19X2) to the low bracket year (19X1) saves income taxes. For example, if your MTR is 28% in 19X2 and 15% in 19X1, each dollar of sales shifted from 19X2 to 19X1 saves 13 cents in federal income taxes. However, in evaluating this action, you will also want to consider commodity price movements and savings in holding costs (including interest).

2. Postpone operating expenses.

By postponing the payment of accounts payable and the purchase of supplies and services until the following higher tax bracket year, income taxes paid over the two tax years can be reduced. Again, you will want to consider if potential increases in prices for these items will more than offset savings in taxes and holding costs.

3. Slow down depreciation.

You can shift depreciation deductions to later years when the tax brackets (and tax savings) are higher by:

- (1) opting not to purchase depreciable property until the next tax year, and
- (2) selecting a slower depreciation policy on assets purchased during the current, higher tax bracket year. However, you should recognize that the second choice has an impact on depreciation deductions over the entire recovery period (for more on this, see the later tax deferral discussion).

4. Capitalize rather than expense.

By capitalizing rather than expensing selected expenditures, you can shift tax deductions from the current year to later years when they are worth more in tax savings due to an assumed higher tax bracket. As noted earlier, the situations where you have the opportunity to pursue this strategy are:

- foregoing the Section 179 deduction.
- treat expenditures as capitalized improvements, not repairs.
- capitalize rather than expense small tool expenditures.
- capitalize soil and water expenses.
- capitalize preproductive period expenses for fruit and nut crops.

5. Forego postponed taxation of crop insurance proceeds.

If you receive crop insurance indemnities or federal disaster payments in the year of the damage, yet under your normal marketing practice, receipts from these crops are reported in the following year, you may elect to report insurance and disaster payments in the year following the damage. Assuming the year following the damage is the higher tax bracket year, you would not want to exercise this option; instead, you would report the payments as taxable income in the current, lower tax bracket year. However, if you previously elected to postpone the reporting of these payments, you must get the consent of your IRS District Director to change the reporting method.

6. Treat CCC loans as income in the year of the loan.

By declaring a CCC loan as income in the year the loan is received (that is, the current lower tax bracket year) rather than the following year when the grain is either forfeited or reclaimed and sold, the loan is taxed at a lower rate. Remember, however, once the loan is reported as a sale, you may not change your method of reporting the loan without obtaining permission from your IRS District Director.

7. Postpone itemized personal deductions.

Postpone itemizable deductions (for example, medical expenses and contributions) until the following higher tax bracket year. This may cause your itemized deductions to exceed the standard deduction the following year. Use the standard deduction for the current year if it is greater than your diminished itemized deductions. This may save taxes by increasing total two-year deductions and by shifting deductions into a later year with a higher marginal tax rate.

In fact, a longer-term strategy for increasing total deductions could be to take your standard deduction every other year and itemize expenditures in the alternate years. By either postponing or preparing selected itemizable deductions (for example, property taxes, medical expenses, contributions, etc.), these expenses can be doubled for the alternate year, perhaps exceeding the standard deduction and thereby increasing total deductions over time.

8. Sell, don't trade, capital items with taxable gains.

By selling rather than trading capital items (for example, machinery, equipment, and vehicles) with a taxable gain before the end of the current year, the gain can be advanced to the current year, which is assumed to have a lower tax bracket. A sale triggers the taxation of any gain realized in the year of the sale. In contrast, if the item is traded in the current year, the gain is subtracted from the basis of the replacement item. A

lower basis has the undesirable impact of less depreciation in the later, higher tax bracket years.

9. Prevent a net operating loss.

Another principle applying in a low income year is to use the above strategies (and others) to shift at least enough income into the year to prevent a net operating loss. Generally speaking, a net operating loss is the excess of deductible business expenses over the business income. Further, certain deductions are not allowed in computing a net operating loss, including personal exemptions and the excess of nonbusiness deductions (for example, standard or itemized deductions) over nonbusiness income. If a net operating loss is about to occur, this generally means you will not fully utilize your personal exemption and standard or itemized deduction to shelter income. If you don't shift enough income into the current year to fully utilize these deductions, their value as a tax shelter is forever lost; that is, they cannot be carried forward or back to shelter income.

However, if you do realize a net operating loss, you have the option of carrying the loss back to offset income reported over the past three years and then carry any remaining loss forward as a deduction up to 15 years. The carryback and associated tax refund must first apply to the earliest year in the carryback period and then chronologically to the remaining two years. Alternatively, you may forego the carryback option and use the net operating loss as a deduction against income realized up to 15 years after the loss year.

LEVELING INCOME AMONG TAX ENTITIES

Because of a progressive tax, income taxes paid on the farm's income may be reduced by more equally distributing (or leveling) income among the various tax entities potentially associated with the business. A tax entity is an individual, regular corporation, estate or trust. Through a more equal distribution of income, you

can move income from an entity with a higher tax bracket to another entity with a lower tax bracket, thereby reducing income taxes on total farm income. Of course, income distributions must represent a reasonable return on resources provided by the various tax entities; otherwise, a taxable gift may result.

INCOME LEVELING OPPORTUNITIES

Income leveling opportunities may include:

- (1) paying children for work performed on the farm,
- (2) gifting income generating property to an individual in a lower tax bracket,
- (3) forming a partnership or Subchapter S Corporation and channeling income to various partners and shareholders, respectively,
- (4) forming a regular corporation and shifting income between the corporate and shareholder entities via salaries paid to employee-shareholders. While a discussion of these opportunities is beyond the scope of this publication, the popularity and ease of income leveling by paying wages to children warrants further comment.

WAGES PAID TO CHILDREN

By paying wages to your children for work performed on the farm, taxable income is shifted from your higher tax bracket to the children's lower one. This strategy saves taxes for the total family.

Parents often ask, "How much can I pay the kids without having to file a return and pay taxes?" The answer to this depends on whether your child has only earned income, such as wages and salary, or both earned and unearned income (for example, interest, dividends, rent). If the child has only earned income, he or she may earn up to the standard deduction, which is \$3,800 in 1994, without filing a return. When both earned and unearned income are present, the 1994 limit is a total of \$600 from both sources. Of course, tax savings for the entire family may occur even when dependent children exceed the earning limits, file a return, and pay taxes.

Children working for their parents are exempt from certain withholdings. If under the age of 18, nothing is withheld for income tax, social security, or Medicare. They are exempt from federal unemployment withholding if under 21. Children are not exempt from withholding if the farm is incorporated, or, if a partnership and one partner is not a parent.

In paying your children to realize tax savings, a true employer-employee relationship must exist; otherwise, the IRS will disallow the wage deduction. Basically, the IRS invokes three criteria to determine if the wages are deductible:

1. Was work actually performed?
2. Was payment reasonable?
3. Was payment actually made?

Obviously, a 10 year old would not be expected to do the same amount of work, nor be paid the same rate as a 17 year old. Likewise, in the eyes of the IRS, a reasonable wage for a 17 year old will likely be less than for an adult. To meet the IRS criteria, parents should assign their children definite job responsibilities and pay a reasonable wage for work actually performed. Also, payroll checks should be issued to the children in the same manner as with all employees.

Example 3 illustrates tax savings that may be realized by paying wages to your children. Assume you and your spouse's income after expenses is \$32,281, with an adjusted gross income (AGI) of \$30,000. You have three dependent children, all under age 18. The tax savings can be shown by comparing the amount of taxes paid with and without paying the children for working. The amounts paid to each child for working on the farm are as follows:

Child #1	= \$ 700
Child #2	= \$2,300
Child #3	= \$3,400
Total Wages	= \$6,400

None of the children have unearned income.

Example 3. After-tax Family Income and Tax Savings Comparisons from Hiring Dependent and Non-Dependent Children.

	No Wages to Children	\$6,400 to Dependent Children Under Age 18	\$6,400 to Non-Dependent Children Over Age 18
Parents Total Income	\$32,281	\$25,881	\$25,391 ¹
Wages to Children	0	6,400	6,400
Taxable Income	11,400	5,452	12,047
Total Family Income Tax	1,714	821	1,804
Self-employment Tax	4,561 ²	3,657 ³	3,588 ⁴
Total Family Tax	6,275	4,478	5,882 ⁵
After-tax Family Income	26,006	27,803	25,909
Tax Savings		1,797	(97 ⁶)

¹ Parents' share of children's FICA deducted as an expense (\$25,881 - \$490 = \$25,391)

² \$32,281 x 0.9235 x 0.153 = 4,561

³ \$25,881 x 0.9235 x 0.153 = 3,657

⁴ \$25,391 x 0.9235 x 0.153 = 3,588

⁵ Includes children's share of FICA. The parents' share of \$490 was considered an operating expense rather than a tax.

⁶ Parents' share of children's FICA added back in: \$6,275 - (\$5,882 + \$490) = \$-97

As can be seen in Example 3, there are two sources of savings to the family. First, there is a savings in income tax. The second source of savings is in self-employment taxes. The combined savings in federal taxes amounts to \$1,797 (\$6,275 - \$4,478). Although you pay your children a total of \$6,400 to work on the farm, your after-tax income is only \$4,603 less (\$6,400 - \$1,797) than it would have been had you not paid your children for working. Moreover, that money is still in the family. After-tax income for the family as a whole is \$27,803, compared to \$26,006, reflecting the \$1,797 savings in taxes.

These are federal tax savings. There may also be a state income tax savings. Rates, as well as the method of calculating taxable income, vary from state to state.

Although there may be exceptions, children age 19 or over, who are not students, and who earn more than \$2,450 in 1994, generally cannot be claimed as dependents. The last column of Example 3 shows the tax situation if none of the children can be claimed as dependents. It is assumed they are under 21, so they are exempt from federal unemployment taxes. However, since they are over 18, they are not exempt from social security taxes. Social security taxes in the amount of \$490 must be paid by the farm business, reducing your income to \$25,391. Another \$490 must be withheld from the children's income. In this situation, there is no tax advantage from hiring your non-dependent children. In fact, your after-tax family income is less than if you had not hired them. This is due to the fact that both you and the children are in the same tax bracket. If you were in a higher bracket than your children, it would be advantageous.

DEFERRING INCOME AND TAXES

Income deferral occurs when the recognition of taxable income and the payment of taxes is postponed to a later point in time. This offers an advantage in that although you must eventually pay the taxes, that payment is postponed; thus, money used to pay taxes can be temporarily invested. The extent of the advantage depends on the return from the invested funds, the length of the tax deferral period, and your expected MTR.

In the following discussion, selected methods for realizing income (and tax) deferral are outlined. Although there is considerable overlap between these methods and those discussed earlier for saving taxes by shifting income to a later lower tax bracket year, the emphasis here is placed on those alternatives with prominent deferral features.

1. Accelerate operating expenses .

Subject to the rules noted earlier (see page 4) and assuming cash accounting, expenses for selected supplies normally incurred the following tax year may be advanced to the current year, thereby lowering taxable income and taxes on that income. Moreover, the one-year deferral can often be realized by advancing the expense only a few days or weeks. Expenses you can easily advance to the current year include feed, seed, fertilizer, chemicals, and fuel. See Example 4 for an illustration of income tax deferral benefits from accelerating operating expenses.

Example 4. Income Tax Deferral Benefit from Prepaying \$1,000 of Fertilizer.

Assume that \$1,000 of fertilizer normally purchased in 19X2 is paid for in late 19X1.
Your marginal tax rate for both years is estimated to be 28%.

19X1		19X2	
\$ 1,000	Added fertilizer expense deduction	\$ 1,000	Reduced fertilizer expense deduction
0.28	Marginal tax rate	0.28	Marginal tax rate
\$280	Reduced 19X1 taxes	\$280	Added 19X2 taxes

By advancing the expense from 19X2 to 19X1, you saved \$280 in 19X1 taxes, but paid \$280 more in 19X2 taxes. Although you did not save taxes over the two years, you used \$280 of the tax savings for an entire year. If the \$280 is invested to earn 10%, the benefit from the one-year tax deferral is \$28.

Of course, factors other than tax deferral should be considered before advancing operating expenses. You should recognize that added taxes will be paid when expenses are advanced to a year with a lower marginal tax rate. Also, if supply prices are decreasing, an earlier purchase is more expensive. In addition, an earlier purchase carries an added interest expense, the amount depending on the interest rate and the period of time the purchase is advanced.

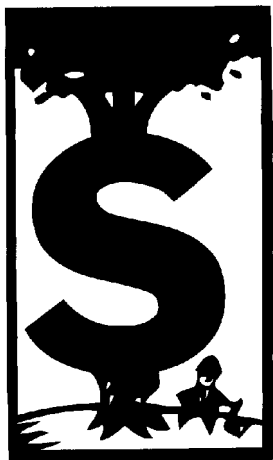
2. Accelerate depreciation.

By using accelerated rather than straight-line depreciation, income and taxes are deferred to later years when depreciation deductions are lower. Thus, accelerated depreciation permits an earlier realization and use of tax savings. The tax deferral advantage associated with accelerated depreciation is illustrated in Example 5.

Example 5. Income Tax Deferral Benefit from Accelerated Depreciation.

Suppose you buy farm machinery with a \$50,000 cost basis and are undecided whether to use an accelerated or slow depreciation method. The machinery qualifies for one-half year of depreciation the year of purchase and will be kept ten years. You anticipate being in the 28% marginal tax rate throughout the ten years. Tax deferred dollars can be invested to earn 10% after taxes.

A comparison of depreciation deductions and related tax savings for the fastest and slowest methods appears in the accompanying table. The fastest method assumes full use of the Section 179 deduction (\$17,500), MACRS-GDS (150% declining balance with optimum switch to straight-line and a seven-year recovery period). Under the slowest method, depreciation is computed using MACRS-ADS (no Section 179 deduction, straight line, ten-year recovery period). Note that total deductions and tax savings over the ten years are the same for both methods (see totals of columns 3, 4 and 6, 7). These totals, however, fail to consider the tax deferral benefits from the faster depreciation method. A more accurate way to compare the two depreciation methods is to account for the opportunity to realize earnings from the earlier receipt of tax savings using the tax deferral benefits of the faster method. This can be done by discounting future tax savings to identify their present value (that is, the value when the depreciation method decision is made). In discounting, the value of future tax savings is reduced to reflect earnings foregone by not having the money available for immediate investment. The rate used to discount future tax savings should reflect the after-tax return from the best available investment, which is assumed to be 10% for the example analysis.



The totals in columns 5 and 8 show a \$2,762 (\$11,794 - \$9,032) advantage in the present value of tax savings realized by the fastest method over the slowest method. This tax deferral advantage will be greater for higher discount rates and smaller for lower discount rates. Further, the tax deferral advantage held by faster depreciation is reduced when your business experiences growth in taxable income and therefore, moves into higher tax brackets in later years. This is due to the slower method yielding more depreciation deductions and tax savings when your business is in a higher tax bracket.

**Example 5. A Comparison of Income Tax Savings Realized by the Fastest and Slowest Depreciation Methods
Used on Farm Machinery with a \$50,000 Cost Basis.**

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Fastest Depreciation MACRS-GDS (150% DB, 7 years)					Slowest Depreciation MACRS-ADS (SL, 10 years)		
Year	Marginal Tax Rate	Discount Factor @ 10% ¹	Annual Deprecia- tion	Tax Savings ²	Present Value Tax Savings ³	Annual Deprecia- tion	Tax Savings ²	Present Value Tax Savings ³
			\$	\$	\$	\$	\$	\$
0	0.28	1.0000	20,981 ⁴	5,875	5,875	2,500	700	700
1	0.28	0.9091	6,217	1,740	1,532	5,000	1,400	1,273
2	0.28	0.8764	4,885	1,367	1,130	5,000	1,400	1,157
3	0.28	0.7513	3,981	1,115	838	5,000	1,400	1,052
4	0.28	0.6830	3,981	1,115	762	5,000	1,400	956
5	0.28	0.6209	3,981	1,115	692	5,000	1,400	869
6	0.28	0.5645	3,981	1,115	629	5,000	1,400	790
7	0.28	0.5132	1,993	558	286	5,000	1,400	718
8	0.28	0.4665	0	0	0	5,000	1,400	653
9	0.28	0.4241	0	0	0	5,000	1,400	594
10	0.28	0.3855	0	0	0	2,500	700	270
TOTAL	XXX	xxx	50,000	14,000	11,794	50,000	14,000	9,032

¹ Equals $1/(1+I)^n$, where I = interest rate and n = year. The interest rate is the after-tax value of money to the taxpayer, which equals the before-tax value times 1 - MTR.

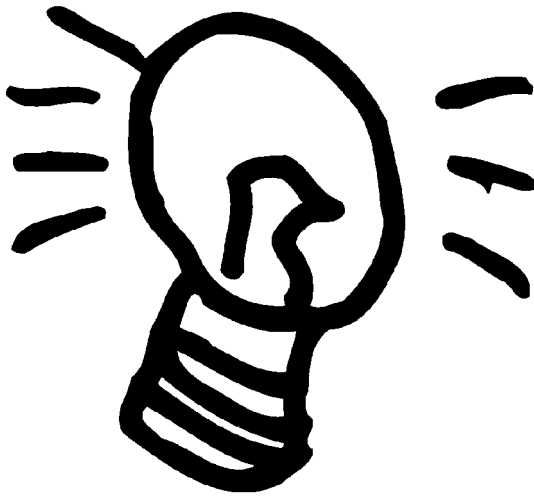
² Equals marginal tax rate times annual depreciation.

³ Equals discount factor times tax savings.

⁴ Includes \$17,500 Section 179 deduction.

3. Delay income-generating sales.

By delaying a sale for a few days, you can make the sale in the following tax year and realize a one-year deferral of the income tax on that sale. However, you should keep in mind the risk of a price decrease during the period the sale is delayed. Postponing a sale also involves an added cost, since sale proceeds are available for investment or loan repayment at a later date. Also, deferral benefits may be more than offset by additional taxes if income is deferred to a year with a higher tax bracket.



4. Use installment sales.

When the sale of real or personal property results in a gain and payment of all or part of the purchase price occurs in a year subsequent to the year of the sale, the sale qualifies as an installment sale. This means that depreciation recapture and/or capital gains tax is prorated over the installment period. If you opt not to use the installment method, the entire amount of the tax is due the year the sale is made. Thus, by structuring a sale so that it qualifies as an installment sale, a deferral of taxes is realized. The installment method is automatically effective unless you “elect out” on the return filed for the year of the sale.

5. Contribute to a retirement plan.

Contributions you make to a qualifying retirement plan that do not exceed the limitations contained in the code reduce taxable income in the year of contribution. They are taxed when withdrawn during retirement. In addition, annual earnings from the retirement contribution are not taxed until withdrawn. Thus, a tax deferral is realized for the period between the time the contribution is made and earnings realized, and the time of withdrawal. Moreover, if your income falls during retirement, the deferral may also reduce taxes by moving income from a higher to a lower tax bracket. You have a higher standard deduction if you are age 65 or older. Examples of retirement plans offering tax deferral benefits for self-employed farmers are Keogh plans, simplified employee pension (SEP), and individual retirement account (IRA).

Although the tax deferral is an attractive feature of retirement plans, the advisability of investing in them is highly dependent upon how their returns, including the tax deferral, compare to the after-tax earnings realized from alternative investments. Further, the liquidity of retirement plan investments may be less than alternative investments. For example, funds withdrawn from your tax deferred retirement plan before age 59 are penalized 10%, unless the withdrawal is due to death or disability. Exceptions from the penalty also apply to early retirement, certain annuities, and medical expenses. Since these rules are quite complex, professional help is suggested in selecting a retirement plan.

OTHER TAX MANAGEMENT TIPS

TRADING VERSUS SELLING MACHINERY

If you are about to replace machinery, you may want to consider the tax implications of trading with a machinery dealer versus selling the machine to a third party and then buying the replacement from the dealer. When traded, replacement machinery has a depreciation basis equaling the cash paid plus the tax basis of the old machine at the time of the trade. On an outright purchase, the full purchase price is the basis. Under these rules, the basis and annual depreciation deductions will be higher when machinery is purchased outright. The tax savings from these higher depreciation deductions depend on your combined marginal income tax rate and social security tax rate.

However, the advantage of a higher tax basis is at least partially offset when depreciation is recaptured

on the sale of the old machine. Depreciation is recaptured (that is, taxed as ordinary income) when the sales price of the old machine exceeds its tax basis. Further, if the sale triggers depreciation recapture, the resulting tax is due when the tax return is filed for the period in which the sale took place. The amount of the tax depends on how much depreciation is recaptured and your marginal income tax rate. No social security tax is paid on depreciation recapture.

Thus, to determine whether it is better to sell or trade, it is necessary to compare the benefit of a higher tax basis against the cost of the near term depreciation recapture when machinery is sold. To illustrate how that comparison can be made, consider Example 6.

Example 6. Analysis of Tax Benefits from Selling versus Trading Machinery.

Assume you are about to replace an old tractor with a new one. If you sell the old tractor, the sale price is \$18,000. It has a tax basis of \$5,000 (that is, the original purchase price minus accumulated depreciation). The dealer has agreed to a \$20,000 value if it is traded for the new tractor. The new tractor will cost \$80,000, plus a \$2,400 sales tax, if purchased outright. The cost of the new tractor if acquired via trade will be \$60,000 cash, plus \$1,800 sales tax. Your combined marginal income tax and social security tax rate is 28% and your marginal income tax rate is 15%.

As reported in the accompanying table, the present value of tax savings is \$1,281 (see column 6 total) greater if the old machine is sold rather than traded. The benefit from a higher tax basis on the new tractor exceeds the taxes paid on recaptured depreciation from the sale of the old tractor. You are cautioned not to generalize from this example to other specific situations. Variation in such key assumptions as tax rates, discount rate, depreciation method, etc., could alter the outcome. Competent tax counsel is suggested for major replacement decisions.

Example 6. An Example Comparison of tax Savings between Selling and Trading Farm Machinery.

	(1)	(2)	(3)	(4)	(5)	(6)
Year	Sell	Trade	Added Tax Deductions from Sell ¹	Added Tax Savings from Sell ²	Discount Factor@ 8% ³	Present Value of Added Tax Savings from Sell ⁴
	\$	\$	\$	\$		\$
Tax Basis of New Tractor	—	82,400 ⁵	66,800 ⁶	—	—	—
Depreciation Recapture on Sale of Old Tractor	0	(13,000) ⁷	—	(13,000)	(1,950)	1.0000
Depreciation ⁸	1	24,451	22,780	1,671	468	0.9259
	2	12,415	9,431	2,984	836	0.8573
	3	9,754	7,410	2,344	656	0.7938
	4	7,950	6,039	1,911	535	0.7350
	5	7,950	6,039	1,911	535	0.6806
	6	7,950	6,039	1,911	535	0.6302
	7	7,950	6,039	1,911	535	0.5835
	8	4,040	3,022	1,018	285	0.5403
Total	XXX	82,400	66,800	2,661	2,435	XXX

¹ Column 1 - Column 2.

² Column 3 x marginal tax rate of 0.15 for depreciation recapture (federal income tax) and 0.28 for depreciation (federal income tax and social security tax).

³ Equals $1/(1+I)^n$, where $I = 8\%$, and $n = \text{year}$. The interest rate (I) is the after-tax value of money to the taxpayer, which equals the before-tax value times $1 - \text{MTR}$.

⁴ Column 4 x Column 5.

⁵ \$80,000 purchase price + \$2,400 sales tax.

⁶ \$61,800 cash + \$5,000 tax basis of trade-in.

⁷ Sale price (\$18,000 - cost basis at time of sale (\$5,000)).

⁸ Depreciation is based on use of the \$17,500 Section 179 deduction and MACRS-GDS (150% DB, 7 years).

PAYING WAGES WITH A COMMODITY

Wage payments in the form of commodities (livestock, grain, etc.) have been used by some producers as a way of reducing taxes. Such wages are sometimes referred to as payments-in-kind (PIK). These non-cash wages are not subject to FICA taxes. Hence, the employer and the employee each save 7.65% on wages of \$57,600 or less. In-kind wages are still subject to income tax once they are sold.

An increasing number of producers are using this strategy as a means of reducing taxes. In some districts, the Internal Revenue Service is beginning to scrutinize returns with high PIK wage payments a little more closely than in the past. Hence, there is an increasing probability that the returns of the employer as well as the employee may be audited. You are advised to study this section carefully, then proceed with caution should you decide to employ this strategy in your business.

It has been suggested by some that the original intent was to allow producers to give employees a side of beef, milk, or other consumable commodities as partial payment for work, without requiring the

employee to report the commodities as income. There is no evidence that this is the case, but a task force was commissioned to study the issue.*

In-kind wages can be paid to family members as well as other employees. As an example, suppose you hire your spouse to help with the work. You can reduce your self-employment taxes by making a wage payment to your spouse in the form of commodities as long as your spouse gets complete title to the goods and has absolute control over their disposition. You would report the fair market value of the commodities you pay your spouse on line 4 of Schedule F of your joint tax return. The commodities are valued as of the day you pay your spouse. You would make an off-setting entry as wages of the same amount on line 24 of Schedule F. The income your spouse receives from the sale is reported on line 7 of Form 1040, as well as on Schedule D. Any marketing expenses incurred by your spouse would also be reported on Schedule D. The proceeds from the sale should not be deposited into the account from which farm expenses are paid, but rather to a separate account over which your spouse has control.



*Statement made to the National Farm Tax Committee by Tony Warcholak, Director of Employment Tax Division, Internal Revenue Service, Washington, DC, May 16, 1994. He issued a memo to district offices in April 1993 saying that the code was very clear and he could determine no ambiguity in the regulations on payments-in-kind, and there was no indication that the congressional intent was anything other than what the code says.

The W-2 form your spouse receives should reflect the value of the commodities received as wages. Since there is no place to indicate that the wages were in-kind, there is the possibility that an IRS employee would think social security taxes were due. It is recommended that a note be included on Line 7 of Form 1040, and possibly on the W-2 Form, identifying them as in-kind wages.

There is nothing to be gained by paying one's minor children with commodities, since minor children are automatically exempt from social security and Medicare taxes. In fact, it may create problems, particularly with payments of livestock. Animals have to be cared for, and the IRS will likely consider the children to be self-employed and require them to pay self-employment taxes on their earnings.*

Although the report of the task force is in final draft form, it has not been published as of this writing. However, it will influence decisions of the IRS. The following are a few factors the IRS consider necessary if PIK wages are to be allowed.

1. Is there documentation of a transfer of ownership of the asset? The receiver must take title to the commodities, pay all costs associated with ownership (storage, insurance, feeding or maintenance), and have control over their disposal. This means that the employee must negotiate the sale, and the risk of gain or loss from sale of the asset is transferred to the employee. It is advisable to document the transfer of ownership in writing and have it signed by witnesses.
2. Is the non-cash payment a cash equivalent? It is recommended that the employer prepare a written employment contract in which the duties of the employee, and the rate of payment in terms of commodities, be clearly stated. Caution is advised here. If the contract stipulates that the quantity to be paid is dependent on the price of the commodity, this will almost certainly be considered a cash equivalent payment. For example, if you tell an employee, "You will be

paid \$1,000 a month in the form of 12% protein hard red winter wheat valued at the time it is delivered to the elevator," this will be considered a cash equivalent payment.

There are other factors that should be understood if an employer pays non-cash wages:

1. The commodities must be valued at current market price at the time payment is made, regardless of when they are sold. This is the amount the employer reports as wages paid on Schedule F. The employee reports the same amount as income on Form 1040. Upon sale of the commodities, any gain or loss resulting from a change in price must be reported by the employee on Schedule D.
2. The employer should make sure the employee understands that since nothing is paid into FICA, there will be no accumulation of social security benefits. One must pay into the system for 40 quarters to get the maximum social security benefit.
3. Non-cash wages are included in the \$2,500 wage threshold for employer payment of social security and Medicare taxes.
4. If the employer can show a definite business purpose for paying wages in commodities, other than one of avoiding FICA taxes, there is a much higher probability that non-cash payments will not be questioned. For example, if the business has a cash flow problem, and interest expense on borrowed money can be reduced or avoided by paying with non-cash wages, the practice would be less likely to be looked upon as a way of avoiding FICA taxes.

Again, you are advised to use non-cash payments with caution, and to be alert to new announcements regarding this issue. It is not known when the report of the task force will be published, but there is still a degree of ambiguity in the interpretation of the law.

* Special exemptions for 4-H and FFA livestock projects can be obtained.

GIFTS IN LIEU OF WAGES

You may be able to reduce taxes by making a gift of commodities instead of paying wages. However, the details of such a transaction are very important, and you should counsel with a competent tax accountant. As an example, assume that you and your spouse file separate returns, and that you claim your children as dependents, none of which are hired on the farm.

You project net income from your grain farm operation to be around \$32,281. You wonder if taxes can be reduced by making a gift of grain to your spouse. Barley is selling at \$2.00 a bushel so you consider giving your spouse 5,000 bushels, thereby reducing your income by \$10,000. You will realize a savings in both self-employment and income taxes. Further, since the gift does not exceed \$10,000, and assuming you have made no other gifts during the year, you will not have to file a gift tax form.

What is your spouse's tax situation? Providing he/she is neither a farmer or a dealer in grain commodities, the amount received on the grain sale need not be reported as earned income for purposes of self-employment taxes. Nor is the gift reported as taxable income. However, when your spouse sells the grain, the income realized from the sale must be reported as income on his/her tax return. As a capital asset, the proceeds would be reported on Schedule D. The results of several filing options are summarized in the accompanying table (Example 7). As is evident, giving the spouse a gift of commodities results in a significant reduction in taxes, regardless of the filing option. However, the savings are significantly reduced when the spouse files a separate return, but is claimed as a dependent by the other spouse.

Example 7. Comparison of Income and Self-employment Taxes With and Without a Gift of Commodities to Spouse for Various Filing Options.*

	Joint Return	Joint Return	Separate Return Claims Spouse As Dependent	Separate Return Does Not Claim Spouse As Dependent
Gift to Spouse	No	Yes	Yes	Yes
Total Net Income	\$ 32,281	\$ 22,281	\$ 22,281	\$ 22,281
½ Self-employment Tax	2,281	1,574	1,574	1,574
Adjusted Gross Income	30,000	20,707	20,707	20,707
Income Tax: You	1,811	414	881	1,234
Spouse	0	1,504	1,504	686
Self-employment Tax (SE)	4,561	3,148	3,148	3,148
Total SE + Income Tax	6,372	5,066	5,533	5,068

*Assumes three dependent children.

If the spouse receiving the commodities as a gift has a farm, and holds the grain as inventory, or has a commodity trading business, the sale would be reported as ordinary income on either Schedule F or Schedule C, and would be subject to self-employment tax.

A gift transaction of this nature should be confined to one gift per year per person if possible. Otherwise, the IRS may declare the recipient a broker of commodities. Title to the commodities must actually be given to the recipient of the gift without any valuable consideration coming back to the donor. In short, there must be full intent to make a gift as well as irrevocable delivery of the property.

The Example 7 analysis assumes the gift is made with commodities produced in a prior year. Production expenses must be reduced accordingly if a

gift is made with commodities produced in the year in which the gift is made. Gifts of commodities, as a strategy to reduce taxes, are only advantageous to the cash-basis farmer, who has a zero basis in the commodities. The farmer operating under the accrual basis will usually have a basis in the commodities almost equal to their value.

It is important to understand that this represents a transfer of an asset, not income. The “assignment of income” doctrine prevents the transfer of income from one taxpayer to another. While the gift itself is not subject to taxes, it may be when and if it is sold. Since the recipient has a zero basis in the property, the full amount of the sales price is considered a gain. Hence, if the gift is an intra-family gift, which is generally the case, the payment of income taxes is only postponed. However, there is a savings in both income and self-employment taxes in this example.

TAX CONSIDERATIONS WHEN BUYING OR SELLING A FARM

If you are buying a farm, tax savings can be realized by allocating the sale price among the various assets in an optimum manner. More specifically, you will want to allocate relatively high values to growing crops and depreciable assets, such as fences, structures, and buildings. More conservative values should go to the dwelling and to land.

The portion allocated to growing crops provides a near term tax savings in that it is subtracted from crop sale proceeds in the year of sale or is a deduction if fed to livestock. Intermediate term tax savings result from depreciation deductions taken on values allocated to depreciable assets. Tax savings from amounts allocated to the land are not realized until the land is sold, since the allocated value is added to the basis of the land.

If you are age 55 or older, you have a once-in-a-lifetime exemption of the first \$125,000 of gain from the sale of a residence. Thus, the tax savings realized from a large allocation of one farm’s sale price to the home are likely to be quite limited. Since under current law, ordinary income and capital gains are taxed the same (except for high income levels where ordinary income tax rates

exceed the 28% maximum capital gains tax rate), the seller is indifferent about how the sales price is allocated. If capital gains receive preferential treatment, the seller will realize tax benefits by allocating the sales price more toward land and less to depreciable assets. This strategy substitutes capital gains income for ordinary income (that is, depreciation recapture).

Also, if you are buying a farm, tax savings can be realized by negotiating for a lower sales price in exchange for a higher interest rate. The interest is tax deductible in the year paid, whereas a lower price results in less depreciation deductions and/or a lower basis in land. The latter provide longer-term and therefore, less valuable tax savings. As long as there is no preferential treatment of capital gains, the seller is indifferent whether income is received as interest (ordinary income) or purchase price (capital gains).

If you are selling a farm, you can sell it outright for cash or make it an installment sale. An installment sale offers a tax advantage in that the tax liabilities are spread out over time as the payments are received. Also, the liability will often be reduced as a result of the

income falling in a lower bracket since the income is realized over several years instead of in a single year. However, several other factors may weigh

heavily in your decision about how to sell the farm (for example, risk of default on payments, reinvestment potential, liquidity needs, etc.).

LIVESTOCK SALES IN A DROUGHT YEAR

If you have sold livestock because of drought conditions, you may treat the sale either as an involuntary conversion or report it on the tax return following the year of the sale. An involuntary conversion means the gain from the sale may be postponable for more than one year. However, several restrictions apply to this option:

- Only livestock held for breeding, dairy, or draft purposes qualify.
- Only livestock sold in excess of normal culling rates are eligible. Thus, if in the absence of drought 25 cows are normally culled, but 45 cows are culled in the drought year, only the gain from 20 cows would not be taxed.
- The livestock must be replaced by similar animals within the next two tax years. If replacements are not purchased within that time period, an amended return must be filed for the year of the sale, the gain reported, and any additional taxes paid. An extension of the replacement period may be obtained by writing to the District Director of the Internal Revenue Service.
- If replacement animals are purchased at a price below what was received from the drought induced sales, the difference is taxed as a gain by filing an amended return for the drought year.
- The tax basis of the replacement animal is equal to the price paid for that animal minus the gain on the drought induced sale that was not taxed due to involuntary conversion treatment. For example, if the price received for a raised

beef cow that was sold because of drought is \$750 and a replacement is purchased for \$750 or less, the tax basis on the replacement is zero. This means there would be no depreciation deductions generated by the replacement resulting in higher income and social security taxes. In following years, livestock purchased to replace the number of animals normally culled are eligible for standard depreciation deductions based on their purchase price.

Instead of treating drought induced sales as an involuntary conversion, you can opt to include the gain from these sales on the tax return for the year following the sale. The following rules apply to this option:

- Livestock held for breeding dairy, draft, or sporting purposes qualify. Unlike the involuntary conversion provisions, livestock held for sale, whether raised or purchased, are eligible for the one-year postponement.
- Producers must be able to show that the sale would not have occurred under usual business circumstances (i.e., drought had not occurred.)
- Drought has resulted in the federal government (President or Department of Agriculture or any of its agencies) declaring the area eligible for federal assistance. However, the forced sales may have occurred before the area become eligible for assistance.
- The tax basis for purchased replacement arrivals is not reduced by the amount of the postponed gain. Thus, if a raised cow is sold for \$750 and a replacement is purchased for \$750, the \$750 paid for the replacement is depreciable.

A difficult, yet potentially important, decision to be made by producers is whether to opt for involuntary conversion or a one-year postponement of gains from drought sales of breeding, dairy, or draft animals. Relative to the one-year postponement, opting for the involuntary conversion has the potential advantage of more than a one-year tax deferral on the gain and the disadvantage of limiting the tax basis (and depreciation deductions) to the excess (if any) of the replacement animal's purchase price over the price received for the animal sold due to drought. Further, it should be recognized that sales of breeding animals are not subject to social security taxes, while depreciation deductions save both income and social security taxes. Thus, a producer with a 15% marginal income tax rate saves 15¢ per dollar of nonrecognized gain, but pays about 28¢ (15¢ income tax + 13¢ social security tax adjusted for income tax savings) additional tax per dollar of foregone depreciation when involuntary conversion is chosen. However, that disadvantage is reduced, since the tax benefit

occurs at an earlier point in time than the payment of additional taxes.

Due to varying taxpayer circumstances, no pat recommendation about involuntary conversion versus a one-year postponement should be given. Producers with substantial drought sales would be well advised to work closely with their accountant in making this decision, since the tax impact may be sizable. For example, we analyzed a situation under the following assumptions: (1) \$750 sales price for raised beef cow sold due to drought, (2) \$750 paid for a replacement animal purchased one year after the drought year, (3) 15% marginal tax rate for all years, (5) accelerated depreciation used on the replacement animal, and (6) a 10% interest rate. In this case, there was a \$54 per head present value tax advantage for selecting a one-year postponement over an involuntary conversion. However, minor changes in these assumptions can dramatically effect the comparison, suggesting that each producer should seek an analysis.



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WESTERN FARM MANAGEMENT EXTENSION COMMITTEE

James Wade, Arizona; Karen Klonsky, California; Norm Dalsted, Colorado; Kent Fleming, Hawaii; Paul Patterson, Idaho; James Johnson, Montana; Gordon Myer, Nevada; Bart Eleveld, Oregon; Larry Bond, Utah; Gayle Willett, Washington; John Hewlett, Wyoming; Don West, Extension Service, USDA; and Darryld Kautzmann, Administrative Advisor, Wyoming. The committee gratefully acknowledges the support of the Farm Foundation.