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Tax Planning and Management Considerations For Farmers in '98

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TAX PLANNING AND MANAGEMENT CONSIDERATIONS FOR FARMERS IN '98

by

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The following article is based on a paper written by George F. Patrick, Extension Economist, Purdue University. The authors of this article are not tax specialists. Please confer with one to apply the following information to your operation and obtain further information. This article provides an overview of recent tax legislation that will affect farm business.

There were many changes that took place in 1998. The Taxpayer Relief Act (TRA) of 1997 introduced income averaging to farmers. The recent tax legislation made this idea permanent. A change in the 1998 legislation makes it possible for farmers to carry net operating loss back for five years. A farmer can choose to carry the net operating loss back five years, carry the loss back two years, or elect to carry the loss forward.

Weather conditions have affected livestock sales. There is now an option that gives producers the option to report the income a year later if weather-related conditions made the farmer sell earlier then normal. A presidentially declared disaster area must exist, although the animals or sales do not need to be located in this area. A direct relationship must be shown between the livestock and sales and the disaster area. When a producer sells more draft, breeding, or dairy animals than normal because of the weather, and replaces them within two years of the sale, a producer may postpone recognizing the gain of livestock by reducing the basis of replacement livestock. A presidentially declared disaster area does not have to exist for producers to take advantage of this tax provision.

Health insurance is a major area that will be changing in the future. Recent legislation increases the deduction of premiums for the self employed. Forty-five percent of the expense can be decreased in 1998, increasing over the next couple years until the year 2003 when 100 percent of premiums will qualify as deductions.

Child tax credits are available at a maximum rate of $400 for 1998. If a child is under the age of 17 as of December 17,1998, and is a child, stepchild, or eligible foster child of the taxpayer, and is claimed as a dependent, they will qualify for this exemption.

Many educational incentives are used to reduce the cost of education. There are four new programs for 1998. These include: the HOPE Credit, Lifetime Learning Credit, Educational IRA, and student loan interest deductibility.

The HOPE credit is nonrefundable credit against federal income taxes up to $1,500 for each student. It is only available for the first two years of a student's higher education program and is effective for expenses paid after December 31, 1997. Most students will qualify for three semesters of expenses. Expenses incurred later may qualify for the Lifetime Learning Credit.

Up to 20 percent of tuition and fees occurring after June 30, 1998 are eligible for this credit. Up to $5,000 of qualified expenses are eligible per tax return (not per student) for the

period of June 30, 1998 to January 1, 2003. This credit will increase up to $10,000 per tax return by the year 2003.

Many Cooperative Extension classes and other continuing education programs will qualify for this credit. The Lifetime Learning Credit is available for any course of instruction that is taken to acquire or improve job skills.

Educational IRAs were created to pay for the expenses of higher education. After 1998, a nondeductible contribution of no more then $500 a year, for each beneficiary under the age of 18, can be made to an education IRA. Each beneficiary can only have one educational IRA that must be used by the time they reach the age of 30.

Money received from education IRAs does not have to be assessed as income unless it exceeds the qualified higher educational expenditures such as: tuition, fees, room, and board. If a student is receiving tax-free education IRA distributions, that student can not claim expenses for the HOPE or Lifetime Learning Credits.

A taxpayer may deduct interest they pay on educational loans for themselves, spouses, or dependents if they are not claimed as a dependent on another taxpayer's return. Interest paid on student loans can be deducted when computing adjusted gross income for 1998 and later years. The maximum interest deduction is $1,000 in 1998, increasing by $500 each year until the year 2001 when it will be $2,500 for later years. This deductible amount is phased out when incomes reach $40,000 for single individuals and $60,000 for joint returns. The deduction is allowable for the amount of interest that must be paid during the first 60 months in which payments are required.

Gift and Estate Tax Provisions

There were many changes to estate and gift tax provisions that affect family farms. The first change reduces the amount of the deferred estate tax interest rate from four to two percent on the first $1,000,000 of taxable value. The interest rate is reduced to 45 percent of the rate applicable in values in excess of $1,000,000. These reduced interest rate payments are not deductible for estate or income tax purposes.

The second change is an increase in the unified credit amount. This increase allows taxpayers to transfer more of their estate at death without incurring more tax expenses.

The third change relates to the qualified family-owned business interest (QFOBI). Decedents whose estate includes QFOBI can deduct from the taxable estate the value of the qualifying business property. The requirements and provisions of QFOBI are very complex. The complexities involve the value of the business, qualifications of heirs, and business participation.

Expensing and Depreciation

There were minor changes in expensing and depreciation. Expensing increases from $18,500 in 1998 to $25,000 for tax years beginning after December 31, 2002. Also, horses that meet qualifications listed in Section 179 can qualify for expensing under this section. Reducing the basis for cost recovery is the main purpose for Section 179. Using Section 179 expensing, reducing taxable income to fall below the personal exemption level, wastes the potential for future depreciation deductions. Please review the 1998 tax book or speak to a tax consultant for further information of expensing and depreciation.

Self-Exempt Tax Purposes

There are several tactics that farm families use to reduce the amount of earnings listed for self-exempt tax purposes. The IRS is challenging these four techniques if they find them lacking in substance and their main purpose is that of tax avoidance. Some of the more common techniques include: renting real estate to business entity, paying minimum agricultural wages (not in cash form), renting land to a spouse, and giving charitable contributions of commodities.

Rental Agreements to a Business Entity

There have been changes in the rental of real estate and what is derived as taxable incomes. Now, if a landowner rents land to a separate business entity in which they participate, they earn a salary as an employee of the corporation and the rental income, the rental income is now considered earnings for self-employment tax purposes.

Paying Non-Cash Wages

When paying non-cash wages to employees or spouses, there are two important guidelines that must be considered. The first is whether the employee has governance and control of the commodity, and the second is a comparison to what is earned and if the payments are equal to cash value. The information that backs these two statements will determine if the wages should be exempt. There should be documentation specifying the agreement between employer and employee to give substance to the contract.

Renting to a Spouse

Real estate is usually jointly owned by farmers and their spouses in most farm operations. Here again, the IRS is looking at the substance of the agreement to make sure that it is not just for tax avoidance. The payment of rent to a spouse will have more economic substance if the property is not jointly owned between the two. If there is a written lease and a rental payment agreement, this is documentation to support the agreement.

It is suggested that the property holder make the necessary tax, insurance, and interest payments from an account that is separate from the farm business account. It is also suggested that the landlord avoid participating in the farm business in a way that is material (such as earning wages).

Commodity Gifts

Giving commodity gifts is often done to reduce self-employment taxes. Giving charitable contributions often reduces taxes for cash basis farmers. In this scenario, the gift should not simply be sold in the charity's behalf, but, rather, be transferred to the charity. The charity then determines when and how it is to be sold.

Charity gifts given to spouses are not allowed by the IRS. These gifts are not recognized as gifts for tax purposes. When giving commodity gifts to other family members, it is best that the gift commodity should be part of the previous year's production and should not have any sales commitments attached to it.

Low market prices this year do not imply low taxable incomes for farmers this year. Farm expenses are deductible when paid when using the cash method of accounting. Income is reported during the year in which the receipts are received. These procedures allow farmers to review their expenses and receipts when they want. This allows them to plan ahead and change their plan of action and make money-saving adjustments for taxes. Farmers should use the period of low income as an opportunity to plan ahead.

Due to the complexity of tax laws and regulations, consulting with a tax professional for tax advice is highly recommended and worth the time and money spent on such a conference. There are many other aspects of tax regulations that have not been discussed in this article. For more information please consult a tax specialist.

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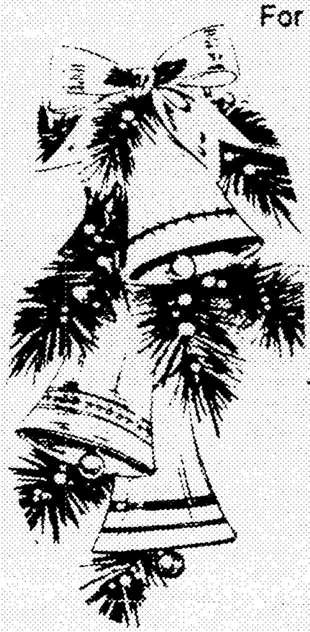

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May each of you have a very

Merry Christmas

and a health, prosperous and

Happy New Year!!

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