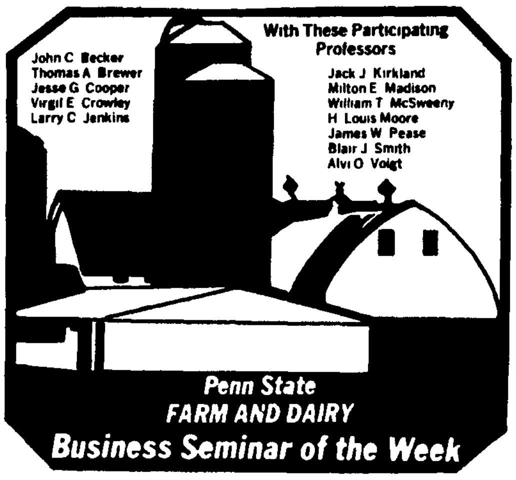

SOMETHING OLD AND SOMETHING NEW FOR INCOME TAX MANAGEMENT

Larry C. Jenkins
Extension Economist

Even though its "power" is vastly dimished, the capital gains provision of the Internal Revenue Code is still important as a tool of income tax management. Capital gain is the term used to describe gain from disposal of capital assets; that is, assets the taxpayer holds for investment or personal purposes. Special provisions of the Internal Revnue Code permit gain from disposal of property used in a trade or business to be treated as capital gain. Under pre-1986 law, that provision provided significant tax benefits to farmers. Sales of cull breeding animals, for example, could qualify for the 60 percent capital gain exclusion and only 40 percent of the gain was taxed.

The Tax Reform Act of 1986 contains major change in the tax rules for capital gains. The 60 percent capital gain exclusion is no longer available. The loss of that exclusion removes part, but not all, of the tax benefits of capital gain income.

Farmers will continue to benefit from capital gain qualifying sales and should be conscious of the advantage of increasing this type income as compared to ordinary income. For upper income taxpayers, capital gain is taxed at a minimum 28 percent rate as compared to top rates of 38.5 percent in 1987 and 33 percent in 1988 for ordinary income. Legislation recently introduced in the U.S. Congress proposes freezing tax rates at the 1987 level or adding a 5 percent surcharge on rates provided by the new tax law. Regardless whether one of these or other "revenue enhancing" measures finally become law, the distinction between capital gain and ordinary income will be an important feature of future tax law.

Capital gain income is not treated as earned income for purposes of self-employment tax. Thus, taxable income that results from capital gain qualifying sales is taxed at a rate more than 12 percent lower than if the income were classified as ordinary income. This provides some incentive for the producer to arrange production patterns so as to qualify more sales as capital gain qualifying sales.

Producers who maintain livestock breeding herds can qualify more sales for capital gain by increasing culling rates. If breeding animals are held long enough to meet the holding period requirement (2 years for cattle, 1 year for hogs), sale of the cull animal is treated as sale of a capital asset. Income received from these sales is not subject to self-employment tax. If the producer is careful in selecting replacement animals, he or she may be able to improve quality and productivity of the breeding herd at the same time tax savings occur due to increased culling rate.

Sales of timber can also produce capital gain income. The seller's decisions and actions determine how timber sales are treated; they may produce ordinary income or they may qualify as capital gain.

A farm operator who cuts and sells timber from owned land may treat the income as ordinary income when the sale is a minor part of the total farm business. In the typical case, there is a zero basis in the timber and all income, except cutting and selling expense, is taxed.

Income from the sale of timber can qualify as sale of a capital asset in either of two situations:

1. The timber is harvested by the owner and he or she elects to treat the cutting of the timber as a sale. Provided the timber was owned more than six months, the difference between fair market value of the timber and it's basis at the time of cutting is capital gain (or loss). The capital gain (or loss) is reported in the year the timber is harvested even if the cut timber is not sold that year. The fair market value of the timber when cut becomes the basis for computing grain or loss at the time the cut timber is finally sold. That final sale produces ordinary income or loss.

2. Timber disposed of under a cutting contract qualifies for capital gain if held more than six months prior to sale. This form of timber sale requires the owner to retain an economic interest during cutting, that is, the owner is paid a set amount per thousand board feet as the timber is harvested.

Using the Net Operating Loss to Reduce Income Tax

Economic conditions sometimes adversely affect farming with the result that individual farm businesses incur a loss. When this occurs, the business may have a **net operating loss** that can be used to recover tax paid in prior years or to reduce future tax payments. Unfortunately, some farm operators have not been aware of this provision of tax law. Consequently, they have paid more tax than required because they did not take advantage of the net operating loss provisions of the Internal Revenue Code.

A net operating loss (NOL) is an excess of allowable business deducations for a tax year over gross income for the same year. The NOL may be carried back three years to recover tax paid in an earlier year or, if not totally used in the carryback period, carried over up to fifteen years to reduce tax that would become due in a latter year. The NOL provides tax relief for nearly all types of taxpayers except partnerships. Individuals, corporations, estates, and trusts can all use the NOL in alleviating the tax obliation.

Partnerships are not allowed a NOL carryback or carryover. However, each member of the partnership may enter his or her share of partnership loss on the individual tax return. If the loss exceeds income for ayear, the loss can be carried back three years and forward fifteen years.

"S" corporations, like partnerships, also are not permitted a NOL carryback or carryover. If a loss occurs, it may be passed to the individual "S" corporation shareholders on a pro-rata basis just as with the partnership. There are special rules for determining the number of years to which a loss may be carried back or forward.

NOL carryback and carryover:

The NOL of an individual is first carried back to the third year preceding the year of loss and applied against income in that year. Tax is then recomputed for the earlier year and a claim for credit or refund is made for the amount of tax reduction. If the NOL is not fully used in the third year preceding the year of loss, the amount not used is carried to the second year and then to the first year preceding the year of loss. The NOL can also be used in the years following the year of loss and can offset income for up to fifteen years after the year of loss.

Two steps are essential in carryback of an NOL. The first of these is to convert the **accounting loss** to a net operating loss. The accounting loss is the amount of loss reflected in the record book at the end of the business year. The accounting loss is converted to a net operating loss by using a worksheet that is attached to the tax form used in filing the NOL. The worksheet is indentified as form 1045, schedule A.

The NOL is usually slightly smaller than the accounting loss reported by an individual. The reason for the difference is that certain deductions can be taken in determining the accounting loss that are not allowed when computing the NOL. These nondeductible items for purposes of the NOL include the personal exemption, NOL from other years, and some types of capital losses.

Step two in filing a NOL is to complete a form 1045, entitled "Applilcation for Tentative Refund." This form is used to report income and tax as originally filed and the corrected information due to carryback of the NOL. The amount of the tax refund is also computed on the form 1045. The completed form 1045 must be filed by December 31 of the year following the year when NOL occured. For example, an NOL in 1987 must be filed by December 31, 1988.

The NOL is a valuable tax management tool because it provides the taxpayer with a method of connecting a given tax year to earlier years and subsquent years. Losses from a given year can be applied against earlier tax payments or used to reduce taxable income in future years. In either case, total tax paid over a period of years can be reduced by application of the net operating loss. (Admittedly, it is preferable to never have a NOL but they sometimes occur, even with the best of management). The net operating loss provisions can be used to partly compensate for the loss of income averaging which was repealed December 31, 1986 as part of the Tax Reform Act of 1986.

GROW WITH CHEMGRO — —
PROVEN PERFORMANCE

AMMON HOOVER
MANHEIM, PA
PLANTED MAY 8,
HARVESTED OCTOBER 12

HYBRID	POP.	H_20	YIELD 15.5%
CHEMGRO 7087	22,000	23.1	126.1
CHEMGRO 9087	22,000	27.4	123.1
CHEMGRO 8086	24,500	23.3	120.8
CHEMGRO 7386	22,500	23.5	120.6
CHEMGRO 6386	23,500	21.8	118.6
CHEMGRO 8986	21,000	27.9	117.8
PIONEER 3358	22,000	23.2	112.5
CHEMGRO 6086	21,000	21.2	112.3
PIONEER 3184	22,000	27.8	99.9
CHEMGRO 3387	22,500	18.1	69.6

COMMENTS: THIS PLOT WAS SEVERELY STRESSED BY HIGH TEMPERATURES AND LACK OF MOISTURE DURING THE GROWING SEASON.

JOHN GOOD
NARVON, PA
PLANTED MAY 8,
HARVESTED OCTOBER 13

HYBRID	POP.	H_2O	YIELD 15.5%
CHEMGRO 8086	23,000	22.4	169.7
CHEMGRO 8086	*22,500	22.6	161.5
CHEMGRO 6386	23,000	19.5	158.2
CHEMGRO 8086	*23,000	22.9	154.8
CHEMGRO 7386	25,000	22.9	154.7
CHEMGRO 6086	22,500	18.9	151.4
CHEMGRO 7087	28,500	22.1	145.7
FUNKS G 4543	22,000	23.2	142.7
CHEMGRO 8986	23,000	27.0	142.3
DEKALB 689	24,500	25.6	142.0
CHEMGRO 9087	22,500	27.1	134.8
CHEMGRO 3387	23,000	17.5	117.6

*COMMENTS: * THESE YIELD RESULTS OF CHEMGRO 8086 WERE FROM CHECK LOCATIONS AT EACH SIDE OF PLOT.*

SAVE MONEY! BUY 9 UNITS — GET 1 FREE

Chemgro
SEEDS

SEND FOR 1987 SHELLING TEST PLOT RESULTS

NAME______________________________
ADDRESS____________________________

CHEMGRO Box 218 East Petersburg, PA 17520
(717) 569-3296 or (800) 346-GROW
(4769)