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Division of Agricultural Sciences and Natural Resources • Oklahoma State University

1997 Tax Relief Act: Impacts on American Farmers and Ranchers

Mike L. Hardin[1]
Assistant Professor and Extension Tax Specialist

Introduction

The '97 Tax Relief Act (TRA97) has been proclaimed by President Clinton and Congress to be a great benefit to all taxpayers. The act does contain many benefits specific to agriculture and all taxpayers in general, but beware of the fine print. Many of the benefits phase in gradually over the next ten years and many taxpayers will not meet the strict tax benefit requirements. It all sounds great, but truly, the "devil **is** in the details." The following summary of (TRA97) creates an awareness of potential tax savings available to Agricultural producers. However, you should contact your tax preparer to determine if your individual situation meets all the requirements.

Child Tax Credit

The Act provides taxpayers a maximum child tax credit of $500 ($400 for 1998) for each qualifying child. A qualifying child is an individual that can be claimed as an exemption, who is under the age of 17 (determined at the close of the calendar year in which the taxpayer's taxable year begins), and who is a child, a stepchild or eligible foster child of the taxpayer. For higher income taxpayers, there is a phase-out of the child credit. The credit is reduced by $50 for each $1,000 that the taxpayers modified Adjusted Gross Income (AGI) exceeds $110,000 for married taxpayers filing jointly, $75,000 for single taxpayers, or $55,000 for married taxpayers filing separately. The Act provides a complex formula for determining the limitations on the amount of the credit and whether it is refundable. This formula depends on whether the taxpayer has three or more children and interacts with the earned income credit (EIC). The child tax credit applies to taxable years beginning after December 31, 1997.

[1] Room 532 Agricultural Hall Stillwater, OK 74078
405.744.6081 Phone
405.744.8210 Fax
mhardin@okway.okstate.edu e-mail

Education Incentives

The Act provides taxpayers with a HOPE Scholarship credit plus a Lifetime Learning credit. The HOPE credit equals 100% on the first $1,000 of qualified tuition and fees, plus 50% of the next $1,000 of such expenses paid. The HOPE credit is not available for the purchase of books. The HOPE credit is only available for a student pursuing a course of study on at least a half-time basis. The HOPE credit is disallowed if the student has been convicted of a felony drug offense.

The Lifetime Learning credit is a nonrefundable credit equal to 20% of qualified tuition expenses not exceeding $5,000. For taxable years beginning on or after January 1, 2003, the dollar amount increases to $10,000. The credits have AGI phase-out amounts and are indexed for inflation. For a taxable year, a taxpayer may elect with respect to an eligible student the HOPE credit, the 20% Lifetime Learning credit, or the exclusion from gross income for certain distributions from an education IRA.

Qualified tuition and fees for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level (and professional degree) courses. The Lifetime Learning credit is also allowed with respect to any course of instruction at an eligible educational institution (whether enrolled in by the student on a full-time, half time, or less than half-time basis) to acquire or improve job skills of the student.

The HOPE credit is effective for expenses paid after December 31, 1997 (in taxable years ending after such date), for education furnished in academic periods beginning after such date. The Lifetime Learning credit is applicable to expenses paid after June 30, 1998 (in taxable years ending after such date), for education furnished in academic periods beginning after such date.

The Act provides an above-the-line deduction for interest paid on student loans. In 1998, the maximum amount is $1,000; 1999 $1,500; 2000 $2,000; 2001 or thereafter $2,500. The deduction phases out at income levels beginning at $40,000 for individuals and $60,000 for joint returns (indexed for inflation beginning after 2002). The deduction is allowed only with respect to interest paid on any qualified education loan during the first 60 months in which interest payments are required. No deduction is permitted for taxpayers who may be claimed as dependents on another taxpayer's return. The deduction of student loan interest applies only to qualified education loans incurred on, before, or after the date of enactment, but only with respect to any loan interest payment due and paid after December 31, 1997, and the portion of the 60-month period after December 31, 1997.

Beginning in 1998, the 10% early withdrawal tax penalty on IRA distributions would not apply to distributions from IRAs. The taxpayer must use the amounts to pay qualified higher education expenses (including those related to graduate-level courses) of the taxpayer, the taxpayer's spouse, or any child, or grandchild of the taxpayer or the taxpayer's spouse. The provision would be effective for distributions after December 31, 1997, with respect to expenses paid after such date for education furnished in academic periods beginning after such date.

Education Individual Retirement Accounts

The act allows taxpayers to establish education IRAs, meaning trusts or custodial accounts created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary. Annual contributions to education IRAs may not exceed $500 per beneficiary, and may not be made after the beneficiary reaches age 18. The contribution limit is phased out for certain high-income contributors. No contribution may be made by any person to an education IRA during any year in which any contributions are made by anyone to a qualified state tuition program on behalf of the same beneficiary.

Until a distribution is made from an education IRA, earnings on contributions to the account are not subject to tax. In addition, the bill provides that distributions from an education IRA are excludable from gross income to the extent that the distribution does not exceed qualified higher education expenses including room and board incurred by the beneficiary during the year the distribution is made, only if the student incurring such expenses is enrolled at an eligible educational institution on at least a half-time basis. The earnings portion of an education IRA distribution not used to pay qualified higher education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax penalty. However, prior to the beneficiary reaching age 30, the bill allows tax-free (and penalty-free) rollovers of account balances from an education IRA benefiting one family member to an education IRA benefiting another family member. The provisions governing education IRAs apply to taxable years beginning after December 31, 1997.

Savings and Investment Incentives

Individual Retirement Arrangements

The Act increases the adjusted gross income (AGI) phase-out limits for determining eligibility to make deductible contributions to an IRA over a period of years.

For single taxpayers the range is as follows:

Taxable years beginning in:	Phase-out Range
1998	$30,000 - $40,000
1999	$31,000 - $41,000
2000	$32,000 - $42,000
2001	$33,000 - $43,000
2002	$34,000 - $44,000
2003	$40,000 - $50,000
2004	$45,000 - $55,000
2005 and thereafter	$50,000 - $60,000

For taxpayers filing joint returns, the range is as follows:

Taxable years beginning in:	Phase-out Range
1998	$50,000 - $60,000
1999	$51,000 - $61,000
2000	$52,000 - $62,000
2001	$53,000 - $63,000
2002	$54,000 - $64,000
2003	$60,000 - $70,000
2004	$65,000 - $75,000
2005	$70,000 - $80,000
2006	$75,000 - $85,000
2007 and thereafter	$80,000 - $100,000

Under prior law a spouse not covered by a retirement plan could not make a deductible IRA contribution if the other spouse was covered by a qualified retirement plan. The Act provides that a non-covered spouse can make a deductible IRA deduction. However, the maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, is phased out for taxpayers with AGI between $150,000 and $160,000.

The Act establishes a new type of nondeductible IRA called the "Roth IRA." If the Roth IRA is invested for more than 5 years and withdrawn after age 59 1/2, the earnings are **not** taxable. The maximum contribution that can be made to a Roth IRA is phased out for individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000. The Roth IRA is not subject to the current minimum distribution requirements at age 70 1/2 and contributions can be made after that age. Only taxpayers with AGI of less than $100,000 are eligible to roll over or convert a current IRA into a Roth IRA.

In 1998, all or part of a current IRA can be rolled into a Roth IRA with the income tax spread over a four-year period. The bill retains present-law nondeductible IRAs where the earnings are tax-deferred until withdrawn. Thus, an individual can make contributions to either a deductible IRA, the current non-deductible IRA, or a Roth IRA. In no case can contributions to all an individual's IRAs for a taxable year exceed $2,000.

In most situations, the Roth IRA will yield better financial returns than either a current deductible or non-deductible IRA. Also, the 10% early withdrawal penalty for distributions from an IRA before age 59 1/2 does not apply to distributions from any IRA for first-time homebuyer expenses. The provision applies to payments and distributions in taxable years beginning after December 31, 1997. In addition, effective for taxable years beginning after Dec. 31, 1997, the IRAs assets may be invested in certain platinum coins and in certain gold, silver, platinum, or palladium bullion.

Capital Gain

The Act reduces the maximum capital gains rate for individuals from 28% to 20% (10% for taxpayers in the 15% bracket), effective May 7, 1997. Real estate depreciation recapture generally will be taxed at a maximum rate of 25 percent. The present maximum 28% rate will be retained for collectibles and, effective July 29, 1997, for assets held between 1 year and 18 months. Beginning in ‘01, the 20% rate drops to 18% (10% drops to 8%) for assets purchased on or after January 1st, ’01 and then held for 5 years. An existing asset can qualify by paying the tax or marking to market value. Caution: Does it make sense to recognize gain and pay tax on an appreciated asset in ’01 to hold the asset an additional 5 years to get a 2% reduction in capital gain rate???

Other Changes

Sales of Personal Residence

No tax is owed on the gain from the sale of a principal residence up to $250,000 (single return), $500,000 (joint return) effective May 7, 1997. Taxpayers must have owned and lived in the home for 2 of the last 5 years. This provision replaces the over age 55 exclusion of $125,000 of gain and the rollover of gain into a replacement residence if purchased within 2 years. The new provision has no age requirements and can be used as often as every 2 years. However, any depreciation taken on a portion of the personal residence used for a home office or other business purpose, after May 7, 1997 will result in taxable income if the personal residence is later sold at a gain.

Alternative Minimum Tax

The Act repeals IRC §56(a)(6) which was the basis for the IRS position that installment sales income for deferred payment contracts were subject to the Alternative Minimum Tax effective for contracts after 1987. Thus, qualified farmers are eligible to use the installment sales method of accounting for both regular tax and alternative minimum tax purposes.

Generally, farmers sell crops in the fall with a portion of the payment to be received the following year. High prices, traditional marketing practices, and a shortage of storage have provided an incentive for farmers to enter into contracts that lock in these high prices, transfer title, which avoids storage costs, and receive payment in the following tax year. If the contract meets the deferred payment contract requirements, the income is reported for regular tax purposes in the next year when the money is received. A valid deferred payment contract can not be assigned or used as collateral for a loan. Also, the contract must not allow any legal right to the money until the next year. Farmers should ignore IRS Notice 97-13, which allowed taxpayers until the due date for 1997 farm tax returns to change their method of accounting and pay (AMT) on deferred payment contracts.

The United States tax court has recently decided a case in favor of William and Vivian Loomis, farmers that the IRS said should pay (AMT) on their deferred payment contracts. Farmers may be able to claim a refund if they voluntarily paid (AMT) on deferred payment contracts. Many farmers were audited by IRS and paid the tax. Other farmers may have paid tax as a result of an IRS appeals settlement or court case decided before the new law was passed.

Two distinct procedures are available for farmers to claim a refund. First, tax returns filed within the last 3 years can be amended by filing Form 1040X. This form requires an explanation of the reason for the change. Simply state that the Tax Relief of 1997 repealed (AMT) for installment sales retroactive to 1987. Second, for taxes paid within the last 2 years, the IRS form 843 can be used to file a claim for refund. The dollar amount of the claim is not required to hold the statute open for refund. The form 843 may be marked “Protective Claim for Refund of (AMT).” IRS will calculate the amount of the refund. **Caution:** There is no provision to extend the 3-year statute for filing an amended return, or the 2-year window to request a refund from the date tax was paid. If a farmer paid (AMT) on a deferred payment contract, act **now** to secure a refund.

Alternative Minimum Tax Repealed for Small Corporations

Corporations both farm and non-farm with gross receipts of less the $5 million will be exempt from the Alternative Minimum Tax beginning in 1998. To qualify, a corporation must have average gross receipts of $5 million or less for the three years prior to its 1998 tax year. To continue to qualify after 1998, or to qualify for the first time as a small business, the company’s three-year average gross receipts can not exceed $7.5 million. If a business fails to qualify in a later tax year, it will apply the (AMT) rules to income, deductions, and transactions from the failure year and all future years.

Alternative Minimum Tax Depreciation Adjustment

The 1997 Tax Relief Act allows the same recovery period for both regular tax and (AMT) purposes. Previously (AMT) required a longer Modified Accelerated Cost Recovery System (MACRS) recovery period. This change conforms the recovery period to one period for both for assets placed in service after 1998. However, if a non-farm taxpayer selected a 200% MACRS depreciation method, it would create an (AMT) adjustment because 150% MACRS method for (AMT) would result in less depreciation. The new law conforms regular tax and (AMT) recovery periods but does not conform depreciation methods. Thus an (AMT) depreciation adjustment would be possible for a non-farm taxpayer. Because the 1988 Tax Act limits farmers to 150% MACRS for all property used in the trade or business of farming, a farmer's depreciation method would be the same for both regular and (AMT) purposes. Thus, the (AMT) depreciation adjustment for farmers is eliminated but only for assets purchased after 1998. Don't throw away the (AMT) software yet.

Estate Tax

The present-law Federal estate tax exemption of $600,000 is increased to $625,000 for decedents dying and gifts made in '98; $650,000 in '99; $675,000 in 2000 and '01; $700,000 in '02 and '03; $850,000 in '04; $950,000 in '05; and $1 million in '06 and thereafter. These amounts are **not** indexed for inflation. After '98, the $10,000 annual exclusion for gifts, the $750,000 ceiling on special use valuation, the $1,000,000 generation-skipping transfer tax exemption, and the $1,000,000 of an estate composed of a closely-held business eligible for the special low interest rate on payment of estate tax on the installment basis are indexed annually for inflation.

Estate Tax Exclusion for Qualified Family-Owned Businesses

For estate tax purposes beginning in '98, an executor may elect to exclude the value of certain qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate and certain other requirements are met. The decedent or a member of the decedent's family must have participated in the business for 5 of 8 years before death. Also, a qualified heir must participate in the business for 5 of 8 years during the 10 years after death. Also, during the 10-year period after death the estate tax benefits will be recaptured if assets are sold to other than a qualified family heir.

To meet the before and after participation requirements the decedent or family heirs must be involved in the physical production and/or management of agricultural production to a level that makes the earnings from that production subject to self-employment tax. Farmers who "rent out" farm assets to receive social security benefits in 4 of the 8 years before their death, may not qualify, unless they or a qualified family member meets the 5 of 8 year participation requirements. The exclusion for family-owned business interests may be taken only to the extent that the exclusion for family-owned business interests, plus the amount effectively exempted by the federal estate tax deduction, does not exceed $1.3 million.

Reduction in Estate Tax for Certain Land Subject to Permanent Conservation Easement

An executor may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement. It must meet the following requirements: (1) the land is located within 25 miles of a metropolitan area or a national park or wilderness area, or within 10 miles of an Urban National Forest; (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution of a qualified real property interest was granted by the decedent or a member of his or her family. The maximum exclusion for land subject to a qualified conservation easement is limited to $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter. The exclusion for land subject to a qualified conservation easement may be taken in addition to the maximum exclusion for qualified family-owned business interests (i.e., there is no coordination between the two provisions). Debt-financed property is eligible for this provision to the extent of the net equity in the property.

Installment Payments of Estate Tax Attributable to Closely Held Businesses

For estate tax installment payments a 2% interest rate applies to tax on $1,000,000 in taxable value of the closely held business assets above any federal exemption. The remainder of such tax is subject to interest at a rate equal to 45 percent of the rate applicable to underpayments of tax (this rate is now approximately 8.0%), and all interest paid on the installment basis is made nondeductible. Taxpayers currently paying estate tax on the installment basis can make a one-time election to receive similar treatment.

Estate Tax Recapture from Cash Leases of Specially Valued Property

If land in a farmer's estate is worth more for non-farm uses, the land can be valued at farm use if a qualified heir operates the land for 10 years after death. The Act clarifies that the cash lease of special use valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, does meet the qualified farm use test. Under prior law such cash leases triggered recapture or immediate payment of estate tax at the higher non-farm use value.

Livestock Sales Effect on Earned Income Credit

The 1996 Tax Reform Act of 1996 added two new classes of "disqualified income." Farmers that receive more than $2200 of capital gain net income and net passive activity income are not eligible for earned income credit. Interest, dividends, net rents and royalties are also disqualified income. IRS interpreted capital gain net income to include gains realized on the sale of draft, breeding, dairy and sporting livestock. Thus, a farmer who sold cull cows of more than $2200 ($2250 for 1997) was not allowed EIC. Provisions in both the House and Senate versions of the 1997 legislation were designed to fix the problem. Those changes were not included in the final bill. For 1997 raised breeding cow sales and capital gain (sales price greater than purchase price) could knock out the EIC. **Possible Solution:** Sales of breeding livestock are reported on Form 4797 based on the farmer's intended breeding use. If, after the decision was made to cull breeding cows, these same cows were sent to the feedlot or fattened on pasture, they may be held for sale in the ordinary course of the farmer's trade or business. **Caution:** additional self-employment tax must be weighed against savings from the earned income credit.

Treatment of Livestock Sold on Account of Weather-Related Conditions

Under prior law, farmers could use either of two provisions to defer gain recognized on the sale of livestock sold on account of drought. IRC §451(e) allows farmers to postpone reporting of gain from the sale of livestock for one year. The other provision allows farmers to postpone gain from dairy, draft, or breeding livestock if like animals are replaced within two years, IRC §1033(e). Gain is postponed only for sales in excess of normal sales, and is subject to other requirements. See Farmer's Tax Guide, Pub 225. The 1997 act expands these present-law exceptions to livestock sold on account of flood or other weather-related conditions. The provisions are effective for sales and exchanges after 1996.

Income Averaging

Income averaging for farmers is allowed on a temporary basis for three years only starting in 1998, 1999, and 2000. Farmers can elect to remove all or part of current (1998) farm income from total taxable income and spread it over the 3 pres. Tax would be based on the marginal rate effective in the last 3 years. The provision applies only to income tax and would not change self-employment tax.

Net Operating Losses and Business Credits

The act modifies net operating loss ("NOL") carryback and carryforward rules. The NOL carryback period is reduced to two years (from three years) and increases the NOL carryforward period to 20 years (from 15 years). The 3-year carryback is retained for NOLs attributable to casualty losses of individuals and NOLs of farmers and small businesses attributable to losses incurred in federally declared disaster areas. The provision is effective for NOLs arising in taxable years beginning after the date of enactment. The act also reduces the carryback period for the general business credit to one year (from three years) and extends the carryforward period to 20 years (from 15 years). The provision is effective for credits arising in taxable years beginning after December 31, '97.

Self-Employed Health Insurance Deduction

The act increases the deduction for health insurance of self-employed individuals. The deduction is 40 percent in '97, 45 percent in '98 and '99, 50 percent in '00 and '01, 60 percent in '02, 80 percent in '03 through '05, 90 percent in '06, and 100 percent in '07 and thereafter. The business percentage is taken as an adjustment to gross income with the remainder allowed as a medical expense on schedule A, itemized deductions.

Home Office Deduction: Clarification of Definition of Principal Place of Business

The act expands the definition of "principal place of business" to include a home office that is used by a taxpayer to conduct administrative or management activities of the business, provided that there is no other fixed location where the taxpayer conducts substantial administrative or management activities of the business. As under present law, deductions will be allowed for a home office only if the office is exclusively used on a regular basis as a place of business and, in the case of an employee, only if such exclusive use is for the convenience of the employer.

The provision applies to taxable years beginning after December 31, 1998. This new provision may allow a farmer who lives in a town near the farm to deduct home office expenses. The business portion of the home must be used regularly and exclusively for record keeping, management, marketing, and other administrative activities.

Summary

The 1997 Tax Relief Act provides significant tax savings for many farmers. While complex requirements and phase-in rules must be met, this law offers the most generous tax planning opportunities of any recent tax legislation. Encourage farm clients to get their records "up-to-date" before year-end to take advantages of these planning opportunities. Tax benefits like the 1.3 million estate tax exclusion will require long-term tax and business organization planning, but the potential tax savings may be well worth the effort.

The Oklahoma Cooperative Extension Service
Bringing the University to You!

The Cooperative Extension Service is the largest, most successful informal educational organization in the world. It is a nationwide system funded and guided by a partnership of federal, state, and local governments that delivers information to help people help themselves through the land-grant university system.

Extension carries out programs in the broad categories of agriculture, natural resources and environment; home economics; 4-H and other youth; and community resource development. Extension staff members live and work among the people they serve to help stimulate and educate Americans to plan ahead and cope with their problems.

Some characteristics of the Cooperative Extension system are:

- The federal, state, and local governments cooperatively share in its financial support and program direction.
- It is administered by the land-grant university as designated by the state legislature through an Extension director.
- Extension programs are nonpolitical, objective, and based on factual information.
- It provides practical, problem-oriented education for people of all ages. It is designated to take the knowledge of the university to those persons who do not or cannot participate in the formal classroom instruction of the university.
- It utilizes research from university, government, and other sources to help people make their own decisions.
- More than a million volunteers help multiply the impact of the Extension professional staff.
- It dispenses no funds to the public.
- It is not a regulatory agency, but it does inform people of regulations and of their options in meeting them.
- Local programs are developed and carried out in full recognition of national problems and goals.
- The Extension staff educates people through personal contacts, meetings, demonstrations, and the mass media.
- Extension has the built-in flexibility to adjust its programs and subject matter to meet new needs. Activities shift from year to year as citizen groups and Extension workers close to the problems advise changes.

This Current Report may also be viewed at the following Web address:
www.okstate.edu/OSU_Ag/agedcm4h/pearl/agecon/taxmgt/taxmgt.htm

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