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Neil Harl

Iowa State University, harl@iastate.edu

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FARMERS AND THE EARNED INCOME CREDIT

— by Neil E. Harl

The earned income credit, enacted in the 1970s, was amended in 1996 to impose two changes in the disqualification rules.1 The 1996 legislation (1) reduced the investment income threshold that disqualifies a taxpayer for the earned income credit from $2350 to $2200 (and indexed the threshold for inflation based on the consumer price index for tax years beginning after 1996),2 and (2) added capital gain net income and net passive activity income to the definition of disqualified income, effective for tax years beginning after December 31, 1995.3 The greater concern is with the addition of “capital gain net income”4 to “disqualified income.”5 If disqualified income exceeds $2200, the earned income credit is disallowed.6

Meaning of “capital gain net income”

For farm and ranch taxpayers, a major question is whether “capital gain net income” includes income from the sale of draft, dairy, breeding and sporting purpose animals, the so-called Section 1231 items used in the trade or business.7

The statute specifies that the term “capital gain net income” is to have the meaning given the term in section 1222 of the Internal Revenue Code.8 Section 1222, in turn, defines capital gain net income as “the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges.”9 That passage focuses attention on the meaning of “capital assets.”10

Section 1221 of the Internal Revenue Code defines “capital assets” as all assets except for five specifically enumerated exceptions.11 Section 1221(2) excludes from the definition of capital assets—

“property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business.”12

The obvious conclusion is that Section 1231 gains from the sale of breeding stock, dairy cows, land used in the business and machinery are not included in the definition of “capital gain net income.”13 Therefore, such income does not count toward the $2200 threshold that can disqualify a taxpayer from the earned income credit.14

The legislative history of the act supports this interpretation—

“The committee believes that individuals with substantial assets could use the proceeds from the sale of those assets in place of the earned income credit to support consumption in times of low income. Transfer programs such as AFDC, food stamps, and Medicaid have asset tests for determining eligibility. Such programs also have caseworkers available to make determinations about the assets owned by a potential claimant. In the case of the earned income credit, the IRS does not have caseworkers to assess the balance sheets of millions of taxpayers’ asset-holdings. Therefore, in order to apply a proxy for an asset-based test, the recently enacted disqualified income test concentrates on the returns generated by those assets. Interest, dividend, and net rental and royalty income represent flows of income from assets that represent wealth of the taxpayer. The committee believes that the net capital gains and other passive income represent other flows of income from assets that could be liquidated to support current consumption.”15

The problem is that IRS in its taxpayer publication16 and some of the software companies have taken the position that gains from Section 1231 assets are included in “capital gain net income.”17 That is believed to be an incorrect interpretation of the 1996 amendment.18 Further clarification from IRS is expected in the near future.

Modified adjusted gross income

The 1996 legislation also changed the definition of “adjusted gross income”19 to “modified adjusted gross income”20 for purposes of the phaseout of the earned income credit. The amendment disregards several items in applying the phaseout rules— (1) net capital losses (if greater than zero) (up to the $3,000 limit, $1500 for a married taxpayer filing a separate return), (2) net losses from trusts and estates, (3) net losses from nonbusiness rents and royalties, and (4) 50 percent of the net losses from business, computed separately for sole proprietorships (other than in farming), sole proprietorships in farming and other businesses.21 For this purpose, amounts attributable to

Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

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a business that consists of compensation for the performance of services by the taxpayer as an employee are not taken into account.22

Again, it appears that the statutory meaning of “capital assets”23 would not require that the losses that must be added back would not be reduced by a net Section 1231 gain.24 The provision imposing a limitation on capital losses25 specifies that—

“In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of— (1) $3,000 ($1500 in the case of a married individual filing a separate return), or (2) the excess of such losses over such gains.”26

In applying that limitation, Schedule D allows taxpayers to reduce gains from Form 4797 by the losses from the sale of capital assets. That would be the correct result27 only if the gains from the sale of property used in the trade or business are treated as gains from the sale of capital assets. This is an ambiguity that needs to be resolved with a technical correction.

Guidance on this issue, including the meaning of “capital asset” in this context, is expected in the near future.

FOOTNOTES
4 I.R.C. § 32(i)(2)(D).
5 I.R.C. § 32(i)(2).
6 I.R.C. § 32(i)(1).
7 I.R.C. § 1231.
8 I.R.C. § 32(i)(2)(D).
9 I.R.C. § 1222(9).
10 See I.R.C. § 1221.
11 Id.
12 I.R.C. § 1221(2).
13 See I.R.C. § 32(i)(2).
14 I.R.C. § 32(i)(1).
17 I.R.C. § 32(i)(2)(D).
18 See note 3 supra.
20 I.R.C. §§ 32(a)(2)(B), 32(c)(5).
21 I.R.C. § 32(c)(5)(B).
22 I.R.C. § 32(c)(5).
23 I.R.C. § 1221.
24 See I.R.C. § 1211(b).
25 Id.
26 Id.
27 See I.R.C. § 1211(b).

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY
GENERAL-ALM § 13.03.∗

DISCHARGE. The debtors, husband and wife, had obtained a loan from a bank and the wife had listed a house as an asset on the financial statements given for the loan. The wife transferred the house to her father within one year of the bankruptcy filing and the bank sought denial of a discharge for the outstanding loan balance under Section 727 for fraudulent transfer of assets within one year of filing. The court held that the claim was nondischargeable because the sale of the house was made for no consideration, the wife kept the transfer secret, and the deed was suspect as to the actual date of transfer; therefore, the wife made the transfer with the intent to defraud the bank. The court held, however, that the debt was nondischargeable only as to the wife, since the husband had no ownership interest in the house and did not participate in the transfer. In re Carter, 203 B.R. 697 (Bankr. W.D. Mo. 1996).

EXEMPTIONS

AVOIDABLE LIENS. The debtor had borrowed funds from a bank and granted the bank a security interest in currently owned and future acquired farm machinery. The bank filed a financing statement covering farm equipment “now or hereafter acquired.” The debtor defaulted on the loan and the bank obtained a judgment against the debtor on the notes. The judgment awarded the bank possession of the collateral and the bank obtained possession. The debtor then filed for Chapter 7 and claimed $5,000 of the equipment as exempt. The bank scheduled an auction sale of the equipment but agreed to withhold several pieces from the sale. The debtor sought to avoid the lien as to $5,000 of the remaining equipment. The bank argued that the judgment gave the bank a possessory security interest in the equipment, making the equipment ineligible for the lien avoidance under Section 522(f). The court held that the nature of the original security interest controlled the availability of avoidance of the lien; therefore, because the original lien was nonpossessory, the lien could be avoided as to exempt tools of the trade under Section 522(f). In re White, 203 B.R. 613 (Bankr. N.D. Tex. 1996).

EARNED INCOME TAX CREDIT. The debtors filed for Chapter 7 in April 1996 and claimed a portion of a 1995 refund as exempt earned income tax credit under Or. Rev. Stat. § 411.760 or § 23.160(1)(i). The court held that the earned income tax credit was not eligible for the exemption as public assistance of a child or spousal support payments. In re Rutter, 204 B.R. 57 (Bankr. D. Or. 1997).