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INCOME TAX MANAGEMENT AND REPORTING FOR SMALL BUSINESSES AND FARMS



2007 Reference Manual for Regional Schools

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2007 TAX FORMS NEEDED BY MANY NEW YORK SMALL BUSINESSES AND FARMERS

Federal Forms

1040	U.S. Individual Income Tax Return Schedule A—Itemized Deductions Schedule B—Interest and Ordinary Dividends Schedule C—Profit or Loss from Business Schedule D—Capital Gains and Losses Schedule E—Supplemental Income and Loss Schedule EIC—Earned Income Credit Schedule F—Profit or Loss from Farming Schedule H—Household Employment Taxes Schedule J—Farm Income Averaging Schedule R—Credit for the Elderly or the Disabled Schedule SE—Self-Employment Tax (Short and Long Schedules)
1040A	Nonitemizers, under \$50,000 Taxable Income, Other Limitations
1040X	Amended U.S. Individual Income Tax Return
943	Employer’s Annual Tax Return for Agricultural Employees
1096	Annual Summary and Transmittal of U.S. Information Returns
1099	Information Returns to Be Filed by Person Who Makes Certain Payments
W-2	Wage and Tax Statement
W-3	Transmittal of Withholding Statements
W-5	Earned Income Credit Advance Payment Certificate
W-9	Request for Taxpayer Identification Number and Certification
1065	U.S. Return of Partnership Income (See Rules for Schedules L, M-1, and M-2)
3115	Application for Change in Accounting Method
3800	General Business Credit
4136	Credit for Federal Tax on Fuels
4562	Depreciation and Amortization (Including Information on Listed Property)
4684	Casualties and Thefts
4797	Sales of Business Property
4835	Farm Rental Income and Expense (Crop and Livestock Shares (Not Cash) Received by Landowner (or Sublessor)) (Income Not Subject to Self-Employment Tax)
5695	Residential Energy Credits
6251	Alternative Minimum Tax—Individuals
6252	Installment Sale Income
7004	Application for Automatic Extension of Time to File
8582	Passive Activity Loss Limitations
8582 CR	Passive Activity Credit Limitations
8606	Nondeductible IRAs
8615	Tax for Children under Age 18 Who Have Investment Income of More Than \$1,700
8801	Credit for Prior-Year Minimum Tax—Individuals, Estates, and Trusts
8812	Additional Child Tax Credit
8814	Parents’ Election to Report Child’s Interest and Dividends
8824	Like-Kind Exchanges
8829	Expenses for Business Use of Your Home

8853	Archer MSAs and Long-Term Care Insurance Contracts
8863	Education Credits
8880	Credit for Qualified Retirement Savings Contributions
8888	Direct Deposit of Refund
8903	Domestic Production Activities Deduction

New York State Forms

IT-2	Wage and Tax Statement Summary
IT-150	Resident Income Tax Return (Short Form)
IT-201	Resident Income Tax Return (for Full-Year State Residents Only)
IT-201-ATT	Itemized Deduction, and Other Taxes and Tax Credits
IT-201-X	Amended Resident Income Tax Return (Only Acceptable Method)
IT-204	Partnership Return
IT-212	Investment Credit (Noncorporate Filers)
IT-215	Claim for Earned Income Credit
IT-217	Claim for Farmers School Tax Credit (Noncorporate Filers)
IT-220	Minimum Income Tax
IT-240	Sales and Use Tax for Nonfilers
IT-249	Claim for Long-Term Care Insurance Credit
IT-272	Claim for College Tuition Credit for New York State Residents
IT-398	NYS Depreciation Schedule for IRC §168K Property
IT-399	New York State Depreciation
IT-800	Opt-Out Record for Tax Practitioners
CT-4-S	New York S Corporation Franchise Tax Return (Short Form for Small Businesses)
CT-46	Investment Credit (for Corporations)
CT-47	Claim for Farmers School Tax Credit (for Corporations)
NYS-45-MN	Quarterly Combined Withholding, Wage Reporting, and Unemployment Insurance Return (Manual Version) (NYS-45-ATT-MN for Attachment)

2007 TAX LEGISLATION AND FARM INCOME SITUATION

What's New in Federal Legislation

Small Business and Work Opportunity Tax Act of 2007 (SBWOTA)

Signed into law on May 25, 2007, by President Bush.

I. Small-Business Tax Relief Provisions

A. General Provisions

1. Extension and modification of work opportunity tax
2. Increase and extension of expensing for small business
3. Determination of credit for certain taxes paid with respect to employee cash tips
4. Waiver of individual and corporate alternative minimum tax limits on work opportunity credit and credit for taxes paid with respect to employee cash tips
5. Family-business tax simplification

B. Gulf Opportunity Zone Tax Incentives

1. Extension of increased expensing for qualified section 179 Gulf Opportunity (GO) Zone property
2. Extension and expansion of low-income housing credit rules for buildings in the GO Zones
3. Special tax-exempt bond financing rule for repairs and reconstructions of residences in the GO Zones
4. GAO study of practices employed by state and local governments in allocating and utilizing tax incentives provided pursuant to the Gulf Opportunity Zone Tax Act of 2005

C. Subchapter S Provisions

1. Capital gain not treated as passive investment income
2. Treatment of bank director shares
3. Treatment of banks changing from reserve method of accounting
4. Treatment of sale of an interest in a qualified subchapter S subsidiary
5. Elimination of earnings and profits attributable to pre-1983 years
6. Deductibility of interest expense of an ESBT on indebtedness incurred to acquire S corporation stock

II. Revenue Provisions

- A. Increase in Age of Children Whose Unearned Income is Taxed as If Parents' Income
- B. Suspension of Penalties and Interest
- C. Modification of Collection Due Process Procedures for Employment Tax Liabilities
- D. Permanent Extension of IRS User Fees
- E. Increase in Penalty for Bad Checks and Money Orders
- F. Understatement of Taxpayer's Liability by Tax Return Preparers
- G. Penalty for Filing Erroneous Refund Claims
- H. Time for Payment of Corporate Estimated Tax

III. Pension-Related Provisions

- A. Revocation of Election Relating to Treatment as Multiemployer Plan
- B. Modification of Requirements for Qualified Transfers
- C. Extension of Alternative Deficit Reduction Contribution Rules
- D. Modification of the Interest Rate for Pension Funding Rules

The Tax Relief and Health Care Act of 2006 (TRHCA of 2006)

On December 8, 2006, Congress approved the Tax Relief and Health Care Act of 2006 (TRHCA of 2006), which included many provisions that would extend expiring or already expired tax provisions. President Bush signed the bill into law December 20, 2006 (it became Pub. L. 109-432).

Prior Legislation

Long-Distance Telephone Excise Tax refunds can still be claimed by individuals and businesses by amending their 2006 Federal Income Tax returns.

The **Tax Increase Prevention and Reconciliation Act of 2005** (TIPRA) was signed into law on May 17, 2006. This legislation covered a variety of items that will affect most taxpayers:

- Increases the age limit for “kiddie tax” purposes to 18 years of age
- Extends the reduced rates for capital gains and dividends for 2 additional years, through 2010
- Extends for an additional 2 years the increased I.R.C. § 179 expensing amount
- Eliminates the Roth IRA conversion income limitation beginning in 2010
- Requires a partial payment to the IRS for offers in compromise
- Tax-exempt interest reporting

The **Heroes Earned Retirement Opportunities Act** was enacted on May 29, 2006. The act allows members of the armed forces serving in a combat zone to deduct contributions to an IRA even if the only compensation received by the taxpayer is excluded from gross income.

Public Law 109-264 was enacted on August 3, 2006. This legislation prohibits states from taxing partnership retirement plan distributions for nonresident retired partners.

The **Pension Protection Act of 2006** (PPA) was signed into law on August 17, 2006. This legislation not only affects pension and IRA plans but also has many charitable provisions:

- Allows for direct payment of federal tax refunds directly to IRAs
- Repeals the sunset provision of EGTRRA(2001 act) as it applied to the provisions relating to IRAs and pensions
- Provides an exclusion from gross income for qualified charitable distributions from an IRA
- Disallowance of charitable deduction(s) for clothing and household items unless the item(s) is in “good” used condition or better
- Requires donor of cash contributions to maintain a bank record or written communication from the donee
- Repeals the sunset provision of EGTRRA (2001 act) for qualified tuition programs (I.R.C. § 529), so that all provisions of EGTRRA (2001 act) that relate to qualified tuition programs are permanently extended
- Makes the saver’s credit under I.R.C. § 25B permanent

These are the legislation acts passed in 2005 that will affect the filing of 2007 income tax returns:

- Katrina Emergency Tax Relief Act of 2005—This legislation was enacted to help the victims of the hurricane and those contributing to the victims.
- Energy Tax Incentives Act—This legislation is 550 pages of energy policy and incentives to conserve energy and use alternatives measures.
- SAFETEA-LU—This act contains the provisions of the Safe, Accountable, Flexible, Efficient Transportation Equity Act.
- Other legislation includes provisions for tsunami relief, disaster mitigation, bankruptcy abuse prevention, and consumer protection.

In addition to the 2007 legislation there is the 2004 legislation that first became effective in 2005 and 2006:

- Working Families Tax Relief Act of 2004—This act established a uniform definition of a qualifying child for several tax benefits and extended many credits and deductions.
- American Jobs Creation Act of 2004—This act made available a general sales tax deduction (for 2004 and 2005) and the domestic production activities deduction.

Some of the benefits of the above legislation for small businesses, farmers, and individuals are as follows:

- Up to a \$500 tax credit for costs incurred to improve the energy efficiency of a taxpayer's main home during calendar years 2006 and 2007
- An individual tax credit of up to \$2,000 for the purchase of renewable energy equipment in 2006 or 2007
- A tax credit for alternative motor vehicles that begins in 2006 to replace the deduction for clean-fuel vehicles, which ended in 2005
- Up to \$2,000 credit for a home builder of new energy-efficient homes in 2006 and 2007
- A tax credit for manufacturers of efficient appliances in 2006 and 2007
- A uniform definition of a qualifying child
- Domestic production activities deduction that may provide a benefit for those taxpayers who can meet its provisions

2007 Farm Income Tax Situation and Outlook

Situation and Outlook for Dairy

It's all about ethanol and exports. The record high milk prices of 2007 have come about because domestic milk supplies have not grown as rapidly as normal for us and because we have found substantial new dairy product demand overseas.

Ethanol burst onto the scene in 2006 and created a strong, new demand for corn. As corn prices rose and additional crop acres were planted to corn, dairy farmers were faced with increased feed prices for purchased corn, forages, and other concentrates. It is estimated that overall feed costs have increased by \$1.00–\$1.50 per hundredweight (cwt) as a result of ethanol production. These higher feed costs have reduced milk output from what would have otherwise been produced.

At the same time that ethanol was impacting milk supplies, the U.S. dairy industry discovered substantial export opportunities. Oceania (Australia and New Zealand) has been involved in a prolonged drought, and their collective milk production is substantially diminished. Milk production in the European Union is also significantly down because those countries struggle with changing agricultural policies that are no longer subsidizing exports of dairy products. In addition, demand for dairy products from China has markedly increased as their economy has grown.

The changing global supply and demand picture would have been enough to create export opportunities for the United States, but our dollar has also weakened against most other currencies. This means that U.S. exports look relatively cheaper to the rest of the world. Ethanol and exports have provided dairy farmers with the highest milk prices ever.

High prices are a signal to the market to produce more product. Dairy farmers will respond with more milk production and, ultimately, milk prices will decline again. The investment in ethanol plants is a capital commitment for probably another 10 years. That means feed costs will remain higher for the foreseeable future, and we shouldn't expect milk prices to drop to levels as low as we have seen in the past decade. Also expect export opportunities to continue, but perhaps not to the degree of the last year.

Some price projections for the Northeast call for a decline in the blend price of about \$1.20 for 2008.

Situation and Outlook for Fruit

Securing harvest labor for fruit and vegetables was a continuing concern for the 2007 harvest. Work orders for H2A labor nearly doubled this past year, as growers attempted to secure adequate labor in anticipation of tight enforcement by Immigration Control and Enforcement (ICE). The potential for labor shortage has now joined the ranks of other risks (e.g., price pressure from imports, increasing costs of fuel, pesticides, and other energy based inputs, as well as increased costs for local labor) that fruit growers have to contend with.

Apples

The first U.S. apple production forecast for the 2007 crop year is 221 million bushels, a relatively modest crop, down 7% from last year and 4% below 2005. Apple production in New York is forecast at 30.7 million bushels, based on conditions as of August 1, according to the USDA, NASS, New York Field Office. This is 3% above the 29.8 billion pounds produced last year, and, if realized, would be the largest crop since 1997. Across the state, growers were experiencing average to above-average fruit conditions despite the statewide hail received in July. Drought in some areas is affecting fruit size, which impacts grades and, ultimately, average prices.

Overall for the state, this marketing season has the prospect of being good, although not as favorable as the outstanding results obtained with the 2006 crop. The list prices for processing apples in New York were slightly higher this year, with the state's largest processor (which processes over a fourth of New York's total apple crop) in the second year of offering 3-year contracts with a 1.2% increase each year. An increase of this magnitude will not compensate processing growers for the increased costs of energy-based inputs and labor. Short crops in Eastern Europe (Poland and Hungary) are a positive outcome for juice prices.

Conditions in the fresh market are favorable with the smaller crop in Washington state, which produces about 60% of the U.S. crop. However, smaller fruit size will lead to lower average prices in New York than last year's record prices.

The total revenue for the New York apple crop will not reach the record level of last year (\$248 million) but will be well above the revenue of any other year on record. Profits will be down for both fresh and processed apples, but overall it should be a relatively good year for the state's growers.

Grapes

Grape production in New York is expected to total 180,000 tons, according to growers' reports. This represents a 16% increase from a year ago, and is about 9% above the 5-year average crop size. Due to minimal insect and hail damage, the grape crop is experiencing average to above-average growing conditions. Drought-like conditions occurred early on, as well as late in the season in some areas of the state. Through mid-September, quality of both juice and wine grapes appears to be excellent with the warm sunny days and cool nights leading to excellent ripening conditions statewide.

Overall, prices were higher than a year ago, both for native varieties, such as Concord and Niagara, as well as hybrid and vinifera grapes used in the highest-quality wines. There is a positive outlook for the marketing situation in the juice grape sector (located primarily in the Lake Erie Region), which had been going through some difficult economic times. Nationally, inventories were low coming into harvest because buyers have come back to the Concord variety as wholesale prices for bulk juice and concentrate decreased in the last couple of years. The cash market was up about \$15 per ton from last year.

Grape acreage in New York State increased slightly in the recent survey of tree fruit and vineyards, in contrast to all other major tree fruits, for which acreage declined. This is mainly due to growth in the small winery sector.

Overall, a total value of production of \$45 million for grapes in New York is expected, the highest the state's growers have realized since 2002, driven largely by a relatively large crop and the recovery in juice grape prices.

Tax Suggestions for Farmers

Here are some tax management suggestions for farmers with 2007 net farm profits:

- Purchase quantities of feed and supplies before the year-end in certain situations. These prepaid expenses may be limited to 50% of other expenses on Form 1040 Schedule F, Profit or Loss from Farming.
- Buy needed machinery now. Take advantage of the I.R.C. § 179 deduction as well as rapid depreciation.
- Pay additional wages to family members who actually work on the farm. Consider paying holiday bonuses to regular employees.
- Purchase IRAs or other tax-deferred retirement plans.
- Utilize income averaging when preparing their tax returns.

FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

Small Business and Work Opportunity Tax Act of 2007

General Provisions

The Small Business and Work Opportunity Tax Act of 2007 (SBWOTA) included a variety of provisions to address general issues that may affect taxpayers.

Extension and Modification of Work Opportunity Tax Credit

The provision extends the work opportunity tax credit (WOTC) for 44 months (for qualified individuals who begin work for an employer after December 31, 2007, and before September 1, 2011).

Qualified Veterans Targeted Group

The provision expands the qualified veterans' targeted group to include an individual who is certified as entitled to compensation for a service-connected disability and (1) having a hiring date that is not more than 1 year after having been discharged or released from active duty in the Armed Forces of the United States, or (2) having been unemployed for 6 months or more (whether or not consecutive) during the 1-year period ending on the date of hiring. Being entitled to compensation for a service-connected disability is defined with reference to section 101 of Title 38, U.S.C., which means having a disability rating of 10% or higher for service-connected injuries.

Qualified First-Year Wages

The provision expands the definition of qualified first-year wages from \$6,000 to \$12,000 in the case of individuals who qualify under either of the new expansions of the qualified veteran group, discussed in the preceding paragraph. The expanded definition of qualified first-year wages does not apply to the veterans qualified with reference to a food-stamp program, as defined under present law.

High-Risk Youth Targeted Group

The provision expands the definition of high-risk youths to include otherwise qualifying individuals age 18 but not yet age 40 on the hiring date. Also, the provision expands the definition of eligible individuals under this category to include otherwise qualifying individuals from rural renewal counties. For these purposes, a rural renewal county is a county outside a metropolitan statistical area (as defined the Office of Management and Budget) that had a net population loss during the 5-year periods 1990–1994 and 1995–1999. Finally, the provision changes the name of the category to the *designated community residents* targeted group.

Vocational Rehabilitation Referral Targeted Group

The provision expands the definition of vocational rehabilitation referral to include any individual who is certified by a designated local agency as having a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing, an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act.

Certification

Under present law, designated local employment agencies may enter into information-sharing agreements to facilitate certification for purposes of WOTC eligibility. Such agreements are subject to confidentiality requirements. Congress expects that the Department of Defense, the Department of Veterans Affairs, and the Social Security Administration will work with the designated local agencies to facilitate certification of the expansions of the qualified veteran category and the SSI recipient category. Finally, Congress expects that the Internal Revenue Service will develop procedures to allow (in addition to original documents) paper versions of electronically completed prescreening notices and photographic copies of hand-signed original prescreening notices for purposes of the credit. This allowance of prescreening notices that are not original documents should be allowed only to the extent it does not foster incorrect or fraudulent filings. The provisions are effective for individuals who begin work for an employer after the date of enactment.

Increase and Extension of Expensing for Small Business

The provision increases the \$100,000 expensing and \$400,000 investment limitation amounts to \$125,000 and \$500,000, respectively, for taxable years beginning in 2007 through 2010. These amounts are indexed for inflation in taxable years beginning after 2007 and before 2011. In addition, the provision extends for 1 year the increased amount that a taxpayer may deduct and the other

I.R.C. § 179 rules applicable in taxable years beginning before 2010. Thus, under the provision, these rules continue in effect for taxable years beginning after 2009 and before 2011. The provision is effective for taxable years beginning after December 31, 2006.

Determination of Credit for Certain Taxes Paid with Respect to Employee Cash Tips

The provision applies with respect to tips received for services performed after December 31, 2006. The provision provides that the amount of the tip credit is based on the amount of tips in excess of those treated as wages for purposes of the FLSA as in effect on January 1, 2007. That is, under the provision, the tip credit is determined based on a minimum wage of \$5.15 per hour. Therefore, if the amount of the minimum wage increases, the amount of the FICA tip credit will not be reduced.

Waiver of Individual and Corporate Alternative Minimum Tax Limits on WOTC and Credit for Taxes Paid with Respect to Employee Cash Tips

The provision treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to WOTC and the credit for taxes paid with respect to employee cash tips. Thus, WOTC and the credit for taxes paid with respect to cash tips may offset the alternative minimum tax (AMT) liability. The provision applies to credits determined in taxable years beginning after December 31, 2006.

Family Business Tax Simplification

The provision generally permits a qualified joint venture whose only members are a husband and wife filing a joint return not to be treated as a partnership for federal tax purposes. A qualified joint venture is one that involves the conduct of a trade or business, if (1) the only members of the joint venture are a husband and wife, (2) both spouses materially participate in the trade or business, and (3) both spouses elect to have the provision apply. All items of income, gain, loss, deduction, and credit are divided between the spouses in accordance with their respective interests in the venture. Each spouse takes into account his or her respective share of these items as a sole proprietor. Thus, it is anticipated that each spouse would account for his or her respective share on the appropriate form, such as Schedule C, Profit or Loss from Business (Sole Proprietorship). The provision is not intended to change the determination under present law of whether an entity is a partnership for federal tax purposes (without regard to the election provided by the provision). For purposes of determining net earnings from self-employment, each spouse's share of income or loss from a qualified joint venture is taken into account just as it is for federal income tax purposes under the provision (i.e., in accordance with their respective interests in the venture). A corresponding change is made to the definition of net earnings from self-employment under the Social Security Act. The provision is not intended to prevent allocations or reallocations, to the extent permitted under present law, by courts or by the Social Security Administration of net earnings from self-employment for purposes of determining social security benefits of an individual. The provision is effective for taxable years beginning after December 31, 2006.

Revenue Provisions

The following provisions of the Small Business and Work Opportunity Tax Act are specific to payment of revenue.

Increase in Age of Children Whose Unearned Income Is Taxed as If Parents' Income

The provision expands the kiddie tax to apply to children who are 18 years old or who are full-time students over age 18 but under age 24. The expanded provision applies only to children whose earned income does not exceed one-half of the amount of their support. The provision is effective for taxable years beginning after the date of enactment.

Suspension of Penalties and Interest

The provision extends the period before which accrual of interest and certain penalties are suspended. Under the provision, the accrual of certain penalties and interest is suspended starting 36 months after the filing of the tax return if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability. The provision is effective for IRS notices issued after the date that is 6 months after the date of enactment.

Modification of Collection Due Process Procedures for Employment Tax Liabilities

Under the provision, a levy issued to collect federal employment taxes is excepted from the pre-levy collection due process (CDP) hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the 2-year period before the beginning of the taxable period with respect to which the employment tax levy is served. However, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy. As the Internal Revenue Code provides for state tax refunds or jeopardy determinations, collection by levy of employment tax liabilities is permitted to continue during the CDP proceedings. The provision is effective for levies issued on or after the date that is 120 days after the date of enactment.

Permanent Extension of IRS User Fees

The provision permanently extends the statutory authorization for IRS user fees. The provision is effective for requests made after the date of enactment.

Increase in Penalty for Bad Checks and Money Orders

The provision increases the minimum penalty to \$25 (or, if less, the amount of the check or money order), applicable to checks or money orders that are less than \$1,250. The provision is effective with respect to checks or money orders received after the date of enactment.

Understatement of Taxpayer's Liability by Tax Return Preparers

The provision broadens the scope of the present-law tax return preparer penalties to include preparers of estate and gift tax, employment tax, and excise tax returns as well as returns of exempt organizations. The provision also alters the standards of conduct that must be met to avoid imposition of the penalties for preparing a return with respect to which there is an understatement of tax. First, the provision replaces the realistic possibility standard for undisclosed positions with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The provision replaces the not-frivolous standard accompanied by disclosure with the requirement that there be a reasonable basis for the tax treatment of the position accompanied by disclosure. The provision also increases the first-tier penalty from \$250 to the greater of \$1,000 or 50% of the income derived (or to be derived) by the tax return preparer from the preparation of a return or claim with respect to which the penalty is imposed. The provision increases the second-tier penalty from \$1,000 to the greater of \$5,000 or 50% of the income derived (or to be derived) by the tax return preparer. The provision is effective for tax returns prepared after the date of enactment.

Penalty for Filing Erroneous Refund Claims

The provision imposes a penalty on any taxpayer filing an erroneous claim for refund or credit. The penalty is equal to 20% of the disallowed portion of the claim for refund or credit for which there is no reasonable basis for the claimed tax treatment. The penalty does not apply to any portion of the disallowed portion of the claim for refund or credit that relates to the earned income credit or any portion of the disallowed portion of the claim for refund or credit that is subject to accuracy-related or fraud penalties. The provision is effective for claims for refund or credit filed after the date of enactment.

The Tax Relief and Health Care Act of 2006

The Tax Relief and Health Care Act of 2006 (TRHCA) includes the following provisions.

Extension of the Above-the-Line Deduction for Higher Education Expenses

The bill allows parents and students to deduct qualified tuition and related expenses for an additional 2 years, through December 31, 2007.

Extension of the State and Local Sales Tax Deduction

The provision that allows taxpayers to elect to deduct their state and local sales taxes as an itemized deduction in lieu of an itemized deduction for state and local income taxes is extended through December 31, 2007.

Extension of Election to Treat Combat Pay as Earned Income for Purposes of the Earned Income Credit

TRHCA extends for 1 year (through December 31, 2007) the availability of the election to treat combat pay that is otherwise excluded from gross income under I.R.C. § 112 as earned income for purposes of the earned income credit.

Extension and Modification of the Research Credit

The research credit is extended through 2007. Effective for tax years ending after December 31, 2006, the rate of the alternative incremental credit is increased. Also, the taxpayer may elect an alternative simplified credit for qualified research expenses. A transition rule permits a taxpayer to elect to use the alternative simplified credit in lieu of the alternative incremental credit if the election is made during the tax year that includes January 1, 2007.

Extension of WOTC and Welfare-to-Work Tax Credit

The work opportunity and welfare-to-work tax credits are extended through 2006. After 2006 the two tax credit programs will be combined and modified. The combined, modified credit is available for 2007.

Extension of the Above-the-Line Deduction for Certain Expenses of Elementary and Secondary School Teachers

The above-the-line deduction of as much as \$250 for personal funds spent by teachers to buy classroom supplies is extended through December 31, 2007.

Extension and Modification of the New Markets Credit

The new markets tax credit, intended to boost investment in community development especially in rural areas, is extended through 2008.

Extension and Expansion to Petroleum Products of Expensing for Environmental Remediation Costs

The provision that allows taxpayers to elect treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred is extended through December 31, 2007. In addition, the definition of hazardous substance is expanded to generally include petroleum products, including crude oil, crude oil condensates, and natural gasoline. The provision applies to expenditures paid or incurred after December 31, 2005, and before January 1, 2008.

Qualified Leasehold Improvements and Qualified Restaurant Property

The special 15-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant property is extended through December 31, 2007.

Extension of Computer Technology Charitable Contribution and Charitable Contribution for Scientific Property Used for Research

The enhanced deduction for qualified computer contributions is extended to apply to contributions made during tax years beginning before January 1, 2008. Under the bill, property assembled by the taxpayer, in addition to property constructed by the taxpayer, is eligible for either the enhanced deduction related to computer technology and equipment or to scientific property used for research. The provision is effective for tax years beginning after December 31, 2005.

Extension of Placed-in-Service Deadline for Certain Gulf Opportunity Zone Property

The placed-in-service deadline for specified Gulf Opportunity Zone property to qualify for the additional first-year depreciation deduction is extended. Specified Gulf Opportunity Zone extension property is defined as property that is substantially used within one or more specified portions of the Gulf Opportunity Zone and that is either (1) nonresidential real property or residential rental property placed in service by the taxpayer on or before December 31, 2010, or (2) in the case of a taxpayer who places in service a building described in (1), property described in I.R.C. § 168(k)(2)(A)(i), if substantially all the use of such property is in such building and that property is placed in service within 90 days of the date the building is placed in service. However, for nonresidential real property or residential rental property, only the adjusted basis of such property attributable to manufacture, construction, or production before January 1, 2010 (progress expenditures), is eligible for the additional first-year depreciation.

Extension of Archer Medical Savings Accounts

The provision extends for 2 years the present-law Archer medical savings account (MSA) provisions (through December 31, 2007).

Extension of Taxable Income Limit on Percentage Depletion for Oil and Natural Gas Produced from Marginal Properties

TRHCA extends for 2 years the present-law taxable income limitation suspension provision for marginal production (through taxable years beginning on or before December 31, 2007).

Extension of Tax Incentives for Investment in the District of Columbia

TRHCA extends the designation of certain economically depressed census tracts in the District of Columbia as the “District of Columbia Enterprise Zone” through December 31, 2007, allowing zone businesses and residents continued eligibility for special tax incentives. In addition, the TRHCA retroactively reinstates the first-time homebuyer credit for the District of Columbia for eligible property purchased after 2005 and before 2008.

Extension of Placed-in-Service Date for Tax Credit for Electricity Produced at Wind, Closed-Loop Biomass, Open-Loop Biomass, Geothermal Energy, Small Irrigation Power, Landfill Gas, Trash Combustion, or Qualified Hydropower Facilities

TRHCA extends through December 31, 2008, the period during which certain facilities may be placed in service as qualified facilities for the electricity production credit. The provision is effective for facilities placed in service after December 31, 2007. The placed-in-service date extension applies for all qualified facilities, except for qualified solar, refined coal, and Indian coal facilities.

Extension of Energy-Efficient Commercial Buildings Deduction

TRHCA extends the deduction to property placed in service before January 1, 2009.

Extension of Energy-Efficient New Homes Credit

TRHCA extends the credit to homes whose construction is substantially completed after December 31, 2005, and that are purchased after December 31, 2005, and before January 1, 2009.

Extension of Credit for Residential Energy-Efficient Property

The provision extends the credit for residential energy-efficient property to property placed in service after December 31, 2005, and before January 1, 2009. The provision also clarifies that all property, not just photovoltaic property, that uses solar energy to generate electricity for use in a dwelling unit is qualifying property. The provision is effective on the date of enactment.

Rollovers from Health FSAs and HRAs into HSAs

TRHCA allows certain amounts in health flexible spending arrangements (FSAs) and health reimbursement arrangements (HRAs) to be distributed from the health FSA or HRA and contributed through a direct transfer to a health savings account (HSA) without violating the otherwise applicable requirements for such arrangements. The provision is effective for distributions and contributions on or after the date of enactment and before January 1, 2012.

Certain FSA Coverage Treated as Disregarded Coverage

TRHCA provides that, for tax years beginning after 2006, in certain cases, coverage under a health FSA during the period immediately following the end of a plan year during which unused benefits or contributions remaining at the end of the plan year may be paid or reimbursed to plan participants for qualified expenses is disregarded coverage. The provision disregarding certain FSA coverage is effective after the date of enactment for coverage for tax years beginning after December 31, 2006.

One-Time Rollovers from IRAs into HSAs

The provision allows a one-time contribution to an HSA of certain amounts distributed from an individual retirement arrangement (IRA). The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA under the provision are not includable in income to the extent that the distribution would otherwise be includable in income. In addition, such distributions are not subject to the 10% additional tax on early distributions. The provision is effective for tax years beginning after 2006. It does not apply to simplified employee pensions (SEPs) or to SIMPLE retirement accounts.

AMT Credit Relief for Individuals

Under TRHCA, an individual's minimum tax credit allowable for any tax year beginning before 2013 is not less than the "AMT refundable credit amount." The AMT refundable credit amount is the greater of (1) the lesser of \$5,000 or the long-term unused minimum tax credit, or (2) 20% of the long-term unused minimum tax credit. The long-term unused minimum tax credit for any tax year means the portion of the minimum tax credit attributable to the adjusted net minimum tax for taxable years before the third tax year immediately preceding the taxable year (assuming the credits are used on a first-in, first-out basis). The additional credit allowed as a result of this provision is refundable. However, the credit is phased out if an individual's income exceeds a certain amount.

Exclusion of Gain on Sale of a Principal Residence by a Member of the Intelligence Community

Under TRHCA, specified employees of the intelligence community may elect to suspend the running of the 5-year test period for purposes of excluding gain on the sale of a personal residence during any period in which they are serving on extended duty. The provision applies to sales and exchanges after the date of enactment and before 2011.

Modification of Tax on Unrelated Business Taxable Income of Charitable Remainder Trusts

TRHCA imposes a 100% excise tax on the unrelated business taxable income of a charitable remainder trust effective for tax years beginning after December 31, 2006. This provision replaces the present-law rule that takes away the income tax exemption of a charitable remainder trust for any year in which the trust has any unrelated business taxable income.

Deduction Allowable for Income Attributable to Domestic Production Activities in Puerto Rico

I.R.C. § 199 is amended to include Puerto Rico within the definition of the United States for determining eligible taxpayers' domestic production gross receipts, but only if all of the taxpayer's gross receipts from sources within Puerto Rico are currently taxable for U.S. federal income tax purposes. Also, any such taxpayer is allowed to take into account wages paid to bona fide Puerto Rico residents in calculating the 50% wage limitation. The provision is effective for the first 2 tax years beginning after December 31, 2005, and before January 1, 2008.

Partial Expensing for Advanced Mine Safety Equipment

A taxpayer may elect to treat 50% of the cost of any qualified advanced mine safety equipment property as a deduction in the tax year in which the equipment is placed in service. The provision applies to costs paid or incurred after the date of enactment, for property placed in service on or before December 31, 2008.

Mine Rescue Team Training Credit

A taxpayer that is an eligible employer may claim a credit for each qualified mine rescue team employee. The provision is effective for tax years beginning after 2005 and before 2009.

Certain Settlement Funds

The provision permanently extends to funds and accounts established after 2010 the treatment of certain settlement funds as beneficially owned by the United States government and, therefore, not subject to federal income tax.

Capital Gains Treatment for Certain Self-Created Musical Works

The provision makes permanent the availability of the I.R.C. § 1221(b)(3) election to treat certain sales of musical compositions or copyrights in musical works as being sales of capital assets (and therefore as generating capital gain). The provision also makes permanent the accompanying rule limiting to adjusted basis the amount of a charitable contribution deduction allowed for musical compositions or copyrights in musical works to which a taxpayer has elected the application of I.R.C. § 1221(b)(3).

Qualified Mortgage Bonds

Modifications to qualified veterans' mortgage bonds are made permanent and the qualified mortgage bond program is expanded to provide veterans a one-time exception to the first-time homebuyer requirement effective as of the enactment date and before 2008.

Premiums for Mortgage Insurance

Certain premiums paid or accrued for qualified mortgage insurance by a taxpayer during the tax year in connection with acquisition debt on a taxpayer's qualified residence are treated as interest that is qualified residence interest and thus deductible. The provision does not apply to mortgage insurance contracts issued before 2007 and terminates for any amount paid or accrued after December 21, 2007, or properly allocable to any period after that date.

Miscellaneous Additional Provisions

TRHCA includes the following other miscellaneous provisions:

- The Indian employment tax credit is extended through tax years beginning on or before December 31, 2007.
- Current incentives related to depreciation of qualified Indian reservation property are extended to apply to property placed in service through December 31, 2007.
- Present-law provisions for qualified zone academy bonds are extended through December 31, 2007, and new arbitrage, spending, and reporting requirements are imposed for obligations issued after the date of enactment concerning allocations of the annual aggregate bond cap for calendar years after 2005.
- Additional provisions in the energy tax portion of the bill extend the present-law business solar and fuel-cell energy credit at current credit rates through December 31, 2008.
- The reduced rates for qualified methanol or ethanol fuel are extended through December 31, 2008.
- The advanced coal credit for subbituminous coal is modified effective for advanced coal project certification applications submitted after October 2, 2006.
- A special depreciation allowance is added for cellulosic biomass ethanol plant property placed in service before January 1, 2013, and after the date of enactment, in tax years ending after such date.
- The phaseout limitation for coke and coke gas otherwise eligible for a credit under I.R.C. § 45K(g) is repealed.
- The annual plan limitation on the HSA contribution limitation is repealed effective for tax years beginning after 2006.
- The employer comparable contribution requirements are modified for HSA contributions made to non-highly compensated employees effective for tax years beginning after 2006.
- Earlier indexing of HSA cost-of-living adjustments is mandated effective for adjustments made for tax years beginning after 2007.
- HSA contributions for months preceding the month that the taxpayer is an eligible individual are allowed effective for tax years beginning after 2006.
- With respect to frivolous returns, the IRS-imposed penalty is increased and other provisions are modified.
- The definition of qualified railroad track expenditures for the railroad track maintenance credit is modified effective for expenditures paid or incurred during tax years beginning after December 31, 2004, and before January 1, 2008.
- The special rule regarding treatment of below-market loans to qualified continuing care facilities is made permanent.
- The active business rules related to taxation of distributions of stock and securities of a controlled corporation are made permanent.

Long-Distance Telephone Excise Tax Refunds

Businesses that claimed the credit will need to report the refunds as income since the amount was claimed as an expense in a prior year. There are two parts to the refund checks: the excise tax and the interest portion. Tax preparers should refer to the Form 8913, Credit for Federal Telephone Excise Tax Paid, as filed for the refund year to determine the breakdown for reporting purposes.

Tax Increase Prevention and Reconciliation Act of 2005

The Tax Increase Prevention and Reconciliation Act (TIPRA) increased and extended the higher AMT exemption amounts that were to expire at the end of 2005. The (MFJ) maximum AMT exemption amount for 2006 was \$62,550. Similar increases were made for other filing statuses. At press time of this publication there has not been a provision to extend the higher AMT exemption amounts for the 2007 tax year.

The age limit that now applies to the kiddie tax has been raised to 18 from 14. The rules otherwise remain the same. The calculation(s) required for 2007 have changed due to the inflationary adjustments.

The 5% and 10% capital gain (long-term) and qualified dividend rates were set to expire at the end of 2008. The act extended these rates through 2010.

Beginning in 2010 taxpayers will be able to convert traditional IRAs to Roth IRAs without regard to their adjusted gross income (AGI). Currently, a taxpayer can make a conversion only if their AGI does not exceed \$100,000. TIPRA also stipulates that conversions occurring in 2010 are to be included in income ratably in the years 2011 and 2012 unless the taxpayer elects otherwise. Any distribution of converted amounts will accelerate the includable amounts.



Practitioner Note

TIPRA gives taxpayers the option of having the 2010 conversion amounts taxable all in 2010 by making an election or by default no taxability in 2010 and half taxable in 2011 and half taxable in 2012.

TIPRA requires that a partial payment, in addition to the user fee, must be given to the IRS by the taxpayer while an offer in compromise is being considered by the IRS. Furthermore, taxpayers must make a down payment of 20% of the offer with the application for lump-sum offers. A lump-sum offer is considered to be a single payment or payments that are five or fewer installments. This provision is effective October 16, 2006 (60 days after enactment).

TIPRA eliminated the information-reporting exception for tax-exempt bond interest payments. Payers of tax-exempt interest are now required to report payments exceeding \$10 per calendar year. This provision is for interest paid after December 31, 2005.

Heroes Earned Retirement Opportunities Act

Public Law 109-227 adds a special rule that combat-zone pay is compensation for the purpose of IRA contributions for the taxpayer as well as for a spousal contribution. This change is retroactive to years after 2003. Contributions must be made within 3 years of May 26, 2006, for 2004 and 2005.

Pension Protection Act of 2006

The Pension Protection Act of 2006 (PPA) requires the IRS to establish procedures for depositing tax refunds directly into an IRA. The IRA must be established prior to the direct deposit request, and the taxpayer must notify the IRA trustee of the year to which the deposit is to apply.

The following provisions of EGTRRA (2001 act) relating to IRAs and pensions were made permanent:

- The increase in the IRA annual contribution limit amount
- The increase in the 401(k) plan annual contribution limit amount
- Provision for catch-up contributions for taxpayers over age 50
- Pension start-up costs tax credit

A direct IRA distribution to charitable organizations is excluded from the gross income of the owner if the IRA owner has attained the age of 70½. Where the IRA includes after-tax amounts, the distributions are first treated as coming from income. The annual exclusion per taxpayer cannot exceed \$100,000. These charitable distributions are considered part of the taxpayer's MRD. This provision is set to expire after 2007.

The PPA authorizes the Treasury Department to issue regulations regarding the denial of a deduction for any contribution to a qualifying organization of household items or clothing that has minimal monetary value, such as used undergarments and socks. In addition, it disallows a deduction for clothing and household items unless the item(s) is in good used condition or better.

The PPA requires the donor of cash contributions to maintain a bank record or written communication from the donee for tax years beginning after enactment. Note that there is no dollar limit for the contribution amount.

All the provisions of EGTRRA (2001 act) that relate to qualified tuition programs are permanently extended, including the following:

- Qualified tuition account withdrawals are exempt from income tax.
- Distributions from qualified tuition accounts not used for higher educational purposes are subject to a 10% additional tax.
- Room and board expenses are qualifying expenses.
- Rollovers from one account to another account are allowable.
- Hope and lifetime learning credits are coordinated with I.R.C. § 529.
- First cousins are treated as members of the family for rollover and change-of-beneficiary purposes.

The credit designed to encourage lower-income taxpayers to contribute to IRAs and other retirement plans, referred to as the saver's tax credit, was extended permanently.

Expired Provisions

Selected tax benefit provisions expired as of December 31, 2006 (and had not been extended at the time of publication):

- AMT
 - ◆ Use of personal credits to offset AMT (other than child tax credit)
 - ◆ Increase in AMT exemption amount
- Credit for qualified electric vehicles
- Depreciation for clean-fuel vehicles

Energy Tax Incentives

A lifetime maximum nonrefundable credit of \$500 per taxpayer is available in 2006 and 2007 for costs incurred to improve the energy efficiency of a taxpayer's main home.

The credit is 10% of the cost of qualified energy-efficient structural improvements and 30% of the cost of specific heating and cooling equipment. There are specific lower credit limits on some items; for example, the lifetime credit for windows is \$200 and for air conditioners is \$300.

In 2006 and 2007 there is a personal tax credit of up to \$2,000 per system for the purchase of renewable-energy equipment, such as photovoltaic property to generate electricity and solar water-heating property using sun energy. These credits are applied separately, and total credits could exceed \$4,000 per year.

Motor Vehicle Credits

The clean-fuel vehicle deduction was replaced with new tax credits starting in 2006 with various termination dates. The new motor vehicle credits have different rates and criteria. The credits are for qualified fuel-cell motor vehicles, advanced lean-burn technology motor vehicles, qualified hybrid motor vehicles, and qualified alternative-fuel motor vehicles. This credit is available only to the original purchaser of a new qualifying vehicle or, if leased, only to the leasing company.

Qualifying Vehicles

The following vehicles qualify for the new motor vehicle credits.

Model Year 2008

- Chevrolet Malibu Hybrid—\$1,300
- Ford Escape 2wd Hybrid—\$3,000
- Ford Escape 4wd Hybrid—\$2,200
- Mercury Mariner 2wd Hybrid—\$3,000
- Mercury Mariner 4wd Hybrid—\$2,200
- Saturn Aura Hybrid—\$1,300

Model Year 2007

- Chevrolet Silverado 2wd Hybrid Pickup Truck—\$250
- Chevrolet Silverado 4wd Hybrid Pickup Truck—\$650
- Ford Escape Hybrid 2wd—\$2,600
- Ford Escape Hybrid 4wd—\$1,950
- GMC Sierra 2wd Hybrid Pickup Truck—\$250
- GMC Sierra 4wd Hybrid Pickup Truck—\$650
- Honda Accord Hybrid—\$1,300
- Honda Accord Hybrid Navi—\$1,300
- Honda Civic Hybrid—\$2,100
- Lexus GS 450h—Reduced rate through 9/30/07 (\$1,550/\$775/\$387.50)
- Lexus RX 400h 4wd—Reduced rate through 9/30/07 (\$2,200/\$1,100/\$550)

- Lexus RX 400h 2wd—Reduced rate through 9/30/07 (\$2,200/\$1,100/\$550)
- Mercury Mariner 4wd Hybrid—\$1,950
- Nissan Altima Hybrid—\$2,350
- Saturn Aura Hybrid—\$1,300
- Saturn Vue Green Line—\$650
- Toyota Camry Hybrid—Reduced rate through 9/30/07 (\$2,600/\$1,300/\$650)
- Toyota Prius—Reduced rate through 9/30/07 (\$3,150/\$1,575/\$787.50)
- Toyota Highlander Hybrid 2wd—Reduced rate through 9/30/07 (\$2,600/\$1,300/\$650)

Model Year 2006

- Chevrolet Silverado 2wd Hybrid Pickup Truck—\$250
- Chevrolet Silverado 4wd Hybrid Pickup Truck—\$650
- Ford Escape Hybrid (Front) 2wd—\$2,600
- Ford Escape Hybrid 4wd—\$1,950
- GMC Sierra 2wd Hybrid Pickup Truck—\$250
- GMC Sierra 4wd Hybrid Pickup Truck—\$650
- Honda Accord Hybrid AT with updated calibration and Navi AT with updated calibration—\$1,300*
- Honda Civic Hybrid CVT—\$2,100
- Honda Insight CVT—\$1,450
- Lexus RX400h 2wd—Reduced rate through 9/30/07 (\$2,200/\$1,100/\$550)
- Lexus RX400h 4wd—Reduced rate through 9/30/07 (\$2,200/\$1,100/\$550)
- Mercury Mariner Hybrid 4wd—\$1,950
- Toyota Highlander 2wd Hybrid—Reduced rate through 9/30/07 (\$2,600/\$1,300/\$650)
- Toyota Highlander 4WD Hybrid—Reduced rate through 9/30/07 (\$2,600/\$1,300/\$650)
- Toyota Prius—Reduced rate through 9/30/07 (\$3,150/\$1,575/\$787.50)

*2006 Honda Accord Hybrid AT and Navi AT without updated calibration qualify for a credit of \$650.

Model Year 2005

- Ford Escape HEV 2wd—\$2,600
- Ford Escape HEV 4wd—\$1,950
- Honda Accord Hybrid AT and Navi AT—\$650
- Honda Civic Hybrid MT and CVT—\$1,700
- Honda Insight CVT—\$1,450
- Toyota Prius—Reduced rate through 9/30/07 (\$3,150/\$1,575/\$787.50)

Quarterly Sales

The credit is available for only a limited time. Tax preparers will need to inquire as to the actual vehicle purchase date. Taxpayers are allowed to claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records its sale of the 60,000th hybrid or advance lean-burn technology. For the second and third calendar quarters after the quarter in which the 60,000th vehicle is sold, taxpayers may claim 50% of the credit. For the fourth and fifth calendar quarters, taxpayers may claim 25% of the credit. No credit is allowed after the fifth quarter.

Toyota has exceeded 60,000 in sales of qualifying vehicles and therefore sales after September 30, 2006, and before April 1, 2007, receive 50% of original credit; sales after March 31, 2007, and before October 1, 2007, receive 25% of original credit and no credit thereafter. Check the IRS Web site for further updates.

Employer Cash Incentives for Hybrids Are Taxable

Some employers are encouraging their employees to purchase hybrid cars and are offering rebates or cash incentives to offset the purchase price of these vehicles. This rebate or cash incentive is just like other forms of compensation; it is taxable and should be included on the year-end W-2 earnings statement.

Farm Diesel Fuel Tax Refund

The 2005 Transportation Act eliminated ultimate vendor claims for nondyed diesel fuel or kerosene sold for farm use after September 30, 2005. If nondyed diesel fuel or kerosene was used for farming purposes, the refund payments were paid to the ultimate registered vendor making the claim. Under the new legislation, the refunds will be paid to the ultimate purchaser under the rules applicable to nontaxable uses of these nondyed fuels. Ultimate purchasers must keep detailed records of usage, dates, suppliers, and amounts and will file Form 4136, Credit for Federal Tax Paid on Fuels, annually or Form 8849, Claim for Refund of Excise Taxes, for quarterly claims over \$749.

Standard Deduction

The standard deduction is indexed to inflation and is adjusted annually, as shown in Figure 1. The 2003 act increased the basic standard deduction amount for married taxpayers filing jointly to twice the basic standard deduction amount for single taxpayers, effective for 2003 until 2010.

FIGURE 1. Basic Federal Standard Deduction for 2006, 2007, and 2008

Filing Status	2006	2007	2008*
Married filing jointly, or qualifying widow(er)	\$10,300	\$10,700	\$10,900
Head of household	7,550	7,850	8,000
Single individuals	5,150	5,350	5,450
Married filing separately	5,150	5,350	5,450

*Projected

Each taxpayer who is over age 65 or blind receives the regular standard deduction plus an additional \$1,050 deduction if married and filing a joint or separate return. The additional deduction is \$1,300 if the taxpayer is single or is the head of the household. The additional deductions are subject to the inflationary adjustment. A taxpayer who is both elderly and blind receives double the additional deduction. The additional deductions for age and blindness cannot be claimed for dependents.

Personal Exemption

The 2007 personal exemption allowed on the federal return is \$3,400 for the taxpayer, his or her spouse, and his or her dependents. Taxpayers may not claim an exemption for themselves or for any other person who can be claimed as a dependent on someone else's tax return.

There is a phaseout of the personal exemption for certain high-income individuals. For 2007 the benefit of the personal exemption is phased out for taxpayers with the following specific high levels of AGI (these threshold amounts are adjusted for inflation annually):

- \$234,600 if married filing jointly or qualifying widow(er) with a dependent child (exemptions completely lost at \$357,100 AGI)
- \$195,500 if head of household (exemptions completely lost at \$318,000 AGI)
- \$156,400 if single (exemptions completely lost at \$278,900 AGI)
- \$117,300 if married filing separately (exemptions completely lost at \$178,550 AGI)

The phaseout in personal exemptions was 2% of the exemption amount for each \$2,500 increment (or any fraction thereof) by which AGI exceeds the appropriate threshold amount for 2005 and earlier years. A married taxpayer filing separately will lose 2% of his or her exemption for each \$1,250 increment above \$117,300. For 2006 and 2007 the phaseout is reduced by one-third and by two-thirds for 2008 and 2009. Full personal exemption is scheduled to be restored after the year 2009. The personal exemption phaseout or reduction is calculated on a nine-line worksheet, the “Deduction for Exemptions Worksheet,” included in the Form 1040, U.S. Individual Income Tax Return, instructions. If AGI exceeds the threshold, complete the worksheet before claiming the personal exemption deduction on line 42 of Form 1040.

Example 1.

Mr. and Mrs. Dairy file jointly; they have two children; and their 2007 AGI is \$294,700. They claim four personal exemptions and the standard deduction. Their reduction and net exemption are calculated as follows:

- $\text{AGI } \$294,700 - \$234,600 \text{ threshold} = \$60,100 \text{ excess.}$
- $\text{The } \$60,100 \text{ excess} \div \$2,500 = 24.04, \text{ or } 25 \text{ excess increments.}$
- $\text{Their reduction is } 25 \times 0.02 \text{ (2\%)} = 0.50 \times \$13,600 \text{ (4 @ } \$3,400) \times 2/3 = \$4,533.$
- $\text{Their net personal exemption is } \$13,600 - \$4,533 = \$9,067.$

A way to evaluate the cost of the personal exemption phaseout to the taxpayer is to calculate the additional tax liability. In Example 1, Mr. and Mrs. Dairy are in the 33% taxable income bracket, where the \$4,533 of phased-out personal exemption will cost \$1,496 in additional taxes. In other words, their \$60,100 of excess AGI caused an additional tax liability of \$1,496, or was effectively taxed at 35.49%.

Dependents

Taxpayers must report the social security numbers of all dependents. The penalty for failure to report this information is \$50. Apply for a social security number by filing Form SS-5 with the Social Security Administration, or file online at <http://www.ssa.gov>.

Taxpayers may not claim an exemption for a dependent who has a gross income of \$3,400 or more, unless it is for their child under age 19 or a full-time student child under age 24 at the end of the tax year. Nontaxable social security benefits and earnings from sheltered workshops are excluded. A full-time student must be enrolled in and attend a qualified school during some part of each of 5 calendar months. Individuals who can be claimed as dependents on another taxpayer's return may not claim a personal exemption on their own return.

The qualified child, student, or other qualified dependent's basic standard deduction allowable is limited to the smaller of the basic standard deduction or the larger of (1) \$850 or (2) the individual's earned income plus \$300, as shown in Figure 2. However, the additional deductions for age or blindness are still available in full.

FIGURE 2. Examples of Single Taxpayer's Standard Deduction

	Base Amount	Earned Income	Earned Income + 300	Larger of the Two	Standard Deduction	Smaller of the Two
Case #1	\$850	\$ 0	\$ 300	\$ 850	\$5,350	\$ 850
Case #2	850	3,000	3,300	3,300	5,350	3,300
Case #3	850	5,600	5,900	5,900	5,350	5,350

Investment or unearned income in excess of \$1,700 that is received by a dependent child under age 18 is taxed at the parent's marginal rate if greater than the income tax using the child rates. A three-step procedure is required to compute the tax on Form 8615, Tax for Children Under Age 18 Who Have Investment Income of More Than \$1,700, where the excess over \$1,700 will be taxed at the parent's marginal rate, and unearned income greater than \$850 but less than \$1,700 will be taxed at 10%.

The election to claim the child's unearned income on the parent's return with Form 8814, Parent's Election to Report Child's Interest and Dividends, is available, and the base amount is \$1,700 with an \$850 tax exemption. This election cannot be made if the child has income other than interest and dividends, if estimated tax payments were made in the child's name, or if the child's income is more than \$8,500.



Practitioner Note

The federal income tax on a taxpayer's child's income, including qualified dividends and capital gain distributions, may be less if the taxpayer files a separate return for the child rather than making the election. Furthermore, inclusion of the child's income on the parent's return may reduce other tax benefits due to increased AGI (e.g., earned income credit, exemptions, tuition credits, and IRA deductions).



Planning Pointer

The kiddie tax is being expanded for tax years beginning after 2007. Planning for children's unearned income now will be prudent.

2007 Tax Rates

All the tax brackets have been adjusted for inflation this year. Each of the top four tax brackets has been increased from 2006, which results in many taxpayers with constant taxable incomes paying somewhat less for income taxes in 2007. The 10% bracket increased by \$275 for single taxpayers and married taxpayers filing separately and twice that for married taxpayers filing jointly. For example, for a married taxpayer filing jointly, the increase of \$550 in the 10% bracket rather than the 15% bracket is a savings of \$27 in income tax liability. After 2010, the 10% rate bracket reverts to the levels under the prior act, unless changed. There is not a 10% bracket for estates and trusts. The 15% bracket for those married taxpayers filing jointly is twice the single bracket. The 2007 tax rate schedules are shown in Figure 3.

FIGURE 3**I.R.C. § 1(a)—Married Individuals Filing Joint Returns and Surviving Spouses**

If Taxable Income Is	The Tax Is
Not over \$15,650	10% of the taxable income
Over \$15,650 but not over \$63,700	\$1,565.00 plus 15% of the excess over \$15,650
Over \$63,700 but not over \$128,500	\$8,772.50 plus 25% of the excess over \$63,700
Over \$128,500 but not over \$195,850	\$24,972.50 plus 28% of the excess over \$128,500
Over \$195,850 but not over \$349,700	\$43,830.50 plus 33% of the excess over \$195,850
Over \$349,700	\$94,601.00 plus 35% of the excess over \$349,700

I.R.C. § 1(b)—Heads of Households

If Taxable Income Is	The Tax Is
Not over \$11,200	10% of the taxable income
Over \$11,200 but not over \$42,650	\$1,120.00 plus 15% of the excess over \$11,200
Over \$42,650 but not over \$110,100	\$5,837.50 plus 25% of the excess over \$42,650
Over \$110,100 but not over \$178,350	\$22,700.00 plus 28% of the excess over \$110,100
Over \$178,350 but not over \$349,700	\$41,810.00 plus 33% of the excess over \$178,350
Over \$349,700	\$98,355.50 plus 35% of the excess over \$349,700

**I.R.C. § 1(c)—Single Individuals
(Other Than Surviving Spouses and Heads of Households)**

If Taxable Income Is	The Tax Is
Not over \$7,825	10% of the taxable income
Over \$7,825 but not over \$31,850	\$782.50 plus 15% of the excess over \$7,825
Over \$31,850 but not over \$77,100	\$4,386.25 plus 25% of the excess over \$31,850
Over \$77,100 but not over \$160,850	\$15,698.75 plus 28% of the excess over \$77,100
Over \$160,850 but not over \$349,700	\$39,148.75 plus 33% of the excess over \$160,850
Over \$349,700	\$101,469.25 plus 35% of the excess over \$349,700

I.R.C. § 1(d)—Married Individuals Filing Separate Returns

If Taxable Income Is	The Tax Is
Not over \$7,825	10% of the taxable income
Over \$7,825 but not over \$31,850	\$782.50 plus 15% of the excess over \$7,825
Over \$31,850 but not over \$64,250	\$4,386.25 plus 25% of the excess over \$31,850
Over \$64,250 but not over \$97,925	\$12,486.25 plus 28% of the excess over \$64,250
Over \$97,925 but not over \$174,850	\$21,915.25 plus 33% of the excess over \$97,925
Over \$174,850	\$47,300.50 plus 35% of the excess over \$174,850

I.R.C. § 1(e)—Estates and Trusts

If Taxable Income Is	The Tax Is
Not over \$2,150	15% of the taxable income
Over \$2,150 but not over \$5,000	\$322.50 plus 25% of the excess over \$2,150
Over \$5,000 but not over \$7,650	\$1,035.00 plus 28% of the excess over \$5,000
Over \$7,650 but not over \$10,450	\$1,777.00 plus 33% of the excess over \$7,650
Over \$10,450	\$2,701.00 plus 35% of the excess over \$10,450

I.R.C. § 1(h)—Capital Gains Rates (Noncorporate Taxpayers)

Category of Gain	Tax Rate
Gain on collectibles	28%
I.R.C. §1202 gain	28%
Unrecaptured I.R.C. §1250 gain	25%
Net long-term capital gain	15%
Reduced long-term capital gain rate if ordinary tax rate is 10% or 15%*	5%

*This rate will be 0% in 2008, 2009 and 2010.

The rates for heads of households are more favorable than for filing single. Single taxpayers who are maintaining a home for themselves and a dependent should qualify. A married taxpayer not living in the same household as his or her spouse for the last 6 months of the year is treated as married filing separately but may qualify as head of household if he or she has a qualified dependent.

Marriage Tax Penalty

The 15% income tax bracket for married taxpayers filing jointly continues at twice the single income tax bracket. This eliminated the marriage penalty in that income tax bracket only. This provision is effective through the end of 2010.



Practitioner Note

This provision fixed the 15% bracket and not other brackets. Therefore, marriage tax penalty has not been completely eliminated.

The other part of the marriage tax penalty has to do with the comparison of the standard deduction between singles and married filing jointly. Two singles used to be afforded a larger standard deduction than a married couple filing jointly. The 2003 act changed this deduction so that the deduction for married filing jointly moved to 200% of the single taxpayer amount. Thus, married taxpayers filing jointly will benefit from the \$5,350 times 2, or a \$10,700 standard deduction in 2007. Inflationary adjustments will continue to be made until the end of the year 2010. Increasing the earned income credit phaseout amounts for joint filers will provide marriage tax penalty relief for earned income credit (EIC) calculations. The 2001 act increased both the beginning and ending of the EIC phaseout ranges by \$1,000 in 2002, \$2,000 in 2005, and \$3,000 in 2008. Married individuals must file a joint return in order to claim the EIC. The calculation of the couple's combined income previously penalized some couples that had a smaller EIC when married compared to unmarried.

Moving Expenses

Moving expenses are defined as the reasonable costs of (1) moving household goods and personal effects from the former residence to the new residence and (2) travel, including lodging during the period of travel, from the former residence to the new place of residence. The 2007 standard mileage rate for a passenger car used for moving is \$0.20 per mile. Meal expenses are no longer included in moving expenses. The new place of work must be at least 50 miles farther from the taxpayer's former residence than the old place of work. The deduction will be subtracted from gross income in arriving at AGI.

The following expenses, previously allowed as moving expenses, no longer qualify: selling and buying expenses on the old and new residences; meals while traveling or living in temporary quarters near the new place of work; cost of premove house hunting; and temporary living expenses for up to 30 days at the new job location.

Report qualified moving expenses on Form 3903, Moving Expenses, and deduct them on line 26 of Form 1040, U.S. Individual Income Tax Return. Qualified moving expenses reimbursed by an employer are excludable from gross income to the extent that they meet the requirements of qualified moving-expense reimbursement.

Itemized Deductions 1040 (Schedule A)

Medical Expenses

Medical expenses that exceed 7.5% of AGI are itemized deductions. Medical expenses are broadly defined to include payments made for nearly all medical and dental services; therapeutic devices and treatments; home modifications and additions made primarily for medical reasons; travel including auto mileage deductions, which is \$0.20 per mile for 2007, and lodging expenses associated with qualified medical care trips; legal fees required to obtain medical services; prescribed medicine and drugs; special schooling and institutional care; qualified health insurance premiums; and the costs to acquire, train, and maintain animals that assist individuals with physical disabilities. Most cosmetic surgery, general health maintenance (such as gym fees and general weight-loss programs), and well-baby care programs will not qualify. However, the cost of weight-loss programs prescribed for the treatment of a disease impacted by obesity does qualify. Remember that itemized medical expenses must be reduced by any reimbursement, including health insurance payments received.

For purposes of the itemized medical expense deduction, the cost of over-the-counter drugs is non-deductible. Rev. Rul. 2003-102 allows over-the-counter drugs to be covered by health-care FSAs. This ruling allows reimbursements for nonprescription drugs by an employer health plan to be excluded from income if substantiated by the employee.

Long-Term Health Care

Long-term health-care premiums are deductible for 2007 by itemizers when combined with other premiums and medical expenses that exceed 7.5% of AGI. However, there are annual limits on the deductible premiums tied to age. Filers over 70 years old can include long-term health-care premiums of up to \$3,680 per year per person, subject to the 7.5% exclusion. Those aged 61 to 70 years old may include \$2,950 per person; 51 to 60 years old, \$1,110 per person; 41 to 50 years old, \$550 per person; and 40 years old and under, \$290 per person—all subject to the 7.5% exclusion.

Qualified long-term care (LTC) insurance contracts are generally treated as accident and health insurance contracts. Contract benefits are generally excludable from taxation as money received for personal injury and sickness. The 2007 excludable per diem benefit limit is \$260 per day or \$94,900

annually. Benefits are reported to taxpayers on 1099-LTC (Long-Term Care and Accelerated Death Benefits) and shown on Form 8853 (Archer MSAs and Long-Term Care Insurance Contracts) Section C. This exclusion limit is ignored if the actual cost of the LTC is more than the per diem payment or if the taxpayer has been certified by a physician as terminally ill and death is expected within 24 months of certification.

Disabled Taxpayers

Disabled taxpayers' business expenses for impairment-related services at their place of employment are itemized deductions not subject to the 7.5% or 2% AGI limits. Disabled taxpayers are individuals who have a physical or mental disability that is a functional limitation to employment.

Itemized Deductions

Itemized deductions not subject to the 2% AGI limit include state income and property taxes, personal casualty losses, and others.

Sales Tax Deduction

The election to deduct state and local general sales taxes instead of state and local income taxes as an itemized deduction on Schedule A (Form 1040), Itemized Deductions, was extended by TRHCA of 2006.

Taxpayers cannot deduct both. Generally, to figure the state and local general sales tax deduction, one could use either actual expenses or the Optional State Sales Tax Tables. To the table amount, taxpayers could add state and local general sales taxes paid on motor vehicles, aircraft, boats, homes, and home-building materials if the rate was the same as the general sales tax rate. Sales taxes paid on items used in a trade or business are not allowed.

Home Mortgage Interest

Home mortgage interest (qualified residence interest) on the taxpayer's principal and second home is an itemized deduction on Form 1040 Schedule A, Itemized Deductions, provided that the mortgage satisfies the following limitations:

- *Home Acquisition Loan*—The mortgage was obtained after October 13, 1987, to buy, build, or improve a main home or a second home, but only if, throughout 2007, the total mortgage debt was \$1 million or less (\$500,000 or less if married filing separately). Note: This limit applies to the total debt on mortgages obtained after October 13, 1987, plus any prior "grandfathered debt."
- *Home Equity Loan*—The mortgage was obtained after October 13, 1987, other than to buy, build, or improve a home, but only if, throughout 2007, this debt was \$100,000 or less (\$50,000 or less if married filing separately).

To be deductible, both types of mortgages must be debt secured by a qualifying home, and the mortgage must be recorded with the county recorder or otherwise perfected under state law.

Mortgage interest that exceeds these limits is nondeductible. However, an exception applies if the disallowed mortgage interest is deductible under another I.R.C. section.



Practitioner Note

There is a tax trap: If a former spouse pays the mortgage interest on an ex-spouse's home, where only the ex-spouse resides after the divorce, there is no interest deduction.

Investment Interest Expense

Investment interest expense is deductible but is limited to the amount of net investment income. Investment interest expense is interest paid on debt incurred to buy investment property. It does not include

investments in passive activities or activities in which the taxpayer actively participates, including the rental of real estate. Net investment income is gross investment income (including investment interest, interest received from the IRS, dividends, taxable portions of annuities, and certain royalties) less investment expenses (excluding interest). Gross investment income was redefined by the 1993 act to exclude net capital gain on the disposition of investment property. The 2003 act extended this exclusion to qualified dividends that are eligible for the reduced tax rates. A taxpayer may elect to include net capital gain and qualifying dividends as investment income only if they are excluded from income qualifying for the long-term capital gain tax rate. By electing to treat net capital gain and/or dividend income as investment income to the extent of excess investment expense, any capital gain or dividend income can effectively be transformed into “tax-free” income by offset.

Example 2. In 2007 Charlie has \$6,000 of investment interest expense but only \$5,000 of investment income. Thus, Charlie can deduct only \$5,000 of his interest expense and must carry forward the other \$1,000 to the next tax year. But, Charlie has \$2,200 of qualified dividend income during 2007. Charlie can elect to have \$1,000 of that dividend income treated as investment income. By this election Charlie can deduct the full \$6,000 of investment interest expense in 2007. The remaining \$1,200 (\$2,200 – \$1,000) of qualified dividend income is subject to the 15% tax rate (5% if in the 10% or 15% brackets).



Practitioner Note

If the dividend has been taxed at the lower rate given to dividends and capital gains, then it is not eligible to be used in determining the amount of deductible investment interest.

Investment Interest Expense Deduction

Form 4952, Investment Interest Expense Deduction, is designed to calculate the amount of investment interest expense that may be deducted in the current tax year, and the amount one can carry forward to future years. The carryover interest deduction is limited to the excess of the current year’s net investment income over investment interest expense, and no deduction is allowed in any year in which there is a net operating loss.

Personal Interest

Personal interest is not deductible.

Charitable Contributions

The standard mileage rate for a passenger car used for charitable causes is \$0.14 per mile for 2007.

For noncash contributions, the taxpayer must obtain from the charity a receipt that describes the donated property, a good-faith estimate of its value, and whether anything was given to the taxpayer in exchange. Taxpayers must use Form 8283, Noncash Charitable Contributions, to report total noncash charitable contributions exceeding \$500.

I. Income Tax Law Changes for Those Who Itemize Their Charitable Deductions

In general, the value of clothing and household items is less than the taxpayer’s basis (cost) in such property with the result that taxpayers generally deduct the fair market value (FMV) of such contributions. A taxpayer can only deduct the *lower* of cost or market value.

For example, if a taxpayer buys a shirt for \$20, wears it once, and then donates it to the charity, then the FMV may be only 50 cents, so that is the amount of the taxpayer’s contribution. A taxpayer must maintain reliable written records, and the donor must generally maintain a receipt from the donor organization.

a. Limitation of Deduction of Household Items and Clothing

Effective on August 18, 2006, and thereafter, no deduction is allowed for a charitable contribution of clothing or household items unless the clothing and item is in *good* used condition or better. The IRS is expected to issue guidance about what is “good condition.” The new law cracks down on donations of broken household items and poor or soiled clothing. The IRS is authorized to deny by regulation a deduction for any contribution that has minimal monetary value, “such as used socks and used undergarments.” In 2003 the IRS reported more than \$9 billion claimed as deductions for clothing and household items.

Under the provision a deduction may be allowed for a charitable contribution of an item of clothing or a household item *not* in good condition or better if the amount claimed for the item is more than \$500 and the taxpayer includes a qualified appraisal with their return.

b. Modification of Recordkeeping Requirements of Cash Donations to Charities

Effective for the first tax year after August 17, 2006 (for most people that means the 2007 tax return), charitable contributions will require more record keeping regardless of amount. Current law required only a contemporaneous record of contributions of money in a log or ledger book. The new provision requires a record of the contribution by a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

The rule requires those who want a charitable deduction for a cash contribution to a charity offering plate, a Sunday school plate, a Salvation Army kettle, the United Way, and so forth, to use either a check or an envelope identifying the donor. The other alternative is to have the bell ringer or donor representative immediately write out a receipt (indicating donor, donee, date, amount) before dropping cash into the kettle or other donation collection box. In a nutshell, no bank record or no receipt means no deduction. Logbooks will not suffice.

c. Substantiation Requirements

In addition to previous record-keeping requirements, substantiation requirements apply in the case of charitable contributions with a value of \$250 or more. No deduction is allowed for any contribution of \$250 unless the taxpayer has a contemporaneous written acknowledgment of the contribution by the donee organization. In general, if the total deduction claimed is more than \$500 for noncash property, the taxpayer must complete Form 8283 (Noncash Charitable Contribution).

II. Special Tax-Free Treatment of Donated IRA Proceeds

The law allows individuals 70½ or older to make a tax-free distribution of IRA proceeds up to \$100,000 per individual per taxable year to a charitable organization during 2006 and 2007. A qualified charitable distribution must be made directly by the IRA trustee to the charitable organization.

Rules for Certain Car Donations Made after December 31, 2004

If a taxpayer donates a car to charity after December 31, 2004, and he or she is eligible to take a tax deduction in excess of \$500, that deduction is determined in one of two ways:

1. If the car is sold without any significant intervening use or material improvement by the charity, the deduction is limited to the amount of gross proceeds from its sale.
2. If the charity intends to make significant intervening use of or materially improve the car, the taxpayer generally can deduct its FMV.

Taxpayer must get a contemporaneous written acknowledgment from the charity and attach it to their income tax returns, Form 1040, U.S. Individual Income Tax Return. If taxpayers do not have an acknowledgment, they cannot deduct their contribution. Taxpayers must obtain the acknowledgment

no later than 30 days after the date the charity sells the car or 30 days from the date of the contribution if the charity intends to make significant intervening use of or materially improve the car.

Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes, should be used by donor organizations to report the contributions of qualified vehicles to the IRS and may be used to provide the donor with written acknowledgment of the contribution.

Deductions Subject to the 2% AGI Limit

Miscellaneous Deductions

The following deductions are subject to the 2% AGI limit:

- Unreimbursed employee business expenses subject to the 2% AGI limit include employment-related educational expenses; expenses for travel, meals, and entertainment (subject to 50% rule); and expenses for lodging, work clothes, dues, fees, and small tools and supplies.
- Employee business expenses reimbursed under a nonaccountable plan are subject to the 2% AGI limit.
- Investment expenses subject to the 2% AGI limit include legal, accounting, and tax counsel fees (not deducted elsewhere in the tax return); clerical help and office rental; and custodial fees.
- Job-hunting expenses may be deductible if one is looking for employment. Job hunters' expenses are deductible if the expenses are incurred in looking for a new job in one's present occupation. The job-searching expenses are not deductible if one is looking for a job in a new occupation or looking for a first job. Factors to determine whether the employment is in the same occupation include job classification, job responsibility, and nature of employment. The following are expenses that may be deductible:
 - ◆ Cost of typing, printing, and mailing resumes
 - ◆ Long-distance phone calls and mailing
 - ◆ Career counseling and agency fees
 - ◆ Travel or transportation expenses

Other deductions include professional dues, books, journals, safe-deposit box rental, hobby expenses not exceeding hobby income, office-in-the-home expenses, and indirect miscellaneous deductions passed through grants or trusts, partnerships, and S corporations.

Meal Expenses

Meal expenses must be directly related to the active conduct of the taxpayer's trade or business (i.e., an organized business meeting or a meal at which business is discussed). A meal taken immediately preceding or following a business meeting will qualify if it is associated with the active conduct of the taxpayer's trade or business. The deductible portion of meal and entertainment expenses paid in connection with a trade or business is 50%. Self-employed individuals claim this deduction on either Form 1040 Schedule C (Profit or Loss from Business [Sole Proprietorship]) or Schedule F (Profit or Loss from Farming), whereas employees deduct 50% of any unreimbursed business meals on Form 1040 Schedule A (Itemized Deductions and Interest & Dividend Income). The deductible percentage of the cost of meals consumed by employees subject to the Department of Transportation (DOT) increased from 75% for 2006 and 2007 to 80% in 2008 and after. DOT employees include Federal Aviation Administration (FAA) employees (pilots, crews, etc.), railroad employees, and interstate truck and bus drivers under DOT regulations.

Itemized Deductions (Overall Limitation)

A taxpayer should itemize if total itemized deductions are greater than his or her standard deduction. The election to itemize can be made or revoked on a timely filed, amended return. The limitation for high-income taxpayers must be considered when comparing itemized deductions with the standard deduction.

The itemized deduction 3%/80% reduction rule for married filing separately in 2007 begins at \$78,200 (AGI), and the limit for all other taxpayers starts at \$156,400 (AGI).

Taxpayers with a 2007 AGI in excess of the limits previously mentioned must reduce all itemized deductions except medical expenses, investment interest, casualty losses, and wagering losses to the extent of wagering gains. Starting in 2006 the reduction equals two-thirds of the lesser of 3% of excess AGI or 80% of the applicable itemized deductions. This net 2% of excess AGI will be the most common reduction and will not be a major additional tax burden unless AGI is very high and the taxpayer has significant applicable itemized deductions. The 7.5% of AGI medical expense adjustment and 2% floor on miscellaneous itemized deductions must be applied before the high-income deduction.

Example 3. Fred and Ann Veryrich's 2007 AGI is \$176,400. Their itemized deductions total \$17,000, including \$12,000 of deductible medical expenses (after the 7.5% AGI deduction) and investment interest. They claim no casualty or wagering losses. They must reduce their itemized deductions as follows:

- $\$176,400 \text{ AGI} - \$156,400 \text{ maximum} = \$20,000 \text{ excess}; \$20,000 \text{ excess} \times 0.03 = \$600.$
- \$600 is less than \$4,000 ($0.80 \times \$5,000$ of applicable itemized deductions).
- $\$600 \times 2/3 = \$400.$
- They reduce itemized deductions by \$400; $\$17,000 - \$400 = \$16,600$ adjusted itemized deductions.

Starting in 2008 the otherwise applicable phaseout is reduced by two-thirds and completely eliminated after 2009.



Planning Pointer

In 2010 there is no phaseout of itemized deductions. This is another tax-planning management area for those who are subject to deduction phaseouts. If they can delay their itemized deductions from 2007 to 2008 and from 2009 to 2010, they will pay less tax.

Interest and Ordinary Dividends (Form 1040 Schedule B)

Most taxpayers do not have to file a separate Schedule B (Form 1040), Interest and Ordinary Dividends, if they have interest or *ordinary* dividend income of \$1,500 or less. Form 1040, U.S. Individual Income Tax Return, filers with over \$1,500 are required to use 1040 Schedule B to list the names and amounts of those who paid them; Form 1040A filers use Schedule 1, Interest and Ordinary Dividends for Form 1040A Filers. In addition to having one less form to file (for many), this enables many taxpayers to use the shorter Form 1040EZ (TeleFile filing by telephone is no longer an option). The \$1,500 threshold replaced the old reporting threshold of \$400. This also affects filers with foreign bank accounts. Filers with less than \$1,500 to report no longer need to file Schedule B to report only on Part III. However, they may need to file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts. Note that failing to file Form TD F 90-22.1 may be subject to a penalty.

Qualified Dividend Income

Noncorporate taxpayers who have qualified dividend income will be taxed at reduced adjusted capital gains rates of 5% or 15%, rather than at ordinary income rates of 10% to 35%. Under the 2003 act, qualified dividends received from domestic and qualified foreign corporations generally will be taxed at the same rates that apply to capital gains. Qualified dividends under this provision and as extended will be taxed at rates of 5% (zero in 2008, 2009, and 2010) and 15%. The act increases the amount of net capital gain (determined separately) by the amount of the taxpayer's eligible qualified dividend income. The act does not change the definition of net capital gain. Qualified dividend income is taxed at the same rates as net capital gain. This applies for purposes of both regular tax and the alternative minimum tax.

Requirements for qualified dividends for tax years beginning after December 31, 2002, are as follows:

- The definition of a dividend is a distribution of property, including money, by a corporation to its shareholders where it is paid out of current or accumulated profits and earnings.
- Payments that are called dividends that do not meet the preceding definition are not eligible for qualified dividend income treatment—for example, dividends paid by cooperatives to their patrons, dividends paid to policyholders by their insurance companies, and distributions from money market funds (even though they are called dividends). Regulated investment companies (RICs; i.e., most mutual funds) can generally distribute qualified dividend income only to the extent that the RIC received qualifying dividend income. RICs will notify shareholders of the amount of any qualified dividend income distributed.
- Any dividend received from a real estate investment trust (REIT) is subject to limitations of I.R.C. §§ 854 and 857. The 2003 act provides pass-through of qualified dividend income for RICs and REITs for any taxable year that the aggregate qualifying dividends received by the company or trust are less than 95% of its gross income, and may not exceed the amount of the aggregate qualifying dividends received by the company or trust.
- The act provides that the reduced rates do not apply to dividends received from any organization that is exempt under I.R.C. §501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or in the preceding year.
- Dividends received from a mutual savings bank that received a deduction under I.R.C. § 591 or deductible dividends paid on employer securities are not qualified dividends.
- Dividends must be received by individual taxpayers (noncorporate).
- A shareholder must hold the dividend-paying stock for at least 61 days during a 121-day period (a technical correction from 120 days) beginning 60 days before the stock trades without its dividend (the ex-dividend date) and including the 60 days after the ex-dividend date [I.R.C. §246(c)]. The holding period changed so that, under the new law, a stock bought on the last day before the ex-dividend date could still meet the holding-period test because there are 61 days left in the 121-day period. Likewise, a stock sold on the ex-dividend date could meet the test because that is the 61st day in the period.
- A similar, but longer, holding period exists for preferred stock dividends attributable to a period exceeding 366 days. This holding period is at least 91 days during a 181-day period beginning 90 days before the ex-dividend date.
- Mutual funds, regulated investment companies, and REITs that pass through dividend income to a shareholder must meet the holding-period test in order to report qualified dividends on Form 1099-DIV, Dividends and Distributions.
- Taxpayers cannot offset or reduce qualified dividend income by other types of capital losses. Capital gains and losses are calculated separately from qualified dividend income.
- Individuals will have to add qualified dividend income to net capital gain in computing their tax on Form 1040, U.S. Individual Income Tax Return, line 44 from the Dividend and Capital Gain Tax Worksheet.

- Qualified dividend income will be reported on 1099-DIV and totaled on Form 1040 line 9b.
- Any dividend on a share of stock, to the extent that the taxpayer is under an obligation to make related payments with respect to positions in similar or related property, is not qualified dividend income.
- Payments in lieu of dividends are not qualified dividend income.
- Dividends paid in tax years beginning after 2010 do not qualify, because the Internal Revenue Code reverts to previous provisions.



Practitioner Note

Dividends declared and made payable by mutual funds in October, November, or December are considered received by shareholders on December 31 of the same year, even if actually paid during January of the following year.



Practitioner Note

On many Form 1040 returns, there have been errors in reporting dividends. Taxpayers were concerned about double accounting and did not report on 1040 line 9a the *total* dividends (qualified and nonqualified), and did not list on line 9b the qualified dividend amount previously included on line 9a.

Electronic Information Returns

Forms such as 1098, 1099, and 5498 can be furnished to the taxpayer electronically if the recipient consents. Electronic furnishing of Form W-2, Wage and Tax Statement, was previously authorized.

Foster-Care Payments

Foster-care payments made by qualified tax-exempt agencies and government agencies can qualify for exclusion from income under I.R.C. §131. The definition of a qualified individual was previously expanded and may include individuals over age 18.



Practitioner Note

The foster-care provider must live in the same home where the care is provided.

Uniform Method for Determining a Child's Age

The IRS has had several rules for determining a child's age for many of the income tax credits. Rev. Rul. 2003-72 clarified and made a more uniform determination of the age threshold for various sections of the tax code. A child born on January 1, 1990, is 17 on January 1, 2007. This same child on December 31, 2006, is considered 16 years old. This rule holds for dependent-care credit, child tax credit, EIC, dependent-care assistance programs, foster-care payments, adoption credit, adoption assistance programs, and dependency exemptions.

The same uniform method does not apply to senior citizens. They attain an age on the day before their birthday for most income tax benefits. A person who was born on January 1, 1943, is considered to be 65 on December 31, 2007, and may claim the additional deduction in addition to the standard deduction. It looks like age has its benefits.

Title II of the 2004 act reduces the complexity by reconciling the five definitions of a child in the tax code into a single definition for a “qualifying child” discussed later.

Earned Income Credit (EIC)

Basic EIC rates have been gradually increasing, and some low-income workers without qualifying children are eligible for EIC. Earned income includes wages, salaries, tips, and net self-employment earnings but does not include interest, dividends, alimony, and social security benefits.

Taxpayers in 2007 will use AGI to determine if they qualify for EIC subject to disqualified income, number of children, and phaseouts.

Use Figure 4 to see whether the taxpayer’s earned income and number of qualified children meet the requirement for the credit, and refer to the IRS tables for the 2007 credit amount.

It is possible for a low-income taxpayer to be eligible for EIC even though that taxpayer does not have a qualifying child. To be eligible, such a taxpayer must be age 25 or older, but under 65 years of age. A married taxpayer that does not meet the minimum age requirement may be eligible if his or her spouse meets the minimum age requirement. Other eligibility rules for the low-income taxpayer are the following: He or she cannot be claimed as a dependent or a qualified child on another person’s tax return; his or her principal residence must be in the United States for more than one-half of the tax year; the return must cover a 12-month period; the taxpayer cannot file a separate return if married; and the taxpayer cannot file Form 2555, Foreign Earned Income, or Form 2555-EZ. The credit percentage is much smaller (7.65%) for taxpayers with no qualifying children, and the credit is phased out over a lower income range.

FIGURE 4. EIC Rates, Income Ranges, and Phaseouts*

Earned Income or AGI Range for Taxpayers <i>Not</i> Filing as Married Filing Jointly (for 2007)					
Qualifying Children	Credit Rate (%)	Maximum Credit	Phaseout	Phaseout Rate (%)	Maximum Credit
None	7.65	\$ 5,600–7,000	\$ 7,000–12,590	7.65	\$ 428
One	34.00	8,350–15,400	15,400–33,241	15.98	2,853
Two or more	40.00	11,750–15,400	15,400–37,783	21.06	4,716
Earned Income or AGI Range for Married Filing Jointly (for 2007)					
Qualifying Children	Credit Rate (%)	Maximum Credit	Phaseout	Phaseout Rate (%)	Maximum Credit
None	7.65	\$ 5,600–9,000	\$ 9,000–14,590	7.65	\$ 428
One	34.00	8,350–17,400	17,400–35,241	15.98	2,853
Two or more	40.00	11,750–17,400	17,400–39,783	21.06	4,716

*This is not an official IRS table. Do not use these figures in tax preparation because numbers are adjusted annually for inflation, and the amount of credit is normally determined by using EIC tables, within \$50 ranges, released by the IRS.

To be eligible for EIC, any taxpayer must have all of the following:

- Earned income
- Earned income and AGI, each below the maximum earned income allowed
- A return that covers 12 months (unless a short-year return is filed because of death)
- A joint return if married (usually)
- Included income earned in foreign countries and not deducted or excluded as foreign-housing amount
- Not be used as a qualifying child who is making another person eligible for the EIC

The 1996 act expanded *disqualified income* to include (among other income items) *capital gain net income*. To disqualify more taxpayers, the law said gains from the sale of passive investments should be included as disqualified income. The IRS *originally* said this included gain from the sale of assets used in a trade or business. This interpretation included assets that met the holding-period requirements of I.R.C. § 1231; these assets are not subject to the recapture rules of I.R.C. §§ 1245, 1250, 1252, and so on. In Rev. Rul. 98-56 (November 1998), the IRS announced that they were reversing their position retroactively as follows:

Section 32 of the Internal Revenue Code allows an EIC to eligible individuals whose income does not exceed certain limits. Section 32(i) denies the earned income credit to an otherwise eligible individual if the individual's "disqualified income" exceeds a specified level for the taxable year for which the credit is claimed. Disqualified income is income specified in § 32(i)(2). Gain that is treated as long-term capital gain under 1231(a)(1) is not disqualified income for purposes of 32(i).

Therefore, gain from the sale of equipment and livestock (e.g., sows, boars, beef cattle, horses, or cull dairy cows) that are I.R.C. § 1231 property is not disqualified income.

In 2007 the EIC is denied to all taxpayers with an excess of \$2,800 of taxable and nontaxable interest income, dividends, net capital gains (excluding those from I.R.C. § 1231 assets), and net income from rents and royalties not derived in the ordinary course of business. All gains from the sale of business assets, including ordinary gains (Form 4797, Sales of Business Property, Part II) and gains recaptured as ordinary income (Form 4797, Part III), are not included in disqualified income.

A member of the U.S. Armed Forces who served in a combat zone may elect to treat combat pay that is otherwise excluded from gross income (under I.R.C. § 112) as earned income for purposes of the EIC. See Combat Zone Exclusion in Pub 3. The amount of nontaxable combat pay should be shown in box 12 of Form(s) W-2 with code Q. If the taxpayer is filing a joint return and both spouses received nontaxable combat pay, they can each make their own election to treat combat pay that is otherwise excluded from gross income as earned income for purposes of the EIC. The elected amount(s) must be reported on line 66b of Form 1040, U.S. Individual Income Tax Return.

Uniform Definition of a Qualifying Child

Beginning in 2005, one definition of a qualifying child is applied for each of the following tax benefits:

- Dependency exemption
- Head of household filing status
- Earned income credit (EIC)
- Child tax credit
- Credit for child- and dependent-care expenses

Tests to Meet

In general, all four of the following tests must be met to claim someone as a qualifying child. Also, there is a citizenship test that must be met.

1. Relationship Test

The child must be the taxpayer's child (including an adopted child, stepchild, or eligible foster child), brother, sister, stepbrother, stepsister, or a descendant of one of these relatives. An adopted child includes a child lawfully placed with the taxpayer for legal adoption even if the adoption is not final. An eligible foster child is any child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

2. Residency Test

A child must live with the taxpayer for more than half of the year. A temporary absence for special circumstances, such as for school, vacation, medical care, military service, or detention in a juvenile facility, count as time lived at home. A child who was born or died during the year is considered to have lived with the taxpayer for the entire year if the taxpayer's home was the child's home for the entire time he or she was alive during the year. Also, exceptions apply, in certain cases, for children of divorced or separated parents and parents of kidnapped children.

3. Age Test

A child must be under a certain age (depending on the tax benefit) to be a taxpayer's qualifying child.

4. Support Test

The child cannot have provided over one-half of his or her support during the year.

Dependency Exemption, Head-of-Household Filing Status, and EIC

For purposes of these tax benefits, a child must be under the age of 19 at the end of the year, or under age 24 at the end of 2007 if a student, or any age if permanently and totally disabled.

A student is any child who, during any 5 months of the year:

1. Was enrolled as a full-time student at a school or
2. Took a full-time, on-farm training course given by a school or a state, county, or local government agency

A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence school, or night school.



Practitioner Note

An adopted child is any child placed with a taxpayer by an authorized placement agency for legal adoption, even if the adoption is not final. An authorized placement agency includes any person authorized by state law to place children for legal adoption. A grandchild is any descendant of a taxpayer's son, daughter, stepchild, or adopted child. A foster child is any child a taxpayer cares for as his or her own child and who is placed with that taxpayer by an authorized placement agency.

Individuals with qualifying children will not be allowed EIC if they fail to identify those children by name, age, and taxpayer identification number (TIN) on their returns.

The following are previous changes to the EIC:

- The EIC phaseout ranges (both beginning and ending) for married joint filers increased by \$2,000 starting in 2005, and an additional \$1,000 increase is planned for 2008.
- In cases where a child may be claimed by two taxpayers, the tiebreaker rule was changed in 2002. Rather than the taxpayer with the highest modified AGI claiming the child, the claim will go to (1) the child's parent, or (2) if (1) does not apply, then the taxpayer with the highest AGI.
- The definition of earned income for purposes of calculating the credit will include only compensation included in gross income and net self-employment (SE) income. Previously, it included compensation excluded from income.
- The residency requirement for a foster child is that the child "has to live with the taxpayer for more than 6 months rather than for the entire year."

EIC Reminders for Farmers

If earned income is negative, there is no EIC. Therefore, a farmer with a negative Form 1040 Schedule F, Profit or Loss from Farming, net farm profit would not get a credit unless there were wages and/or Form 1040 Schedule C, Profit or Loss from Business (Sole Proprietorship), income more than enough to offset the loss on Form 1040 Schedule F, or the optional method of reporting SE income is used. A farmer with a negative net farm profit may use the optional method of reporting up to \$1,600 of SE income to collect an EIC that would partially or wholly cover the SE tax and also provide one-quarter of social security coverage, providing disqualified income (such as interest and dividends), earned income, and AGI are all less than the maximums allowed.

If AGI is greater than the maximum allowed, there would be no credit even if earned income is below the maximum. Many dairy farmers could have a Form 1040 Schedule F profit in the EIC range but not get a credit (or at least it is limited) because of gains from cattle sales shown on Form 4797, Sales of Business Property (or any other source of income that is not classified as "earned"), which would be included in AGI.

Before attempting to manage the net farm profit or SE income to result in an EIC with which to pay the SE tax and provide social security coverage, a farmer needs to understand the EIC rules and the interactions between EIC, SE tax, and income tax.

The Earned Income Credit Advance Payment Certificate (Form W-5) may be used by any employee eligible for EIC to elect advanced payments from his or her employer. The EIC payments made by an employer to his or her employee offset the employer's liability for federal payroll taxes. Use the IRS tables to determine advanced payments of EIC. Advanced payments are limited to 60% of the credit amount for one qualifying child. The maximum that a taxpayer can receive throughout the year with his or her pay is \$1,648, regardless of the total number of children a taxpayer may have. A taxpayer may be able to claim a larger credit but must file his or her 2007 tax return to claim more. An employer's failure to make required advanced EIC payments is subject to the same penalties as failure to pay FICA taxes. Employers of farm workers do not have to make advance EIC payments to farm workers paid on a daily basis (IRS Pub. 225, Farmer's Tax Guide).

Child Tax Credits

The child tax credit allows taxpayers to claim a credit for each qualifying child less than 17 years of age at the end of the year. Generally, a qualifying child is one whom the taxpayer claimed as a dependent and is a son, daughter, adopted child, grandchild, stepchild, eligible foster child, or sibling, stepsibling, or their descendant as a U.S. citizen or resident alien. For the taxable year 2006 until the end of 2010 (2004 act extender), the tax credit is \$1,000. For taxpayers with AGI in excess of the applicable threshold

amount, the credit is phased out. The phaseout rate is \$50 for each \$1,000 of modified AGI (AGI plus certain foreign-source income), or fraction thereof, in excess of the following thresholds: \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing jointly, and \$55,000 for married individuals filing separate returns. See Figure 5 for an example of various filers with one child.

FIGURE 5. One Eligible Child, Tax Credit Phaseout Based on Modified AGI

	Threshold Starting MAGI	Completely Gone MAGI
Married joint return	\$ 110,001	\$ 130,001
Single or head of household	75,001	95,001
Married separate return	55,001	75,001

In addition, the child tax credit is limited by the amount of the income tax owed as well as any AMT tax owed. For example, if the amount of the credit a taxpayer can claim is \$1,000, but the amount of the taxpayer's income tax is \$500, the credit ordinarily will be limited to \$500.

For 2007, the total amount of the child tax credit and any additional child tax credit cannot exceed the maximum of \$1,000 for each qualifying child.

Individuals entitled to receive the child tax credit and additional child tax credit may also be eligible to receive the child- and dependent-care credit and the earned income tax credit.

Taxpayers may claim the child tax credit on Form 1040, U.S. Individual Income Tax Return, or 1040A or file electronically, the credit is not available for those that file Form 1040EZ.

Child- and Dependent-Care Credits

If a taxpayer paid someone to care for a child or a dependent so he or she could work, he or she may be able to reduce income tax by claiming the credit for his or her child- and dependent-care expenses on his or her federal income tax return. This credit is available to people who, in order to work or to look for work, have to pay for child-care services for dependents under age 13. The credit is also available if they paid for care of a spouse or a dependent of any age that is physically or mentally incapable of self-care.

The initial rate of credit is 35% of qualified expenses. The rate is decreased by 1% for each \$2,000 (or fraction thereof) of AGI over \$15,000, but the percentage never goes below 20%. The credit rate is reduced to 20% for eligible taxpayers with AGIs over \$43,000. The maximum credit for individuals with AGIs under \$15,001 is \$1,050 for one qualifying individual and \$2,100 for two qualifying individuals.

For 2007, taxpayers may use up to \$3,000 of the expenses paid in 2007 for one qualifying individual, or \$6,000 for two or more qualifying individuals. These dollar limits are reduced by the amount of any dependent-care benefits provided by an employer that was excluded from income.

To claim the credit for child- and dependent-care expenses, a taxpayer must meet the following conditions:

- Must have earned income from wages, salaries, or other taxable compensation, or net earnings from self-employment. If married, both must have earned income, unless one spouse was either a full-time student or was physically or mentally incapable of self-care. If the taxpayer chose to include nontaxable combat pay in earned income when figuring the earned income tax credit for 2007, also include it in earned income when figuring the amount of dependent-care benefits to exclude or deduct from income.

- Payments for care expenses cannot be paid to someone claimed as a dependent on the return or to a child who is under age 19.
- The filing status for this credit must be single, head of household, qualifying widow(er) with a dependent child, or married filing jointly.
- The care must have been provided for one or more qualifying persons identified on Form 2441, Child- and Dependent-Care Expenses, to claim the credit.
- The taxpayer (and, if the taxpayer is married, his or her spouse) must maintain a home that he or she lives in with the qualifying child or dependent.

Adoption Tax Benefits

A \$11,390 credit per child (including special-needs children) is allowed for qualified adoption expenses paid or incurred by a taxpayer. This credit is phased out ratably for taxpayers with modified AGI (MAGI) between \$170,820 and \$210,820. Eligible children are under 18 or are incapable of caring for themselves. There are several special rules on the timing of the credit in I.R.C. §§ 23 and 137. For special-needs children, the credit is allowed only for the year in which the adoption becomes final. The adoption credit is allowed against regular tax and AMT, less other nonrefundable credits and foreign tax credits. To take this credit or exclusion, complete Form 8839, Qualified Adoption Expenses.

In addition to the adoption credit, employer-paid or employer-reimbursed funds under an adoption assistance program are excludable. An employee may be eligible for both the credit and exclusion, provided they are not for the same expenses. The exclusion from gross income of employer adoption assistance cannot happen until the year in which a special-needs adoption becomes final.

Education Incentive Opportunities

Figure 6 presents the benefits, restrictions, and limitations on several tax incentives for participants in higher education.

FIGURE 6. Education Incentive Program

	Hope Credit	Lifetime Learning Credit
Tax incentives	Per student: 100% of first \$1,100 and 50% of next \$1,100 used for tuition and fees for higher education for at least half-time students incurring expenses during the tax year (increased amounts for 2006 and 2007)	Per taxpayer: 20% of first \$10,000 for tuition and fees for any higher education, including upgrading skills, paid on behalf of taxpayer, spouse, or dependent to whom taxpayer is allowed an exemption
Restrictions	<ul style="list-style-type: none"> * Only for first 2 postsecondary years * May not be claimed using any expenses paid by a Coverdell education savings account (ESA) distribution * Maximum of 2 tax years * Nonrefundable * Not allowed for persons claimed as dependents on another taxpayer's return 	<ul style="list-style-type: none"> * May not be claimed in the same tax year for the same person as claimed for the Hope credit * May not be claimed using any expenses paid by a Coverdell ESA distribution * Nonrefundable
MAGI limits	Phaseout range starts at \$47,000 and ends at \$57,000 for singles; the range is \$94,000 to \$114,000 for joint returns; and the credit is not available to married filing separately.	Phaseout range starts at \$47,000 and ends at \$57,000 for singles; the range is \$94,000 to \$114,000 for joint returns; and the credit is not available to married taxpayers filing separately.
Coverdell ESA		
Tax incentives	<ul style="list-style-type: none"> * Up to \$2,000 of nondeductible contributions (from all contributors) per beneficiary as a trust account or custodial account for qualified higher education expenses for the withdrawal year of a designated beneficiary * Liberalized expense items including elementary, secondary, special-needs, and technology purchases <p>Caution: Any balance remaining after the beneficiary reaches 30 or dies is deemed distributed within 30 days. The age 30 distribution rule does not apply to special-needs beneficiaries.</p>	
Restrictions	<ul style="list-style-type: none"> * 10% penalty plus tax on unqualified withdrawals * Cash contributions only * No contributions after account holder attains age 18 <p>(The age 18 contribution rule does not apply to special-needs beneficiaries.)</p>	
MAGI limits	Phaseout range starts at \$95,000 and ends at \$110,000 for singles; the range is \$190,000 to \$220,000 for joint returns; and the credit is not available to married taxpayers filing separately. Only individuals have phaseouts; corporations and other entities may contribute regardless of AGI.	
Deadline for contribution	Contribution deadline is April 15 (not including extensions) of the following year, and distributions of excess contribution will not be subject to additional tax if made on or before June 1 of the year following contribution.	

Continued

Student Loan Interest Deduction

Tax incentives	An above-the-line adjustment to gross income rather than an itemized Form 1040 Schedule A deduction: up to \$2,500 for 2007 for interest paid on loans for higher education expenses while at least half-time student. Deduction is allowed with respect to interest paid over any period of time.
Restrictions on a qualifying loan	<ul style="list-style-type: none"> * No deduction if student is allowed as dependent on another taxpayer's return * No double benefits, as with home equity loans * See Final Regulations T.D. 9125, 5/6/2004, summary following Figure 6.
MAGI limits	Phaseout range starts at \$55,000 and ends at \$70,000 for singles; the range is \$110,000 to \$140,000 for joint returns; and the deduction is not available to married taxpayers filing separately.

Qualified Tuition Program

Qualified tuition program	Sponsored by a state to purchase tuition credits or save for payment of higher education expenses (known as 529 plans, named after the I.R.C. section that allows these plans). (Must be state-sponsored or an educational institution meeting requirements.)
Taxation of earnings used for higher education in state-sponsored program	Distributee excludes earnings from taxation. If not used for qualified expense, the distributee is taxed on earnings and there is a 10% penalty (some exceptions).
Beneficiary	The definition of family members includes first cousins.
Coordination with lifetime learning and Hope educational credits	Taxpayers can claim credits and exclude from income earnings distributed from this program as long as the expenses claimed are not the same as those for which a credit was claimed.

2007 Deduction of Higher Education Expenses (Above-the-Line Benefits)

Deductible expenses	Qualified higher education expenses are tuition and related expenses of taxpayer, spouse, or dependents.
Deductible maximum	For 2007, \$4,000 is the maximum amount deductible for single taxpayers or heads of households (HOHs) whose MAGI doesn't exceed \$65,000 (\$130,000 for joint returns). For 2007, \$2,000 is the maximum amount deductible for single taxpayers or HOHs whose MAGI exceeds \$65,000 but doesn't exceed \$80,000 (\$160,000 for joint returns).
AGI limits (once exceeded the deduction is eliminated)	Limits are \$80,000 for single taxpayers or HOHs and \$160,000 for married taxpayers filing jointly.
Ineligible taxpayers	<ul style="list-style-type: none"> * Married taxpayers filing separately and taxpayers that may be claimed by some one else * Taxpayers whose MAGI exceeds the applicable dollar limits already shown * Taxpayers that have claimed a Hope or lifetime learning credit for the year for the same student
Eligible taxpayers	Taxpayers under the preceding AGI limits are eligible. Taxpayers may claim an exclusion of distributions from a tuition plan, an educational IRA, or interest on educational savings bonds as long as not claimed using the same expenses.

The final regulations in T.D. 9125, May 6, 2004, clarify the student loan interest deduction.

- Capitalized interest is deductible as qualified educational loan interest. Loan origination fees or late fees are considered interest if they are a charge for the use of money rather than for specific services.
- Interest payments made by someone other than the taxpayer/borrower are treated as first paid to the taxpayer and then paid by the taxpayer to the lender. If the third party pays interest on the taxpayer's behalf as a gift, the taxpayer may deduct the interest.

Estimated Tax Rules

The minimum threshold after subtracting income tax withholding and credits for estimated tax payments is \$1,000. To avoid underpayment of estimated tax, individuals with prior-year AGI not exceeding \$150,000 (\$75,000 if married filing separately) must make timely estimated payments at least equal to (1) 100% of last year's tax, or (2) 90% of the current year's tax liability. However, for individuals who exceed the \$150,000 (\$75,000 if married filing separately) prior year's AGI amount, the safe harbor is 110%. Similar rules apply to trusts and estates.

Example 4. Susan Ford, a salesperson, has the financial situation depicted in Figure 7.

FIGURE 7. Susan Ford's Taxes on AGI

Expected AGI for 2007	\$65,150
Tax shown on 2006 return	10,500
Projected tax on 2007 return	12,000
Projected tax to be withheld in 2006	10,900

Susan expects to owe at least \$1,000 additional tax ($\$12,000 - \$10,900 = \$1,100$), so she should make an estimated tax payment; however, she expects her income tax withholding (\$10,900) to be at least 90% of the actual tax liability as shown on her 2007 return ($\$12,000 \times 90\% = \$10,800$). Therefore, Susan does not need to pay estimated tax nor will she have a penalty. Furthermore, since the amount withheld in 2007 exceeded her 2006 tax liability, she also would avoid estimated tax payments and penalties.

Farmers and fishermen who receive at least two-thirds of their total gross income from farming are exempt from estimated tax payments, providing they file and pay taxes by March 1. New York State (NYS) officially follows the federal definition of gross income from farming.

Retirement Plan Contributions

In the tax years 2006 and 2007, taxpayers have both opportunities and rewards for contributing to retirement plans. Figure 8 gives some increased limits in the plans over last year's limitations.

The upper and lower limits of the phaseout range for deductible IRAs has increased by \$5,000 for all filing statuses other than married filing separately. The deductible IRA phaseout MAGI limits for employees covered at work are as follows (dependent upon filing status):

Single, head of household	\$50,000–60,000
Married filing jointly	75,000–85,000
Married filing separately	0–10,000

The MAGI phaseout ranges for contribution to a Roth IRA are

Single, head of household	\$95,000–110,000
Married filing jointly	150,000–160,000
Married filing separately	0–10,000

FIGURE 8. Limitations on Contributions

	Year		
	2006	2007	2008
IRAs, traditional & Roth	\$ 4,000	\$ 4,000	\$ 5,000
Simple	10,000	10,500	
401(k), 403(b), 457, and SEP	15,000	15,500	
Defined contribution	44,000	45,000	
Defined-benefit plan ¹	175,000	180,000	
Compensation limit	220,000	225,000	
Stock bonus & profit share	25%	25%	

¹Maximum annual benefit to be funded.

Additional Contributions

Catch-up or additional contributions to certain retirement plans are made possible by the 2001 act for individuals age 50 and older. These contributions are additions to the above limits, but total contributions still cannot exceed his or her earnings. The IRA contributions are still subject to AGI phaseout limits. The catch-up contribution provision does not apply to after-tax employee contributions of I.R.C. § 457 plan participants in their last 3 years before retirement. Limits for catch-up contributions of certain retirement plans are given in Figure 9.

FIGURE 9. Catch-Up Contribution Limits

Year	IRA	Simple	401(k), 403(b), 457, and SEP
2003	\$ 500	\$ 1,000	\$ 2,000
2004	500	1,500	3,000
2005	500	2,000	4,000
2006+	1,000	2,500	5,000

Nonrefundable Credit Allowed for Elective Deferrals and IRA Contributions

Contributions to some IRAs and employer-sponsored retirement plans are deductible or excludable from income. Beginning in 2002, the 2001 act provides a nonrefundable tax credit for contributions made to qualified plans by eligible taxpayers. The amount of the credit depends on the taxpayer's AGI, and the maximum annual contribution eligible for the credit is \$2,000. There are limits on AGI, dependent upon the taxpayer's filing status. The AGI is determined without adjustments for

I.R.C. §§ 911, 931, and 933 (foreign income adjustments). Eligible individuals include those over 17, but not if they are full-time students or claimed as dependents on someone else's return. The credit is available on elective contributions to I.R.C. § 401(k) plans, I.R.C. § 403(b) annuities, I.R.C. § 457 plans (eligible deferred-compensation arrangement of a state or local government), SEPs or SIMPLEs, contributions to a traditional or Roth IRA, and voluntary after-tax employee contributions to a qualified retirement plan. The credit is reduced by amounts received over a previous period, as defined in the 2001 act, by taxable distributions from any qualified retirement plan or savings arrangement listed in Figure 9.

There is an exception that excludes distributions from a Roth IRA. The AGI-based credit rates for 2004 to 2007 are given in Figure 10.

FIGURE 10. Credit Rates Based on AGI

Joint Return		Head of Household		All Other Filers		Credit
Over	Not Over	Over	Not Over	Over	Not Over	Percentage
\$ 0	\$31,000	\$ 0	\$23,250	\$ 0	\$15,500	50%
31,000	34,000	23,250	25,500	15,500	17,000	20%
34,000	52,000	25,500	39,000	17,000	26,000	10%
52,000		39,000		26,000		0%

Roth 401(k)

For tax years after 2005, a 401(k) plan is permitted (but not required) to include a qualified Roth contributions program, under which a participant can elect to have all or a portion of the participant's elective deferrals (called designated Roth contributions) under the plan contributed to a designated Roth account and included in income when earned. A Roth 401(k) allows participants, after January 1, 2006, to make after-tax contributions up to the 401(k) maximum of \$15,500 for 2007 (plus \$5,000 catch-up if eligible). The advantage of the Roth 401(k) over the original Roth IRA is that it is not limited by the taxpayer's MAGI. Distributions at retirement will be tax-free.

Employer-Provided Education Assistance

The exclusion for up to \$5,250 of employer-paid educational assistance for undergraduates is available for courses beginning before January 1, 2011. The employer-paid education exclusion for graduate studies was effective for courses beginning in 2002 and remains until changed or until January 1, 2011. Be sure that this benefit is a written contract as an employee benefit, or the assistance might end up taxable to the employee. No more than 5% of the amounts paid by the employer during the year for educational assistance under a qualified plan can be provided to more than 5% owners of the employer and the spouses or dependents of such more than 5% owners.

Deduction for Teacher's Expenses

Eligible educators in public and private elementary and secondary schools who work at least 900 hours during the school year as a teacher, instructor, counselor, principal, or aide may claim a deduction for purchases of books and classroom supplies. They may deduct up to \$250 in qualified expenses on line 23 of the taxpayer's Form 1040, U.S. Individual Income Tax Return. Qualified expenses are unreimbursed expenses for supplies, books, equipment, and other materials used in the classroom. Educators should maintain records and receipts of qualifying expenses, noting the date, amount, and purpose of each purchase.

IRS Helps Heirs Locate Estate's Assets

If someone dies without a will, the IRS will allow heirs to see the last tax return filed before that person's death per Rev. Rul. 2004-68. Heirs must qualify that they have a financial interest in the information to determine if they have located all the estate's assets.

User Fees Required for Offers in Compromise

The IRS adopted final regulations requiring a \$150 user fee for processing offers in compromise. The fees are not refundable if the offer is withdrawn, rejected, or returned unprocessed. There will be no user fee for offers based solely on doubt as to liability, and no fees for low-income taxpayers (below poverty guidelines set by the Department of Health and Human Services). As previously mentioned, TIPRA requires partial payments to be submitted with an offer in compromise.

Five-Year Carryback of Net Operating Losses (NOLs)

The 2002 act temporarily extended the net operating loss (NOL) carryback period to 5 years for NOLs arising in taxable years ending in 2001 and 2002. This did not affect farm NOLs that already qualify for the 5-year carryback. For NOLs arising in 2003 and later, the former 2-year carryback rule applies to nonfarm NOLs. Taxpayers are not forced to use the longer carryback period for 2001 and 2002 NOLs. Taxpayers may elect out of the 5-year period, but the election is irrevocable. Taxpayers had the choice of two elections: one to not have the 5-year carryback, and one to waive the carryback entirely. Farmers continue to have these choices regarding farm NOLs.

2007 Form 1040 Draft as of June 8, 2007

- The 2006 line 23 for Archer MSA deduction with attachment of Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, is now drafted on the 2007 Form 1040, U.S. Individual Income Tax Return, as educator expenses
- The 2006 line 47 for foreign tax credit with attachment Form 1116, Foreign Tax Credit (Individual, Estate, or Trust), where necessary is now drafted on the 2007 Form 1040 on line 51.
- The 2006 line 48 for credit for child- and dependant-care expenses with attachment of Form 2441, Child- and Dependent-Care Expenses, is now drafted on the 2007 Form 1040 on line 47.
- The 2006 line 49 for credit for the elderly or the disabled with attachment of Schedule R, Credit for the Elderly or Disabled, is now drafted on the 2007 Form 1040 on line 48.
- The 2006 line 50 for education credits with attachment of Form 8863, Education Credits (Hope and Lifetime Learning Credits) is now drafted on the 2007 Form 1040 on line 49.
- The 2006 line 51 for retirement savings contributions credit is now drafted on the 2007 Form 1040 on line 53.
- The 2006 line 52 for residential energy credits with attachment Form 5695, Residential Energy Credits, is now drafted on the 2007 Form 1040 on line 50.
- The 2006 line 53 for child tax credit with attachment Form 8901, Information on Qualifying Children Who Are Not Dependents (For Child Tax Credit Only), if necessary is now drafted on the 2007 Form 1040 on line 52.
- The 2006 line 59 for unreported social security and Medicare tax is now called “Social security and Medicare tax on tip income not reported to employer” on the 2007 line 59 draft of Form 1040.

The IRS simplified the signature requirements of tax return preparers. Notice 2004-54 says that income tax return preparers may sign original returns, amended returns, or requests for filing extensions by rubber stamp, mechanical device, or computer software program. But the taxpayer must still provide his or her true signature on the return sent to the IRS.

Form 941 Quarterly Payroll Tax Return

Starting in 2006 employers that deposit less than \$2,500 per quarter in payroll taxes can file Form 941, Employer's Quarterly Federal Tax Return, once a year if they have an on-time payment record for at least 2 years.

LONG-TERM CAPITAL GAINS RATES

The paperwork on capital gains continues to be challenging. Schedule D (Form 1040), Capital Gains and Losses, itself has been simplified, but now there are two versions of the worksheet to complete, plus capital gains require careful attention to page 2 of Form 6251, Alternative Minimum Tax—Individuals. The 2003 tax act lowered the two basic capital gains rates to 5% and 15% (previously 10% and 20%). These lower rates of tax apply to adjusted net capital gain, which is calculated as the excess of net long-term capital gain over any net short-term capital loss for the tax year. A taxpayer's gain or loss is treated as long-term only if the asset is held the required holding period. Rates of 25% and 28% continue to apply to certain types of capital gains (discussed later).

For all of 2007, the maximum rate of tax on adjusted net capital gain of an individual is 15%, or 5% if the taxpayer would have been taxed at the 10% or 15% rate on ordinary income. These lower rates apply to both regular and alternative minimum tax.



Planning Pointer

For 2008 the tax rate on adjusted net capital gains may be zero. A taxpayer who files a joint return with a spouse and has only adjusted net capital gain could have taxable income of as much as \$63,700 and pay no federal income tax. Such taxpayers may wish to delay asset sales from 2007 to 2008 in order to avoid the current federal 5% capital gains tax rate. Note: NYS does not have such a provision.

Some assets are excluded from adjusted net capital gains and are ineligible for the lowest long-term rates. Gain from the sale of I.R.C. § 1250 property (general-purpose buildings and other depreciable real estate) that would be ordinary income under I.R.C. § 1245 depreciation recapture rules, and that has not already been taxed as ordinary gain under I.R.C. § 1250, has a maximum tax rate of 25%. The maximum rate on net capital gain from the sale of collectibles and certain small business stock under I.R.C. § 1202 remains at 28%.

In order to qualify as long-term, assets must be held the required holding period. Cattle (dairy or breeding) and horses (breeding, sport, work, or draft) must be held for 24 months to qualify for the 5% or 15% capital gain rates. The holding period for other I.R.C. § 1231 assets, as well as capital assets, to qualify for these rates remains at 12 months. Short-term gains are still taxed as ordinary income. For assets other than livestock, the holding period begins the day after the date of acquisition.

Taxpayers who are not required to file a Form 1040 Schedule D, Capital Gains and Losses, can enter capital gain distributions from mutual funds directly on Form 1040 line 13, check the box, and calculate the tax on all taxable income on the Qualified Dividends and Capital Gain Tax Worksheet. This worksheet provides the reduced capital gains tax rates on these distributions even though a Schedule D is not completed.

Installment-sale payments are taxed under the ordinary or capital gain rates in effect for the year received and not those in effect in the year of the actual sale. Consequently, payments received in 2007 are eligible for the lower rates.

Adjusted Net Capital Gain Exclusions

Adjusted net capital gain (ANCG) excludes unrecaptured gain from the sale of I.R.C. § 1250 assets (general-purpose buildings), gain on collectibles, and I.R.C. § 1202 small-business stock gain.

Computing Net Capital Gain

Remember that some or all of capital gain income can be taxed below its maximum rate if the taxpayer is in or *below* the 28% taxable income bracket. Noncorporate taxpayers will compute their net capital gains tax by applying capital gain income to the 10%, 15%, or 25% taxable income bracket in the following order:

1. If there are unused **10% or 15% taxable regular income rates** after applying the ordinary income to the 10% and 15% brackets, then
 - a. Unrecaptured I.R.C. § 1250 gain: The 25% maximum is reduced to the 10% or 15% ordinary tax rate, if the 10% bracket or 15% bracket is not fully used.
 - b. Collectibles and other 28% rate gain assets: The 28% maximum is reduced to the 10% or 15% ordinary tax rate, if the 10% bracket or 15% bracket is not fully used.
 - c. Adjusted net capital gain—remainder after (b): The 15% maximum is reduced to 5%.
2. If there is unused **25% taxable regular income rate bracket** after applying the ordinary income to the 25% brackets, then
 - a. Unrecaptured I.R.C. § 1250 gain: The 25% maximum is not reduced and is taxed at the 25% rate in the 25% bracket or any higher bracket.
 - b. Collectibles and other 28% rate gain assets: The 28% maximum is reduced to the 25% ordinary tax rate, if the 25% bracket is not fully used.
 - c. Adjusted net capital gain—remainder after (c) (from list 1): The 15% maximum is not reduced.
3. If there are unused **28% taxable regular income rates** after applying the ordinary income to the 28% brackets, then
 - a. Unrecaptured I.R.C. § 1250 gain: The 25% maximum is not reduced and is taxed at the 25% rate in the 28% bracket or any higher bracket.
 - b. Collectibles and other 28% rate gain assets: The 28% maximum is not reduced and is taxed at 28% in the 28% bracket or any higher bracket.
 - c. Adjusted net capital gain—remainder after (c) (from list 2): The 15% maximum is not reduced.

Example 5. Mr. and Mrs. F. P. Milker file a joint return, and their 2007 15% taxable income tax bracket goes to \$63,700. Their taxable income after personal exemptions and itemized deductions is \$66,600, exceeding the 15% bracket by \$2,900, as shown in Figure 11. Their taxable income includes \$6,000 of unrecaptured I.R.C. § 1250 gain from the sale of a farm building, \$3,500 of capital gain from the sale of antiques, and \$10,000 of ANCG from the sale of dairy cattle. All livestock sold were held over 24 months. Note that the 15% bracket was first filled with unrecaptured I.R.C. § 1250 gain and the 28% rate gain collectibles, allowing them to be taxed at the 15% rate. Then the 15% bracket was filled with ANCG (from the raised cows), allowing it to be taxed at 5%. Only the balance of the ANCG was pushed into the 15% capital gains rate.

FIGURE 11. Determination of Tax Rates with Various Income Sources

	Notes	Tax On	Tax Rate
Ordinary income		\$15,650	10%
Ordinary income		31,450	15%
Gain on farm building sale (unrecaptured I.R.C. § 1250 gain)	25%	6,000	15%
Gain on sale of antiques	28%	3,500	15%
Gain on sale of dairy cattle (ANCG, \$10,000 total)			
Held more than 2 years	15%	7,100	5%
Subtotal		<u>\$63,700</u>	
Amount in excess of 15% bracket sold		2,900	15%
Total taxable income		<u><u>\$66,600</u></u>	

Netting Capital Gains and Losses

The following rules apply to the netting of capital gains and losses:

1. Short-term capital losses, including carryovers, are combined with short-term capital gains. Any net short-term capital loss is used to reduce long-term capital gains in the following order: 28% sale gain, unrecaptured I.R.C. § 1250 gain (25%), and adjusted net capital gain (15%).
2. Gains and losses are netted within the four long-term capital gain groups to determine a net capital gain or loss for each group. There can be no net loss in the 25% group, which is limited to gain to the extent of straight-line depreciation.
3. A net loss from the 28% group (including long-term capital loss carryovers) is used to reduce gain in the 25% group, and then any net loss balance is carried to the lower groups.
4. A net loss from the 15% group is used to reduce gain from the 28% group, and any remaining net loss is carried to the 25% group.

Note that long-term capital loss carryovers are used to reduce gains or increase loss in the 28% group, regardless of the source of that carryover.

Net Capital Losses

A net capital loss results for the year if a taxpayer's capital losses on Form 1040 Schedule D, Capital Gains and Losses, exceed capital gains. Only a maximum of \$3,000 of any such net capital loss may be deducted in determining gross income for the current year (by transfer to page 1 of Form 1040). Any excess capital loss becomes a capital loss carryover to be used in future years (until used, there is no expiration). The capital loss carryover may be short-term, long-term, or a combination of the two, depending on whether it arises from Form 1040 Schedule D Part I, Part II, or both. In the year to which the loss is carried, the short-term capital loss carryover is entered in Part I, Form 1040 Schedule D; the long-term is entered in Part II. In either event, these losses net against any other gains and losses arising in this carryover year. Again, if the net result is a loss, the loss deduction is limited to \$3,000,

and any excess becomes a carryover to the following year. Short-term capital losses are considered used first in the event that only a portion of the capital losses of the year is deductible.

Inherited Property Rules

Legislation of recent years did not change the step-up in basis rule that gives a decedent's property a new basis equal to its FMV on the date of death (or alternative valuation date). Only gain that occurs after that date will be subject to income tax. Inherited property (except for I.R.C. § 1231 livestock) will automatically be considered as held for the required holding period for long-term capital gains treatment. For I.R.C. § 1231 livestock, the date acquired by the decedent is used to determine the holding period.

Capital Gains and AMT, Flow-Through Entities, and Small Business Stock

The lower long-term capital gains rates will be used to compute AMT (Form 6251, page 2). Entities such as S corporations, partnerships, estates, and trusts may pass through capital gains to their owners or beneficiaries and must make the determination of when a long-term capital gain is taken into account on its books.



Practitioner Note

Taxpayers who make gifts of stock held over 1 year to their children at least 18 years old and in the 10% or 15% bracket may be able to lower their overall tax liability. Parents may want to buy back the same securities in the open market because wash-sales restrictions do not apply when capital gains are realized.

On the sale or exchange of small business stock (I.R.C. § 1202 stock) held for more than 5 years, 50% of the gain may be excluded from the taxpayer's gross income. The remaining capital gain is taxed at 28%. Gain eligible for the 50% exclusion may not exceed the greater of \$10 million or 10 times the taxpayer's basis in the stock. If such small business stock is sold before meeting the 5-year holding requirement, there is no exclusion, and the gain will be taxed at the normal maximum capital gains tax rate (if the required holding period has been met). This 50% exclusion amount is a tax preference item for AMT purposes.

SALE OF TAXPAYER'S PRINCIPAL RESIDENCE

Currently, there is an exclusion of gain from the sale of a principal residence amounting to \$250,000 (\$500,000 for joint filers). The old (pre-May 7, 1997) rollover of gain provision and the 55 years of age requirement were repealed and replaced with this current exclusion under I.R.C. § 121.

This new exclusion can be used by taxpayers of any age on each home they have owned and used as a principal residence for at least 2 years during the 5-year period ending on the sale date. Use of the exclusion is limited to once every 2 years. Use of the old exclusion prior to May 7, 1997, does not affect the availability of the new exclusion. Married taxpayers filing joint returns are eligible for a \$500,000 exclusion if all of the following apply: either spouse has owned the residence for at least 2 years, both spouses have lived in it for at least 2 years, and neither spouse has used the new exclusion in the past 2 years.

Married spouses who qualify for the \$500,000 exclusion may elect to exclude \$250,000 of gain from the sale of each spouse's principal residence within a 2-year period. Those who are married and filing jointly, but are living apart, also get the \$250,000 exclusion on the qualified sale of each spouse's principal residence. A recently married spouse does not lose eligibility for the \$250,000 exclusion by marrying a taxpayer that has used the exclusion within 2 years.

A partial exclusion may be claimed by taxpayers who have excluded the gain on the sale of another home sold within 2 years of the current sale, if the current sale was due to a change in place of employment, change in health, or unforeseen circumstances of a qualifying individual. Regulations have been issued to provide safe harbors for these reasons, including the following unforeseen circumstances:

1. Involuntary conversion of the residence
2. A natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence
3. Death of a qualified individual
4. A qualified individual's cessation of employment, making him or her eligible for unemployment compensation
5. A qualified individual's change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household
6. A qualified individual's divorce or legal separation under a decree of divorce or separate maintenance
7. Multiple births resulting from the same pregnancy of a qualified individual

For this purpose, qualifying individuals are (1) the taxpayer, (2) the spouse, (3) the co-owner of the property in question, or (4) a person whose principal place of abode is the taxpayer's household.

Example 6. Mr. and Mrs. Jobhopper sold and moved out of their first home March 2, 2007, because of a change in employment. They began renting and living in that home on June 28, 2005, but did not buy it until August 4, 2005. They lived in the home for 612 days but owned it for only 575 days. Their partial exclusion is based on the portion of the 2-year (730 days) ownership requirement that they lived in the house (575 days), the shorter of the two requirements. Their partial exclusion for 2007 is \$393,850 ($575 \div 730 = 0.7877$; $0.7877 \times \$500,000 = \$393,850$); therefore Mr. and Mrs. Jobhopper can exclude up to \$393,850 of any gain realized on the sale of their residence.

Gains from insurance proceeds and other reimbursements for homes destroyed or condemned also qualify for the exclusion.

In certain situations, gain on the sale of a residence may be ineligible for the exclusion. The sale of a remainder interest in a home to a person related to or an entity owned by the taxpayer does not qualify.

Gain equal to any depreciation allowed or allowable for the business use of a home after May 6, 1997, cannot be excluded but would be recognized as gain from the sale of I.R.C. § 1250 property. Furthermore, if the structure with business use is not part of the dwelling unit, none of the gain from that structure qualifies for exclusion. Such a separate business-use structure would be reported on Form 4797, Sales of Business Property.

The final regulations state that the gain exclusion for the sale of residence applies to the sale of vacant land owned and used as part of the taxpayer's principal residence, provided that a qualifying sale of the dwelling unit occurs within 2 years before or after the sale of the related vacant land. The vacant land must be adjacent to land containing the dwelling unit. If the residence is not sold prior to filing the tax return for the year of the vacant land sale, the gain on the land must be reported and then an amended return filed when the qualifying residence is actually sold.

Other specific rules (1) affect transfers incident to a divorce, (2) define time of ownership for surviving spouses, and (3) define periods of use for taxpayer's transferred to nursing homes.

If any gain is to be recognized, the sale of residence is reported directly on Form 1040 Schedule D, Capital Gains and Losses. On the line directly below that used to report the total gain, the exclusion amount (if any) is listed as a loss with a description of "Section 121 exclusion." If no gain is to be recognized, no reporting is required, unless the taxpayer has received a Form 1099-S, Proceeds from Real Estate Transactions.

INCOME AVERAGING FOR FARMERS

Individual taxpayers with certain farm income may elect a 3-year method of income averaging. Elected farm income (EFI) is deducted from the current year's taxable income and, in effect, one-third of it is added to each of the 3 prior years' taxable income to be taxed at the rates of those prior years (referred to as *base years*). However, C corporations, estates, and trusts may not use the election. The IRS reports that this tax-saving method of calculating tax is being underutilized by taxpayers.

Elected Farm Income (EFI)

EFI is taxable income attributed to any farming business and designated to be included in the election. This includes not only net farm profits from Form 1040 Schedule F, Profit or Loss from Farming, but also an owner's share of net farm income from an S corporation (including wages), partnership, or limited liability company (LLC). It does not include wages from a C corporation. Gains from the sale of farm business property (excluding land and timber) regularly used in farming for a substantial period may be included in EFI. Farm NOLs must also be included, which may reduce the benefit of income averaging. A farming business includes nursery production, sod farming, the production of ornamental trees and plants, as well as the production of livestock, fruit, nuts, vegetables, horticultural products, and field crops. However, gain from the sale of trees that are more than 6 years old when cut is not eligible farm income, because these trees are no longer classified as ornamental trees. The income, gain, or loss from the sale of grazing and development rights or other similar rights classified as attributable to a farming business are not electable for farm income.

The terms *regularly used* and *substantial period* are not defined in the Internal Revenue Code or committee reports. Regulations (§ 1.1301-1) have clarified that if a taxpayer ceases farming and later sells farm business property (other than land) within a reasonable time after the cessation, the gains or losses from the sale will be considered farm income. If the sale is within 1 year, it will be deemed to be within a reasonable time. For sales beyond 1 year, one will need to consider all facts and circumstances.

The tax imposed when income averaging is elected will be the current year's federal income tax liability without the EFI, plus the increase in the 3 prior years' tax liability caused by the addition of one-third of the EFI to each of the years. Farm income averaging does not affect SE tax. Effective in 2004 and later years, the use of income averaging will not result in an increase in AMT.

Farm taxpayers who elect income averaging will be able to spread taxable farm income over a 4-year period and designate how much (in equal amounts in each of the 3 base years) and what type of farm income (ordinary or capital gains) to include in EFI. Form 1040 Schedule J, Income Averaging for Farmer and Fishermen, is used to compute and report the tax from income averaging. The relevant tax rates for capital gains apply in the current year as well as in the base-year calculations.

Example 7. Fruit growers Mr. and Mrs. B & B Goodyear have a substantial increase in farm income in 2007. Receipts are up, and costs are down. Mrs. Goodyear works off-farm. When Form 1040 Schedule F, Profit or Loss from Farming, profits of \$58,000 are combined with nonfarm income and deductions, taxable income is \$87,700. They file a joint return. Their taxable income for 2007 and the previous 3 years is shown in Figure 12.

FIGURE 12. Goodyears' Taxable Income

Year	Taxable Income
2007	\$87,700
2006	27,900
2005	52,050
2004	25,200

The Goodyears elect to income average in 2007. Their maximum EFI is \$58,000 (taxable income attributed to farming). Their optimum EFI may be taxable income that exceeds their 15% tax bracket or \$24,000 (\$87,700 – 63,700). They decide to use \$24,000 of their Form 1040 Schedule F profit as EFI and tax \$8,000 at the tax rates in effect in each of the 3 base years.

Question 1. Will all of the EFI be taxed at 15%?

Answer 1. In 2005 their 15% tax bracket ended at \$59,400, and their taxable income was \$52,050, leaving \$7,350 of the 15% rate bracket available for EFI from the current year. Therefore, \$650 (\$8,000 – \$7,350) added to the 2005 base-year income will be taxed at 25%.

Question 2. Should the Goodyears reduce EFI to avoid the 25% tax bracket in 2005?

Answer 2. For each \$1 of EFI subject to the 25% tax rate in 2005, \$2 is taxed at 15% in the other base years. Therefore, the marginal tax rate for the Goodyear's EFI is 18.33% $[(15 + 15 + 25) \div 3]$. If they put less than \$24,000 in the 2007 EFI, their 2007 taxable income will exceed \$63,700, and their marginal tax rate will be 25%.

Question 3. How much income tax will the Goodyears save by income averaging in 2007?

Answer 3. They will save 10% (25% rate – 15% rate) on the first \$22,050 ($3 \times \$7,350$) or \$2,205, and 6.67% (25% – 18.33%) on the remaining \$1,950 of EFI or \$130, for a total tax reduction of \$2,335.

Base-Year Losses

The IRS allows the use of negative taxable incomes in the base years when performing the income-averaging calculation. This, in effect, allows such taxpayers to income average using 0% tax rates for the base years with eligible losses. However, there can be no double benefit from the negative taxable incomes already reflected in the NOL arising from that year.

Example 8. Sam had a \$45,000 Schedule F, Profit or Loss from Farming, loss in 2004. He and his wife filed a joint return and claimed five exemptions (including three children). Taxable income was calculated as shown in Figure 13.

FIGURE 13. Sam's Taxable Income

Schedule F	\$(45,000)
Standard deduction	(9,700)
Exemptions	(15,500)
Taxable income	<u><u>\$(70,200)</u></u>

Sam's NOL for 2004 would be \$45,000. This NOL must be removed from taxable income, leaving (\$25,200) to be used as base-year income for 2004 on Sam's Schedule J, Income Averaging for Farmers and Fishermen.

Questions and Answers

Question 1. Which taxpayers qualify for farm income tax averaging?

Answer 1. I.R.C. § 1301 says that "individuals engaged in a farming business" qualify, and it specifically excludes estates and trusts. The IRS instructions indicate that individual owners of partnerships, LLCs, and S corporations qualify (farm income flows through the business and retains its character in the hands of the individual owner taxpayer). C corporations and their owners do not qualify for farm income averaging.

Question 2. Does the EFI retain its character as unused brackets are carried forward, and may the taxpayer select the type of income to include in EFI?

Answer 2. Taxpayers will be allowed to carry forward the unused lower brackets as ordinary farm income and keep capital gains in current-year taxable income, or select the best combination of ordinary farm income and qualified capital gains to meet their tax management objectives. When a combination of ordinary farm income and capital gains is included in EFI, the IRS indicates that an equal portion of each type of income must be added to each base year. The taxpayer cannot add all of the capital gains to a single prior year.

Any capital gain that is added to base-year income will be treated at the capital gains tax rate in effect for that prior year. Therefore, 2007 farm business gains of a taxpayer in a 25% income tax bracket could be eligible for a 5% capital gains tax rate if the taxpayer has a base year in the 15% income tax bracket and includes these gains in elected farm income.

Question 3. Do farm owners who rent their farm or land for agricultural production qualify?

Answer 3. If the farm owner materially participates in the farming activity and properly reports the income on Form 1040 Schedule F, Profit or Loss from Farming, this income qualifies for income averaging. Final regulations also make this true if the farm owner does not materially participate but receives share rental income (properly reported on Form 4835, Farm Rental Income and Expenses). This is a change from prior interpretation. For crop-share rents the lessor needs to have a written crop-share lease agreement. Cash rental income reported on Form 1040 Schedule E, Supplemental Income and Loss, is not income attributable to a farming business.

Question 4. How much farm use is required to meet the “regularly used in farming” rule that applies to gains from the sale of farm business property?

Answer 4. All sales reported on Form 1040 Schedule F are qualified. Sales of raised dairy and breeding livestock reported on Form 4797, Sales of Business Property, qualify. Sales of farm property for which depreciation and I.R.C. §179 deductions are claimed also qualify. Therefore, it appears as if all sales of farm machinery, buildings, livestock, and other eligible I.R.C. § 1231 property qualify as being “regularly used.”

Question 5. If I.R.C. § 1231 gain is part of EFI, is it subject to recapture because of unrecaptured I.R.C. § 1231 losses in the base years?

Answer 5. Final regulations indicate that I.R.C. § 1231 gains would be taxed at the long-term capital gains rate for the prior year. The I.R.C. § 1231 loss of that prior year remains fully deductible from ordinary income, and the I.R.C. § 1231 loss carryover to subsequent years is unchanged.

Question 6. Can the election to income average be made on an amended return?

Answer 6. Final regulations changed the answer to this question to “yes.” The previous requirement that income averaging could only be amended if there is another change on the return was rescinded.

Question 7. If a prior-year return reflected an NOL carryover that was only partially applied, will any additional NOL carryover be used in that prior year when one-third of this year’s EFI is “carried to a base year”?

Answer 7. No, the amount of the NOL applied is not refigured to offset the EFI added to that prior year. Similarly, the base-year’s income, deductions, and credits are not affected by the additional income allocated to that year (e.g., the taxable portion of social security benefits or the allowable Form 1040 Schedule A, Itemized Deductions). In essence, Form 1040 Schedule J uses the tax brackets of the base years without altering the tax returns originally filed for those base years.

Question 8. Must a taxpayer use the same filing status in each year?

Answer 8. No, the tax will be computed based on the filing status in effect for each base year and the election year.

Question 9. What tax rate will be used for the kiddie tax when income averaging has been used on the parents’ tax return?

Answer 9. The tax rate is the parents’ effective tax rate after farm income averaging has been applied.

Question 10. Can a taxpayer use income averaging even though it provides no current-year tax savings?

Answer 10. Yes, although taxpayers may have to override their tax preparation software in order to print the Form 1040 Schedule J. This technique may be used to shift income to the oldest base-period year, which will drop out of the calculations for the following year. This may allow the base-period incomes (and marginal tax rates) to even out in anticipation of income averaging in future years. Note that optimizing base-period income has become easier again with tax brackets being the same for the current and all 3 base years.

Question 11. Can the use of income averaging create or increase AMT liability?

Answer 11. No, because lawmakers voted in October 2004 to permit income tax to be determined for the AMT comparative computation without regard to income averaging. That is, tentative AMT is compared to regular income tax before income averaging.

Planning Guidelines and Information

Implement economically sound income tax management practices throughout the year rather than use income averaging as the only tax management strategy. Use tax management practices that reduce taxable income and then elect income averaging as needed.

Income averaging should be used to transfer as much high-bracket income as possible from the election year to low tax brackets in the base years. There will be cases in which the EFI used in a base year is not taxed in the lowest bracket, but income averaging will still save taxes. A farm taxpayer needs the following information to determine whether and how much 2007 farm income should be averaged:

- Taxable income for 2007 as well as ordinary income and capital gain attributed to farming
- Taxable income from his or her 2004, 2005, and 2006 tax returns
- Taxable income tax brackets for 2007 and the 3 prior years (see Figure 14)

Priority of Goals

1. Elect farm income until the marginal rate of the current year is not greater than the average of the marginal rates at which the elected farm income is being taxed in the base years. Be sure to consider the effective rate if capital gains exist in the base year or are included in EFI.
2. Load the oldest base year followed by an equal amount in the other base years to the extent this can be done without increasing tax.
3. Elect additional income attempting to level the income of the current and prior 2 base years to prepare these years to be base years for next year's income averaging, again, only to the extent this can be done without increasing tax.

FIGURE 14. Top End of Taxable Income Tax Brackets

Bracket	Single	Married Filing Jointly	Head of Household	Married Filing Separately
2007				
10%	\$ 7,825	\$ 15,650	\$ 11,200	\$ 7,825
15%	31,850	63,700	42,650	31,850
25%	77,100	128,500	110,100	64,250
28%	160,850	195,850	178,350	97,925
33%	349,700	349,700	349,700	174,850
2006				
10%	\$ 7,550	\$ 15,100	\$ 10,750	\$ 7,550
15%	30,650	61,300	41,050	30,650
25%	74,200	123,700	106,000	61,850
28%	154,800	188,450	171,650	94,225
33%	336,550	336,550	336,550	168,275
2005				
10%	\$ 7,300	\$ 14,600	\$ 10,450	\$ 7,300
15%	29,700	59,400	39,800	29,700
25%	71,950	119,950	102,800	59,975
28%	150,150	182,800	166,450	91,400
33%	326,450	326,450	326,450	163,225
2004				
10%	\$ 7,150	\$ 14,300	\$ 10,200	\$ 7,150
15%	29,050	58,100	38,900	29,050
25%	70,350	117,250	100,500	58,625
28%	146,750	178,650	162,700	89,325
33%	319,100	319,100	319,100	159,550

CCC COMMODITY LOANS AND LOAN DEFICIENCY PAYMENTS

When market prices for commodities fall below the marketing assistance loan rates offered by the Commodity Credit Corporation (CCC), producers may realize more income by taking advantage of one or more of the government options. Those options and the income tax consequences are discussed in this section.

CCC Nonrecourse Marketing Assistance Loan

Instead of selling a commodity, producers can use the commodity as collateral for a nonrecourse loan from the CCC. This option puts cash in the producer's pocket at the time of harvest and lets the producer wait to see whether market prices improve.

I.R.C. § 77 provides for an election to treat these loans as income in the year received. The election is made on Form 1040 Schedule F, Profit or Loss from Farming. If the producer has not made the I.R.C. § 77 election, the CCC loan is treated the same as any other loan. Rev. Proc. 2002-9 provides procedures for an automatic change in accounting methods in the event that a taxpayer wishes to stop reporting loans as income.

If market prices subsequently rise above the loan rate, producers will choose to repay the loan, with interest, and then sell the commodity for more than the loan.

The income tax consequences of the sale depend upon whether or not the I.R.C. § 77 election has been made. In any event, the interest expense is deductible on Form 1040 Schedule F. Typically, the I.R.C. § 77 election has not been made, so the producer has no basis in the commodity. Therefore, the full sale price must be reported as Form 1040 Schedule F income. If the I.R.C. § 77 election has been made, the producer has basis in the commodity equal to the amount of the loan. That basis is subtracted from the sale price to determine the gain on the sale, which is reported in the resale section of Form 1040 Schedule F.

If market prices do not rise above the loan rate, producers will choose to redeem the commodity by paying the posted county price (PCP) to the CCC. By making that payment, the producer is no longer obligated on the loan and can keep the difference between the original loan rate and the PCP. This replaces the previous option of forfeiting the grain to the CCC.

A producer who redeems the commodity by paying the PCP will receive a Form CCC-1099-G from the CCC for the difference between the loan rate and the PCP (market gain). That amount must generally be reported as an agricultural program payment on Form 1040 Schedule F. This is true even if the producer uses CCC certificates rather than cash to repay the loan and, as a result, does not receive a CCC-1099-G.

However, if the producer made an I.R.C. § 77 election, the difference between the loan rate and the PCP is not reported as taxable, because the full loan amount has already been reported in taxable income in the year received. Instead, this difference is subtracted from the producer's basis in the commodity so that the producer now has basis in the commodity only equal to the PCP. The producer should still report the market gain on line 6a on Form 1040 Schedule F but not include it as taxable on line 6b.

Loan Deficiency Payment

If market prices are below loan rates, producers can simply claim a loan deficiency payment (LDP) for their crops, rather than borrowing from CCC. That payment is equal to the difference between the loan rate and the PCP on the date the LDP is claimed. Producers get the same result as if they had taken the loan and paid the PCP rate on the date they claimed the LDP. The LDP is reported as an Agricultural Program Payment.

Note that reconciling taxpayer records to the amounts reported on Form CCC-1099-G can be challenging:

- CCC loan activity is not reported on the Form 1099. Borrowings and program payments may be commingled in taxpayer records.

- Often, advance government payments are made. Then, if market conditions are better than expected, these advances must be repaid. Sometimes these payments are simply netted from subsequent government payments; at other times they are paid by taxpayer check and can be confused with PCP “purchase” payments or repayments of CCC loans.
- Program payments are typically direct deposited to the producer’s bank account. Sometimes these payments are applied directly to CCC loan payments.
- Interest paid to CCC on loans is not reported to the taxpayer on a Form 1099.

PROVISIONS FOR BUSINESS ACTIVITY

The provisions discussed in this section apply primarily to business activities.

Energy Credits for Home Builders and Appliance Manufacturers

Builders of new energy-efficient homes may qualify for a \$2,000 income tax credit in 2006 and 2007. The homes must be substantially completed after August 8, 2005, and be certified to have a 50% reduction in annual heating and cooling energy consumption. Manufactured homes will also qualify, and if they do not meet the 50% standard, but meet a 30% standard, they will qualify for a \$1,000 credit.

Residential appliances (e.g., dishwashers, clothes washers, refrigerators) produced in 2006 and 2007 that have energy savings of 15% to 25% will qualify for a \$75 to \$175 credit to the manufacturer.

Business Record Keeping

Record keeping is probably one of the tasks that many farmers and small business operators enjoy the least. However, as this reference manual indicates, it is very important to the business. The tax laws covering farming and small businesses are very complicated.

The advantage of a good set of records is that they will help the business do the following:

- Prepare a tax return
- Support receipts and deductible expenses on a tax return
- Prepare accurate financial statements
- Chart and monitor the progress of the business

The IRS indicates that a taxpayer must keep these business records to prove the income or deductions on a tax return. The period of time varies dependent upon the individual business situation (Figure 15). The period of retention is never less than 3 years from the due date of the return and can be for a lifetime. The taxpayer should always keep copies of his or her filed tax returns.

FIGURE 15. Keeping Records for Income Tax Purposes

In This Situation	Keep for This Length of Time
A. You owe additional tax, and situations B, C, and D do not apply to you.	3 years
B. You do not report income that you should report, and it is more than 25% of the gross income shown on your return.	6 years
C. You file a fraudulent income tax return.	No limit
D. You do not file a complete return.	No limit
E. You file a claim for credit or refund after you file your return.	Later of: 3 years or 2 years after tax was paid
F. Your claim is due to a bad-debt deduction.	7 years
G. Your claim is due to a loss from worthless securities.	7 years
H. Keep records on an asset for the life of the asset or until you dispose of the asset and, if by death or gift, inform recipient of basis.	No limit

Business Use of Home

Expenses associated with the business use of the home are deductible only if they can be attributed to a portion of the home or separate structure used exclusively and regularly as the taxpayer's principal place of business for any trade or business, or a place where the taxpayer meets or "deals with" customers or clients in the ordinary course of business. Because a farmer's principal place of business is the entire farm, and most farmers live in homes that are on the farm, an office in their home would be at their principal place of business (IRS Pub. 225). A self-employed farmer who lives on the farm must still use the home office exclusively and regularly for farm business in order to deduct the applicable business use of home expenses.

Exclusive use means only for business. If a farmer uses the family den, dining room, or his or her bedroom as an office, it does not qualify. *Regular use* means on a continuing basis, and a regular pattern of use should be established. Regular use does not mean constant use. The office should be used regularly in the normal course of the taxpayer's business.

For tax years beginning after December 31, 1998, the home-office rules are more relaxed. The definition of principal place of business was expanded. It allows a deduction for administration and management, even though the work is performed elsewhere. I.R.C. § 280A(c)(1) indicates that a home office will qualify as the principal place of business if (1) the office in the home is used for the administrative or management activities of the taxpayer's trade or business, and (2) there is no other fixed location where the taxpayer conducts substantial administrative or management activities of the trade or business. All other rules continue to apply. The space must be used exclusively and regularly for business. IRS Pub. 587, *Business Use of Your Home*, provides examples that describe situations in which a taxpayer's home office will qualify.

Farmers who reside off the farm, crop consultants, and sales representatives will be allowed home-office deductions if they meet two additional rules: Home-office activities must be equal to or of greater importance to their trade or business than are non-office activities, and time spent at the home office must be greater than that devoted to nonoffice activities.

Form 1040 Schedule C, Profit or Loss from Business (Sole Proprietorship), filers who claim expenses for business use of the home must file Form 8829, Expenses for Business Use of Your Home. Form 4562, Depreciation and Amortization, will be required if it is the first year the taxpayer claims such expenses. Limitations on use of home expenses as business deductions are calculated on Form 8829.

Form 8829 is not filed with Form 1040 Schedule F, Profit or Loss from Farming, but it may be used as a worksheet to help farmers determine the appropriate expenses to claim. Applicable expenses for business use of the home include a percentage of the interest, taxes, insurance, repairs, utilities, and depreciation claimed.



Caution—When a taxpayer sells a home on which expenses for business use have been claimed, tax consequences may occur. Final Treas. Regs. under I.R.C. § 121 reflect a taxpayer-friendly change by the IRS. Previously, the IRS had indicated that any portion of the residence used for business could disqualify that portion from exclusion if that portion was not used as the taxpayer's principal residence for at least 2 out of the 5 years prior to sale. Under the final regulations, as long as the home office is part of the "dwelling unit" of the residence, then only the gain equal to the depreciation allowed or allowable after May 6, 1997, is treated as taxable gain. However, if the office is in a building separate from the dwelling unit, a portion of the gain must still be allocated to that office and reported on Form 4797, Sales of Business Property, under the normal rules for the sale of business property.

Transportation Expenses

When a taxpayer has two established places of business, the cost of traveling between them is deductible as an ordinary and necessary business expense under I.R.C. § 162, because the taxpayer generally travels between them for business reasons. However, when one business is located at or near the taxpayer's residence, the reason for travel can be questioned. In Rev. Rul. 94-47, the IRS takes the position that transportation expenses incurred in travel from the residence are deductible only if the travel is undertaken in the same trade or business as the one that qualifies the taxpayer for a deductible home office. The expense of commuting from personal residence to place of business is not deductible.

Business-trip expenses for a spouse, dependent, or other individual are not deductible unless the person is an employee of the person paying for or reimbursing the expenses; the travel is for a bona fide business purpose; and the expenses for the spouse, dependent, or other individual would otherwise be deductible.

Provisions for Health Insurance and Medical Expenses

The following provisions apply to expenses for health insurance and medical care.

Self-Employed Health Insurance Premiums

This tax provision allows self-employed taxpayers to deduct 100% of health insurance premiums paid as an adjustment to income on Form 1040, U.S. Individual Income Tax Return. Also, if taxpayers pay premiums on a qualified long-term care contract for themselves, their spouses, or their dependents, they can include these premiums (subject to the annual limits stated previously). Self-employed taxpayers include sole proprietors, partners, and less-than-2% S corporation shareholders.

Qualified health insurance premiums are limited to health insurance coverage of the taxpayer and the taxpayer's spouse and dependents. The deduction may not exceed earned income. (This may be another reason to elect the optional method of computing self-employment tax in a farm loss year.) It does not reduce income subject to self-employment tax, and the amount deducted as an adjustment to gross income may not be included in medical expenses claimed as itemized deductions. A taxpayer eligible for coverage in an employer's subsidized health insurance plan may not deduct insurance premiums he or she pays, even if it is the taxpayer's spouse that is the employee. Eligibility is tested monthly.

Medical Saving Programs

The HSA was originally introduced in 2004 to take the place of the Archer MSA. These accounts provided an opportunity for taxpayers to save tax-deferred income for future health needs. Contributions to an HSA may be made by the employer, the employee, or a member of the employee's family. The contributions are tax-deductible, and withdrawals are tax-free if used for qualifying medical expenses. To qualify for an HSA, the individual must be covered under a high-deductible health plan (HDHP) and no other general health insurance plan. The HSAs are tax-exempt accounts with a financial institution in which employees of a small employer or self-employed taxpayer save money for future medical expenses. For details on this program, see IRS Pub. 969, Health Savings Accounts and Other Tax-Favored Health Plans.

Employee Health and Accidental Insurance Plans

An employer can claim premiums paid on employee health and accident insurance plans as a business expense on Form 1040 Schedule F (Profit or Loss from Farming) or C (Profit or Loss from Business). As a qualified fringe benefit, the payments are not included in employee income [I.R.C. § 105 (b)]. Plans purchased from a third party (an insured plan), as well as self-insured plans, qualify, but the latter are subject to nondiscrimination rules.

A written plan is not required if it is purchased through a third-party insurer. Self-insured plans must have a written document that describes the expenses and benefits paid by the employer. A plan that reimburses an employee for health insurance premiums paid by the employee can work, but direct payment of premiums by the employer is less complicated.

Health insurance purchased for an employee's family qualifies, even if a member of that family is the employer. A taxpayer operating a business as a sole proprietorship can employ his or her spouse, provide health insurance that covers the spouse-employee and the family of the spouse-employee (including the employer), and deduct the cost as a business expense (Rev. Rul. 71-588). With the increase in the deduction for self-employed health insurance premiums to 100%, there will be less incentive to have the spouse on payroll for this purpose. However, as a business deduction, the use of this fringe-benefit deduction would reduce the employer's self-employment tax. Note that paying *cash* wages in addition to providing this fringe benefit may actually result in an increase in social security taxes for the couple (if the employer's earnings are above the earnings base) and a potential reduction in social security benefits to the employer.

The following rules apply when the taxpayer employs his or her spouse, pays the family health insurance premiums as a nontaxable employee benefit, and deducts them as a business expense:

1. The spouse must be a bona fide employee with specific duties, and the salary and benefits received must be proportionate to the duties.
2. The employer must file all payroll reports, withhold income and FICA taxes, and furnish a Form W-2, Wage and Tax Statement, to the employee. The taxpayer may question the value of this added bookkeeping and paperwork unless the business is already doing payroll reporting.

Business Use of Automobiles

Automobile expenses are deductible if incurred in a trade or business or in the production of income. Actual costs or the standard mileage rate method may be used. The 2007 standard mileage rate is 48.5 cents per mile for all business miles driven (leased as well as purchased vehicles). The standard mileage rate may not be used when the automobile has been depreciated using a method other than straight-line, or the car is used for hire. The standard mileage rate may be used on up to four vehicles. The use of I.R.C. § 179, accelerated cost recovery system (ACRS) or modified accelerated cost recovery system (MACRS) depreciation also causes disqualification from using the standard rate. When a taxpayer uses

the standard rate on a vehicle in the first year it is used in the business, the taxpayer is making an election not to use MACRS depreciation or I.R.C. § 179.

Cell Phones Used for Business

The IRS has some very strict rules on the deductibility of cell-phone expenses. They require detailed records of business use, and deductions based on estimates are disallowed according to the Tax Court (T.C.M. 2001-165). Businesses must have a logbook or similar documentation for substantiation.

Return Preparers Have to Issue Privacy Policy Statements

Under Reg. 16 CFR Part 313, all financial institutions, including accountants or other tax preparation services that are in the business of completing tax returns, must provide a privacy policy disclosure statement to customers. All customers must also be provided with a copy at least annually. See the regulation for the specific information to be provided in the disclosure statement.

New York Employer's Annual FUTA Return

NYS employers will again in 2007 be able to use Form 940-EZ. In both 2004 and 2005 the NYS Department of Labor informed NYS employers that their Federal Unemployment Tax Act (FUTA) rate had to be increased since the state had not repaid all of the loans made by the federal government to the state's Unemployment Insurance Trust Fund. These loans had been incurred to meet unemployment insurance benefit obligations resulting from the September 11 attacks and the resulting economic downturn in the state.

Since New York was able to repay loans from the federal unemployment fund during 2006, New York employers will be able to claim a full FUTA tax credit of 5.4% if they have paid their state unemployment taxes in full and on time. This results in an effective FUTA tax rate of 0.8%.

CORPORATE AND PARTNERSHIP PROVISIONS

This section covers provisions of new legislation for corporations and partnerships.

Corporations

C (regular) corporations are subject to federal income tax rates ranging from 15% to 39%. Capital gains are taxed at the regular corporate rates. A personal service corporation is taxed at a flat rate of 35%. The 2007 tax rates for small businesses are given in Figure 16.

FIGURE 16. 2007 Corporate Tax Rates for Small Businesses*

Taxable Income	Tax Rate
\$0 to \$50,000	15%
\$50,001 to \$75,000	\$7,500 plus 25% on amount over \$50,000
\$75,001 to \$10,000,000	\$13,750 plus 34% on amount over \$75,000 plus 5% on taxable income from \$100,000 to \$335,000

*Tax rates for corporations with more than \$10 million of taxable income average approximately 35%.

Salaries and qualified benefits paid to corporate officers and employees are deducted in computing corporate taxable income, but dividends paid to stockholders come from corporate profits that are taxed in the C corporation. Corporate dividends are also included in the stockholders' taxable income.

If the estimated tax for the year is expected to be \$500 or more, a corporation is required to make estimated tax payments equal to the lesser of 100% of the tax shown on its return for the current year or 100% of last year's tax (the prior year's tax must be greater than \$0).

Corporations that have elected S corporation status are generally not tax-paying entities but must file Form 1120S, U.S. Income Tax Return for an S Corporation. S corporation shareholders will include their share of business income, deductions, losses, and credits on their individual returns.

The AMT has been repealed, effective January 1, 1998, for small corporations (not more than \$22.5 million of total gross receipts in the preceding 3-year period).

Farm-family C corporations (at least 50% of stock owned by members of the same family) with annual gross receipts exceeding \$25 million in any year after 1985 must use accrual tax accounting. Additional exceptions to accrual accounting are provided for S corporations and C corporations engaged in operating a nursery or raising or harvesting trees (other than fruit or nut trees). When farm corporations become subject to the gross receipt rule and are required to change to accrual accounting, an adjustment (I.R.C. § 481) resulting from the change is included in gross income over a 4-year period, beginning with the year of the change.

Partnership Filing Rules and Issues

A partnership that fails to file a timely and complete return is subject to penalty unless it can show reasonable cause for not filing Form 1065, U.S. Return of Partnership Income. A family-farm partnership with 10 or fewer partners will usually be considered as meeting this requirement if it can show that all partners have fully reported their shares of all partnership items on their timely filed income tax returns. Each partner's proportionate share of each partnership item must be the same, and there may be no foreign or corporate partners.

Schedules L, M-1, and M-2 on Form 1065 are to be completed on all partnership returns unless all three of the following apply: (1) the partnership's total receipts are less than \$250,000; (2) total partnership assets are less than \$600,000; and (3) Schedules K-1 are filed and furnished to the partners on or before the due date of the partnership return, including extensions. Even though the IRS does not require these records, the companies should still maintain records dealing with assets, liabilities, and equity, in addition to the reconciliation needed to arrive at taxable income.

Limited liability companies with more than one member will file Form 1065 unless they elect to be taxed as corporations.

Premiums for health insurance paid by a partnership on behalf of a partner for services as a partner are treated as guaranteed payments (usually deductible on Form 1065 as a business expense, listed on Schedules K and K-1, and reported as partner income on Form 1040 Schedule E). A partner who qualifies can deduct 100% of the health insurance premiums paid by the partnership on his or her

behalf as an adjustment to income on Form 1040. According to IRS instructions, the health insurance may instead be treated as a distribution to the partner with the resulting effect on capital accounts.

Partnership tax returns may now be filed electronically. Beginning in 2006 paper Form 8453-P, U.S. Partnership Declaration and Signature for Electronic Filing, is generally no longer required to be filed by the partnership.

INCOME TAX IMPLICATIONS OF CONSERVATION AND ENVIRONMENTAL PAYMENTS AND GRANTS RECEIVED BY FARMERS

Farmers and participating landowners are receiving NYS or federal grants and payments for a number of different conservation and environmental programs. Here is a review of the income tax consequences associated with some of the programs.

Cost-Sharing Payments under I.R.C. §126

Cost-sharing payments that qualify under I.R.C. § 126 may be excluded from income reported by farmers. Several federal and state programs have been certified under I.R.C. § 126. On a federal level, these include the Wetlands Reserve Program, the Soil and Water Conservation Assistance Program, the Agricultural Management Assistance Program, the Conservation Reserve Program, and the Forestland Enhancement Program. On a NYS level, eligible programs include the NYS Agricultural Nonpoint Source Abatement and Control Grant Program, the NYC Watershed Agricultural Program, the Skaneateles Lake Watershed Agricultural Program, and other watershed protection programs. To be excluded, the payment must be for capital expenditures such as concrete pads, storage tanks, tile drains, diversion ditches, and manure storage. The fact that the agency states that the payments qualify under I.R.C. § 126 is not sufficient to allow exclusion. Payments for items that can be expensed on Form 1040 Schedule F, Profit or Loss from Farming, including soil and water conservation expenses, may not be excluded. A portion of a payment that increases annual gross receipts from the improved property by more than 10% or \$2.50 times the number of affected acres may not be excludable. The depreciable basis of the improvement is reduced by the amount of payment excluded from gross income.

All excluded I.R.C. § 126 payments are subject to recapture as ordinary income to the extent that there is gain upon sale of the property within 10 years of receiving the payment (I.R.C. § 1255). If the property is sold after 10 and before 20 years, a declining percentage of the excluded payment is recaptured.

Conservation Reserve Payments

Farmers enrolled in the Conservation Reserve Program (CRP) are compensated for converting erodible cropland to less intensive use. They receive annual CRP rental payments that are ordinary income. In Notice 2006-108, 2006-51 IRB 118 (December 2006), the IRS stated its position that CRP payments are subject to self-employment tax whether the taxpayer fulfills the contractual obligations for maintaining the land or arranges for a third party to do so. The IRS intends to issue a Revenue Ruling on this matter that will clarify their position. The IRS notice and anticipated ruling is designed

to eliminate the idea of reporting such payments on either Form 1040 Schedule E, Supplemental Income or Loss, or Form 4835, Farm Rental Income and Expenses, which arose as a result of the Wuebker Tax Court case.

Wetlands Reserve Program (WRP)

Farmers and other landowners may be receiving permanent or nonpermanent easement payments for enrolling land in the Wetlands Reserve Program (WRP), where its use is limited to hunting, fishing, periodic grazing, haying, and managed timber production. Landowners participating in the WRP are also eligible for cost-sharing payments to restore the land to a healthy wetland condition.

Granting a permanent easement results in the same tax consequence as selling development rights. The taxpayer is allowed to reduce the entire basis in the underlying property before reporting gain from the easement (Rev. Rul. 77-414). If the land has been held for more than 1 year, the gain is I.R.C. § 1231 capital gain.

Example 9. True Wetland enrolls 100 acres under the WRP permanent easement option and receives \$500 per acre, or \$50,000. The basis of the 100 acres, purchased in 1970, is \$35,000. True reduces the basis to \$0 and realizes a \$15,000 capital gain.

Permanent easement payments spread over more than the first year should be reported as installment sales. Because interest is not included in any current WRP contract, it must be imputed, and a portion of each payment must be allocated to interest. The grantor of a discounted or bargain sale permanent easement may be able to claim a charitable deduction for the difference between its value and the price received.

Nonpermanent easement payments are ordinary income unless the taxpayer accepts the position taken by the American Farmland Trust and reports them in the same way as perpetual or permanent easement payments. The IRS and the Tax Court say that the payments are ordinary income, and if the taxpayer continues to use the land in an associated farming or timber activity, they are included in self-employment income.

Cost-sharing payments under the WRP are eligible to be excluded under I.R.C. § 126. Otherwise these restoration payments are reported as Form 1040 Schedule F (Profit or Loss from Farming) income, where they may be offset by the restoration costs. If the taxpayer continues to farm, some or all of the cost-sharing payments may qualify to be deducted as soil and water conservation expenses (subject to the 25% of gross farming income limitation) or depreciated as improvements. Income and expenses associated with managing and maintaining the WRP land are reported on Form 1040 Schedules F or C (Profit or Loss from Business).

INCOME FROM CANCELLATION OF DEBT AND RECAPTURE AGREEMENTS

The tax code specifies that cancellation of debt, called *discharge-of-indebtedness income* (DII), is ordinary income to the borrower. In many situations, the DII does not result in taxable income. In return for not reporting the income, the taxpayer must reduce tax attributes, such as investment credit, NOLs, and basis in assets, which may result in tax liability for the taxpayer in future years.

Solvent and insolvent farmers receive no relief from gain triggered on property transferred in settlement of debt. The difference between basis and FMV is gain to be reported in the same manner as if the property had been sold. Only debt discharge in excess of the FMV of the relinquished property is considered DII. The FMV is ignored for nonrecourse debt, and the entire difference between the basis of property transferred and the debt canceled is gain or loss.

Bankrupt and Insolvent Debtor Rules

For bankrupt or insolvent debtors, if canceled debt exceeds total tax attributes, the excess canceled debt is not reported as taxable income. However, if cancellation of debt outside of bankruptcy causes a taxpayer to become solvent, the solvent debtor rules must be applied to the DII equal to the amount of solvency.

Solvent Farmer Rules

In order to qualify for the solvent farmer rules, discharged debt (DD) must be *qualified farm indebtedness*, which is debt incurred directly in connection with the operation of the farm business. Additional qualified farm indebtedness rules are as follows: (1) 50% or more of the aggregate gross receipts of the farmer for the 3 previous years must have been attributable to farming; and (2) the discharging creditor must (a) be in the business of lending money, (b) not be related to the farmer, (c) not have sold the property to the farmer, and (d) not receive a fee for the farmer's investment in the property. These rules are quite restrictive and will prevent some solvent farmers from using tax attributes to offset DII.

Solvent farmers must reduce tax attributes in exchange for not reporting DII as income. The basis reduction for property owned by the solvent taxpayer must take place in the following order: (1) depreciable assets, (2) land held for use in farming, and (3) other property. The general rule that basis may not be reduced below the amount of the taxpayer's remaining debt does not apply under these special solvent farmer rules. The DII remaining after tax attributes have been reduced must be included in a solvent farmer's taxable income. If the DII exceeds the total tax attributes, all the tax attributes will be given up and the excess of DII over the tax attributes will be included in income and may cause a tax liability.

Discharge of indebtedness is not includable in income if the transaction is a purchase price reduction [I.R.C. §108(c)(5)].

Farm Service Agency Recapture of Previously Discharged Debt

Some farm owners were required to give the Farm Service Agency (FSA) a shared appreciation agreement or a recapture agreement in exchange for the discharge of debt. The agreement allows FSA (formerly FmHA) to recapture part of the debt that was previously discharged if the farm is sold for more than the appraised value at time of discharge. If the taxpayer treated the debt reduction as DII for tax purposes at the time of the workout, then an FSA recapture will trigger a tax consequence. A typical appreciation agreement would obligate the farmer to pay the FSA the lesser of (1) the excess of the amount received when the farm is sold over the amount paid to FSA under the agreement, or (2) the difference between the FMV of the farm at buyout and the amount paid under the agreement. When DD is recaptured, the tax treatment of some DII may need to be changed. The DII originally

recognized as ordinary income now becomes a deduction against ordinary income. The DD offset by a reduction in attributes is added back to the same attributes, and the DD not recognized under insolvency rules requires no adjustment.

LIKE-KIND EXCHANGES

Taxpayers may postpone recognition of gain on property they relinquish if they exchange that property for property that is like kind. The gain is postponed by not recognizing the gain realized on the relinquished property and reducing the basis in the acquired property. Both the relinquished property and the acquired property must be used in a trade or business or held for investment [I.R.C. § 1031(a)(1)]. This section provides a summary of these rules [Reg. § 1.1031(k)-1].

Rules and Requirements

The first requirement is that the transaction must actually be an exchange of qualifying property. A sale of property followed by a purchase of a like kind does not qualify for nonrecognition under I.R.C. § 1031. Gain or loss is recognized if the taxpayer actually or constructively receives money or non-like-kind property before the taxpayer actually receives the like-kind replacement property. Property received by the taxpayer will be treated as property not of a like kind if it is not identified before the end of the identification period *or* the identified replacement of property is not received before the end of the exchange period.

The identification period begins the day the taxpayer transfers the relinquished property and ends at midnight **45 days** later. The exchange period begins on the day the taxpayer transfers the relinquished property and ends on the earlier of **180 days** later or the due date (including extensions) for the taxpayer's tax return. (If more than one property is relinquished, then the exchange period begins with the earliest transfer date.)

Deferral of tax is also possible with *reverse* like-kind exchanges (in which the seller acquires replacement property *before* the original property is sold). Rev. Proc. 2000-37 outlines the very exacting requirements that must be met for such swaps to qualify as like-kind exchanges.

Replacement Property

Replacement property is identified only if it is designated as such in a written document signed by the taxpayer and is properly delivered before the end of the identification period to a person obligated to transfer the property to the taxpayer. Replacement property must be clearly described in a written document (real property by legal description and street address; personal property by make, model, and year). In general, the taxpayer can identify from one to three properties as replacement property. However, there can be any number of properties identified as long as their aggregate FMV at the end of the identification period does not exceed 200% of the aggregate FMV of all the relinquished properties (the 200% rule). Identification of replacement property can be revoked in a signed written document properly delivered at any time before the end of the identification period.

Identified replacement property is received before the end of the exchange period if the taxpayer actually receives it before the end of the exchange period and the replacement property received is substantially the same property as that identified. A transfer of property in a deferred exchange will not fail to qualify for nonrecognition of gain merely because the replacement property is not in existence or is being produced at the time it is identified.

If the taxpayer is in actual or constructive receipt of money or other property before receiving the replacement property, the transaction is a *sale* and not a deferred exchange (unless the reverse exchange requirements are met). The determination of whether the taxpayer is in actual or constructive receipt of money or replacement property is made without regard to certain arrangements made to ensure that the other party carries out its obligation to transfer the replacement property. These arrangements include replacement property secured or guaranteed by a mortgage, deed of trust, or other security interest in property; by a standby letter of credit as defined in the regulations; or by a guarantee of a third party. It is also made without regard to the fact that the transferee is secured by cash, if the cash is held in a qualified escrow account or trust.

Qualified Escrow Account and Intermediary

A qualified escrow account or trust is one in which the escrow holder or trustee is not the taxpayer or a disqualified person, and the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefits of the cash are limited until the transaction is closed.

A qualified intermediary (Q/I) is a person who is not the taxpayer or a disqualified person and acts to facilitate the deferred exchange by entering into an agreement with the taxpayer for the exchange of properties. A Q/I enters into a written agreement with the taxpayer, acquires the relinquished property from the taxpayer, and transfers the relinquished property and the replacement property.

The taxpayer's agent at the time of the transaction is a disqualified person. An agent is a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties.

Real Property

For real property, *like kind* is interpreted very broadly. Any real estate can be exchanged for any other real estate and qualify for I.R.C. § 1031 as long as the relinquished property was, and the acquired property is, used in a trade or business or held for investment. Consequently, a farm can be exchanged for city real estate, and improved real estate can be exchanged for unimproved real estate. However, care must be exercised to ensure that any I.R.C. § 1245 property included as part of the real estate given up is replaced with an equal amount of such property in the replacement real estate received. I.R.C. § 1245 property includes single-purpose livestock and horticultural facilities, silos, grain bins, and drainage tile.

Farm Business Personal Property

Like kind is interpreted to mean *like class* for personal property. Under final regulations issued May 18, 2005, *like class* means that both the relinquished and replaced properties are in the same product class under the North American Industry Classification System (NAICS). Previously, property was classified under the Standard Industrial Classification (SIC) System. Generally, this will have no impact on the classifications previously used for farm property to qualify as *like kind*.

Most equipment used in a farm business is included in product class 33311, which includes items such as combines, planters, tractors, plows, haying equipment, and milking machines. Farmers will generally qualify for I.R.C. § 1031 treatment when they exchange farm equipment for farm equipment. However, automobiles, general-purpose trucks, heavy general-purpose trucks, information systems,

and other office equipment are all assigned to separate product classes. Livestock of different sexes are not property of a like kind, but exchanges of same-sex livestock have qualified as tax-free exchanges.

LIKE-KIND EXCHANGE DEPRECIATION RULES

IRS Notice 2000-4 requires that for property placed in service after January 2, 2000, the basis of the traded item continues to be depreciated over the remaining recovery period of the old property, using the same method and convention. Accumulated depreciation of the old asset would carry over and potentially be subject to recapture upon the sale of the newly acquired asset under I.R.C. § 1245 depreciation recapture rules. Any additional cost basis would be treated as newly acquired property. This provision applies to all MACRS property, but taxpayers that did not calculate depreciation in accordance with this announcement prior to January 3, 2000, are not required to change depreciation calculations. If they wish to change prior depreciation calculations, the procedure described in the instructions for Form 3115, Application for Change in Accounting Method, should be followed.



Practitioner Note

Temporary regulations under I.R.C. § 168 issued on February 27, 2004, allow taxpayers to elect to not apply the principles of IRS Notice 2000-4 and go back to the prior procedure of combining the remaining basis of the traded item with the cash paid to boot and treating the asset as a single item on the depreciation schedule. The potential recapture under I.R.C. § 1245 for the accumulated depreciation on the traded item still carries over to the newly acquired asset. The election is made by noting at the top of Form 4562 "Election Made Under Section 1.168(i)-6T(i)." The election is available on an asset-by-asset basis.

Example 10. Under rules prior to Notice 2000-4 (including the election to not follow this notice under the temporary regulations),

- Farmer Pat paid \$100,000 for a combine in 2004.
- Pat depreciated it as 7-year property using MACRS 150% declining balance.
- In 2007 Pat traded the combine and \$40,000 cash for a tractor.
- Calculation of the basis in the new tractor is as shown in Figure 17.

FIGURE 17. Calculation of Basis

Beginning combine basis		\$ 100,000
2004 depreciation	$\$100,000 \times 10.71\%$	(10,710)
2005 depreciation	$\$100,000 \times 19.13\%$	(19,130)
2006 depreciation	$\$100,000 \times 15.03\%$	(15,030)
2007 depreciation	$\$100,000 \times 12.25\% \times 1/2$	(6,125)
Ending basis		49,005
Boot cash for the tractor		40,000
Basis in new tractor		<u>\$ 89,005</u>

Calculation of Pat's total 2007 depreciation on these two assets is as shown in Figure 18.

FIGURE 18. Calculation of Depreciation

Combine from Figure 17		\$ 6,125
Tractor	$\$89,005 \times 10.71\%$	9,532
		<u>\$15,657</u>

Example 11. Under Notice 2000-4, which requires Pat to continue depreciating the carried-over basis over the remaining life of the combine, continuing with the same depreciation rate,

- Farmer Pat paid \$100,000 for a combine in 2004.
- Pat depreciated it as 7-year property using MACRS 150% declining balance.
- In 2007 Pat traded the combine and \$40,000 cash for a tractor.
- Calculation of the total 2007 depreciation on these two assets is as shown in Figure 19.

FIGURE 19. Calculation of Depreciation on Two Assets

2007 (fourth-year depreciation) on combine that was traded and has left the farm:		
Combine traded (left the farm)	$\$100,000 \times 12.25\%$	\$12,250
2007 (first-year depreciation) on tractor that is on the farm:		
Tractor on farm (boot only)	$\$40,000 \times 10.71\%$	4,284
Total depreciation		<u>\$16,534</u>

The Notice 2000-4 rules result is a greater first-year depreciation for Pat than under prior rules (\$16,534 versus \$15,657). The advantage of this methodology is that, where the trade-in has not been depreciated to zero, the new method yields a faster recovery than would be available if the remaining basis was added to the basis of the new property and depreciated accordingly. Next year, if Pat trades that new tractor in for a baler, Pat will have a three-line calculation of depreciation, but only one piece of equipment left on the farm.

Bookkeeping

Pat's depreciation schedule will need some notes to keep track of what machinery is gone, what is remaining on the farm, and which was traded for which. Notice 2000-4 does not give any guidance in this area. Pat should keep the traded property on the depreciation schedule with a note as to which piece it was traded for and the basis of the new equipment, which will be just the boot price. If Pat is a frequent trader, it may take several lines to support the depreciation and basis in the traded and acquired property. If Pat ultimately sells the piece of equipment, the remaining basis of all the traded items will be added to the basis of the item being sold to determine gain. The election under the temporary regulations starts to look attractive—even though it may result in less current depreciation expense.

Other Like-Kind Exchange Rules and Requirements

IRS Form 8824, Like Kind Exchanges, is used as a supporting statement for like-kind exchanges that either generate no taxable gain or are reported on other forms, including Form 4797 (Sale of Business Property) and Form 1040 Schedule D (Capital Gains and Losses). A separate Form 8824 should be attached to Form 1040, U.S. Individual Income Tax Return, for *each* exchange. Form 8824 should be filed for the tax year in which the seller (exchanger) transferred property to the other party in the exchange.

If the relinquished property is subject to depreciation recapture under I.R.C. §§ 1245, 1250, 1252, 1254, or 1255, part or all of the recapture may have to be recognized in the year of the like-kind exchange. Any recapture potential not recognized in the year of the exchange will carry over as an attribute of the asset received in the exchange.

Like-kind exchanges between related parties can result in recognition of gain if either party disposes of the property within 2 years after the exchange.

Domestic Production Activities Deduction—I.R.C. § 199

The American Jobs Creation Act of 2004 added I.R.C. § 199 as an incentive for businesses to hire U.S. workers to increase domestic production. I.R.C. § 199 provides a deduction to businesses that manufacture, produce, grow, or extract property within the United States.



Practitioner Note

This section highlights those portions of I.R.C. § 199 most relevant to farm tax reporting. For further details, refer to T.D. 9263 for final regulations released May 24, 2006. This replaced proposed regulations released October 20, 2005.

In general the deduction is based on net income from qualifying production activities (QPAI). The deduction is 6% of QPAI for 2007, 2008, and 2009 (an increase from 3% of QPAI in 2005 and 2006; and increasing to 9% for 2010 and thereafter). However, for individuals, the deduction is based on the lesser of AGI or QPAI taxable income and then limited to 50% of Form W-2 wages (both of which are discussed later). This deduction is available to sole proprietors, regular C corporations, and to S corporation shareholders, partners, LLC members, and members of agricultural cooperatives.

Qualified Production Activity Income

In order to calculate QPAI, it is first necessary to define a qualifying activity. The general definition is that the activity must involve the manufacture, production, growth, or extraction of property within the United States. In addition to sales from such activities, the income from the following is includable:

1. The rental or lease of tangible personal property if the property was produced by the taxpayer in the United States. However, rental income from a related party does not qualify. For this purpose, related party includes the following:
 - ◆ Members of an affiliated service group
 - ◆ Corporations that are part of a controlled group
 - ◆ Other trades or business under common control

2. The construction or substantial renovation of real property (e.g., buildings, roads, utilities)
3. Architectural and engineering services related to #2
4. The sale of natural gas produced by the taxpayer

Nonqualified receipts would include:

1. Any increase in the value of the property occurring by activities outside the United States. This amount must be subtracted in determining domestic gross receipts.
2. Resale activities except to the extent that the taxpayer has added value to the product by manufacture or production
3. Sales of food and beverages prepared by the taxpayer at a retail establishment
4. Any receipts from a nonqualified activity, which could include the following:
 - ◆ Interest earned and finance charges on accounts receivable
 - ◆ Services provided other than those in #3 in the list of qualifying receipts
 - ◆ Sale of tangible personal property not produced by the taxpayer, or produced outside the United States
 - ◆ Sale, lease or rental of real property, even if constructed by the taxpayer

Grain, fruit, vegetable, and livestock production clearly qualify as production activities. However, service activities often provided by farmers, such as trucking and custom service (e.g., plowing, spraying, combining) do not qualify. Receipts from the storage of agricultural commodities qualify provided that the taxpayer owns the commodity at the time it is stored. Government payments qualify to the extent that they are substitutes for gross receipts that would qualify. Patronage income from cooperatives does not qualify, but the cooperative may pass through to patrons QPAI that it generated (Form 1099 PATR, Taxable Distributions Received from Cooperatives).

For many farmers, QPAI will be the net income from Schedule F (Form 1040), Profit or Loss from Farming, plus any raised livestock sales reported on Form 4797, Sales of Business Property. (Purchased livestock that are reported on Form 4797 would not appear to qualify since the taxpayer did not manufacture or grow them.) If nonqualifying receipts are 5% or more of total gross receipts, it will be necessary to allocate expenses as discussed later.

? Query—How will the IRS classify the sale of cows that were purchased as calves, raised and held for milk production, and then culled from the milking herd?

The domestic production gross receipts (DPGR) from the qualifying activity are reduced by all related deductions and expenses plus a ratable portion of deductions not directly attributable to the qualifying activity (i.e., overhead). It becomes essential that a taxpayer's records be able to identify expenses directly related to the qualified activity versus any nonqualifying activity. If cost of goods sold (COGS) cannot be directly identified, any reasonable method can be used to make the allocation. There is an exception for small businesses that allows COGS to be prorated based on qualifying gross receipts as a percentage of total gross receipts. A small business is defined as one having 3-year average annual gross receipts not exceeding \$5 million or as taxpayers permitted to use the cash method of accounting under Rev. Proc. 2002-28 (generally, where the principal business activity is *not* manufacturing). Indirect expenses may also be allocated by any reasonable method. In this case, if gross receipts of the taxpayer are \$100 million or less, these indirect expenses may be prorated based on relative gross receipts. If the taxpayer maintains allocation records for another purpose, such as cost control or profit center management, the taxpayer must use these same allocations in calculating QPAI (unless such allocations are "unreasonable").

**Practitioner Note**

When inputs for production are imported, it is the greater of cost or *value at the time of import* that must be used as COGS.

**Practitioner Note**

I.R.C. § 199 provides a de minimis rule regarding allocations between qualified and nonqualified receipts that allows nonqualifying receipts to be included in the calculation of QPAI and exempts the taxpayer from any requirement to allocate expenses. The de minimis rule applies if the taxpayer's nonqualifying receipts are less than 5% of total gross receipts.

Form W-2 Wage Limit

The qualified domestic production deduction is limited to 50% of the taxpayer's qualifying wages. Rev. Proc. 2006-22 (2006-23 I.R.B. 1033) provides three alternatives for calculating wages from Form W-2, Wage and Tax Statement, information. In all cases, only wages subject to FICA and federal income tax withholding are included. This means that agricultural wages paid in kind (commodities or other non-cash compensation) do not qualify. Also, payments to partners or limited liability company members are not W-2 wages.

Form W-2 does not necessarily report wages that are consistent with the I.R.C. § 199 definition of W-2 wages. Three alternatives are provided in Rev. Proc. 2006-22. Most farm taxpayers will use the *unmodified box 1 method*. In this method, the employer-taxpayer uses the lesser of the totals from either box 1 or box 2 of all Forms W-2. However, if wages result in limiting the I.R.C. § 199 deduction, one of the alternate methods of calculating the wage limit should be considered, especially if the employees have made elective deferrals to retirement plans.

**Practitioner Note**

Wages paid to employees of the taxpayer through an agent are eligible wages for computing the I.R.C. § 199 deduction even though the Forms W-2 are issued from the agent.

**Law Change**

The Tax Increase Prevention and Reconciliation Act of 2005 provides that for tax years beginning after May 17, 2006, only wages allocable to domestic production may be used for the 50% limitation.

Taxable Income Limit

For 2007, 2008, and 2009, the I.R.C. § 199 deduction is limited to 6% of taxable income of a corporation and to 6% of the AGI of individuals, estates, and trusts (an increase from the 3% limits for 2005 and 2006 and an increasing to 9% after 2009).

Claiming the Deduction

Form 8903, Domestic Production Activist Deduction, is used to calculate the deduction. Individuals claim this deduction as an adjustment to gross income. Therefore the deduction does not reduce the taxpayer's self-employment tax. C corporations claim this deduction on the "other deductions" line. Trusts are entitled to the I.R.C. § 199 deduction if the income is not distributed to the beneficiaries.

Taxpayers may also receive QPAI and qualifying wage information from entities that do not pay taxes of their own—S corporations, partnerships, and LLCs. In addition, agricultural cooperatives may pass through this information to their patrons on Form 1099-PATR, Taxable Distributions Received from Cooperatives.



Practitioner Note

For S corporations, partnerships, and LLCs, the W-2 wages they may pass through to owners are limited to a maximum of two times the QPAI they are distributing. This prevents a recipient taxpayer from using excess wages from one entity to qualify for a larger I.R.C. § 199 deduction from another business



Law Change

The restriction on W-2 wages passing through from such entities has been eliminated for tax years beginning after May 17, 2006.

Form 8903 applies the limits by first limiting QPAI to the taxpayer's taxable income (or AGI for individuals, estates, and trusts). Taking 6% (for 2007) of the lesser of these two income measures provides the tentative I.R.C. § 199 deduction. This tentative deduction is then limited to 50% of Form W-2 wages allocable to domestic production from all sources.

Example 12. Mr. Domestic Dairy, a sole proprietor, has a 2007 Form 1040 Schedule F (Profit or Loss from Farming) net income of \$39,000 and \$1,000 of Form 4797 (Sales of Business Property) raised cull cow sales. Make the assumption that all of his income is qualified and the dairy farm paid and reported W-2 (Wage and Tax Statement) hired chore wages of \$4,400. His wife had a W-2 income of \$50,000 as a school principal. How much domestic production can they claim and how much will it save them in federal taxes?

Form 8903, Domestic Production Activities Deduction, compares the farm's net income from qualified production activities ($\$39,000 + \$1,000 = \$40,000$ QPAI), which is less than \$90,000 AGI without the domestic production activities deduction (DPAD). Then the form multiplies the QPAI \$40,000 times 6% for 2007, resulting in \$2,400 for potential DPAD. Next compare this with 50% of Form W-2 wages ($\$4,400 \times 50\%$) reported by the domestic production business (all allocable to domestic production), resulting in \$2,200 in wage limitation. The smaller of the two calculations, or \$2,200, is the domestic production activities deduction that goes on Form 1040 line 35 (U.S. Individual Income Tax Return). This deduction lowers AGI to \$87,800 and saves $\$2,200 \times 25\%$ tax bracket, or \$550 of federal income taxes. Note that DPAD does not reduce the taxpayer's self-employment tax.

Alternative Minimum Tax

The I.R.C. § 199 deduction is allowed in the calculation of the AMT. However, for regular C corporations, the taxable-income limitation is replaced with an alternative minimum taxable-income limitation when computing the deduction for AMT purposes.

DEPRECIATION AND COST RECOVERY

The Job Creation and Worker Assistance Act of 2002 made substantial changes to this area by allowing taxpayers to claim 30% bonus depreciation on qualifying property placed in service under a binding

contract after September 10, 2001. The Jobs and Growth Tax Relief Act of 2003 increased the bonus depreciation to 50% for purchases made under a binding contract after May 5, 2003, and placed in service prior to January 1, 2005. For assets placed in service after December 31, 2004, there is no bonus depreciation.

As noted under 2007 legislation, SBWOTA of 2007 increased the I.R.C. § 179 deduction to \$125,000 for 2007 (discussed later). Other than the I.R.C. § 179 deduction, and Notice 2000-4 and subsequent temporary regulations regarding like-kind exchanges (see the previous section), the standard depreciation rules for regular income tax have not changed. The AMT depreciation rules were modified in 1998 and will reduce the depreciation adjustment for 1999 and subsequent years. MACRS provides for eight classes of recovery property, two of which may be depreciated only with straight-line. MACRS applies to property placed in service after 1986. Pre-MACRS property continues to be depreciated under the ACRS or pre-ACRS rules. Most taxpayers will be using MACRS, ACRS, and the depreciation rules that apply to property acquired before 1981. This section concentrates on the MACRS rules, but some ACRS information is included. Additional information on ACRS and pre-ACRS rules can be found in the Farmer's Tax Guide, IRS Pub. 225.

Depreciable Assets

A taxpayer is allowed cost recovery or depreciation on purchased machinery, equipment, and buildings and on purchased livestock acquired for dairy, breeding, draft, and sporting purposes. The taxpayer that owns the asset must claim depreciation. A taxpayer cannot depreciate property that he or she is renting or leasing from others. The costs of most capital improvements made to leased property may be depreciated by the owner of the leasehold improvements under the same rules that apply to owners of regular depreciable property. A lessor cannot depreciate improvements made by the lessee.

Depreciation or cost recovery is not optional. It should be claimed each year on all depreciable property, including temporarily idle assets. An owner who neglects to take depreciation when it is due has three opportunities to recover the lost depreciation. It may be recovered by filing an amended return in any of the following situations:

- An incorrect amount was claimed due to a mathematical error.
- An incorrect amount was claimed due to a posting error.
- A “method of accounting for the property” has not been adopted.

A method of accounting has been adopted if an incorrect amount of depreciation has been claimed on two or more consecutively filed tax returns for reasons other than a mathematical or posting error. In this case, Form 3115, Application for Change in Accounting Method, is filed to request a change in accounting method and to document the amount of adjustment being claimed on *subsequently filed* tax returns. Various Rev. Procs. have been issued (2002-9, 2002-19, 2002-33) to describe the process. If the adjustment is negative (due to previously understated depreciation), it may be taken in total on the next tax return filed. If the adjustment is positive and exceeds \$25,000, it is reported equally on the next 4 years' returns. Form 3115 must be filed with the National Office of the IRS, and a signed copy must be attached to the taxpayer's return for the tax year that the correction in depreciation is made. There is no fee for filing Form 3115 under these automatic approval procedures.

Expensing the purchase of small assets is not an option according to the Tax Court (T.C.M. 2001-149). If the item has a useful life greater than 1 year, it is to be depreciated. The only exception stated is that if the aggregate total of all such items for the tax year is less than 1% of operating expenses and net income, the expense would be allowed.

MACRS Classes

The MACRS class life depends on the asset depreciation range (ADR) midpoint life of the property, as shown in Figure 20.

Assets are placed in one of the eight MACRS classes, regardless of the useful life of the property in the taxpayer's business. Examples of the types of farm assets included in each MACRS class are shown in Figure 21.

FIGURE 20. MACRS Class Life and ADR Midpoint Life

MACRS Class	ADR Midpoint Life
3-year	4 years or less
5-year	More than 4 years but less than 10
7-year	10 years or more but less than 16
10-year	16 years or more but less than 20
15-year	20 years or more but less than 25
20-year	25 years or more other than I.R.C. §1250 property with an ADR life of 27.5 years or more
27.5-year	Residential rental property
39-year (31.5 if acquired before 5/13/93)	Nonresidential real property

Three-Year Property

- I.R.C. § 1245 property with an ADR class life of 4 years or less is 3-year property. This includes over-the-road tractors and hogs held for breeding purposes. It does not include cattle, goats, or sheep held for dairy or breeding purposes because the ADR class life of these animals is greater than 4 years.
- I.R.C. § 1245 property is considered 3-year property if it is used in connection with research and experimentation. Few farmers will have this type of property.
- Race horses more than 2 years old when placed in service and all other horses more than 12 years old when placed in service are considered 3-year property.

Five-Year Property

- All purchased dairy and breeding livestock (except hogs and horses included in the 3- or 7-year classes)
- Automobiles, light trucks (under 13,000 lbs unladen), and heavy-duty trucks
- Computers and peripheral equipment, typewriters, copiers, and adding machines
- Logging machinery and equipment

Seven-Year Property

- All farm machinery and equipment
- Silos, grain storage bins, fences, and paved barnyards
- Breeding horses or workhorses (12 years old or younger)
- Office furniture

Ten-Year Property

- Single-purpose livestock and horticultural structures (7-year property if placed in service before 1989)
- Orchards and vineyards (15-year property if placed in service before 1989)

Fifteen-Year Property

- Depreciable land improvements, such as sidewalks, roads, bridges, water wells, drainage facilities, and fences other than farm fences, which are in the 7-year class (does not include land improvements that are explicitly included in any other class, or buildings or structural components)
- Orchards, groves, and vineyards when they reach the production stage if they were placed in service before 1989

MACRS Classes 20 Years and Higher

- Twenty-year property includes farm buildings such as general-purpose barns, machine sheds, and many storage buildings.
- Property that is 27.5-year includes residential rental property.
- Property that is 39-year (31.5 if acquired before May 13, 1993) includes nonresidential real property.

**FIGURE 21. ACRS, MACRS, and MACRS Alternative Depreciation System (ADS)
Recovery Periods for Common Farm Assets**

Asset	Recovery Period (Years)		
	ACRS	MACRS	ADS
Airplane	5	5	6
Auto (farm share)	3	5	5
Calculators, copiers, and typewriters	5	5	6
Cattle (dairy or breeding)	5	5	7
Communication equipment	5	7	10
Computer and peripheral equipment	5	5	5
Farm buildings (general-purpose)	19	20	25
Farm equipment and machinery	5	7	10
Fences (agricultural)	5	7	10
Goats (breeding or milk)	3	5	5
Grain bin	5	7	10
Greenhouse (single-purpose structure)	5	10 ^a	15
Hogs (breeding)	3	3	3
Horses (nonrace, younger than 12 years of age)	5	7	10
Horses (nonrace, 12 years of age or older)	3	3	10
Logging equipment	5	5	6
Machinery (farm)	5	7	10
Mobile homes on permanent foundations (for farm labor housing)	19	20	25
Office equipment (other than calculators, copiers, or typewriters) & furniture	5	7	10
Orchards	5	10 ^b	20

**FIGURE 21. ACRS, MACRS, and MACRS Alternative Depreciation System (ADS)
Recovery Periods for Common Farm Assets (Continued)**

Asset	Recovery Period (Years)		
	ACRS	MACRS	ADS
Paved lots	5	15	20
Property with no class life	5	7	12
Rental property (nonresidential real estate)	19	39 ^c	40
Rental property (residential)	19	27.5	40
Research property	5	5	12 ^d
Sheep (breeding)	3	5	5
Silos	5	7	12 ^d
Single-purpose livestock structure (housing, feeding, storage, and milking facilities)	5	10 ^a	15
Single-purpose horticultural structure	5	10 ^a	15
Solar property	5	5	12 ^d
Storage (apple, onion, potato)	5	20	25
Tile (drainage)	5	15	20
Tractor units for use over the road	3	3	4
Trailer for use over the road	5	5	6
Truck (heavy-duty, general-purpose)	5	5	6
Truck (light, less than 13,000 lbs)	3	5	5
Vineyard	5	10 ^b	20
Water well	5	15	20
Wind energy property	5	5	12 ^d

^aIf placed in service before 1989, recovery period is 7 years.

^bIf placed in service before 1989, recovery period is 15 years.

^cIf placed in service before May 13, 1993, recovery period is 31.5 years.

^dNo class life specified; therefore, 12-year life assigned.

Cost Recovery Methods and Options

Accelerated cost recovery methods for MACRS property are shown in Figure 22. Depreciation on farm property placed in service after 1988 is limited to 150% declining balance (DB), rather than the 200% available for nonfarm property (both with crossover to straight-line). There are two straight-line (SL) options for the classes eligible for rapid recovery. The SL option may be taken over the MACRS class life or the MACRS alternative depreciation system (ADS) life. A fourth option is 150% DB over the ADR midpoint life. The changes in depreciation required for AMT purposes are discussed in this section under “AMT Depreciation” and in the “Alternative Minimum Tax” section.

Orchards and vineyards placed in service after 1988 are not eligible for rapid depreciation. They are in the 10-year class, and depreciation is limited to SL.

FIGURE 22. Accelerated Cost Recovery Methods for MACRS

Class	Most Rapid MACRS Method Available
3-, 5-, 7-, and 10-year	
Farm assets	150% DB if placed in service after 1988 ¹ 200% if placed in service 1987 through 1988 ¹
Nonfarm assets	200% DB
15- and 20-year	150% DB
27.5- and 39 (31.5)-year	SL <i>only</i>

¹See exception for orchards and vineyards earlier.

The MACRS law does not provide standard percentage recovery figures for each year. However, the IRS and several of the tax services have made tables available, such as Figure 23.

FIGURE 23. Annual Recovery (Percentage of Original Depreciable Basis)*

(The 150% DB percentages are for 3-, 5-, 7-, and 10-year class farm property placed in service after 1988.)

Recovery Year	3-Year Class		5-Year Class		7-Year Class		10-Year Class		15-Yr Class	20-Yr Class*
	200% DB	150% DB	200% DB	150% DB	200% DB	150% DB	200% DB	150% DB	150% DB	150% DB
1	33.33	25.00	20.00	15.00	14.29	10.71	10.00	7.50	5.00	3.75
2	44.45	37.50	32.00	25.50	24.49	19.13	18.00	13.88	9.50	7.22
3	14.81	25.00	19.20	17.85	17.49	15.03	14.40	11.79	8.55	6.68
4	7.41	12.50	11.52	16.66	12.49	12.25	11.52	10.02	7.70	6.18
5			11.52	16.66	8.93	12.25	9.22	8.74	6.93	5.71
6			5.76	8.33	8.92	12.25	7.37	8.74	6.23	5.29
7					8.93	12.25	6.55	8.74	5.90	4.89
8					4.46	6.13	6.55	8.74	5.90	4.52
9							6.56	8.74	5.91	4.46
10							6.55	8.74	5.90	4.46
11							3.28	4.37	5.91	4.46
12–15									5.90 [†]	4.46
16									2.95	4.46
17–20										4.46
21										2.24

*Rounded to two decimals; see IRS Pub. 946 for more precise 20-yr class rates.

[†]The percentage is 5.90 in years 12 and 14, 5.91 in years 13 and 15.

Half-Year and Mid-Month Conventions

MACRS provides for a half-year convention in the year placed in service, regardless of the recovery option chosen (reflected in Figure 23). A half-year of recovery is taken in the year of disposal (not reflected in the table unless disposal is in the final year of the cost recovery period). No depreciation is allowed on property acquired and disposed of in the same year. Property in the 27.5-year and 39-year classes is subject to a mid-month convention in the year placed in service.

Mid-Quarter Convention

If more than 40% of the year's depreciable assets (other than 27.5- and 39-year property) are placed in service in the last quarter, *all* of the assets placed in service during that year must be depreciated using a mid-quarter convention. Assets placed in service during the first, second, third, and fourth quarters will receive 87.5%, 62.5%, 37.5%, and 12.5% of the year's depreciation, respectively. The amount expensed under I.R.C. § 179 is not considered in applying the 40% rule. In other words, the amount expensed under I.R.C. § 179 can be taken on property acquired in the last quarter, which may help avoid the mid-quarter convention rule (see Example 13 in the "Election to Expense Depreciable Property" section).

MACRS Alternative Depreciation

The MACRS ADS is required for some property and is an option for the rest. It is an SL system based on the alternative MACRS recovery period (ADR midpoint lives). Farmers who are subject to capitalization of preproductive expenses, discussed later, may elect to avoid capitalization; but if they do so, they must use the ADS life on all property. As noted later, any taxpayer required to use ADS is ineligible for bonus depreciation (which expired December 31, 2004) but may still use the I.R.C. § 179 expense deduction.

Election to Expense Depreciable Property

The I.R.C. § 179 expense deduction is \$125,000 for 2007 and will be indexed again for inflation for 2008 through 2010 before reverting to the pre-2003 act level of \$25,000 for 2011. The expense deduction is phased out dollar for dollar for any taxpayer that places over \$500,000 (up from \$430,000 in 2006) of property in service in any year, with a complete phaseout at \$625,000. Eligible property is defined as I.R.C. § 1245 property to which I.R.C. § 168 (accelerated cost recovery) applies. In addition, off-the-shelf computer software is eligible property. Property must be used more than 50% of the time in the business to qualify. General-purpose buildings, property acquired from a related person, and certain property leased by noncorporate lessors do not qualify. Excluded is property used outside the United States, property used by tax-exempt organizations, property used with furnished lodging, property used by governments and foreigners, and air-conditioning and heating units. When property is acquired by trade, I.R.C. § 179 deductions may not be claimed on the basis of the trade-in.

In the case of partnerships, the \$125,000 limit applies to the partnership as well as to each partner as an individual taxpayer. A partner who has I.R.C. § 179 allocations from several sources could be in a situation where only \$125,000 may be expensed because of the \$125,000 limitation. Any allocations in

excess of \$125,000 are lost forever, which is a different result from the limitation discussed in the next paragraph. The same concept applies to allocated I.R.C. § 179 deductions from S corporations.

The amount of the I.R.C. § 179 expense deduction is limited to the amount of taxable income of the taxpayer that is derived from the *active* conduct of all trades or businesses of the taxpayer during the year. Taxable income for the purpose of this rule is computed excluding the I.R.C. § 179 deduction. Any disallowed I.R.C. § 179 deductions due to this taxable income limitation are carried forward to succeeding years. The deduction of current plus carryover amounts is then limited to the taxable business income of that carryover year.

I.R.C. § 179 regulations provide that wage and salary income qualifies as income from a trade or business. Therefore, such income can be combined with income (or loss) from Form 1040 Schedules C (Profit or Loss from Business) or F (Profit or Loss from Farming) in determining income from the “active conduct of a trade or business” when calculating the allowable deduction. I.R.C. § 1231 gains and losses from a business actively conducted by the taxpayer, as well as ordinary gains and losses from business assets reported on Form 4797, Sales of Business Property, are also included. Trade or business income includes the amount of such items flowing through to the taxpayer’s return from S corporations and partnerships.

Gains from the sale of I.R.C. § 179 assets are treated like I.R.C. § 1245 gains. The amounts expensed are recaptured as ordinary income in the year of sale. The I.R.C. § 179 expense deduction is combined with depreciation allowed in determining the amount of gain to report as ordinary income on Part III of Form 4797.

If property is converted to personal use or if business use drops to 50% or less, I.R.C. § 179 expense recapture is invoked no matter how long the property was held for business use. The amount recaptured is the excess of the I.R.C. § 179 deduction over the amount that would have been deducted as depreciation. The recapture is reported on Part IV of Form 4797 and then on Form 1040 Schedule F.

Every business owner who has purchased MACRS property should consider the I.R.C. § 179 expense deduction. Note, however, that New York investment tax credit will be lost on the amount of an otherwise qualifying purchase that is expensed under I.R.C. § 179. Consideration should first be given to taking the expense deduction on highway vehicles since these are ineligible for the credit. Generally, I.R.C. § 179 should not be used to reduce AGI below standard (or itemized) deductions plus exemptions, unless an additional reduction in self-employment tax is worth more than depreciation in a future tax year. Also, the taxpayer must be sure not to use more I.R.C. § 179 deduction than the amount of taxable income from the “active conduct of a trade or business.”

SBWOTA also extended the taxpayer’s ability to make or revoke an I.R.C. § 179 expensing election on an amended return for tax years before 2011 without consent of the commissioner. (Available for tax years beginning after 2002 as a result of the 2003 act and subsequent extensions).



Practitioner Note

Previous guidance was that taxpayers should not rely on unused I.R.C. § 179 deduction to bail them out upon audit, because this election to expense was only allowed on a timely filed tax return. Current rules now would allow any unused I.R.C. § 179 deduction to be claimed if, for example, it is determined that certain parts, supplies, or repairs should have been capitalized rather than expensed.

The I.R.C. § 179 deduction can also be used to manage the triggering of the mid-quarter convention in order to maximize depreciation deductions.

Example 13. V. Sharp placed \$205,000 worth of 7-year MACRS property in service. He could expense \$125,000 and claim \$8,568 of depreciation ($\$205,000 - 125,000 = \$80,000 \times 0.1071 = \$8,568$) under the half-year convention. If \$155,000 of Sharp’s property was placed in service in the last quarter and the \$125,000 I.R.C. § 179 election is applied to this \$155,000, \$30,000 is left to be used in the 40% test. Thus, $\$30,000 \div (\$205,000 - 125,000) = 0.375$, which is less than 40%, so Sharp

avoids the mid-quarter rules. However, if his depreciable items had totaled \$198,000, and \$155,000 was placed in service in the last quarter, he would be caught by the 40% rule, even if he applied the \$125,000 I.R.C. §179 to the items placed in service in the last quarter. That is, $\$30,000 \div (\$198,000 - 125,000) = 0.41$, and all the depreciation items would be subject to the mid-quarter convention.

If the 40% rule is triggered, the depreciation on property acquired in the first and second quarters actually increases. Taxpayers are not allowed to use the mid-quarter rules voluntarily. However, choice of property to expense under I.R.C. §179 could work to the advantage of a taxpayer that wanted to become subject to the rules. If third-quarter property could be expensed and thereby have the 40% rule triggered, the depreciation on first- and second-quarter property would be increased. Whether this increases total depreciation for the year would depend on the proportion placed in service in each quarter.

MACRS Property Class Rules

For 3-, 5-, 7-, and 10-year MACRS property, the same recovery option *must* be used for all the property acquired in a given year that belongs in the same MACRS class.

Example 14. A farmer purchased a tractor, harvester, and combine in 2007. All belong in the 7-year property class. The farmer may not recover the tractor over 7 years with rapid recovery (150% DB) and the other items over 7 or 10 years with SL. However, a taxpayer may choose a different recovery option for property in the same MACRS class acquired in a subsequent year. For example, a farmer could have chosen SL 10-year recovery for equipment purchased in 2005 (7-year property) and 150% DB for 7 years for equipment purchased in 2006 and could now select SL 7-year recovery for all machinery purchased in 2007.

A taxpayer may select different recovery options for different MACRS classes established for the same year. For example, a taxpayer could select fast recovery on 5-year property, and SL over 7 years on 7-year property.

Some Special Rules on Autos and Listed Property

There are special rules for depreciation on vehicles and other listed property. If used less than 100% in the business, the maximum allowance is reduced, and if used 50% or less, the I.R.C. § 179 deduction is not allowed, and depreciation is limited to SL. The maximum depreciation and I.R.C. § 179 expense allowance for four-wheeled vehicles called luxury cars (6,000 pounds or less) placed in service in 2007 is \$3,060 for the first year and \$4,900 for the second year (both up \$100 from the 2006 limit). Unchanged for 2007 are the \$2,850 limit for the third year and the \$1,775 limit for each succeeding year (see Figure 24). If the business-use percentage is less than 100%, these limits are reduced accordingly. (Note that in 2001 through 2004 there were higher limits in the first year if bonus depreciation was used.) Sport-utility vehicles weighing more than 6,000 pounds but no more than 14,000 pounds are limited to a maximum I.R.C. § 179 expense of \$25,000 each. The balance of the cost is depreciable under MACRS rules without any further restrictions. Cellular telephones acquired after 1989 are listed property. Computers are listed property unless they are used only for business. Starting in the year 2003, pickups and vans have depreciation caps that are different from those of other automobiles, as shown in Figure 24. The 2007 limits for pickups and vans are unchanged from 2006 except for a \$100 reduction in year 3.

FIGURE 24. Depreciation Limitations for Passenger Autos, Pickups, and Vans

Year Placed in Service	1st Year	2nd Year	3rd Year	Later Years
1998	\$ 3,160	\$ 5,000	\$ 2,950	\$ 1,775
1999	3,060	5,000	2,950	1,775
2000	3,060	4,900	2,950	1,775
2001–2002 regular	3,060	4,900	2,950	1,775
2001–2002 with 30% bonus starting 9/11/01	7,660	4,900	2,950	1,775
2003 regular for cars	3,060	4,900	2,950	1,775
2003 regular for pickups and vans	3,360	5,400	3,250	1,975
2003 additional for 30% bonus	4,600			
2003 additional for 50% bonus starting 5/6/03*	7,650			
2004 regular for cars	2,960	4,800	2,850	1,675
2004 regular for pickups and vans	3,260	5,300	3,150	1,875
2004 only additional for 50% bonus*	7,650			
2005 regular for cars	2,960	4,700	2,850	1,675
2005 regular for pickups and vans	3,260	5,200	3,150	1,875
2006 regular for cars	2,960	4,800	2,850	1,775
2006 regular for pickups and vans	3,260	5,200	3,150	1,875
2007 regular for cars	3,060	4,900	2,850	1,775
2007 regular for pickups and vans	3,260	5,200	3,050	1,875

*Note: This limitation applies even if the taxpayer elects 30% bonus depreciation. For details, see the discussion of bonus depreciation that follows.

AMT Depreciation

For I.R.C. § 1245 property placed in service after 1998, if the 200% DB MACRS method is used for regular tax purposes, depreciation must be recalculated for AMT purposes using 150% DB MACRS. The difference between regular depreciation and this redetermined amount is an income adjustment subject to inclusion in alternative minimum taxable income. For all other property placed in service after 1998, the depreciation method is the same for regular tax and AMT purposes. Therefore, farm property placed in service after 1998 is depreciated using the same method for AMT purposes. (Note: There could still be an AMT adjustment on such property if it was acquired using a trade-in that has a different basis for AMT purposes due to prior-year AMT depreciation rules discussed later.) An adjustment remains for nonfarm property depreciated using 200% DB MACRS as well as for other property placed in service prior to 1999.

For I.R.C. §1245 property placed in service after 1986 and before 1999, depreciation must be recalculated for AMT purposes by using Figure 25.

FIGURE 25. I.R.C. § 1245 Property Placed in Service Prior to 1999

Used for Regular Tax Purposes	Must Use for AMT Purposes
150 DB MACRS	150 DB, ADS life
200 DB MACRS	150 DB, ADS life
SL MACRS ADS	SL, ADS life ADS

The AMT depreciation adjustment for I.R.C. § 1250 property placed in service after 1986 and before 1999 is the difference between what was claimed for regular income tax and what was allowed under MACRS ADS SL depreciation.

Bonus Depreciation

Bonus depreciation is not available on any item placed in service after December 31, 2004. The following discussion is provided in the event that this mandatory depreciation was not claimed and the taxpayer did not “elect out.” In such a case, it would be necessary to file an amended return or Form 3115, Application for Change in Accounting Method, to claim additional depreciation.

As a result of the Job Creation and Worker Assistance Act of 2002, there was an opportunity to claim a front-end additional depreciation deduction (equal to 30% of original cost) on any *new* asset placed in service on or after September 11, 2001. This is being referred to as the *bonus depreciation*. The 2003 act provides a 50% bonus depreciation for similarly qualified property placed in service after May 5, 2003, but before December 31, 2004. This special depreciation allowance is in addition to the I.R.C. § 179 direct-expense deduction.

Qualified Property

The following qualifications are used to determine whether assets are eligible for bonus depreciation:

- Under regulations issued September 5, 2003, the *total cost (including adjusted basis of any traded item)* is eligible for this bonus depreciation.
- The asset has a depreciable life of 20 years or less.
- The original use of the asset must commence with the taxpayer. (See additional details under the “What Constitutes New?” section.)
- The property must be used over 50% for the business.

What Constitutes New?

For equipment and buildings, the determination is not too difficult. There is the issue of reconditioned or rebuilt property—it is considered used property and therefore ineligible. However, if the taxpayer makes capital improvements to existing property (i.e., does the reconditioning), those capital improvement expenditures are eligible for bonus depreciation.

What about cattle? If the animal has been used for its dairy or breeding purpose, it is no longer new. Thus, milk cows purchased from another farmer’s herd would not qualify, but the purchase of heifers from one in the business of raising dairy replacements would qualify.

Mandatory Use or Election Out

The use of bonus depreciation is mandatory on eligible purchases. If not claimed, basis will still be reduced under the allowed or allowable rules. The taxpayer was allowed to elect out of the use of bonus depreciation on qualifying purchases. The taxpayer was also able to elect out of 50% bonus depreciation and claim 30%. However, the time has run out for a taxpayer to elect out of using bonus depreciation unless approval of the commissioner is obtained.

Impact of Use of ADS Depreciation

If the taxpayer is a fruit grower or vineyardist who is required to use ADS depreciation because they have elected out of the uniform capitalization rule (discussed in a later section), they are ineligible for the bonus depreciation. However, if a taxpayer simply elects to use ADS to stretch the useful life

(rather than being required to do so), he or she must still claim bonus depreciation on otherwise qualifying property unless the taxpayer elects out.

Luxury Car Limits Modified

To accommodate 50% bonus depreciation on eligible lightweight vehicles, the amount of first-year depreciation allowed on passenger vehicles was increased (taxpayers must prorate for business-use percentage; see Figure 24). However, this increased limit was only available if bonus depreciation was used. The higher limits continue to apply even if the taxpayer elects 30% bonus depreciation (starting May 6, 2003).

Interaction with I.R.C. § 179

Bonus depreciation is in addition to the I.R.C. § 179 deduction on qualifying property. The I.R.C. § 179 deduction is taken first, and then the remaining basis is eligible for bonus depreciation.

Alternative Minimum Tax

Bonus depreciation was also allowed in the calculation of alternative minimum taxable income (AMTI), so there will be no additional depreciation adjustment for AMT as a result of using bonus depreciation.

Additional Depreciation Rules

MACRS rules allow half a year's depreciation in the year of disposition if using the half-year convention. If the mid-quarter convention applies, depreciation is allowed for the quarters held in the year of disposition. For 27.5- and 39-year property, depreciation is claimed in the year of disposition based on the months held in that year. The depreciation tables reflect the full year's depreciation except in the final year of the recovery period. Therefore it is necessary to manually adjust the table amount of depreciation for the months the asset was actually held. An asset under the mid-quarter convention sold in May will receive only 4.5 months of depreciation in the year of disposition.

When assets are sold, gain to the extent of all prior depreciation on all I.R.C. § 1245, as well as on 3-, 5-, 7-, 10-, and 15-year MACRS property, is ordinary income. There is no recapture of depreciation on property in the 20-year class if SL recovery is used (see the section "A Review of Farm Business Property Sales").

Property placed in service during a short tax year is subject to special allocation rules that vary with the applicable convention used. Details are provided in IRS Pub. 946, *How to Depreciate Property*.

Choosing Recovery Options

Taxpayers will maximize after-tax income by using I.R.C. § 179 and rapid recovery on 3-, 5-, 7-, 10-, and 15-year MACRS property, assuming the deductions can be used to reduce taxable income and do not create an AMT adjustment that results in AMT liability. The taxpayer that will not be able to use all the deductions in the early years may want to consider one of the SL options. A taxpayer in a low tax bracket may wish to forgo the I.R.C. § 179 deduction to save tax deductions for future years if higher tax brackets are expected. Also, the loss of NYS investment tax credit (ITC) on any amount expensed under I.R.C. § 179 should be considered.

Using SL rather than 150% DB on 20-year property will preserve capital gain treatment (at a 25% maximum rate) at the time of disposal because the amount of depreciation in excess of SL is treated as ordinary income at the time such I.R.C. § 1250 property is sold. However, the tax savings will not be

realized until many years from now, and if the asset is fully depreciated at the time of sale, there is no *excess* depreciation to be recaptured as ordinary income. For most taxpayers, the choice of the best recovery option for 20-year MACRS property should be based on the value of concentrating depreciation in early years versus spreading it out—that is, using 150% DB MACRS. The time value of money makes current-year depreciation more valuable than that used in later years. However, depreciation claimed to reduce taxable income below zero is wasted.

Reporting Depreciation and Cost Recovery

Form 4562, Depreciation and Amortization, is used to report the I.R.C. § 179 expense election, depreciation of recovery property, depreciation of nonrecovery property, amortization, and specific information concerning automobiles and other listed property. Depreciation, cost recovery, and I.R.C. § 179 expenses are combined on Form 4562 and entered on Form 1040 Schedule F, Profit or Loss from Farming. However, partnerships and S corporations will transfer the I.R.C. § 179 expense election to Schedule K (Form 1065 or 1120S), rather than combining it with other items on Form 4562. Furthermore, I.R.C. § 179 is excluded when calculating net earnings for self-employment at the partnership level on Schedules K and K-1. Therefore, I.R.C. § 179 must be included as an adjustment on the partner's Form 1040 Schedule SE, Self-Employment Tax, if the partner meets the test for the I.R.C. § 179 deduction to be taken (i.e., business income limitation and overall \$125,000 limit).

Uniform Capitalization Rules for Fruit Growers and Nursery Owners

Plants subject to uniform capitalization rules include fruit trees, vines, ornamental trees and shrubs, and sod, providing the preproductive period is 24 months or more. The preproductive period begins when the plant or seed is first planted or acquired by the taxpayer. It ends when the plant becomes productive in marketable quantities or when the plant is reasonably expected to be sold or otherwise disposed of. An evergreen tree that is more than 6 years old when harvested (severed from the roots) is not an ornamental tree subject to capitalization rules. Timber is also exempt. If trees and vines bearing edible crops for human consumption are lost or damaged by natural causes, the nondepreciable costs of replacing trees and vines do not have to be capitalized.

In Notice 2000-45, the IRS has now provided the following list of commercially grown plants with nationwide weighted-average preproductive periods in excess of 2 years: almonds, apples, apricots, avocados, blackberries, blueberries, cherries, chestnuts, coffee beans, currants, dates, figs, grapefruit, grapes, guavas, kiwifruit, kumquats, lemons, limes, macadamia nuts, mangoes, nectarines, olives, oranges, papayas, peaches, pears, pecans, persimmons, pistachio nuts, plums, pomegranates, prunes, raspberries, tangelos, tangerines, tangors, and walnuts. This is not an all-inclusive list. For other plants grown in commercial quantities in the United States, the nationwide weighted-average preproductive period must be determined based on available statistical data.

Fruit growers who choose to capitalize will need to establish reasonable estimates of the preproductive costs of trees and vines. Nursery owners could use the farm-price method to establish their preproductive costs of growing trees, vines, and ornamentals. Capitalization requires the recovery of orchard, vineyard, and ornamental tree preproductive period expenses over 10 years, SL.

If growers elect not to capitalize, they must use ADS to recover the costs of trees and vines (20-year SL) and all other depreciable assets placed in service. Only the preproductive period growing costs may be expensed.

Accurate Records Needed

Accurate and complete depreciation records are basic to reliable farm income tax reporting and good tax management. Depreciation and cost recovery must be reported on Form 4562, Depreciation and Amortization. A complete depreciation and cost recovery record is needed to supplement Form 4562; however, it is not necessary to file the complete list of items included in the taxpayer's depreciation and cost recovery schedules.

GENERAL BUSINESS CREDIT

The general business credit (GBC) is a combination of investment tax credit, work opportunity credit, welfare-to-work credit, research credit, low-income housing credit, disabled access credit, and others (see the following page for other GBCs). Form 3800, General Business Credit, is used to claim the credit for the current year, to apply carryforward from prior years, and to claim carryback from later years. The credit allowable cannot reduce regular tax below tentative AMT. It is also limited to \$25,000 plus 75% of net regular tax liability above \$25,000. Special limits apply to married persons filing separate returns, controlled corporate groups, estates and trusts, and certain investment companies and institutions. The Taxpayer Relief Act of 1997 (TRA 97) changed the carryback period to 1 year and the carryforward period to 20 years, beginning in 1998. The 3-year carryback and 15-year carryforward rules remain for all credits earned before 1998.

Review of Federal Investment Credit

Federal ITC was repealed for most property placed in service after December 31, 1985. The ITC may still be earned on rehabilitated buildings, qualified reforestation expenses, and certain business energy investments. ITC is 10% of the amount of qualified investment, with more liberal allowances for some rehabilitated historic buildings. The ITC is a direct reduction against income tax liability. If it cannot be used in the year it is earned, it can be carried back and carried forward to offset tax liability in other years.

If property is disposed of before the ITC claimed is fully earned, the credit must be recomputed to determine the amount to recapture. Recapture rules apply when there is early disposition of rehabilitated buildings, business energy property, or reforested land for which investment credit has been claimed. The amount of recapture is 100% during the first year of service and declines to zero after 5 full years of service. Form 3468 (Investment Credit) is used for computing ITC; Form 4255 (Recapture of Investment Credit) is used to recapture ITC.

Rehabilitated Buildings

The rehabilitated buildings (expenditures) credit is 10% for a qualified rehabilitated building and 20% for a certified historic structure. The building (other than a certified historic structure) must have been first placed in service before 1936. Expenditures for the interior or exterior renovation, restoration, or reconstruction of the building qualify for the credit. Costs for acquiring or completing a building, or for the replacement or enlargement of a building, do not qualify. The credit is available for all types of buildings that are used in a business. Buildings that are used for residential purposes qualify only if they are certified historic structures that are used for residential purposes. The use of a building is determined based on its use when placed in service after rehabilitation. Thus, rehabilitation of an apartment

building for use as an office building would render the expenditure eligible for credit. The basis for depreciation must be reduced by 100% of the investment credit claimed. Expenditures must exceed the greater of the adjusted basis of the property or \$5,000. Qualifying investment is reduced by any I.R.C. § 179 expense claimed on the building.

Gasification

A 20% credit is provided for projects that convert coal, petroleum residue, biomass (except recyclable paper), or other material into gas. Certification by the Department of Energy and approval by the IRS are required. Any credit claimed reduces the depreciable basis of the property. The credit maximum is \$130 million.

Energy

Business energy investment credit is equal to 10% of the basis of qualified microturbine property and geothermal energy equipment placed in service during the tax year. A 30% credit applies to qualified fuel-cell property, equipment that illuminates the interior of a structure using fiber-optic distributed sunlight, or equipment that provides solar-process heat or uses solar energy to generate electricity, provide hot water, or heat or cool a structure. The basis of any qualifying equipment must be reduced by 50% of ITC claimed.

Other General Business Credits (GBCs)

In addition to federal investment credits, a variety of other GBCs are available to taxpayers.

Tax Credit for Child-Care Expenses Provided by Businesses for Employees' Children

Business taxpayers may receive a credit equal to 25% of qualified expenses for employee child care plus 10% of child-care referral and resource services, up to a maximum of \$150,000 credit per year. Employer's expenditures are deductible as ordinary and necessary business expenses. Qualified child-care expenses include costs to acquire, build, rehabilitate, or expand nonprincipal residence (within meaning of I.R.C. § 121) depreciable property. The fact that a child-care facility is in a residence will not prevent it from being qualified if it meets all the other requirements in I.R.C. § 45F. To be qualified, the facility must meet open enrollment, nondiscrimination, and other regulations contained in I.R.C. § 45F, as well as applicable state and local laws. Credits taken for costs of building, purchasing, or rehabilitating a facility are subject to recapture for the first 10 years after it is placed in service. The basis of the facility or the deduction for expenses must be reduced by the credit claimed.

Pension Plan Credit for Start-Up Costs for Small Businesses

Any small business that sets up a new qualified defined-benefit or defined-contribution plan may receive a nonrefundable income tax credit for 50% of the first \$1,000 in administrative and retirement education costs. Eligible plans would also include an I.R.C. § 401(k) plan, SIMPLE plan, or SEP plan. A small business is one that employed, in the preceding year, 100 or fewer employees with compensation of at least \$5,000. Credit is for only the first 3 plan years and must include at least one non-highly compensated employee. Although part of the GBC, any unused credit may *not* be carried back to years prior to 2002.

Work Opportunity Credit

The work opportunity credit (which due to SBWOTA now applies to qualifying individuals who start to work no later than September 1, 2011) is available to employers on first-year employee wages paid (Form 5884, Work Opportunity Credit). First-year wages paid to targeted group employees with 120 to

400 hours of service earn 25% credit. The credit increases to 40% when an eligible employee reaches or exceeds 400 hours. There are nine targeted groups, including qualified SSI recipients, recipients of long-term family assistance and temporary assistance for needy families (TANF), certain food-stamp recipients, designated community residents (replaces prior high-risk youth group), economically disadvantaged ex-felons, and certain disabled workers and veterans. Qualification rules were modified for disabled workers, veterans and “high risk youth.”

Welfare-to-Work Credit

The welfare-to-work credit (Form 5884) is available to employers on qualified wages paid to long-term family assistance recipients who start to work no later than December 31, 2007. The credit is 35% on qualified first-year wages and 50% on qualified second-year wages. The credit applies to the first \$10,000 of an eligible employee’s wages each year for a maximum credit of \$8,500 over 2 years. Wages include the value of benefits, health insurance benefits, and employer contributions, including educational assistance and dependent-care expenses.

In general, to qualify as long-term family assistance recipients, members of a family must have been receiving family assistance for at least 18 months before the hiring date. The recipient must be certified by a designated local agency as being a member of a family receiving assistance. Employers cannot get work opportunity credit and welfare-to-work credit on the same employee.

The welfare-to-work credit has been unified with the work opportunity credit for those hired after December 31, 2006.

Credit for Increased Research Expenditures

The credit for increased research expenditures (formerly the research and development credit) is set to expire for expenditures after December 31, 2007 (as of date of publication), and amounts to 20% of qualified research expenditures. This credit is claimed on Form 6765, Credit for Increasing Research Activities.

Disabled Access Credit

The disabled access credit may be claimed on Form 8826, Disabled Access Credit, by an eligible small business that incurs expenses for providing access to persons with disabilities. The credit is 50% of eligible expenses that exceed \$250 but do not exceed \$10,250. An eligible business is one that for the preceding year did not have more than 30 full-time employees or did not have more than \$1 million in gross receipts. An employee is considered full-time if employed at least 30 hours per week for 20 or more calendar weeks in the tax year.

Miscellaneous Credits

Other GBCs include those for new markets tax, low-income housing, alcohol fuels, enhanced oil recovery, renewable electricity production, empowerment zones, American Indian employment, and employer FICA tax on tips.

A REVIEW OF FARM BUSINESS PROPERTY SALES

Because farm taxpayers are affected by preferential capital gains tax rates, income averaging, and the complexities of installment sale reporting rules, tax planning for farm property sales has increased in importance. The first step in tax planning is making the distinction among gains from sales of property used in the farm business that are eligible for capital gains treatment, gains subject to recapture of depreciation, and Form 1040 Schedule F (Profit or Loss from Farming) income.

IRS Property Classifications

The reporting of gains and losses on the disposition of property held for use in the farm business continues to be a complicated, but important, phase of farm tax reporting. Form 4797 (Sales of Business Property) must be used to report gains and losses on sales of farm business property. Form 1040 Schedule D (Capital Gains and Losses) is used to accumulate capital gains and losses. The treatment of gains and losses on disposition of property used in the farm business can be better understood after a review of the IRS classifications for such property.

I.R.C. § 1231 Property

I.R.C. § 1231 includes gains and losses on the sale or exchange of business assets meeting a holding-period requirement. (See the discussion later explaining that livestock must be held for dairy, breeding, sport, or draft to qualify as I.R.C. § 1231 property.) The required holding period is 24 months for cattle and horses and 12 months for all other business assets, including unharvested crops sold with farmland that was held at least 1 year. There are instances, however, when gain on livestock, equipment, land, buildings, and other improvements is treated specifically under I.R.C. §§ 1245, 1250, 1252, and 1255 (resulting in a portion of these gains being treated as ordinary income).

Under I.R.C. § 1231, net gains are treated as long-term capital gains, but net losses are fully deductible ordinary losses.



Practitioner Note

Net I.R.C. § 1231 gains are treated as ordinary income to the extent of unrecovered net I.R.C. § 1231 losses for the 5 most recent prior years. A taxpayer that claimed a net I.R.C. § 1231 loss on the 2003, 2004, 2005, or 2006 return and has a net I.R.C. § 1231 gain for 2007 must recapture the losses on the 2007 return (if they have not already been used against I.R.C. § 1231 gains in earlier years). Losses are to be recaptured in the order in which they occurred. Any current-year I.R.C. § 1231 gains in excess of these prior-year losses would still receive long-term capital gains treatment. Total gain is unaffected—this provision simply converts gain from capital gain to ordinary income.

I.R.C. § 1245 Property

I.R.C. § 1245 is one of the depreciation recapture sections. Farm machinery and purchased dairy, breeding, sport, and draft livestock held for the required period and sold at a gain are reported under this section. Gain will be ordinary income to the extent of depreciation and I.R.C. § 179 expense deductions. Gain to the extent of depreciation claimed on capitalized preproduction costs is also reported here. Even if a taxpayer elects out of uniform capitalization rules (UCR) and instead uses the ADS method of depreciation, the preproduction costs that would have otherwise been capitalized must be recaptured as ordinary income.

Single-purpose livestock and horticultural structures (placed in service after 1980) are I.R.C. § 1245 property. Nonresidential 15-, 18-, and 19-year ACRS property becomes I.R.C. § 1245 property if fast recovery (regular ACRS) has been used. Other tangible real property, including silos, storage structures, fences, paved barnyards, orchards, and vineyards, is I.R.C. § 1245 property.

I.R.C. § 1250 Property

Farm buildings and other depreciable real property held over 1 year and sold at a gain are reported in I.R.C. § 1250 unless the assets are I.R.C. § 1245 property. If a method other than SL depreciation was used, the gain to the extent of depreciation claimed after 1969 that exceeds what would have been allowed under SL depreciation is recaptured as ordinary income. No recapture takes place when only SL depreciation has been used. A taxpayer may shift such real property to SL depreciation without

special consent. In addition, gain to the extent of SL depreciation on I.R.C. § 1250 assets sold after May 6, 1997, is called unrecaptured I.R.C. § 1250 gain and is taxed at a maximum rate of 25%.

General-purpose farm buildings (including a house provided rent-free to employees) placed in service after 1986 are MACRS 20-year property eligible for 150% DB depreciation. Depreciation claimed that exceeds SL must be recaptured as ordinary income when the buildings are sold. A different MACRS option may be used on a substantial improvement to the original building. If fast recovery has been used on either the building or a substantial improvement to it, gain will be recaptured on the entire building to the extent of fast recovery. Any remaining gain will be capital gain. For residential rental real estate, gain will be recaptured only to the extent that fast-recovery deductions exceed SL on ACRS 15-, 18-, and 19-year property.

Example 15. A general-purpose farm building was purchased in 2005 for \$20,000. Regular MACRS was used until the building was sold for \$23,000 in 2007. Accumulated depreciation totaled \$2,861. Total gain was therefore \$5,861, as shown in Figure 26. SL depreciation would have been \$2,000, so an excess depreciation of \$861 would be recaptured as ordinary income. The gain from SL depreciation would be taxed at a maximum rate of 25%. The \$3,000 of gain resulting from the sale price exceeding the original cost would be subject to long-term capital gains rates (5% or 15%).

FIGURE 26. Calculation of Total Gain and Tax on Gain

Purchase price	\$20,000
Selling price	23,000
Basis (\$2,861 accumulated depreciation)	17,139
Gain	5,861
Tax on Gain	
SL depreciation (taxed at maximum rate of 25%)	2,000
Excess depreciation (recaptured at ordinary income rates)	861
Sales price in excess of cost (taxed at long-term capital gains rates)	3,000
	<u>\$ 5,861</u>

Note that for corporations, I.R.C. § 291(a) increases the ordinary income recapture by 20% of the additional amount that would be treated as ordinary income if the property were subject to the recapture rules for I.R.C. § 1245 property. Although corporations do not receive reduced tax rates on capital gain, this provision may impact the tax consequences of an installment sale of I.R.C. § 1250 property by a corporation.

I.R.C. § 1252 Property

Gain on the sale of land held less than 10 years will be part ordinary and part capital gain when soil and water conservation expenditures have been expensed. If the land was held 5 years or less, all soil and water or land-clearing expenses taken will be recaptured as ordinary gain. If the land was held more than 5 years and less than 10, part of the soil and water expenses will be recaptured. The percentages of soil and water conservation expenses subject to recapture during this time period are as follows: 80% for the sixth year after acquisition of the land, 60% for the seventh year, 40% for the eighth year, and 20% for the ninth year. Figure 27 gives an illustration.

FIGURE 27. Example of Recaptured Gain

Cost of farmland acquired April 1, 2001	\$ 100,000
Soil and water expenses deducted on 2002 tax return	8,000
Price land was sold for on May 15, 2007	130,000

During the time the land was owned, no capital improvements were made other than the soil and water expenses, so the adjusted tax basis at time of sale was \$100,000. The gain of \$30,000 would normally be all capital gain. The land was held for 6 years, so 80% of the soil and water conservation expenses ($\$8,000 \times 0.80 = \$6,400$) must be recaptured as ordinary gain. The balance of the gain ($\$30,000 - \$6,400 = \$23,600$) qualifies for capital gains treatment.

I.R.C. § 1255 Property

If government cost-sharing payments for conservation have been excluded from gross income under the provisions of I.R.C. § 126, the land improved with the payments will come under I.R.C. § 1255 when sold. All the excluded income will be recaptured as ordinary income if the land has been held less than 10 years *after the last government payment had been excluded*. Between 10 and 20 years, the recapture is reduced 10% for each additional year the land is held. There is no recapture after 20 years.

Use of Form 4797 and Form 1040 Schedule D by Farmers

All sales of farm business properties are reported on Form 4797 (Sales of Business Property) to separate I.R.C. § 1231 gain and loss from ordinary gain and loss. Casualty and theft gains and losses are reported on Form 4684 (Casualties and Thefts) and transferred to Form 4797. Part III is used to apply the recapture provisions to any business asset held the required holding period and sold at a gain. The ordinary gain is transferred to Part II. The remaining capital gain is transferred to Part I, where it is combined with other I.R.C § 1231 gains and losses.

If the I.R.C § 1231 gains and losses reported on Form 4797 result in a *net gain*, net I.R.C. § 1231 losses reported in the prior 5 years must be recaptured as ordinary income by transferring I.R.C. § 1231 gain equal to the nonrecaptured losses to Part II. Any remaining gain is transferred to Form 1040 Schedule D (Capital Gains and Losses) and combined with capital gain or loss, if any, from disposition of capital assets. If the I.R.C. § 1231 items result in a *net loss*, the loss is combined with ordinary gains and losses on Form 4797 Part II and then transferred to Form 1040, U.S. Individual Income Tax Return.

Livestock Sales

The majority of livestock sales from Northeast farms are animals that have been held for dairy, breeding, or sporting purposes. Income from such sales is always reported on Form 4797, Sales of Business Property. Dairy cows culled from the herd and cows held for dairy or breeding purposes are the most common of these sales. Sales of horses and other livestock held for breeding, draft, or sporting purposes also go on Form 4797.

Income from livestock held primarily for sale is reported on Form 1040 Schedule F, Profit or Loss from Farming. Receipts from the sale of “bob” veal calves, feeder livestock, slaughter livestock, and dairy heifers *raised for sale* are entered on Form 1040 Schedule F, line 4. Sales of livestock purchased for resale are entered on line 1 of Form 1040 Schedule F and, for a cash-basis farmer, the purchase price is recovered in the year of sale on line 2. The intent of holding livestock is a key issue in determining whether sales should be reported on Form 4797 or Form 1040 Schedule F.

Dairy, Breeding, Sport, or Draft Livestock

Dairy cattle raised or purchased to replace or add to the taxpayer's herd are held for dairy purposes. Dairy cattle that are raised or purchased and developed as breeding stock to be sold to other farmers are held for sale. Livestock held for dairy, breeding, sport, or draft purposes are classified into two groups according to length of holding periods:

1. *Cattle and horses held 2 years or more, and other breeding livestock held 1 year or more*—Animals in this group are I.R.C. § 1231 livestock. Emus and ostriches are currently excluded from the IRS definition of I.R.C. § 1231, but alpacas would qualify if held for breeding purposes.
2. *Cattle and horses held less than 2 years and other breeding livestock held less than 1 year*—These sales do not meet holding-period requirements.

Most dairy animals will meet the 2-year holding period requirement. Major exceptions are raised young stock sold with a herd dispersal and the sale of cows that were purchased less than 2 years prior to sale. The age of raised animals sold will determine the length of the holding period. The date of purchase is needed to determine how long purchased animals are held. The holding period begins the day after the animal is born or purchased and ends on the date of disposition.

Reporting Sales of I.R.C. § 1231 Livestock

Sales of I.R.C. § 1231 livestock are entered in Part I or Part III of Form 4797, Sales of Business Property. Because Part III is for recapture, purchased I.R.C. § 1231 livestock that produce a gain when sold are to be entered in Part III, where they are taxed as I.R.C. § 1245 property. Sales of raised I.R.C. § 1231 livestock that are held for dairy, breeding, sport, or draft purposes are entered in Part I. All purchased I.R.C. § 1231 livestock (held the required holding period) that result in a *loss* when sold are also entered in Part I.

Reporting Sales of Livestock Not Meeting Holding-Period Requirements

Dairy, breeding, sport, or draft livestock that are *not held for the required period*, whether sold for a gain or loss, will be entered in Part II of Form 4797, Sales of Business Property. This will include raised cattle that are held for dairy or breeding but sold before they reach 2 years of age and purchased cattle held for dairy or breeding but held for less than 2 years. Tax forms for reporting common farm business property sales are shown in Figure 28.

FIGURE 28. Summary of Reporting Most Common Farm Business Property Sales

Type of Farm Property	Tax Form and Section
1. Cattle and horses held for dairy, breeding, sport, or draft purposes and held for 2 years or more; plus other breeding or sporting livestock held for at least 1 year:	
(a) Raised (I.R.C. § 1231 property).	4797, Part I
(b) Purchased, sale results in gain (I.R.C. § 1245 property).	4797, Part III
(c) Purchased, sale results in loss (I.R.C. § 1231 property).	4797, Part I
2. Livestock held for dairy, breeding, sport, and draft purposes but not held for the required period	4797, Part II
3. Livestock held for sale	Schedule F, Part I
4. Machinery held over 1 year:	
(a) Sale results in gain.	4797, Part III
(b) Sale results in loss.	4797, Part I
5. Buildings, structures, and other depreciable real property held over 1 year:	
(a) Sale results in gain.	4797, Part III
(b) Sale results in loss.	4797, Part I
6. Farmland, held over 1 year sold at gain:	
(a) Soil and water expenses were deducted or cost-sharing payments excluded.	4797, Part III
(b) If 6a does not apply.	4797, Part I
7. Machinery, buildings, other depreciable real property, and farmland held for 1 year or less	4797, Part II

Gifts and Below-Market Sales

If a taxpayer sells an asset at below market value, the transaction is in essence part sale and part gift. A taxpayer should always determine FMV and file the appropriate income and/or gift tax returns. If an individual sells to a family member and the value may be questioned, or discounts were used to arrive at the value of the gift or sale, they should file a gift tax return. This is true even if the amount of the gift is below the 2007 annual gift tax exclusion of \$12,000 per person. This filing is important because it starts the statute of limitations running. If a gift tax return (with adequate disclosure) is filed, the IRS has only 3 years to challenge the value of the gift. If the taxpayer does not disclose certain gifts in a manner to apprise the IRS of the nature and amount of the gift, the period of limitations is held open indefinitely, and the gift amount may even be added back into an estate tax calculation.

INSTALLMENT SALES

The installment method of reporting may be used by taxpayers (who are nondealers) for the sale of real property or personal property (except for the gain caused by depreciation or other ordinary income recapture). Installment sales continue to be a practical and useful method used in transferring farms to the next generation. The installment method is required when qualified property is sold and at least one payment is received in the following tax year, unless the seller elects to report all the sale proceeds in the year of disposition. This election is made by simply reporting the total proceeds in the year of sale.

Taxable income from installment sales is computed by multiplying the amount of principal received in any year by the gross profit ratio. The gross profit ratio is gross profit (selling price minus the total of adjusted tax basis, expenses of sale, and recapture gains ineligible for installment reporting) divided by contract price (selling price minus mortgage assumed by buyer, plus any mortgage assumed in excess of adjusted tax basis). Form 6252, Installment Sale Income, is used to report installment sales income. Interest must be charged on the outstanding balance at the published applicable federal rate (AFR), or higher; otherwise, it will be imputed by the IRS. IRS Pub. 225 contains a chapter on installment sales.

Depreciation Recapture

Recaptured depreciation does not qualify for installment sale reporting. That portion of the gain attributed to recaptured depreciation of I.R.C. §§ 1245 and 1250 property (or ordinary income recapture under I.R.C. §§ 1252 or 1255) must be excluded from installment sale reporting. I.R.C. § 179 expenses are also subject to I.R.C. § 1245 recapture. The full amount of recapture is reported as ordinary income in the year of sale regardless of when the payments are received.

Example 16. Frank Farmer sells his raised dairy cows, machinery, and equipment to his son Hank for \$180,000. The cows are valued at \$80,000, and the machinery is valued at \$100,000. Hank will pay \$30,000 down and \$30,000 plus interest for 5 years. Frank's machinery and equipment has an adjusted basis of \$45,000; its original basis was \$125,000. The raised cows have zero basis. Frank's gain on the sale of machinery and equipment is \$55,000 (\$100,000 – \$45,000). The full \$55,000 is recaptured depreciation because prior depreciation, \$80,000, is greater. Frank must report \$55,000 received from machinery in the year of sale. He will report the \$80,000 cattle sales gain using the installment method.

When the sale of I.R.C. §§ 1245 and 1250 property produces gain in addition to the amount recaptured, the amount of recaptured depreciation reported in the year of sale is added to the property's basis to compute the correct gross profit ratio. This adjustment must be made to avoid double taxation of the recapture amount as payments are received.

Related-Party Rules (I.R.C. § 453)

The installment sale and resale rules should be reviewed before farmers or other taxpayers agree to a sales contract. Gain will be triggered for the initial seller when there is a disposition by the initial buyer, and the initial seller and buyer are closely related. (Closely related persons would include spouse, parent, children, and grandchildren, but not brothers and sisters.) The amount of gain accelerated is the excess of the amount realized on the resale over the payments made on the installment sale. Except for marketable securities, the resale recapture rule will not generally apply if the second sale occurs 2 or more years after the first sale, and it can be shown that the transaction was not done for the avoidance of federal income taxes. The 2-year period will be extended if the original purchaser's risk of loss was lessened by holding an option of another person to buy the property.

The resale rule will not apply if the second sale is also an installment sale where payments extend to or beyond the original installment sale payments. Also exempt from the resale rule are dispositions (1) after the death of either the installment seller or buyer, (2) resulting from involuntary conversions of the property (if initial sale occurred before threat or imminence), and (3) nonliquidating sales of stock to an issuing corporation.

An additional resale rule prevents the use of the installment method for sales of depreciable property between a taxpayer and his or her partnership or corporation (50% ownership), and a taxpayer and a trust of which he or she (or spouse) is a beneficiary. All payments from such a sale must be reported as received in the first year, and all gains are ordinary income [I.R.C. §§ 453(g) and 1239].

AMT Issues

Farmers may use the installment method of accounting for AMTI from the disposition of property used or produced in farming. However, other individuals who regularly sell tangible personal property are not able to use the installment method to report income from sales in tax years beginning after August 5, 1998.

General Rules

Losses cannot be reported on an installment sale. A partnership may use the installment sale method of reporting gain on the sale of partnership property.

The capital gains rules in effect at the time an installment payment is received and reported determine how the gain is taxed. However, a change in the capital gain holding-period requirement after the year of sale would not change a long-term gain to a short-term gain or vice versa.

The sale or exchange of an installment sale contract results in a gain or a loss. The gain or loss is the difference between the amount realized and the basis of the contract. The *amount realized* is the amount received by the seller, including FMV of property received instead of cash. The *basis* of the contract is the same as the remaining basis of the underlying property.

The cancellation of all or part of an installment obligation is treated like a sale or other disposition of the obligation, except that gain or loss is calculated as the difference between the FMV and the basis of the obligation if the parties are unrelated [I.R.C. §§ 453B(f)(1) and 453B(a)(2)]. With related parties the remaining balance of the installment obligation is its deemed sales price.

Unstated and Imputed Interest Rules

If the installment sale contract interest rate does not provide at least the AFR, part of the principal payment must be treated as interest income by the seller and as an interest deduction by the buyer. The amount of interest that must be recognized is called imputed interest. The imputed interest rule applies even if the seller elects out of the installment method or has a loss on the sale. When recharacterization of the loan is required, the seller's interest income increases and capital gain decreases. See Figure 29 for a list of recent AFRs, based on length of term.

Imputed interest rules applicable to certain debt instruments, including installment sales, are covered under I.R.C. §§ 1274 and 483. There are several special rules and numerous exceptions that complicate the understanding and application of imputed interest rules. Of special interest are the following:

1. All sales and exchanges in which the seller financing does not exceed \$4,630,300 (in 2006, indexed thereafter) must have an interest rate of the lesser of 100% of the AFR or 9% (compounded semiannually). Sales in excess of this amount do not have the 9% rate cap.
2. All sale-leaseback transactions are subject to rates equal to 110% of AFR.

3. The sale or exchange of the first \$500,000 of land between related persons (i.e., brothers, sisters, spouse, ancestors, or lineal descendants) in 1 calendar year must have the lesser of a stated rate of 6% compounded semiannually or the AFR.
4. The imputed interest rules do not apply to the sale of personal-use property, annuities, patents, and any other sale that does not exceed \$3,000.
5. Imputed as well as stated interest may be accounted for on the cash accounting method on sales of farms not exceeding \$1 million and any other installment sale not exceeding \$250,000.
6. The AFR can be the current month's rate or the lower of the 2 preceding months' rates.

FIGURE 29. Recent Applicable Federal Rates (AFRs)

Term	Compounding Period	Sept. 2007	Oct. 2007	Nov. 2007
Short-term (3 yrs or less)	Annual	4.82%	4.19%	%
	Monthly	4.71%	4.11%	%
Mid-term (over 3 to 9 yrs)	Annual	4.79%	4.35%	%
	Monthly	4.68%	4.26%	%
Long-term (over 9 yrs)	Annual	5.09%	4.88%	%
	Monthly	4.98%	4.77%	%

Source: IRS Web site, <http://www.irs.gov/taxpros/lists/0,,id=98042,00.html>.

LEASING OF LAND AND OTHER FARM ASSETS

Production Flexibility Contract (PFC) Payments on Leased Land

The 1996 Farm Bill provides production flexibility contract (PFC) payments to landowners and tenants based on the crop acreage base for the leased land. In general, these PFC payments are divided between the landowner and the lessee according to their respective share of the crop produced. This may induce landowners to shift from a cash rent arrangement to a share lease, to be able to share in the government payments. If the landowner begins to materially participate, then it will affect the landowner's self-employment taxes and social security benefits, because the income would be reported on Form 1040 Schedule F, Profit or Loss from Farming. If the landowner does not meet any of the material participation tests (Farmer's Tax Guide, IRS Pub. 225), then they can report their share of the crop on Form 4835 (Farm Rental Income and Expenses), rather than as cash rent on Form 1040 Schedule E (Supplemental Income and Loss), and still not be subject to SE taxes.

Rental Income and Deductions [I.R.C. § 1402(a)(1)]

Generally, rental income from real estate and from personal property leased with the real estate (including crop-share rents) is reported on Form 1040 Schedule E (Supplemental Income and Loss) and not included in net earnings from self-employment. Crop- and livestock-share rents are reported on Form 4835 (Farm Rental Income and Expenses) and flow through to Form 1040 Schedule E. However, there are two exceptions (the second of which is very important to farm operators):

1. Rentals received in the course of the trade or business of a real estate dealer are included in net earnings from self-employment.
2. Production of agricultural or horticultural commodities—income derived by the owner or tenant of land—is included in net earnings from self-employment if the following apply:
 - a. There is an arrangement between the taxpayer and another person under which the other person produces agricultural or horticultural commodities on the land, and the taxpayer is required to participate materially in the production or the management of the production of such commodities.
 - b. There is material participation by the taxpayer with respect to the agricultural or horticultural commodity.

The IRS (with support from the Tax Court) has taken the position that rent received by a taxpayer for land rented to a partnership or corporation in which the taxpayer materially participates is subject to SE tax (i.e., the material participation of the entity arrangement is wrapped into the lease arrangement). Working for wages as an employee of the farm operation has also been considered as part of the overall arrangement, making the rental payments paid to the employee or landowner subject to SE tax. However, in December 2000, the Eighth Circuit Court of Appeals indicated that fair rental amounts would not be subject to SE tax because there would then be no indication that what would otherwise be compensation was being shifted to rental income. For taxpayers outside the Eighth Circuit, the IRS is not bound by this decision. However, the Eighth Circuit decision could be cited as substantial authority, permitting taxpayers to avoid the imposition of the 20% penalty for the intentional disregard of IRS rules. (Note: In October 2003, the IRS commissioner issued a nonacquiescence notice regarding this court decision.)

The language of I.R.C. § 1402 appears to exclude rents paid on farm buildings and improvements from SE tax even if there is an overall arrangement found to be providing for material participation. That is, only land rent may be affected.

Income and expenses from the rental of personal property (not leased with real estate) is reported on Form 1040 Schedule C, Profit or Loss from Business (Sole Proprietorship), or C-EZ, Net Profit from Business (Sole Proprietorship). Net profit from Form 1040 Schedule C is included in SE income. Material participation is not a factor in classifying income from the rental of personal property that is not leased with real estate.

Paying Rent to a Spouse

It is common for husbands and wives to own farm real estate as joint tenants—for one to operate the farm as the sole proprietor and to pay SE tax on the entire farm net profit. Paying rent to a spouse for use of the property he or she owns might reduce SE tax.

Although Rev. Rul. 74-209, 1974-1, allows an operator to deduct rent paid to a spouse as a joint owner of business property equal to one-half its fair rental value, more recent IRS rulings and opinions have qualified that ruling. The IRS indicated the deduction for spousal rent is allowable only if there is a bona fide landlord-tenant relationship and that substance rather than form governs. Note also the issue discussed earlier, which could cause the rental income to be subject to SE tax if the spouse is an employee of the farm and the arrangement can be construed collectively as providing for material participation.

Strategy

If a sole proprietor deducts rental payments made to a spouse for use of his or her jointly owned property, or a farm entity pays land rent to one of its owners, the following precautions are suggested:

1. Make sure there is a formal written and signed rental agreement and an FMV rental rate for buildings separate from farmland, with at least annual payments.
2. Deduct the taxes, interest, and insurance on the rented property on the owner's Form 1040 Schedule E, Supplemental Income and Loss.
3. If payments are made to a spouse, the spouse should deposit the rental income in a separate account and pay his or her tax and interest payments from the account.
4. The farm operator must file Form 1099 for all rent payments made in excess of \$600.
5. The landowner must avoid material participation.



Practitioner Note

An IRS determination that land rent is SE income because of material participation from an overall arrangement not only would cause additional SE tax to be paid but also could affect eligibility for social security benefits of those landowners collecting benefits prior to full retirement age.

Passive-activity issues also arise with rental arrangements. Although it may be possible to structure arrangements between spouses to avoid material participation for SE tax issues, the passive-activity rules are different. For the passive-activity rules, participation by a spouse is considered participation by the landowner. This deemed participation invokes the “self-rental” rules, which prevent any profits from the activity being used to allow the deduction of passive losses from other sources. However, under the self-rental rules, any losses from the rental arrangement would still be subject to the passive-activity loss rule limitations.

Valid Tax Lease or Conditional Sales Contract

To determine whether an agreement is a lease or a sales contract, one needs to look at the intent, based upon the facts and circumstances in the agreement. This issue frequently arises when acquiring equipment. Generally, an agreement will be a conditional sales contract rather than a lease for tax purposes if any of the following are true:

1. The agreement applies part of each payment toward an equity interest.
2. The lessee gets the title to the property upon payment of a stated amount under the contract.
3. The amount the lessee pays for a short period of time is nearly the amount that would have to be paid to buy the property.
4. The lessee pays much more than the current fair rental value of the property.
5. The lessee can purchase the property at a nominal price compared to the value of the property at the time of purchase.
6. The lessee has the option to buy the property at a nominal price compared to the total amount the lessee has to pay under the lease.
7. The lease designates part of the payments as interest or part of the payments is easy to recognize as interest.

The most common lease arrangement today is the leveraged lease of newly purchased equipment, in which a large portion of the purchase price is financed with a loan that is fully amortized by lease

payments from the lessee. These leases are used for automobiles, trucks, computers, equipment, and so forth. The IRS will accept these transactions as a valid lease if all the following conditions are met:

1. When the lessee places the property in use, the investment of the lessor must be at least 20% of the cost of the property.
2. The lease term includes all renewal or extension periods at fair rental value at the time of the renewal or extension.
3. No lessee may purchase the property at a price less than its FMV when exercised.
4. The lessee may furnish none of the cost of the property (i.e., no trade-ins).
5. The lessee may not lend to the lessor any of the money or guarantee indebtedness to acquire the property.
6. The lessor must expect to receive a profit from the transaction.

For cash method taxpayers, the allowable deduction for prepaid lease payments, as a general rule, is limited to the taxable year for the months expired. In the case of *Zaninovich v. Commissioner*, the Court of Appeals ruled that if an expenditure results in the creation of an asset having a useful life that extends substantially beyond the close of the tax year, then that expenditure may not be deductible, or may be deductible only in part, for the taxable year made. The Court of Appeals adopted the *1-year rule*, which treats an expenditure as a capital expenditure (i.e., buildings, machinery, and equipment) if it creates an asset or secures a like advantage to the taxpayer and has a useful life in excess of 1 year. On the other hand, an expenditure can be deducted in full if the benefit of the payment does not exceed 1 year (e.g., cash rent).

ALTERNATIVE MINIMUM TAX (AMT)

The AMT is a separate but parallel tax system. Its purpose is to impose a minimum tax on high-income taxpayers with so many deductions, exemptions, and credits that their regular income tax is very low or zero. However, more taxpayers may be subject to AMT as personal deductions and nonrefundable credits increase. AMT may be created by adding back certain deductions and exemptions used to compute the regular tax and by disallowing most tax credits.

If the AMT regulations are not changed, it is estimated that by 2008 over 25% of taxpayers will be paying AMT.

Corporations with 3-year average annual gross receipts of less than \$7.5 million are currently exempt from AMT.

AMT depreciation for pollution-control facilities placed in service after December 31, 1998, must be computed using MACRS class lives and the SL method (for regular tax purposes these facilities qualify for 5-year amortization).

AMT Rate and Exemption Phaseout

The AMT has a two-tiered 26% and 28% rate system for noncorporate taxpayers. The 26% rate applies to the first \$175,000 of AMTI (\$87,500 for married filing separately) in excess of the exemption. The 28% rate begins at \$175,000 of AMTI. The lower capital gain rates used when computing regular taxes are also used to compute AMT on net capital gains. The exemptions are not indexed. However, the Tax Increase Prevention and Reconciliation Act of 2005 increased the exemption amount for 2006.

Legislation is pending to extend the increase to 2007. Otherwise, the exemption amount for 2007 will return to earlier levels, for example, \$45,000 for married filing jointly. The exemption is phased out at a rate of 25% of AMTI exceeding specific levels, as shown in Figure 30. If the taxpayer's AMTI exceeds the exemption, he or she will have a calculated AMT but will pay AMT only if it exceeds the regular tax.

FIGURE 30. AMT Exemption and Phaseout

Filing Status	Maximum Exemption	AMTI Exemption Phaseout Threshold	Complete Phaseout At
Joint & qualifying widow(er)	\$45,000	\$ 150,000	\$ 330,000
Single & head of household	33,750	112,500	247,500
Married filing separately	22,500	75,000	165,000
Trusts and estates	22,500	75,000	165,000

The AMT exemption for individuals subject to the kiddie tax has been increased to the child's earned income plus \$6,300 for 2007. This amount is indexed for inflation. The annual exemption cannot exceed \$33,750.

Alternative Minimum Taxable Income (AMTI)

AMTI is calculated on Form 6251, Alternative Minimum Tax—Individuals, by starting with Form 1040, U.S. Individual Income Tax Return, taxable income before subtracting personal exemptions or the standard deduction, but after subtracting itemized deductions, if any. Any NOL carryforward used in calculating the regular tax is added (disallowed).

Adjustments and Preferences

The first category of the following list contains adjustments treated as exclusions. The AMT from *exclusion* items is not eligible for a credit against the following year's regular tax. The remaining adjustments are *deferral* items and are used in computing AMT credit in future years.

1. The exclusion items (in addition to the personal exemptions and standard deduction already excluded from the starting number from Form 1040) are certain itemized deductions from Form 1040 Schedule A (Itemized Deductions), including a reduction of medical deductions by an additional 2.5% of AGI, miscellaneous deductions subject to the 2% rule, state and local taxes, and interest adjustments. Interest adjustments include the difference between qualified housing interest and qualified residence interest, interest income on private activity bonds that are exempt from regular tax, and a net investment interest adjustment that could be either positive or negative. Preferences treated as exclusion items include certain carryovers of charitable contributions, tax-exempt interest from specified private activity bonds, and excess tax-depletion allowances.
2. Itemized deductions disallowed on Form 1040 Schedule A for higher-income taxpayers are now allowed.
3. The depreciation adjustment is the net difference between accelerated MACRS depreciation and that allowed for AMT. This continues to be an adjustment item on farm tax returns. (See a discussion of this topic in the "Reporting Depreciation and Cost Recovery" section.)

4. Adjusted gain or loss from dispositions reported in Form 4797 (Sales of Business Property) or Form 1040 Schedule D (Capital Gains and Losses) and Form 4684 (Casualties and Thefts) that have a different basis for AMT than for regular tax (because of the accumulated AMT depreciation adjustment).
5. Incentive stock option adjustments, passive-activity adjustments, AMTI from estates and trusts, and tax-exempt interest from private activity bonds.
6. Accelerated depreciation on real and leased property and amortization of certified pollution control facilities placed in service before 1987.
7. Other adjustments may be required for intangible drilling costs, long-term contracts, certain loss limitations, mining costs, patron's distributions, pollution control facilities, research and experimental costs, and tax shelter farm activities.

Related Adjustments

Any item of income or deduction for a regular tax purpose that is based on income (e.g., earned income, AGI, MAGI, or taxable income from a business) must be recalculated based on alternative tax AGI.

Alternative Tax Net Operating Loss Deduction (ATNOLD)

The alternative tax net operating loss deduction (ATNOLD) is the last step in calculating AMTI. The alternative tax NOL is generally limited to 90% of AMTI and is calculated and deducted after all adjustments and preferences have been added in. For an ATNOLD generated or taken as a carryforward in tax years ending in 2001 or 2002, 100% may be deducted against AMTI. The ATNOLD is calculated the same as the regular NOL except

1. The regular tax NOL is adjusted to reflect the adjustments required by the AMT rules.
2. The ATNOLD is reduced by the preference items that increased the regular tax NOL.

Form 1045, Application for Tentative Refund, can be used to calculate the ATNOLD, providing the adjustments from the preceding list are made.

Tentative Minimum Tax

The minimum tax exemption reduced by the 25% phaseout is subtracted from AMTI before the 26% and 28% rates are applied. Taxpayers with net capital gains from Form 1040 Schedule D (Capital Gains and Losses) apply the appropriate capital gains rates by completing Part IV of Form 6251 (Alternative Minimum Tax—Individuals). However, be aware that the existence of capital gains may trigger AMT on ordinary income by causing the phaseout of the AMT exemption amount. The AMT foreign tax credit is then subtracted to arrive at tentative minimum tax. A taxpayer who has regular foreign tax credit will compute AMT foreign tax credit in much the same manner, using a separate Form 1116 (Foreign Tax Credit).

Example 17. Taxpayers with a large net capital gain, Mary and Tom Worker, file a joint return in 2007. Their W-2 (Wage and Tax Statement) wage income was \$74,400. The stock market had rebounded and on July 1, 2007, they liquidated a large portion of their holdings and have a \$313,700 long-term capital gain. Their total income was \$388,100. They claimed a \$10,700 standard deduction and would have

claimed \$6,800 of personal exemptions, but they were completely phased out because of income levels. The result was \$377,400 of taxable income. See Figure 31 for the calculation of their income tax liability.

FIGURE 31. Regular Tax Calculation

$\$15,650 \times 10\%$ ordinary	\$ 1,565
$\$48,050 \times 15\%$ ordinary	7,208
$\$313,700 \times 15\%$ (capital gains rate)	47,055
Total regular tax liability	<u>\$55,828</u>

But with the lower tax rates and expanded brackets are Mary and Tom subject to AMT? See Figure 32 for the AMT calculation.

FIGURE 32. AMT Calculation

Taxable income before personal exemptions	\$377,400
Standard deduction	+ 10,700
Tentative AMT income	388,100
Less AMT exemption amount	-0-*
AMT income	388,100
$\$74,400 \times 26\%$ ordinary	19,344
$\$313,700 \times 15\%$ (capital gains rate)	47,055
Total AMT tax liability	<u>\$ 66,399</u>

*The \$45,000 exemption is totally phased out at this level of total income.

Mary and Tom pay the larger of the two calculations, \$66,399, which is \$10,571 more than the regular tax liability.



Practitioner Note

Even though the long-term capital gains are taxed at the same rate for regular and AMT tax calculations, the benefits of the lower and wider regular income tax brackets for ordinary income as well as the standard deduction and personal exemptions are lost when taxpayers are subject to AMT.

AMT and Credits

Tentative minimum tax less the regular income tax equals AMT. Regular income tax excludes several miscellaneous taxes, such as the tax on lump-sum distributions. Regular income tax is reduced by the foreign tax credit (but not business tax credits) before it is entered on Form 6251, Alternative Minimum Tax—Individuals.

The limitation on the use of GBCs is calculated on Form 3800 (General Business Credit), not on Form 6251. The GBC can only be used to reduce regular income tax to the amount of the tentative AMT.

The foreign tax credit is allowed to offset AMT. For tax years through 2006, taxpayers are permitted to use their personal nonrefundable credits (e.g., education credits, dependent-care credit, and

saver's credit) to offset both the regular tax and the minimum tax. Beginning in 2007 taxpayers will only be able to offset AMT by the adoption credit, the child tax credit, the savers' credit and the EIC. The other personal nonrefundable credits will reduce a taxpayer's regular income tax but only down to the amount of the tentative AMT.

The GBCs, including investment credit, can be carried forward to the extent that they do not provide a current-year tax benefit because of the AMT.

Who-Must-File Test

More taxpayers are required to file Form 6251 (Alternative Minimum Tax—Individuals) than have an AMT liability. Form 6251 must be filed if the tax on AMTI reduced by the exemption amount exceeds the taxpayer's regular tax. If the total of AMT adjustments and preferences items is negative, Form 6251 should be filed to show the IRS that the taxpayer is not liable for AMT. Also, if any credits are limited by tentative AMT, Form 6251 must be filed.

AMT Credit

The AMT credit allows a taxpayer to reduce regular income tax to the extent that *deferral* adjustments and preferences created AMT liability in previous years. The AMT credit also includes any credit for producing fuel from a nonconventional source that was disallowed in an earlier year because of AMT. The credit means that the taxpayer, in the long run, will not pay AMT on the deferral items.

Part I of Form 8801, Credit for Prior-Year Minimum Tax, is used to compute the AMT that would have been paid in the previous year on the exclusion items if there had been no deferral items. This requires the computation of a minimum tax credit NOL deduction, which is calculated like the ATNOLD except that only the exclusion adjustments and preferences are included. It also requires computation of the minimum foreign tax credit on the exclusion items.

Part II of Form 8801 is used to compute the allowable minimum tax credit and the AMT credit carryforward. The computation includes unallowed credit for producing fuel from a nonconventional source and the electric vehicle credit.

INFORMATIONAL RETURNS

Informational Forms (Often Issued or Received by Small Businesses)

Form 1099-MISC

Form 1099-MISC, Miscellaneous Income, must be filed by any person engaged in a trade or business for each nonemployee paid \$600 or more for services performed during the year. Rental payments, prizes, awards, and fish purchases for cash must also be reported when one individual receives \$600 or more and royalties of \$10 or more. Payments made for nonbusiness services are excluded. Payments made to corporations are excluded unless the payment is for legal services of any dollar amount (no \$600 threshold). When payments of \$600 or more are made to the same individual for services and merchandise, payments for the merchandise can be excluded only if the contract and bill show that a determinable amount was for the merchandise.

Form 1099-INT

Form 1099-INT, Statement for Recipients of Interest Income, is filed by bankers and financial institutions when interest paid or credited to individual taxpayers is \$10 or more. It is also filed by any taxpayer if, in the course of a trade or business, \$600 or more of interest is paid to a noncorporate recipient.

Form 8300

Form 8300 (Report of Cash Payments Over \$10,000 Received in a Trade or Business) is filed by the recipient of cash in excess of \$10,000 received in the course of a trade or business, within 1 year, in one lump sum or in separate payments, from the same buyer or agent, and in a single or related transaction. Cash includes all currency and specific monetary instruments (e.g., cashier's checks, bank drafts, traveler's checks, and money orders). The report must be filed within 15 days after receiving more than \$10,000.

Money Services Businesses

Money Services Businesses (MSBs) include any person conducting business of more than \$1,000 with the same person on the same day in currency dealing or exchange, check cashing, issuing or selling or redeeming traveler's checks or money orders, or providing money transfers in any amount.

Businesses must register with the Department of the Treasury and are required to file suspicious activity reports and to file currency transaction reports. The required forms include FinCEN Form 107, Registration of Money Services Business; FinCEN Form 104, Currency Transaction Report; and TD F 90-22.56, Suspicious Activity Report by Money Services Business.

Filing Dates and Penalties

The Forms 1099 must be furnished to the person named on the return on or before January 31 and to the IRS with Form 1096, Annual Summary and Transmittal, on or before February 28. There is a single penalty of \$15 per information return for failure to file timely returns if filed by March 30 (30 days late), with a \$25,000 cap for small businesses. This penalty increases to \$30 per return if filed between March 30 and August 1, with a \$50,000 cap for small businesses. Returns filed after August 1 or never filed have a \$50 penalty per return and a \$100,000 cap for small businesses. The penalties are waived if the taxpayer can demonstrate that the Form 1099 error or late filing was due to reasonable cause and not to willful neglect.

There is a mandatory requirement to use magnetic media or electronic filing if the client has 250 or more informational returns. Taxpayers who ignore this requirement face a \$50 penalty per informational return. Waivers for this requirement must be requested on Form 8508 (Request for Waiver from Filing Information Returns on Magnetic Media), 45 days in advance of the due date of the return. The due date for filing information returns with the IRS is extended to March 31 for returns filed electronically.

SOCIAL SECURITY TAX AND MANAGEMENT SITUATION, AND OTHER PAYROLL TAXES



Planning Pointer

Annual increases in the earnings subject to social security (FICA and SE) taxes continue to place a high priority on exploring opportunities to reduce the burden of these taxes through wise tax management.

The Current Social Security Tax

The social security earnings base increased to \$97,500 for 2007. There is no cap on the amount of earnings subject to Medicare tax. FICA and SE tax percentage rates remain the same as in 2006. The total rate is divided into two components representing the social security and the Medicare tax. The maximum 2007 social security tax is \$6,045.00 (employer's share), up \$204.60 from 2006. See Figure 33 for the 2006 through 2008 social security and Medicare tax rates.

FIGURE 33. Social Security Tax Table

Year	Soc. Sec.	Medicare	FICA Rate %		Self-Employment Rate %	
			Soc. Sec. ¹	Medicare ¹	Soc. Sec.	Medicare
2006	\$ 94,200	Unlimited	6.20	1.45	12.40	2.90
2007	97,500	Unlimited	6.20	1.45	12.40	2.90
2008	100,700 ²	Unlimited	6.20	1.45	12.40	2.90

¹Paid by both employer and employee.

²Projected.

Employers use separate social security and Medicare tax withholding tables. Forms 941 (Employer's Quarterly Federal Tax Return) and 943 (Employer's Annual Federal Tax Return for Agricultural Employees) require social security and Medicare taxes to be reported separately. The self-employment tax is calculated on Form 1040, Schedule SE (Self-Employment Tax). The SE tax is separated into a social security tax of 12.4% and a Medicare tax of 2.9% for a total tax of 15.3%.

Deductions for Self-Employed Taxpayers

The following two deductions are available to self-employed taxpayers:

1. Self-employed taxpayers receive an adjustment to gross income equal to one-half of SE taxes. The rationale for this tax deduction is that employees do not pay income taxes on the one-half of FICA taxes paid by their employer.

2. Self-employed taxpayers deduct 7.65% from SE income when computing net earnings from self-employment. This is achieved by multiplying total profit from Form 1040 Schedules C (Profit or Loss from Business) or F (Profit or Loss from Farming) by 0.9235 on Schedule SE (Self-Employment Tax). This adjustment is made before applying the social security and Medicare tax earnings base. Taxpayers reporting less than \$94,200 of SE income will receive the greatest benefit from the deduction. This adjustment is allowed because employees do not pay social security tax on the value of their employer's share of FICA tax.

Farmer's Optional Method

The optional method allows taxpayers to pay SE tax on two-thirds of gross farm income if gross income is below \$2,400. Taxpayers with gross farm income in excess of \$2,400 may use this optional method and report \$1,600 of SE income when net farm income is less than \$1,733. Self-employed non-farmers have a similar option. Self-employed workers should give serious consideration to using the optional method if they are not currently insured under the social security system. To be eligible for social security disability benefits, a worker who is 31 or older, to be fully insured, must have 40 quarters of coverage or be currently insured with 20 quarters in the 10 years immediately before disability or death. The earnings required to receive one quarter of credit increased to \$970 in 2006. Thus, the optional method will yield only *one* quarter of coverage. This is an important negative change in the coverage for farmers trying to be currently insured under the social security system. Earning \$3,880 anytime during 2006 will provide four quarters of coverage.

Example 18. Ima Cow has \$2,800 of 2007 gross farm income netting only \$1,300 of net farm income. He would pay SE tax of $\$1,300 \times 0.9235 \times 0.153 = \184 . The optional method would result in $\$1,600 \times 0.153 = \245 of SE tax and still earn only one quarter of coverage. Ima may realize an additional benefit by using this method and paying the SE tax—that benefit would be an increase of reportable income for the EIC.

Nonfarm Optional Method

There is an optional method for determining net earning from nonfarm self-employment, much like the method discussed earlier. A taxpayer may use this optional method if he or she meets all of the following tests:

1. He or she is self-employed on a regular basis. This means that his or her actual net earnings from self-employment were \$400 or more in at least 2 of the 3 tax years before the one for which this method was used. The net earnings can be from either farm or nonfarm earnings or both.
2. He or she has used this method less than 5 years. (There is a 5-year lifetime limit.) The years do not have to be one after another.
3. His or her net nonfarm profits were less than \$1,733 and less than 72.189% of gross nonfarm income.

Wages Paid to Spouse, Children, and Farm Workers

Farm employers must pay FICA taxes and withhold income taxes on their employees if they pay wages of more than \$2,500 to all agricultural labor during the year. Any employee receiving \$150 or more of wages is subject to FICA and tax withholding even if the employer's total annual payroll is less than \$2,500. All employees are covered if the annual payroll exceeds \$2,500. Seasonal farm piecework labor is exempt from the \$2,500 rule, providing the employee is a hand harvester, commutes to the job daily from a permanent residence, and was employed in agriculture for less than 13 weeks in the prior year. Seasonal farm piecework labor is subject to the \$150 rule. The \$150 test is applied separately on each employee.

Wages earned by a person employed in a trade or business by his or her spouse and wages paid to individuals 18 years old and over who work for their parent(s) in a trade or business are subject to FICA taxes and income tax withholding. Children under age 18 working for a parent's partnership, corporation, or estate are also covered by social security. Sole proprietors and husband-wife partnerships that hire their children who are less than 18 years old need not pay social security tax or FUTA for children under 21. Wages paid by a parent to a child for domestic service in the home are not covered until the child reaches 21.

Taxation of Social Security Benefits

Social security recipients are potentially subject to two sets of rules on taxation of social security benefits. Disability benefits are treated the same way as other social security benefits. The rules that tax 50% of social security benefits have been in effect for several years. The rules that tax up to 85% of social security benefits for higher-income taxpayers became effective in 1994. The United States or Canadian social security benefits are taxed exclusively in the country where the recipient resides.

The 85% rules apply to single taxpayers, heads of household, married taxpayers filing separately with provisional incomes above \$34,000, and married taxpayers filing jointly with provisional incomes above \$44,000. Provisional income is MAGI plus 50% of social security benefits. The MAGI is AGI plus tax-exempt interest and certain foreign-source income. Since these numbers have not been increased for inflation, several more taxpayers each year will find themselves subject to taxation of social security benefits.

For taxpayers with provisional incomes above these thresholds, gross income includes the lesser of the following:

1. Eighty-five percent of the taxpayer's social security benefit
2. The sum of 85% of the excess of the taxpayer's provisional income above the applicable threshold amount plus the lesser of
 - a. The amount of social security benefit included under previous law or
 - b. The amount of \$4,500 (\$6,000 for married taxpayers filing jointly)

For married taxpayers filing separately, gross income will include the lesser of 85% of social security benefits or 85% of provisional income (i.e., the threshold is \$0).

The 50% rules apply to single taxpayers with provisional incomes between \$25,000 and \$34,000 and to married persons filing jointly with provisional incomes between \$32,000 and \$44,000. For taxpayers in these ranges, the inclusion is still limited to the lesser of (1) one-half of the benefits received, or (2) one-half of the excess of the sum of the taxpayer's AGI, interest on tax-exempt obligations, and

half of the social security benefits over the base amount (\$32,000 for persons filing jointly, \$0 for married persons filing separately but living together, and \$25,000 for all others). Medicare receipts are excluded from gross income.

Reduction of Benefits

When a person's wage and self-employment earnings exceed the statutory earnings limit, social security benefits of the working beneficiary and dependents are reduced by a percentage of the excess earnings. In 2007 the annual earnings limit for those less than full retirement age is \$12,960, and for those who have attained full retirement age, earnings are unlimited. The reduction of benefits is one-half of excess earnings when the taxpayer is less than full retirement age. Full retirement age for those born in 1941 is 65 and 8 months; for those born in 1942 it is 65 and 10 months; and for those born in 1943 through 1954 it is 66 (see the Social Security Administration Web site for those born in later years). The 2007 cost-of-living increase in benefits was 3.3%.

Retirement Planning Considerations

Although the earnings cap for those workers over full retirement age who are getting social security benefits has been eliminated, those under full retirement age still have to stay under \$12,960 in earnings in 2007 to avoid a reduction of benefits because of earnings. Usually work done prior to drawing benefits but paid later does not affect benefits. Commissions, sick pay, vacation pay, bonuses, and carryover crops might fall into the category not to be counted in earned income for social security, but they are taxable for federal tax purposes. Carryover grain sales made by retiring farmers are excluded from reducing social security benefits if both (1) the grain was produced and in storage before or during the first month of benefits, and (2) the grain is sold in the first year after beginning to draw benefits. Remember that this carryover grain sale must be reported on Schedule F, Profit and Loss from Farming, and Schedule SE, Self-Employment Tax (Form 1040).

The retirement earning test for loss of some benefits for the year the individual reaches full retirement age in 2007 is \$2,870 per month before the month of full retirement age. This test applies only to earnings prior to attaining full retirement age. If the retiree fails the test, \$1 in benefits will be withheld for every \$3 in earnings above the limit for that period of months. There is no limit on earnings beginning the month an individual attains full retirement age.

"Nanny Tax" Social Security Domestic Employment Act

The Social Security Domestic Employment Act, or "nanny tax," allows the payment of employment taxes for domestic workers (e.g., babysitters, yard workers, house cleaners) to be reported on the employer's income tax return. The 2007 wage threshold for reporting and paying social security taxes is \$1,500 annually. During 2007, taxpayers may exclude from wages up to \$110 a month in transit passes given to their employees to commute to their homes by public transportation or up to \$215 a month in employer-provided qualified parking.

Household employers use Schedule H, Household Employment Taxes (Form 1040), to report and pay social security, Medicare, FUTA (threshold still \$1,000), and withheld income taxes. Farmers may

treat wages paid to domestic workers under the \$1,500 annual threshold rules, rather than the \$150 and \$2,500 agricultural wage thresholds, by filing Form 1040 Schedule H.

Household employers must include an employer identification number (EIN) on forms they file for their employees, such as Form W-2 (Wage and Tax Statement) and Form 1040 Schedule H. An EIN can be obtained by completing and filing Form SS-4, Application for Employer Identification Number. Order Form SS-4 by calling (800) TAX-FORM or online at <http://www.irs.gov>.

Wages paid to household workers under the age of 18 are exempt from any social security and Medicare taxes unless household employment is the worker's principal occupation.

Preparers' Election for Alternative Identification Numbers

As an alternative to preparers including their own social security number on prepared returns, they may use a preparer ID number (PTIN), obtained by filing Form W-7P, Application for Preparer Tax Identification Number. The number, when issued, will begin with a "P" followed by eight digits with no dashes. NYS also allows use of the PTIN.

Small Firms Will Pay FUTA Less Often

Beginning in 2004, employers are required to make a quarterly deposit for the FUTA only if the accumulated tax exceeds \$500. By raising the requirement, it has reduced the burden for employers with up to eight employees or less.

Reminder: As covered previously, New York employers will have their FUTA rate for 2006 drop back to 0.8% ($\$7,000 \times 0.8\%$), the same rate that many other states pay. This amount will be reported on federal Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return. The Form 940-EZ has been discontinued. Previously, quarterly FUTA deposits were required if FUTA liability exceeded \$100 in the quarter, even if other payroll tax thresholds were not met.

NEW YORK STATE INCOME TAX

The NYS 2007–2008 Budget Bill was passed in April 2007. The bill included few changes for income tax purposes; however, major changes were made in the STAR *rebate* program.

Personal Income Tax

The following personal income tax items were affected by the budget bill:

- Partnership tax abuse remedy
- Mandated New York S corporation election
- Low-income housing tax credit enhancement
- Tax shelter reporting
- Make permanent Department of Taxation and Finance (DTF) authorization to collect child support
- Single-sales-factor acceleration
- Business tax rate cuts

- Combined filing amendment
- Extension of bank tax and GLBA provisions
- Tax treatment of REITS and RICS
- Taxation of certain banking corporations
- Middle-class STAR rebate program
- New York City STAR credit
- Business Taxes
- School Property Tax

Review of State Income Tax Changes Prior to 2007

As a reminder, here are some of the changes that were made to state income tax provisions prior to 2007.

Empire State Child Credit

For taxable years beginning on and after January 1, 2006, resident taxpayers are allowed a refundable personal income tax credit equal to the greater of 33% of their allowed federal child tax credit under I.R.C. § 24 or \$100 per qualifying child. A taxpayer whose federal AGI exceeds the threshold amounts in I.R.C. § 24(b)(2) (i.e., \$110,000 in the case of a joint return, \$75,000 in the case of an individual who is not married, and \$55,000 in the case of married filing separately) cannot claim a credit based upon \$100 per qualifying child even if that calculation provides the greater credit. For purposes of this credit, a *qualifying child* is a child who qualifies for the federal child tax credit and is at least 4 years of age. Married taxpayers who file separately for NYS purposes may elect to divide the credit in any manner that they want.

Volunteer Firefighters and Ambulance Workers Credit

This part provides a resident who serves as a volunteer firefighter or ambulance worker for the entire year with a \$200 tax credit against his or her personal income tax. A volunteer firefighter or ambulance worker is eligible for this credit provided he or she does not receive a real property tax exemption that relates to his or her services as a volunteer firefighter or ambulance worker under Title 2 of Article 4 of the Real Property Tax Law for 2007. If both spouses filing a joint return qualify for the credit, they may both take the credit. Credit is effective for tax years beginning on or after January 1, 2007.

Noncustodial Parent Earned Income Tax Credit

For tax years beginning on or after January 1, 2006, and before January 1, 2013, NYS full-year residents who are noncustodial parents and pay child support may be eligible for the noncustodial parent NYS EIC. The credit is a refundable tax credit for a taxpayer who is 18 years of age or older and is the parent of a minor child or children with whom the taxpayer does not reside; has an order that has been in effect for a least one-half of the tax year requiring him or her to make child-support payments that are payable through a support collection unit; and is current on his or her child support, for every order requiring him or her to make child-support payments, in the tax year for which the credit is sought. The credit is equal to the greater of 20% of the amount of the federal earned income tax credit that would be allowed to parents with one qualifying child (determined from the column for single, head of household, or qualifying widow(er) in the federal EIC table, even if the taxpayer's filing status is married filing joint return) or 2.5 times the amount of the federal earned income tax credit that

would be allowed to taxpayers with no qualifying children. This credit is claimed in lieu of the NYS EIC. *Qualifying child* is a child who meets the definition of a qualifying child under I.R.C. § 32(c)(3).

The Department will receive verification from the Office of Temporary and Disability Assistance (OTDA) that a taxpayer's child-support obligations are paid. A taxpayer who has been denied the credit has the right to request a review from the support collection unit through which the child support-payments are made.

Farmers' School Tax Credit

The tax law, relating to the farmers' school tax credit, was amended to provide for the following enhancements effective for tax years beginning on or after January 1, 2006:

- The base acreage available to farmers in calculating their tax credit has been increased to 350 acres, up from the current limit of 250 acres.
- The modified NYS AGI limitation amount has increased from \$100,000 to \$200,000. Farmers with modified NYS AGI in excess of this \$200,000 (formerly \$100,000) are subject to a phaseout of the tax credit.
- Income received from the production of Christmas trees qualifies as gross income from farming.
- A new § 210.22(j) has been added to allow for the election by the shareholders to deem the gross income of New York C corporations to their shareholders. In the event the election is made, the federal gross income from farming will be zero for the New York C corporation in the tax year the election is in effect.

Also started in tax year 2006, agricultural school property tax credit of commercial horse-boarding operations will be allowed against the New York corporate franchise and personal income taxes. The gross income from farming will also include gross income from commercial horse-boarding operations as defined in § 301, the Agriculture and Markets Law, to the extent not included in farm income reported on the individual's or corporation's federal income tax return. This legislation clarified that horse boarding is included under the definition of federal gross income from farming.

An enhancement for tax years beginning in 2005 and after is that eligible school district property taxes levied on qualified property owned by the taxpayer's father, mother, grandfather, grandmother, brother, or sister qualify for the credit if the taxpayer has a written agreement with the owner(s) that the taxpayer intends to eventually purchase said property, even if the taxpayer did not actually pay the school taxes on the qualified agricultural property. Also the owner(s) must give the taxpayer a document stating that the owner(s) is waiving his/her right to claim the credit on the qualified property that is subject to the written agreement. The requirements for the written agreement are that it must be signed by all parties and have been in effect for at least part of the tax year to which the tax credit relates. The requirements for the waiver form are that it can be only for 1 tax year and must include the name of the owner(s), the names of the relative, a statement that the owner(s) are waiving the claim to the farmers' school tax credit, the tax year, the date the agreement to sell was entered into, and the signature of the owner(s). This waiver document is irrevocable for the year entered into.

This credit has been extensively taught and included in this manual for the last several years. Refer to previous manuals, and for more information on the Farm Property School Tax Credit, see NYS Pubs. 51 dated November 1997 and 51.1 dated December 2006 for questions and answers.

National Guard Subtraction

The class of members of the New York National Guard who may subtract from federal AGI the income received for performing active service within the state is expanded to include members of the New York National Guard who are called into active service by the federal government pursuant to federal active-duty orders issued under Title 10 of the United States Code. This provision applies retroactively to taxable years beginning on and after January 1, 2004.

Note that this applies to members of the NYS organized militia and not United States reserve units. See Advisory Opinion, Petition No. I070522A issued August 27, 2007.

Home Heating System Credit

For tax years beginning in 2006 and 2007, an individual can take a credit against his or her NYS personal income tax based on the costs incurred by him or her on or after July 1, 2006, and before July 1, 2007, that are directly associated with the replacement of an existing home heating system. The replacement system must be installed in a residence that is the taxpayer's principal residence at the time the costs are incurred. The residence must be located in New York State, and the installation must be completed before December 31, 2007. The credit is not allowed for the installation of a home heating system in a newly constructed principal residence. To qualify for this credit, the home heating system that replaces the old system must, after installation, qualify for and be labeled with an Energy Star label. The amount of the credit is equal to 50% of the costs incurred on or after July 1, 2006, and before July 1, 2007, that are directly associated with the replacement of an existing home heating system. However, the credit cannot exceed \$500. Use Form IT-240, Claim for Home Heating Credit. If this credit exceeds the New York taxpayer's personal income tax for the year, the excess may be credited or refunded.

Clean Heating Fuel Credit

The credit amount equals \$0.01 per gallon for each percent of biodiesel included in the bioheat, not to exceed \$0.20 per gallon, purchased by the taxpayer on or after July 1, 2006, but before July 1, 2007. The bioheat must be used for space heating or hot water production for residential purposes within New York State. If a taxpayer makes more than one purchase of bioheat that qualifies for this credit and the percentage of biodiesel included in the bioheat varies, a separate calculation must be made for each purchase of bioheat. If two or more taxpayers share in the purchase of bioheat, the amount of the credit allowable to each taxpayer is to be prorated according to the percentage of the total bioheat purchased by each taxpayer.

The credit is claimed for the tax year (2006 or 2007) in which the bioheat is purchased. In general, bioheat is deemed purchased on the date of delivery regardless of when the payment is made. However, bioheat that is purchased under a plan that requires the taxpayer to prepay the supplier for a certain number of gallons of bioheat at a fixed price will be treated as purchased on the date the prepayment was made, not the date of delivery. The credit is claimed on Form IT-241, Claim for Clean Heating Fuel Credit. Credit not used can be credited or refunded.

Conservation Easement Credit

For tax years beginning on or after January 1, 2006, a new refundable income tax and corporate franchise tax credit is available equal to 25% of school district, county, and city/town real property taxes paid on land that is subject to a conservation easement. The conservation easement is a perpetual and permanent easement that meets the provisions of Article 49 of the Environmental Conservation Law and must be granted to either a public or private conservation agency. It must be filed with the Department of Environmental Conservation and comply with Title 3 of Article 49 and I.R.C. § 170(h). The maximum allowable tax credit under this part is \$5,000 and this credit in combination with any other credit for school district, county, and city/town real property taxes cannot exceed such taxes. If all or part of the allowable credit under this part is unable to be deducted, it is treated as an overpayment and can be either credited or refunded to the taxpayer.

Alternative Fuels Credit

Section 606(p) of the tax law has been amended to reinstate the alternative fuels credit for alternative-fuel vehicle refueling property for tax years beginning January 1, 2006, and ending December 31, 2010.

Under prior law, the alternative fuels credit expired for tax years beginning after 2004. Taxpayers will be allowed a credit for alternative-fuel refueling property placed in service during the tax year. The alternative fuels credit is 50% of the cost of new alternative-fuel refueling property used in a trade or business and located in New York State and for which a deduction is allowed under I.R.C. § 30-C. There is no limit on the credit for alternative-fuel refueling property.

Alternative-fuel vehicle refueling property means any such property that is qualified within the meaning of I.R.C. § 30C but does not include alternative-fuel vehicle refueling property relating to a qualified hybrid vehicle. The credit is not refundable but can be carried over for an unlimited number of years. In addition, recapture of the credit may be required if the property ceases to qualify.

Rehabilitation of Historic Properties Credit

For tax years beginning on or after January 1, 2007, the rehabilitation of historic properties credit and the historic homeownership rehabilitation credit are available. The rehabilitation of historic properties credit is a tax credit for a certified historic structure located in New York State in an amount equal to 30% of the credit amount allowed to such taxpayer under I.R.C. § 47(c)(3) for the same tax year, not to exceed \$100,000. The credit is not refundable but can be carried over for an unlimited number of years. If the corresponding federal credit is recaptured by the taxpayer, 30% of such amount is required as a New York credit recapture.

A *certified historic structure* is a structure that meets the definition of a certified historic structure under I.R.C. § 47(c)(3). The historic homeownership rehabilitation credit is a tax credit for the rehabilitation of historic homes. The credit is 20% of the qualified rehabilitation expenditures made by the taxpayer, with respect to a qualified historic home, not to exceed \$25,000 for all taxpayer residences. The historic homeownership rehabilitation credit may be claimed in the taxable year in which the final certification step of the certified rehabilitation is completed. In the case of a husband and wife, the amount of the credit may be divided in any manner they both elect.

New York S Corporation Franchise Tax (Article 9-A)

The tax law has been amended to eliminate the tax on entire net income (ENI) base for New York S corporations and impose only the fixed-dollar minimum tax as prescribed in § 210(1)(d) of the tax law. For a termination year, the tax for a New York S corporation short year is the fixed-dollar minimum tax. Accordingly, a New York S corporation is subject to the applicable fixed-dollar minimum tax as shown in the following section.

Fixed-Dollar Minimum Tax (Article 9-A)

The fixed-dollar minimum tax for Article 9-A taxpayers, including New York S corporations, has reverted to the amounts that were imposed in 2003. Those amounts are shown in the Figure 34.

FIGURE 34. Fixed-Dollar Amounts Imposed for Article 9-A Taxpayers

For a Corporation with a Gross Payroll of	Fixed-Dollar Minimum Tax Equals
\$6,250,000 or more	\$1,500
More than \$1,000,000 but less than \$6,250,000	425
More than \$500,000 but not more than \$1,000,000	325
More than \$250,000 but not more than \$500,000	225
\$250,000 or less	100
However, if the corporation's gross payroll, total receipts, and average value of gross assets are each \$1,000 or less.*	800

*If a tax year is less than 12 months, compute the gross payroll and total receipts by dividing the amount of each by the number of months in the short year and multiplying the result by 12.

Exemption from Tax for Certain Article 9-A Corporations

A corporation that is no longer doing business, employing capital, or owning or leasing property in New York State in a corporate or organized capacity that has filed a final return with the Department of Taxation and Finance for the last tax year it was doing business and has no outstanding tax liability for such final return or any tax return for prior tax years will be exempt from the fixed-dollar minimum taxes for tax years following the last year the corporation was doing business. This provision applies to tax years beginning on or after January 1, 2006.

Reduction in State Sales Tax on Fuels

The NYS sales tax on gasoline and diesel fuel was capped at 8 cents per gallon on and after June 1, 2006. This reduction applies to the state portion (4%) on retail purchases of fuel. This cap amounts to 8 cents per gallon when fuel is priced at \$2.00 per gallon or more. If fuel is lower than \$2.00, it is taxed at the 4% sales tax rate. Local governments, including New York City, are authorized to make this same reduction or continue to charge their local tax on the full amount of the sales price of fuel.

State Sales Tax on Clothing and Footwear

The New York Legislature allowed the sales tax on clothing and footwear costing less than \$110 to expire. Consequently, beginning April 1, 2006, there is a year-round exemption from NYS sales tax for those items costing less than \$110 per time or pair. Any county or city in New York can choose to enact this exemption or continue collecting the local share of the sales tax.

Nursing-Home Assessment Tax Credit

This credit creates a refundable nursing-home assessment tax credit under the personal income tax. Public Health Law imposes an assessment on the gross receipts of residential health-care facilities. These facilities, in turn, pass the costs of this assessment on to their clients. These costs are covered by Medicaid and private insurance, but individuals without such coverage must pay the assessment themselves. Taxpayers may claim the credit for any assessment amount that is separately stated and accounted for on the billing statement of a resident of a residential health-care facility which is paid directly by the individual taxpayer. The credit was first effective in tax year 2005.

Special Additional Mortgage Recording Tax Credit

The credit creates a refundable personal income tax credit for the special additional mortgage recording tax paid by lenders and individuals on residential mortgages. This credit is not available to taxpayers in counties within the Metropolitan Commuter Transportation District (MCTD) or Erie County if the mortgage relates to real property that in the aggregate contains not more than six residential dwelling units. Unused credit may be refunded or carried forward to future tax years. The credit is effective retroactively beginning in tax year 2004.

Limited Liability Company Fees

The LLC temporary fees were extended for the 2005 and 2006 tax years. These fees were as follows: the \$100-per-member fee, the \$500 minimum fee per entity, and the maximum fee of \$25,000 per entity. These provisions expired on January 1, 2007, after which the basic fee reverted to \$50 per member, the minimum fee to \$325 per entity, and the maximum fee to \$10,000 per entity. Furthermore, single-member LLCs will no longer be required to pay the fee.

Electronic Filing of Returns

The legislation mandates electronic filing for certain income tax preparers. It requires those preparers filing more than 100 original personal income tax (PIT) returns during calendar year 2006, and preparing at least one authorized return using tax preparation software in 2007, to file all authorized returns

electronically. Preparers will be penalized \$50 for each failure to electronically file returns. The penalty may be waived if the failure to electronically file was due to reasonable cause and not willful neglect. Taxpayers may elect not to electronically file their return, and that would also absolve the preparer from any penalty. Once a preparer is subject to mandatory electronic filing, he or she is subject to it forever.

Electronic Signature: Personal Identification Number (PIN)

New York has simplified the signature requirement for e-filed personal income tax returns. Beginning with tax year 2005, the paper signature was eliminated from Form IT-201-E. All taxpayers must sign their e-file returns using the self-select five-digit PIN method or the practitioner PIN method similar to that of the IRS. If filing a joint return, a PIN is needed for each taxpayer. The PIN signature eliminates the need to mail any forms or documents to the Tax Department for an e-filed tax return.

In addition, many taxpayers were previously required to enter their previous-year federal AGI as part of the signature process for NYS e-file returns. This requirement has been eliminated as well. This change to the signature process will simplify the filing process.

Please note that return preparers will be required to retain Form TR-579, New York State e-file Signature Authorization Form, for their clients who e-file.

SUMMARY OF 2007–2008 NEW YORK STATE TAX PROVISIONS¹

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Personal Income Tax

Partnership Tax Abuse Remedy

Part K of Chapter 60 of the Laws of 2007 amends the NYS tax law by authorizing the tax commissioner to disregard personal service or S corporations formed or availed of primarily to avoid or evade NYS income tax. Nonresidents could avoid personal income taxation by having their New York sourced distributive share from a corporation or partnership paid to an out-of-state entity, which in turn expenses the income by paying a salary to the individual shareholder or partner. The out-of-state entity generally pays minimum tax while the individual avoids tax on the salary since he does not perform services in New York. The IRS currently has similar authority under I.R.C. § 269A in relation to personal service corporations formed to avoid or evade federal income tax. The provision is effective for taxable years beginning on or after January 1, 2007.

Mandated New York S Corporation Election

Part L of Chapter 60 of the Laws of 2007 requires that entities that are eligible S corporations for federal tax purposes and that have not made the election to be New York S corporations, are deemed to be New York S corporations if the corporation’s investment income for the current taxable year is more than 50% of its federal gross income for the year. This provision does not apply to S corporations that are subject to the Bank Tax (Article 32). The provision is effective for taxable years beginning on or after January 1, 2007.

Low-Income Housing Tax Credit Enhancement

Part M of Chapter 60 of the Laws of 2007 amends the NYS tax law by increasing the aggregate amount of low-income housing tax credits the Commissioner of Housing and Community Renewal may allocate by \$4 million dollars. The aggregate dollar amount of credit that the commissioner may allocate to eligible low-income buildings is now \$16 million. This section takes effect immediately.

Tax Shelter Reporting

Part I of Chapter 60 of the Laws of 2007 extends through July 1, 2009 the provisions of Part N of Chapter 61 of the Laws of 2005, which created Section 25 of the NYS tax law. Section 25 requires the disclosure and reporting of federal and New York reportable and listed transactions. Such reportable transactions are defined by Internal Revenue Service Notice or other guidance as having the potential to be improper tax avoidance practices.

Make Permanent DTF Authorization to Collect Child Support

Part C of Chapter 60 of the Laws of 2007 makes permanent the statutory authorization for improved child-support and spousal-support arrears collection and enforcement through a continuing partnership between the Office of Temporary and Disability Assistance (OTDA) and the Department of Taxation and Finance (DTF). This collaboration began pursuant to Chapter 706 of the Laws of 1996, which had an original sunset date of June 30, 1999. The authorization was subsequently extended several times.

Business Taxes

Single-Sales-Factor Acceleration

Part B of Chapter 60 of the Laws of 2007 amends the Article 9-A business allocation percentage (BAP) formula so that corporations will compute their BAP solely with their receipts factor starting with tax years beginning on or after January 1, 2007. Under legislation enacted in 2005, the transition of the BAP from three-factor apportionment of property, payroll and receipts, with the receipts factor double weighted, to single-receipts-factor apportionment was to be phased in starting in 2006. The schedule called for single-receipts-factor apportionment for tax years beginning on or after January 1, 2008. This part accelerates the schedule by 1 year.

Business Tax Rate Cuts

Part N of Chapter 60 of the Laws of 2007 contains several tax rate cuts for businesses, banks, and insurance companies. The cuts include:

- A reduction in the Article 9-A Corporate Franchise Tax rate on ENI from 7.5% to 7.1%
- A reduction of the ENI rate to 6.5% for qualified New York manufacturers and emerging technology companies
- A reduction in the Article 9-A AMTI rate from 2.5% to 1.5%
- A reduction in the Article 32 Bank Tax ENI rate from 7.5% to 7.1%
- A reduction in the Article 33 Insurance Tax rate on life-insurance company income from 7.5% to 7.1%

Part N defines a manufacturer as, “a taxpayer . . . principally engaged in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture, or commercial fishing.” The generation and distribution of electricity, the distribution of natural gas, and the production of steam associated with the generation of electricity are

specifically excluded. Part N also amends the computation of the qualified small business rate recapture to properly account for the changes in the Article 9-A rate. If the ENI base is not more than \$290,000, the tax rate will continue to be 6.5%. If the ENI base is more than \$290,000 but not over \$390,000, the amount of tax shall be \$18,850, plus 7.1% of the excess of the entire net income base over \$290,000 but not over \$390,000, plus 4.35% of the excess of the ENI base over \$350,000 but not over \$390,000.

Finally, Part N clarifies the method by which the MTA surcharge is calculated for Article 9-A taxpayers. It provides that the NYS tax, which is the basis of the surcharge, is the highest of the four tax bases specified in Article 9-A, plus the additional tax on subsidiary capital. However, for purposes of the surcharge, the tax on the highest of the four tax bases must be recomputed using the tax rates and limitations in effect for taxable years beginning on or after July 1, 1997, and before July 1, 1998, if such tax base is not the fixed-dollar minimum tax. These provisions take effect for tax years beginning on or after January 1, 2007, except the special manufacturing tax rate takes effect for tax years beginning on or after January 31, 2007.

Combined Filing Amendment

Part J of Chapter 60 of the Laws of 2007 concerns combined reporting under the Article 9-A and Article 33 corporate franchise taxes. New York was, and remains, a separate filing state (i.e., each taxpayer is presumed to file a separate return); however, in certain circumstances combined reports are necessary in order to properly reflect the taxpayer's activities, income, or capital in New York and in order to properly reflect the taxpayer's New York tax liability. Prior to the amendment there were three prerequisites in order for a combined return to be permitted or required: a unitary relationship between related corporations; common ownership or control; and an improper reflection of the activities, income, or capital of the taxpayer arising from separate filing. Also, prior to the amendment, the presence of substantial intercorporate transactions created a presumption that filing on a separate basis did not result in a proper tax liability. As a result of Tax Appeals Tribunal case law, taxpayers or the Tax Department could rebut this presumption by demonstrating that the transactions were conducted at arm's length prices. This amendment eliminates the issue as to whether the transactions occurred at arm's-length prices. If the ownership and unitary tests are met, accompanied by substantial intercorporate transactions, the taxpayer must file a combined return with those corporations with which the tests are met. In instances where the ownership and unitary tests are met but there are no substantial intercorporate transactions, the Tax Department retains the ability to demonstrate that a combined return is required.

In determining whether substantial intercorporate transactions exist, consideration is given to all the activities and transactions among the related corporations, such as manufacturing, acquiring, or selling goods or performing services, financing sales, incurring expenses, or performing customer services using common facilities or employees for related corporations, or transferring assets, including accounts receivables, patents, and trademarks, between related corporations. Insurance tax-specific activities also include selling policies or contracts, reinsuring risks, or collecting premiums for related corporations. A conforming amendment was also made to the Articles 9-A, 32 (the franchise tax on banking corporations), and 33 statutory provisions that require any federal deduction for royalty payments made to related corporations to be added back in the computation of NYS entire net income. The amendment provides that taxpayers who are included in a combined return are not required to make the add back.

Middle-Class STAR Rebate Program

This program replaces the rebate/personal income tax credit that was enacted into law in 2006. Real property owners who received basic STAR exemptions on their property and whose affiliated income is no more than \$250,000 will receive rebate checks in 2007. The size of the rebate depends on the property owners' income and the location of the property. Enhanced STAR exemption recipients will receive a rebate check that is not based on income.

The rebate computation for basic STAR begins with a base amount. The Office of Real Property Services (ORPS) will compute for each school district segment (town-specific) the rebate base amount, which is determined by the exempt amount established for each segment for purposes of the basic STAR exemption in the 2006–2007 school year, multiplied by the 2006–2007 school district tax rate for the segment. For the 2007–2008 school year, downstate counties (New York City, Suffolk, Nassau, Westchester, Rockland, Putnam, Orange, and Dutchess) will receive rebates equal to the base amount multiplied by an increase factor determined by the property owners' affiliated income. For affiliated income up to \$120,000 the increase factor is 60%, for income between \$120,001 and \$175,000 the increase factor is 45%, and for income between \$175,001 and \$250,000 the increase factor is 30%. For the remainder of the upstate counties in 2007–2008, the increase factors are the same as previously mentioned, but the affiliated income brackets are up to \$90,000, between \$90,001 and \$150,000, and between \$150,001 and \$250,000. Affiliated income is defined as federal AGI less any IRA distributions for all resident owners of the property and any owners' spouses filing a joint income tax return or any spouse that resides primarily on the property.

Once the Tax Department receives the application for the 2007–2008 basic STAR rebate, the Tax Department will verify the affiliated income of the parcel by examining the property owners' income tax return for the 2005 tax year. Each year thereafter, the tax year is advanced by 1 year. If the affiliated income cannot be determined, no rebate will be issued. Special rules apply for low-income individuals who are not required to file a tax return, and for property owners who were nonresidents in the year of the income tax return. Property owners who disagree with the Tax Department's determination of affiliated income, or whose income could not be determined, may seek reconsideration of the rebate amount. The application for reconsideration must be filed with the Tax Department no later than March 31st of the following year.

OTHER ITEMS OF IMPORTANCE TO NEW YORK TAXPAYERS

Use Tax Collection Line on New York Income Tax Forms

The NYS personal and other income tax forms have a line 59 on Form IT-201 and line 35 on Form IT-150 for taxpayers to report unpaid state and local compensating use tax on purchases made inside or outside New York State. If a taxpayer is an individual, estate, or trust that is a **New York resident** for sales and use tax purposes and **the taxpayer is filing a NYS personal income tax return or fiduciary income tax return**, that sales tax is due on the due date of the income tax return, without regard to any extension of time to file the return. In the instructions, taxpayers are informed of their legal requirements to remit such use taxes when they have made purchases outside of the state, in person, or through remote means.

Most tangible personal property is subject to sales or compensating use tax. Some examples are tobacco products, alcohol, candy, clothing, books, electronic equipment, furniture, collectibles, gasoline when purchased without paying the tax, and other items purchased in and out of state. Taxpayers also may owe additional local tax if they bring property to their locality that they purchased in another locality that has a lower tax rate.

If a taxpayer is an individual, estate, or trust that is a New York resident for sales and use tax purposes and **the taxpayer is not filing a NYS personal income tax return or fiduciary income tax return**, the taxpayer must pay any sales or use tax owed by filing Form ST-140, Individual Purchaser's Report of Sales and Use Tax, for the period covered by that taxpayer's tax year for federal income tax purposes. Form ST-140 is due on the date a taxpayer's federal income tax return is due, without regard to extensions of time to file. If no federal income tax return is required to be filed, Form ST-140 is due on the date a taxpayer's federal return would have been due, without regard to extensions of time to file. A taxpayer must report and pay sales or use tax liability on ST-140, Individual Purchaser's Report of Sales and Use Tax, on the same items listed previously for New York residents.



Practitioner Note

All businesses that are registered, or required to be registered, with the Tax Department for sales tax purposes must pay their sales and use taxes on their sales tax return for purchases made by the businesses.

For further questions and answers, see New York State Department of Taxation and Finance Pub. 774 (3/07), Purchaser's Obligations to Pay Sales and Use Taxes Directly to the Tax Department, and instructions for the specific income tax return of the taxpayer. For the current sales tax rates by county, see New York State Department of Taxation and Finance Pub. 718 (8/07), New York State Sales and Use Tax Rates by Jurisdiction; New York State Department of Taxation and Finance Pub. 718-A (8/07), Enactment and Effective Dates of Sales and Use Tax Rates; and New York State Department of Taxation and Finance Pub. 718-C (8/07), Local Sales and Use Tax Rates on Clothing and Footwear.

New York State School Tax Relief (STAR)

The NYS school tax relief (STAR) program provides a partial exemption from school property taxes for owner-occupied primary residences. There is an exemption for those property owners under 65 and for those over 65 years of age. Senior-citizen property owners must be 65 years of age or older, as of December 31, 2007, and must provide their 2006 federal or state income tax return, not to exceed \$67,850 (preliminary estimate) AGI, reduced by any "taxable amount" from an IRA, or individual retirement annuity.

The enhanced STAR senior-citizen exemption is a \$50,000 (adjusted by individual counties' equalization rate) exemption from the full value of their property. The eligible senior citizen must apply with the local assessor for the enhanced STAR exemption by March 1, in most towns. This is the taxable status date, but deadlines vary, so most taxpayers should apply earlier. In counties where the sales price differential factor is greater than one, the exemption amounts will be adjusted upward.

The basic STAR program is available to all primary residence homeowners, regardless of age. The full value assessment exemption is \$30,000 (adjusted by individual counties' equalization rate) in the school year 2007 to 2008. To be eligible, an owner must own and live in a one-, two-, or three-family residence, mobile home, condominium, cooperative apartment, or farmhouse. Under recent legislation, the exemption for persons with disabilities and limited incomes is subtracted from assessed value before subtracting the STAR exemption.

Chapter 83 of the Laws of 2002 provides for a cost-of-living adjustment to the maximum income allowed under the enhanced STAR exemption for persons age 65 and over. For applications on the 2007 assessment rolls, the maximum 2005 income tax year income AGI limit is estimated to be \$67,850. This amount is indexed annually based on the rate of inflation used to index social security benefits. The taxable status data related to assessment rolls to be completed in 2007 is the applicable income tax year of 2005.

New York Tuition Savings Program

A taxpayer may contribute up to \$5,000 per year exempt from New York personal income tax to an I.R.C. § 529 account to be used for higher education expenses at qualified institutions. Married individuals can each contribute up to \$5,000 each year. These contributions are subtracted from a taxpayer’s federal AGI in calculating the New York AGI. The interest income earned receives tax-free treatment until withdrawn. Nonqualified withdrawals are subject to income tax. NYS contributions to all accounts for any beneficiary are subject to a maximum account balance, which is established annually to reflect the cost of a 4-year undergraduate education.

Standard Deductions and Exemptions

The standard deductions and exemptions for 2007, based on tax status, are shown in Figure 35.

FIGURE 35. NYS Standard Deductions and Exemptions for 2007

Standard Deduction	2007
Tax status:	
Joint (surviving spouse)	\$15,000
Head of household	10,500
Single	7,500
Married filing separately	7,500
Dependent filers	3,000
Exemption	1,000

An NYS exemption is not available for either the taxpayer or the spouse.

New York Personal Income Tax Rates

There are three separate rate tables for (1) married filing jointly and qualifying widow(er); (2) heads of households; and (3) single, married filing separately, and estates and trusts (Figure 36). Filing status conforms to federal status except that when the New York resident status of spouses differs, separate returns must be filed.

The temporary highest tax bracket in effect for tax years 2003 to 2005 were eliminated in 2006.

FIGURE 36. NYS Income Tax Table for 2007

Married Filing Jointly and Qualifying Widow(er)			
Over	Not Over	Tax	
\$ 0	\$ 16,000	4.00% of the excess over	\$ 0
16,000	22,000	\$ 640 plus 4.50% " " " "	16,000
22,000	26,000	910 plus 5.25% " " " "	22,000
26,000	40,000	1,120 plus 5.90% " " " "	26,000
40,000		1,946 plus 6.85% " " " "	40,000

Head of Household			
Over	Not Over	Tax	
\$ 0	\$ 11,000	4.00% of the excess over	\$ 0
11,000	15,000	\$ 440 plus 4.50% " " " "	11,000
15,000	17,000	620 plus 5.25% " " " "	15,000
17,000	30,000	725 plus 5.90% " " " "	17,000
30,000		1,492 plus 6.85% " " " "	30,000

Single or Married Filing Separately or Estates and Trusts			
Over	Not Over	Tax	
\$ 0	\$ 8,000	4.00% of the excess over	\$ 0
8,000	11,000	\$ 320 plus 4.50% " " " "	8,000
11,000	13,000	455 plus 5.25% " " " "	11,000
13,000	20,000	560 plus 5.90% " " " "	13,000
20,000		973 plus 6.85% " " " "	20,000

New York Earned Income Tax Credit (NY EIC)

An EIC is allowed against New York personal income tax. The New York earned income credit (NY EIC) is 30% of the allowable federal EIC for taxable years. The EIC must be reduced by the taxpayer’s household credit. Therefore, a taxpayer will not receive the benefits of both the NY EIC and the household credit. To claim this credit, a taxpayer must complete Form IT-215, Claim for Earned Income Credit. For more information, see Pub. 310-NY.

Credit for Child and Dependent Care (NY CDC)

Taxpayers with NYAGI of \$25,000 or less are allowed a New York child- and dependent-care (NY CDC) credit of 110% of the federal child- and dependent-care credit whether or not the taxpayers actually claimed the federal credit. This refundable credit is gradually phased down from 110% to 20% of

the federal CDC credit for taxpayers with NYAGIs between \$25,000 and \$65,000. At \$65,000 and over NYAGI, the rate remains at 20% of the federal credit. To claim this credit taxpayers must complete Form IT-216, Claim for Child- and Dependent-Care Credit.

Gross Receipts Tax Credit

This is a refundable tax credit expired for tax years ending after December 31, 2006.

College Tuition Tax Credit/Deduction

For tax years beginning on or after January 1, 2001, full-year resident taxpayers may claim on Form IT-272 either a refundable tax credit or an itemized deduction for qualified college tuition expenses (not room, board, transportation, fees, books, etc.) paid on behalf of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents. Taxpayers must file Form IT-150 or Form IT-201 to get the credit from Form IT-272. Taxpayers must file Form IT-201 to get the itemized deduction. The tax benefits are available for *undergraduate-level* study at any qualifying *in-state* or *out-of-state* institution of higher education. The student *does not* need to be enrolled in a degree program to claim either tax benefit.

The itemized deduction is also available to part-year residents and nonresidents. However, the refundable credit is limited to full-year NYS residents.

Qualified institutions of higher education include any institution of higher education, as well as business, trade, technical, or other occupational schools that are recognized and approved by the Regents of the University of the State of New York or a nationally recognized accrediting agency or association accepted by the regents and that provide a course of study leading to the granting of a post-secondary degree, certificate, or diploma.

For purposes of both the credit and deduction, *qualified college tuition expenses* are defined as tuition expenses less refunds, scholarships, or financial aid. It does not matter whether the expenses were paid by cash, by check, by credit card, with borrowed funds, or with funds from a qualified state tuition program. The maximum expense amount is \$10,000 per student.

If an eligible student is claimed as a dependent on another person's tax return, only the person who can claim the student as a dependent may claim the credit. If an eligible student is *not* claimed as a dependent on another person's tax return, only the student may claim the credit. However, if a taxpayer is married and filing separate returns, the next section, "Spouses Filing Separately" applies.

The maximum amount of qualified college tuition expenses allowed for each eligible student is \$10,000, and there is no limit on the number of eligible students for whom a taxpayer may claim a credit. Full-year NYS residents may claim a refund of any college tuition credit that is in excess of their NYS tax liability.

Spouses Filing Separately

If a taxpayer and spouse are filing separate returns, they can each claim their own credit on a separate Form IT-272. Or, one may claim the college tuition credit, and the other may claim the itemized deduction. However, they must each claim their separately computed credit or deduction based only on the amount of qualified college tuition expenses *each has paid* (or was treated as having been paid) for the taxpayer, spouse, or person claimed as a dependent on their separate return. The taxpayer cannot claim a credit or deduction for qualified college tuition expenses that were paid for the spouse's dependent. (These expenses are treated as paid by the spouse for purposes of the credit.)

The refundable credit is calculated as follows:

- For taxpayers with expenses of \$5,000 or more, the credit equals the qualified tuition expenses times 4%.
- For taxpayers with expenses of less than \$5,000, the credit equals the lesser of the amount spent for qualified tuition expenses or \$200.

In the tax year 2007 the credit will be as shown in Figure 37.

FIGURE 37. 2007 College Tuition Credit Ranges

Tuition Expense Range	Credit Range
\$0 to \$5,000	\$0 to \$200
\$5,000 to \$10,000	\$200 to \$400

In lieu of claiming the credit, a resident may elect to claim the New York college tuition itemized deduction if he or she itemized deductions on his or her federal return. The deduction is equal to the qualified tuition expense (limited to \$10,000). Both the credit and the deduction should be calculated to determine which provides the greater tax benefit. Taxpayers cannot claim both the credit and the deduction. The college tuition itemized deduction is also available to nonresident and part-year resident taxpayers.

For comparative purposes the benefit of the college tuition itemized deduction is determined by multiplying a taxpayer's tuition expense, up to \$10,000, by that taxpayer's marginal state income tax rate. Taxpayers should use the worksheet in the instructions to help determine if the college tuition itemized deduction or the college tuition credit offers the greater tax savings. Those who do not itemize will take the tuition credit option.

For more information see Pub. 10-W, FAQs: New York State College Tuition Credit and Itemized Deduction and FAQs: New York State College Tuition Credit and Itemized Deduction.

Qualified Long-Term Care Insurance Credit

The long-term care credit was increased in 2004 to 20% of the premiums paid during the year for qualified long-term insurance policies. This credit is not refundable for personal income taxpayers, but unused credit can be carried forward. If the amount of the credit allowable for any taxable year exceeds the tax liability for the year, the excess may be carried over to the following year or years and then deducted from the liability for such year or years. The credit is also available to employers who pay premiums for qualifying policies for their employees. To claim this credit, taxpayers must complete Form IT-249.

New York State Investment Credit (NYIC)

The New York State investment credit (NYIC) for individuals is 4% on qualified tangible personal property (and other tangible property used in production, including buildings and structural components) acquired, constructed, reconstructed, or erected on or after January 1, 1987. For corporations, the rate is 5% on the first \$350,000,000 of investment credit base and 4% on any excess.

MACRS property placed in service after December 31, 1986, qualifies for NYIC. This means that farm property in the ACRS or MACRS 3-year class should qualify. There is no reduction in the amount of credit allowed for 3-year property, and if kept in use for 3 years, it will earn 4% NYIC. Highway-use motor vehicles are ineligible for NYIC.

All ACRS and MACRS property that qualifies for NYIC and is placed in a life class that is 5 years or longer earns full credit after 5 years, even if a longer SL option is elected. The same is true of 7-, 10-, 15-, and 20-year MACRS property. Non-ACRS/MACRS properties that qualify for NYIC must still be held 12 years.

Excess or unused credit may be carried over to future tax years, but the carryforward period is limited to 10 years. In no event may the credit claimed prior to 1997 be carried over to taxable years beginning on or after 2007. The 1997 bill expanded general business corporations' carryforward period for unused investment tax credits from 10 to 15 years. There is no provision for carryback of NYIC. Unused NYIC claimed by a *new business* is refundable. The election to claim a refund of unused credit can be made only during the first 5 years a business operates in New York. Shareholders of electing S corporations that qualify as new businesses may also receive refunds of their pro rata shares of the corporation's credit. This refundable credit is not an additional credit for new businesses. A business that is substantially similar in operation and ownership to another business that has operated in the state will not qualify.

If property on which the NYIC was taken is disposed of or removed from qualified use before its useful life or specified holding period ends, the difference between the credit taken and the credit allowed for actual use must be added to the taxpayer's tax liability in the year of disposition. However, there is no recapture once the property has been in qualified use for 12 consecutive years.

Use IT-212 to claim NYIC and retail enterprise credit, as well as to report early disposition of qualified property.

New York State—Other Miscellaneous Credits

NYS tax law provides for the following additional credits:

- New York State household credit—Taxpayers can claim this credit right on Forms IT-150 or IT-201. For more information, see the instructions for the form.
- Resident credit—If a taxpayer is a full-year or part-year resident of New York State and part of his or her income was taxed by another state, by Washington, D.C., or by a Canadian province, he or she may claim this credit; to do so, the taxpayer must complete Form IT-112-R and attach a copy of the other tax return. For more information, see form instructions.
- Automated external defibrillator credit—To claim this credit, taxpayers must complete Form IT-250.
- Employment of persons with disabilities credit—To claim this credit, taxpayers must complete Form IT-251. For more information, see TSB-M-98(1)I.
- Fuel-cell electric generating equipment credit—To claim this credit, taxpayers must complete Form IT-259.
- Solar electric generating equipment—To claim this credit, taxpayers must complete Form IT-255. For more information, see TSB-M-00(2)I and form instructions.
- Low-income housing credit—To claim this credit, taxpayers must receive a housing credit allocation from the Division of Housing and Community Renewal (DHCR) and complete Forms DTF-625 and DTF-625ATT and DTF-624. Any credit recapture is reported on Form DTF-626. For more information, see the form instructions or access the DHCR Web site.

- Qualified emerging technology company employment credit—To claim this credit, taxpayers must complete Form DTF-621. For more information, see TSB-M-00(2)I and form instructions.
- Qualified emerging technology company capital tax credit—To claim this credit, taxpayers must complete Form DTF-622. For more information, see TSB-M-00(2)I and form instructions.
- Resident credit against separate tax on lump-sum distributions—To claim this credit, taxpayers must complete Form IT-112.1 and attach a copy of federal Form 4972 and a copy of the other state tax return. For more information, see form instructions.

New York State Minimum Tax

Federal items of tax preference after New York modifications and deductions are subject to the New York State minimum tax rate of 6%. The specific deduction is \$5,000 (\$2,500 for a married taxpayer filing separately). A farmer who has over \$5,000 of preference items must complete Form IT-220 but may not be subject to minimum tax. New York personal income tax (less credits) and carryover of NOLs are used to reduce minimum taxable income. The NYIC cannot be used to reduce the minimum income tax.

Estimated Tax Rules

If a taxpayer has taxable income from which no taxes are withheld during the year, that taxpayer may have to pay estimated tax. However, a taxpayer will not have to pay estimated tax if any of the following qualifications are met:

- Tax withholding during 2007 is at least 90% of the total tax due for tax year 2007.
- Tax withholding during 2007 is at least 100% of the total tax for the 2006 tax year (110% of that amount if the taxpayer is not a farmer or a fisherman and the New York AGI shown on that return is more than \$150,000 or, if married filing separately for 2007, more than \$75,000). However, if a taxpayer did not file a 2006 tax return, or that taxpayer's 2006 tax return did not cover all 12 months, this item does not apply.
- A taxpayer owes less than \$300 of New York State, city of New York, or city of Yonkers tax after deducting tax withheld and credits that the taxpayer is entitled to claim. The \$300 threshold is applied separately against each taxing jurisdiction.

Payments for New York State Income Tax

The New York Tax Department is now accepting credit cards for payment of personal income tax liabilities and estimated tax payments, which can be made through certain plastic card vendors. The taxpayers pay the convenience fees for this service.

Cornell Income Tax Web Site

Check the Cornell Agricultural and Small Business Finance Web site (<http://agfinance.aem.cornell.edu>) for information on the following:

- Dates and locations of current and future scheduled seminars
- Problems encountered by other Cornell Tax School practitioners
- Tax issues affecting NYS filers

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OTHER A.E.M. EXTENSION BULLETINS

EB No	Title	Fee (if applicable)	Author(s)
2007-15	Fruit Farm Business Summary: Lake Ontario Region, New York 2006		White, G., DeMarree, A. and J. Neyhard
2007-14	Dairy Farm Business Summary, Central Valleys Region, 2006	(\$12.00)	Knoblauch, W., Karszes, J., Radick, C., Wickswat, C., Manning, J., Balbian, D., Allhusen, G., Buxton, S. and L. Putnam
2007-13	Dairy Farm Business Summary, Intensive Grazing Farms, New York, 2006	(\$16.00)	Conneman, G., Grace, J., Karszes, J., Degni, J., Munsee, D., Putnam, L., Staehr, A. and C. Kyle
2007-12	Quantifying the Contributions to Dairy Farm Business Risk: Implications for Producer's Risk Management Strategies		Schmit, T., Chang, H., Boisvert, R. and L. Tauer
2007-11	Dairy Farm Business Summary, Northern New York Region, 2006	(\$12.00)	Knoblauch, W., Putnam, L., Karszes, J., Murray, P., Vokey, F., Ames, M., Van Loo, W., Deming, A. and J. Prosper
2007-10	Dairy Farm Business Summary, Western and Central Plateau Region, 2006	(\$12.00)	Knoblauch, W., Putnam, L., Karszes, J., Grace, J., Munsee, D. and J. Petzen
2007-09	Dairy Farm Business Summary, New York Small Herd Farms, 80 Cows or Fewer, 2006	(\$16.00)	Knoblauch, W., Putnam, L., Kiraly, M. and J. Karszes
2007-08	Producing a Business Plan for Value-Added Agriculture		Streeter, D.
2007-07	Dairy Farm Business Summary, Northern Hudson Region, 2006	(\$12.00)	Conneman, G., Putnam, L., Wickswat, C., Buxton, S., Smith, R. and J. Karszes
2007-06	Dairy Farm Business Summary, Western and Central Plain Region, 2006	(\$12.00)	Knoblauch, W., Putnam, L., Karszes, J., Hanchar, J., Moag, G., Getty, K. and Z. Waite

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