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# INCOME TAX MANAGEMENT AND REPORTING FOR SMALL BUSINESSES AND FARMS


## 2002 Reference Manual for Regional Schools

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# 2002 TAX LEGISLATION AND FARM INCOME SITUATION [1]

## What's New in Federal Legislation

The Job Creation and Worker Assistance Act of 2002, hereafter referred to as the "2002 Act," was signed into law in March 2002. It was called a "something for everyone" Act. However, of importance to all, is that many of the changes and benefits of the previous 2001 Act are phased in over the next 9 years and then, unless changed, the 2001 Act provisions revert to the pre-2001 Act rules and regulations. This "sunset clause," which repeals all of the 2001 Act at the end of 2010, will add a lot of uncertainty to tax planning in the next 9 years. The combined benefits and law changes of the two acts will be discussed and explained in this manual. Some of the highlights and benefits to small businesses, farmers, and individuals are the following:

- A new 10% bracket for individuals has been added for a portion of the taxable income currently taxed at 15%. Trusts and estates are not eligible for this bracket.
- Furthermore, the other income tax brackets are lowered by 0.5% again in 2002, and gradually lowering each existing bracket to 25%, 28%, 33%, and 35% by the year 2006 and later.
- The 2001 Act increases the alternative minimum tax (AMT) exemption amount for married filing jointly and surviving spouses by $4,000 and for other individuals by $2,000. This change applies to the 2001 through 2004 tax years.
- The child tax credit was modified and increased to $600 per eligible child and will reach $1,000 in the year 2010. The often-difficult refund calculation of the child tax credit has taken on additional complexity but will no longer be reduced by AMT.
- The adoption credit and employer-provided assistance exclusion was increased to $10,000 per eligible child starting in 2002.
- The 2001 Act extended the exclusion for employer-provided educational assistance to graduate education after December 31, 2001, and makes the provision permanent for both graduate and undergraduate courses.
- The 2001 Act increased the annual contributions limit to Coverdell Education Savings Accounts to $2,000 per beneficiary after December 31, 2001, but still offered no deduction for the contribution. The qualified expenses have been expanded to include elementary and secondary school expenses. In addition, the taxpayer can coordinate expenses with Hope Credits, Lifetime Learning Credits, and qualified tuition programs, which was previously not allowed.
- A new above-the-line deduction for taxpayers with qualified higher education expenses paid during the years 2002 to 2005 is phasing in from $3,000 to $4,000 then stopping in the year 2006.
- Higher phaseout adjusted gross income (AGI) ranges are allowed for student loan interest deductions in 2002. Also, there is no more need for counting months to see if the loan is in the first 60 months of repayment, because the Act repeals the rules on number of months and voluntary payments are deductible.
- The estate and gift tax applicable exclusion amounts have been accelerated and increased. For estates of decedents dying after 2001, the exclusion amount is increased to $1 million and then steps up to $3.5 million in 2009, before repeal of estate tax in 2010. The gift tax is uncoupled from the estate tax, and the applicable exclusion will remain at $1 million from 2002 to 2010. The estate and gift tax highest brackets are gradually reduced.

[1] This manual was written by Charles H. Cuykendall, Senior Extension Associate of Agricultural Finance and Management for the Department of Applied Economics and Management at Cornell University, and Gregory J. Bouchard, Manager of Farm Credit of WNY Tax Service in Phelps, New York.

- Most retirement plan contribution limits were increased, and special catch-ups above the annual limits are allowed for individuals aged 50 and over, beginning in 2002.
- Previously, a state death tax credit was allowed against federal estate tax for taxes paid to any state for property included in a gross estate. New York imposed a "pick-up" tax, which was equal to the maximum federal credit allowed. Under the 2001 Act from 2002 to 2004, the state death tax credit is reduced by 25% per year until gone in 2005. New York will have to amend their estate tax in order to collect any revenues from this tax after 2004.
- Beginning in 2010, the step-up in basis rules as of the date-of-death are replaced by rules that apply the carryover basis to assets received from an estate. With the elimination of the estate tax, the carryover basis rules require the gain on property received for a decedent's estate to be carried over to the heir. However, there are a few exceptions to add to the required bookkeeping of basis from the decedent's property. The estate executor can add some amounts to the basis of certain assets. For example, the executor may step up basis by the sum of: (a) $1.3 million, (b) unused capital losses and net operating losses from the decedent's final tax form, and (c) any loss the decedent would have had from the sale of assets immediately before death. Property received by a surviving spouse will be entitled to an additional $3 million step-up.
- The 2002 Act offers an economic stimulus to businesses with a 30% additional first-year depreciation for most types of *new* nonrealty property acquired after September 10, 2001.
- As has been the case for farm net operating losses (NOLs), nonfarm NOL carryback periods are extended to 5 years, for NOLs arising in tax years ending in 2001 or 2002.
- Primary and secondary school educators may claim a deduction of up to $250 in unreimbursed expenses for books and supplies used in the classroom.
- Information returns, including Forms 1099, may be furnished to recipients electronically.

## 2002 Farm Income Tax Situation

In 2001, dairy producers received the highest milk prices ever recorded in the United States. However, 2002 was the lowest milk price year in more than a decade. Low farm incomes coupled with rising feed costs placed many dairy farms in a difficult cash position. There are a few mitigating circumstances to the cash flow problems. Many farms prepurchased feed, fertilizer, and other inputs with last year's record milk prices. For many producers, last year's motivation may have been the avoidance of taxes, but this year's reality is that exposure to expensive inputs has been blunted.

In May of 2002, President Bush signed into law the current farm bill. Many of the dairy provisions of the bill are a continuance of preexisting programs, such as the Dairy Price Support Program and the Dairy Export Incentive Program. However, a new countercyclical payment program was introduced and is referred to as the Milk Income Loss Contract, or MILC. This program triggers direct payments to dairy producers when the Boston class I price drops below $16.94. The payments are capped at 2.4 million pounds of milk production per farm in each fiscal year with retroactive payments from December, 2001, through September, 2005. The average payments in the first fiscal year will be $1.08 per hundredweight (cwt).

For income tax planning in 2003, one would expect milk prices to gradually improve through the summer before declining in the latter half of the year. The average statistical uniform, or blend, price is forecast to improve by about $0.70 per cwt over 2002. This improved milk price will also mean that next year's MILC payments will decline by about $0.22 per cwt. Large inventories of butter and growing inventories of cheese will not let milk prices rebound dramatically. To follow the forecast and other developments in the dairy situation visit the Cornell Program on Dairy Markets and Policy at www.dairy.cornell.edu.

An unseasonably warm spring followed by a series of frost events during late April resulted in significant damage to fruit crops in most of the growing areas. All major tree-fruit-producing regions in New York State incurred damage, but damage in the Hudson Valley appeared to be more widespread than in other regions. Some vineyards in the Chautauqua-Erie area, a Concord

grape belt, experienced significant frost damage. In the Finger Lakes, damage to the grape crop appears to be highly variable. Grape production is estimated to be off by 9% from last year. Prices are lower for juice grapes. Apple production in the state of New York is estimated to be 28% below last year. If these estimations are realized, this would be the lowest production since 1973.

Because of drought, New York State yields for vegetable crops were poor to average without irrigation and about average with irrigation. New York sweet corn for processing is expected to report decreased production again this year, with production estimates down 42% from last year (less contracted acreage and lower yields). Onions prices were average this year with yields were down by 14% because of spring wetness.

#### Tax Suggestions for Farmers

Tax management suggestions for farmers with 2002 net farm profits:

- Purchase quantities of feed and supplies before the year-end. These prepaid expenses may be claimed if they do not exceed 50% of other expenses on Schedule F.
- 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 Christmas bonuses to regular employees.
- Purchase IRAs or other tax-deferred retirement plans.

# FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

## Standard Deduction

The standard deduction is indexed to inflation and is adjusted annually, as shown in Table 1.

**Table 1. Basic Federal Standard Deduction for 2001, 2002, and 2003**

| Filing Status | 2001 | 2002 | 2003[1] |
|---|---|---|---|
| Married filing jointly; or qualifying widow(er) | $7,600 | $7,850 | $7,950 |
| Head of household | 6,650 | 6,900 | 7,000 |
| Single individuals | 4,550 | 4,700 | 4,750 |
| Married filing separately | 3,800 | 3,925 | 3,975 |

[1] Projected

Each taxpayer over age 65 or blind receives the regular standard deduction plus an additional $900 deduction if married and filing a joint or separate return. The additional deduction is $1,150 if the taxpayer is single or head of household. The additional deductions are subject to the inflationary adjustment. A taxpayer that 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 2002 personal exemption allowed on the federal return is $3,000 for the taxpayer, their spouse, and their dependents. The projected amount for 2003 is $3,050. Taxpayers may not claim an exemption for themselves or 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 2002, 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:

- $206,000 if married filing jointly or qualifying widow(er) with dependent child; (exemptions completely lost at $328,500 AGI)
- $171,650 if head of household; (exemptions completely lost at $294,150 AGI)
- $137,300 if single; (exemptions completely lost at $259,800 AGI)
- $103,000 if married filing separately; (exemptions completely lost at $164,250 AGI)

The phaseout in personal exemptions is 2% of the exemption amount for each $2,500 increment (or any fraction thereof) by which AGI exceeds the appropriate threshold amount. A married taxpayer filing separately will lose 2% of his or her exemption for each $1,250 increment above $103,000. The personal exemption phaseout or reduction is calculated on a nine-line worksheet called the **Deduction for Exemptions Worksheet,** included in the 1040 instructions. If AGI exceeds the threshold, complete the worksheet before claiming the personal exemption deduction on line 40 of Form 1040.

Full personal exemption is scheduled to be restored after the year 2009. The above phaseout will gradually be reduced after 2005.

**Example 1.** Mr. and Mrs. Dairy file jointly, have two children, and their 2002 AGI is $266,100. They claim four personal exemptions and the standard deduction. Their reduction and net exemption are calculated as follows:

- AGI $266,100 – $206,000 threshold = $60,100 excess.
- $60,100 excess ÷ $2,500 = 24.04 or 25 excess increments.
- Their reduction is 25 × .02 (2%) = .50 × $12,000 (4 @ $3,000) = $6,000.
- Their net personal exemption is $12,000 – 6,000 = $6,000.

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 35% taxable income bracket, where the $6,000 of phased-out personal exemption will cost $2,100 in additional taxes. In other words, their $60,100 of excess AGI caused an additional tax liability of $2,100 or added 3.1% to their tax liability.

## 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 online from www.ssa.gov.

Taxpayers may not claim an exemption for a dependent who has gross income of $3,000 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) $750 or (2) the individual's earned income plus $250 (Table 2).

**Table 2. Examples of Single Taxpayer's Standard Deduction**

| | Base Amount | Earned Income | Earned Income + $250 | Larger of the Two | Standard Deduction | Smaller of the Two |
|---|---|---|---|---|---|---|
| Case # 1 | $750 | $0 | $250 | $750 | $4,700 | $750 |
| Case # 2 | $750 | $5,000 | $5,250 | $5,250 | $4,700 | $4,700 |

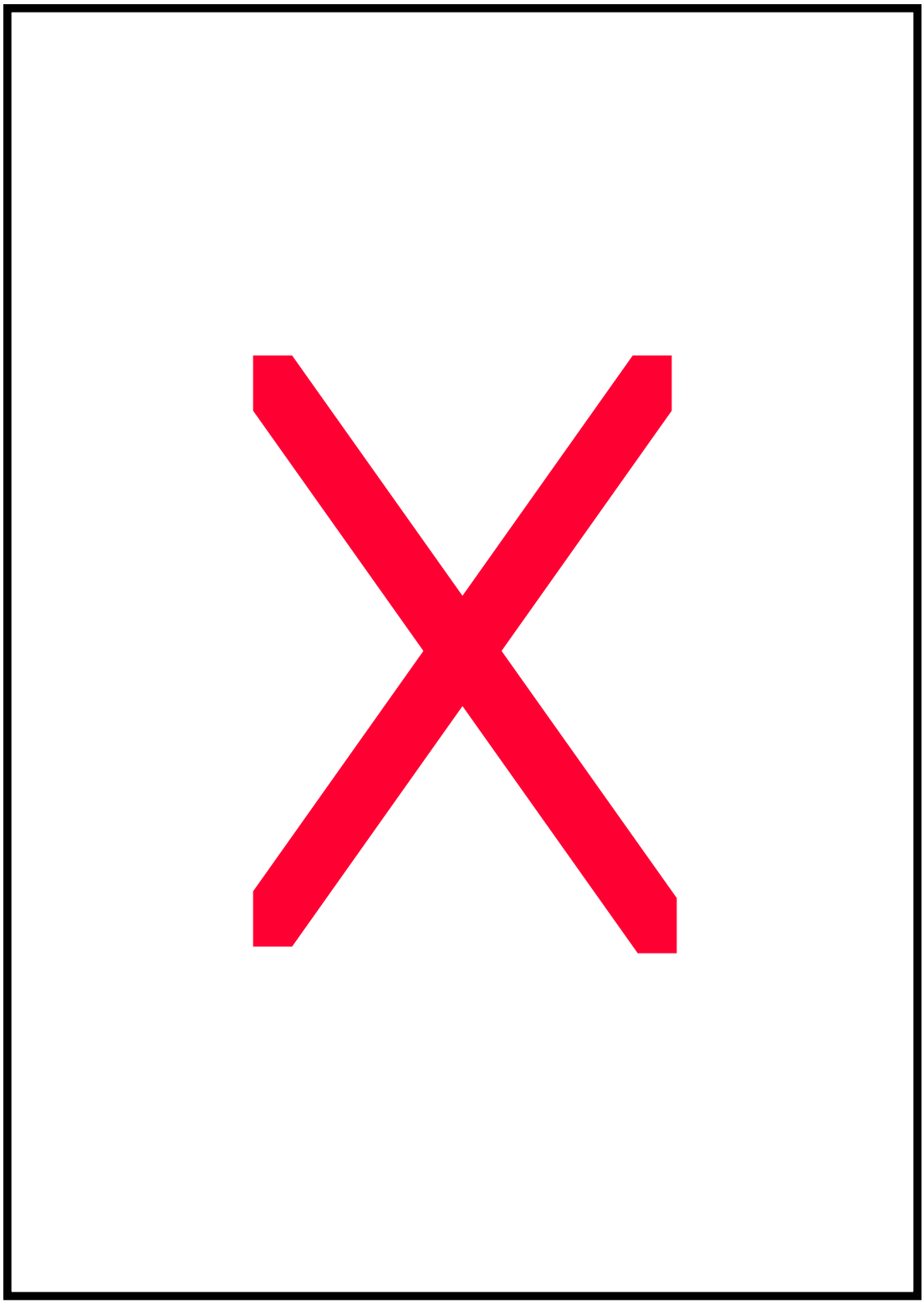
Investment or unearned income in excess of $1,500 received by a dependent child under age 14 is taxed at the parent's marginal rate if greater than the income tax using the child rates. A three-step procedure is required to compute the tax on **Form 8615, Tax for Children Under Age 14 Who Have Investment Income of More than $1,500** , where the excess over $1,500 will be taxed at the parent's marginal rate and unearned income greater than $750 but less than $1,500 will be taxed at 15%.

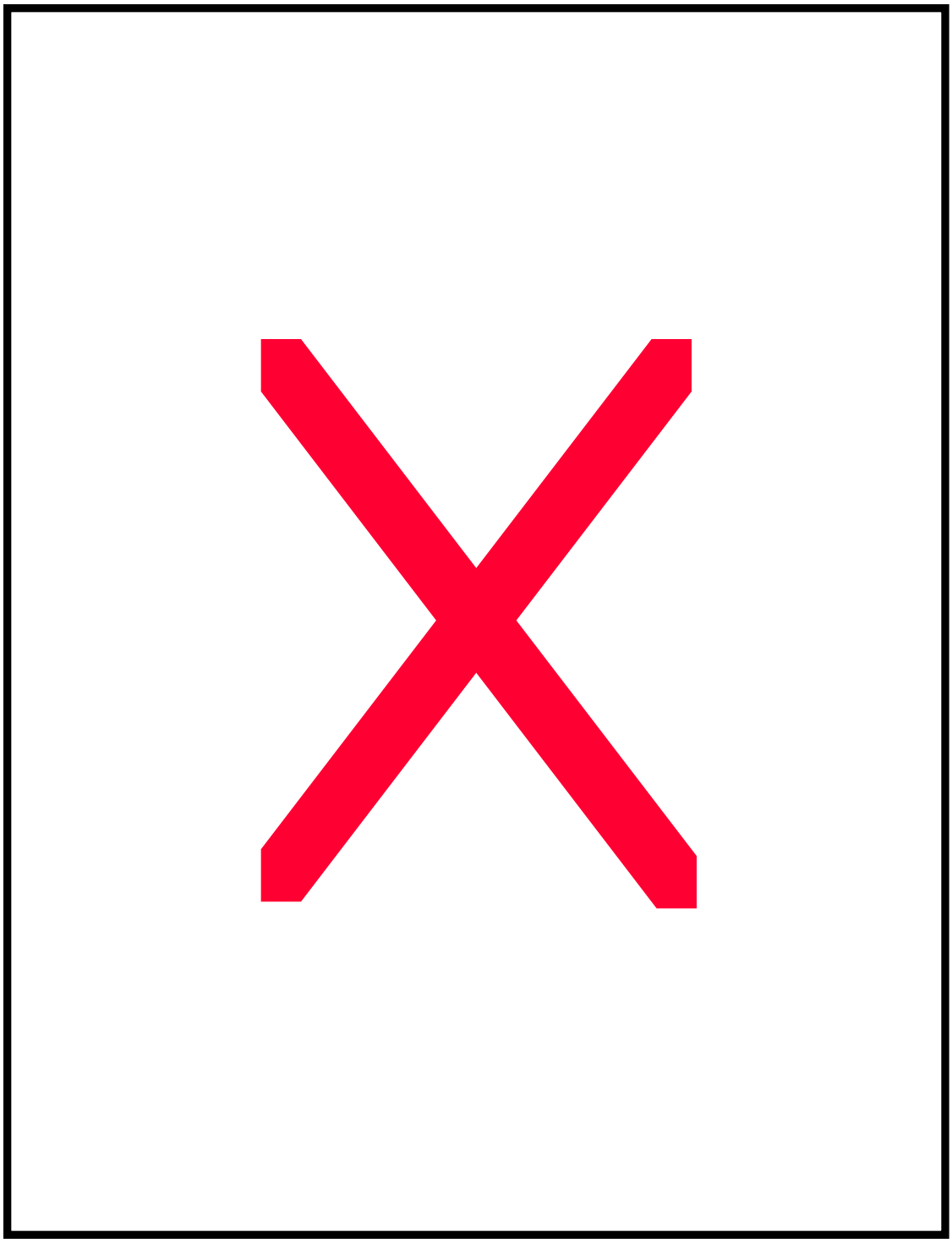
The election to claim the child's unearned income on the parent's return with **Form 8814, Parent's Election to Report Child's Interest and Dividends** , is still available, and the adjusted $1,500 base amount and $750 tax exemption are indexed for inflation on Form 8814. This election cannot be made if the child has income other than interest and dividends or if estimated tax payments were made in the child's name, or the child's income is more than $7,499.

## 2002 Tax Rates

All the tax brackets have been adjusted for inflation this year. Each tax bracket has been moved up approximately 3.3% from 2001, which results in many taxpayers with constant taxable incomes paying somewhat less income taxes in 2002. The 2002 tax rate schedules are shown in Table 3.

Please note that in 2002 there is a 10% bracket in each of the first four (individual) tax rate schedules below. There is not a 10% bracket for estates and trusts.





The rates for head of household are most favorable. Single taxpayers who are maintaining a home for themselves and a dependent should qualify. Married taxpayers not living in the same household for the last 6 months of the year are treated as married filing separately but may qualify as head of household if he or she has a qualified dependent.

The 2001 Act reduced the percentage on each bracket above 15% by 0.5% in 2001. In 2002, all brackets above 15% are reduced another one-half percentage point. In 2004 and 2006 all brackets above 15% are lowered by 1% in each of the 2 years with an extra 1.6% reduction in the highest bracket. At the end of the adjustment period the former 28%, 31%, 36%, and 39.6% brackets will be reduced to 25%, 28%, 33%, and 35% over the period+ 2001 to 2006.

**Planning Pointer.** For those people with the ability to delay income or accelerate expenses, this is a tax management opportunity because tax rates are scheduled to be lower the following year

### Marriage Tax Penalty

The tax rates for married taxpayers continue to be higher than for single taxpayers. Relief of the marriage tax penalty will start in the year 2005. At that time the 15% rate bracket for married filing jointly will increase to 1.8 times the 15% tax bracket for an unmarried individual; it will further increase to 1.87 times the tax bracket in 2006, 1.93 in 2007, and 2 n 2008 and thereafter until 2011.

**Practitioner Note.** Notice the 2001 Act only fixed the 15% bracket and not other brackets. So actually the Act has not completely eliminated the marriage tax penalty.

The other part of the marriage tax penalty has to do with the comparison of standard deduction between singles and married filing jointly. Two singles are currently afforded a larger standard deduction than a couple married filing jointly ($4,700 × 2 = $9,400 versus $7,850). The 2001 Act changes this deduction starting in the year 2005 so that the deduction for married filing jointly moves to 174% of the single taxpayer amount and, finally, reaches 200% in the year 2009. Inflationary adjustments will continue to be made.

Increasing the credit phaseout amounts for joint filers will provide marriage tax penalty relief for earned income credit calculations. The 2001 Act increases by $1,000 in 2002, $2,000 in 2005, and $3,000 in 2008, both the beginning and ending of the earned income credit phaseout ranges. Married individuals must file a joint return in order to claim the earned income credit. The calculation of the couple's combined income previously penalized some couples that had a smaller earned income credit when married compared to unmarried.

## Itemized Deductions (Schedule A)

### Medical Expenses

Medical expenses that exceed 7.5% of AGI are itemized deductions not subject to the additional 2% AGI limit. 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 deduction for 2002, which is $.13 per mile ($.12 for 2003), 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. Remember that itemized medical expenses must be reduced by any reimbursement, including health insurance payments received.

Beginning in 1997, qualified long-term care (LTC) insurance contracts are generally treated as an accident and health insurance contract. Contract benefits are generally excludable from taxation

like money received for personal injury and sickness. The 2002 excludable per diem benefit limit is $210 per day or $76,650 annually. Benefits are reported to taxpayer on 1099-LTC and shown on Form 8853 Section B. This exclusion limit is ignored if the actual cost of the LTC is more than the per diem payment or the taxpayer has been certified by a physician as terminally ill and death is expected within 24 months of certification.

### Long-Term Health Care

Long-term health care premiums are deductible for 2002, 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 $2,990 per year per person subject to the 7.5% exclusion. Those aged 61 to 70 years may include $2,300 per person; 51 to 60 years $900 per person; 41 to 50 years $450 per person; and 40 years and under $240 per person, all subject to the 7.5% exclusion.

### Handicapped Taxpayers

Handicapped 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. Handicapped 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, and personal casualty losses (list not complete).

### Home Mortgage Interest

Home mortgage interest (qualified residence interest) on the taxpayer's principal and second home is an itemized deduction on Schedule A, providing 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 2002 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 2002 this debt was $100,000 or less ($50,000 or less if married filing separately).

To be deductible, both types of mortgages must be secured debt, 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 code section.

**Practitioner Note.** Also, there is a tax trap: If you pay the mortgage on an ex-spouse's home, where only the ex-spouse resides after the divorce, there is no interest deductibility.

### 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 portion 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. A

taxpayer may elect to include net capital gain as investment income only if it is excluded from income qualifying for the long-term capital gain tax rate.

### Investment Interest Expense Deduction

Form 4952, Investment Interest Expense Deduction, is designed to calculate the amount of carryover interest that may be deducted in the current tax year. The carryover interest deduction is limited to the excess of 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

Charitable contributions are subject to substantiation and disclosure rules. One set of rules applies to separate contributions of $250 or more. For separate cash contributions exceeding $250, a taxpayer cannot rely solely on a canceled check but needs substantiation from the charity showing the amount and date the contribution was made. Acknowledgment must be obtained from the charity by the earlier of the filing date or the due date of the return, including extensions. 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** to report total noncash charitable contributions over $500.

For contributions exceeding $75, for which the taxpayer receives something in exchange (such as a dinner), the charity must provide a statement to the taxpayer that informs the donor that the value of the contribution that is deductible is the difference between the contribution and the value of the goods or services received by the taxpayer. Also, the charity must provide the donor with a good-faith estimate of the value of whatever the charity gave to the donor. The standard mileage rate for a passenger car used for charitable causes is $.14 per mile.

### Moving Expenses

Moving expenses are no longer itemized deductions. Report qualified moving expenses on **Form 3903** and deduct them on line 26 of Form 1040.

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 standard mileage rate for a passenger car used for moving is $.13 per mile ($.12 for 2003). Meal expenses are no longer included. The new place of work must be at least 50 miles farther from the taxpayer's former residence than was 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 pre-move house hunting; and temporary living expenses for up to 30 days at the new job location.

Qualified moving expenses reimbursed by an employer are excludable from gross income to the extent they meet the requirements of qualified moving expense reimbursement.

## Deductions Subject to 2% AGI Limit

### Miscellaneous Deductions

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; 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 incurred in looking for a new job in their present occupation. The job searching expenses are not deductible if looking for a job in a new occupation or looking for a first job. Factors to determine if 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; and 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 proceeding 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 Schedule C or F whereas employees deduct 50% of any unreimbursed business meal on Schedule A. The deductible percentage of the cost of meals consumed by employees subject to the Department of Transportation (DOT) will gradually increase from 65% for 2002 to 80% in 2008. DOT employees include Federal Aviation Administration (FAA) employees (pilots, crews, etc.), railroad employees, and interstate truck and bus drivers under DOT regulations.

### Itemized Deductions

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 2002 begins at $68,650 (AGI) and the limit for all other taxpayers starts at $137,300 (AGI).

Taxpayers with a 2002 AGI in excess of the above limits must reduce all itemized deductions except medical expenses, investment interest, casualty losses, and wagering losses to the extent of wagering gains. The reduction equals the lesser of 3% of excess AGI or 80% of the applicable itemized deductions. Three percent of excess AGI will be the most common reduction and will not be a major additional tax burden unless AGI is very high or the applicable itemized deductions are relatively low. The 7.5% of AGI medical expense adjustment and 2% floor on miscellaneous itemized deductions must be applied before the high-income deduction.

**Example 2.** Fred and Ann Veryrich's 2002 AGI is $157,300. 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:

- $157,300 AGI – $137,300 maximum = $20,000 excess; $20,000 excess × .03 = $600.
- $600 is less than $4,000 (.80 × $5,000 of applicable itemized deductions).
- They reduce itemized deductions by $600; $17,000 – $600 = $16,400 adjusted itemized deductions.

The above limitation on itemized deductions will be phased out starting in 2006 and completely eliminated after 2009. Starting in 2006, the otherwise applicable phaseout is reduced by one-third. Similarly, in 2008, the phaseout is reduced by two-thirds.

**Planning Pointer.** Then, 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 2005 to 2006, from 2007 to 2008, and from 2009 to 2010, they will pay less tax.

## Interest and Ordinary Dividends (Schedule B)

For 2002 tax returns, many taxpayers will no longer have to file a separate schedule if they have interest or dividend income of $1,500 or less. Form 1040 filers use Schedule B to list the names and amounts of those who paid them; Form 1040A filers use Schedule 1. In addition to having one less form to file (for many), this change will enable many taxpayers to use the shorter form 1040EZ or use TeleFile to file by telephone. The new IRS standard replaces the existing reporting threshold of $400. This does not affect filers with foreign bank accounts, because they must continue to report any foreign interest or dividends on Schedule B.

## Electronic Information Returns

For tax years ending after March 9, 2002, some forms like 1098, 1099, and 5498 can be furnished to the taxpayer electronically if the recipient consents. Electronic furnishing of Form W-2 was previously authorized in 2000, and Treas. Reg. §31.6051-1T has the details.

## Foster Care Payments

In 2002, 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 has been expanded and may include individuals over age 18.

## Earned Income Credit (EIC)

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

Beginning in 2002 taxpayers will use AGI to qualify not modified adjusted gross income (MAGI).

Use Table 4 to see if the taxpayer's earned income and number of qualified children meet the requirement for the credit, and refer to the IRS tables for 2002 credit amount.

**Table 4. EIC Rates, Income Ranges, and Phaseouts** [1]

| Earned Income or AGI Range for Taxpayers Not Filing as "Married Filing Jointly" (for 2002) | | | | | |
|---|---|---|---|---|---|
| **Qualifying Children** | **Credit Rate (%)** | **Maximum Credit** | **Phaseout** | **Phaseout Rate (%)** | **Maximum Credit** |
| None | 7.65 | $ 4,910 – 6,150 | $6,150 – 11,060 | 7.65 | $376 |
| One | 34.00 | 7,370 – 13,520 | 13,520 – 29,201 | 34.00 | 2,506 |
| Two or more | 40.00 | 10,350 – 13,520 | 13,520 – 33,178 | 40.00 | 4,140 |

**Earned Income or AGI Range for Married Filing Jointly (for 2002)**

| Qualifying Children | Credit Rate (%) | Maximum Credit | Phaseout | Phaseout Rate (%) | Maximum Credit |
|---|---|---|---|---|---|
| None | 7.65 | $ 4,910 – 7,150 | $7,150 – 12,060 | 7.65 | $376 |
| One | 34.00 | 7,370 – 14,520 | 14,520 – 30,201 | 34.00 | 2,506 |
| Two or more | 40.00 | 10,350 – 14,520 | 14,520 – 34,178 | 40.00 | 4,140 |

[1]This is not an official 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 released by IRS.

It is possible for some low-income taxpayers 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 more, 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 cannot file Form 2555 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.

To be eligible for the Earned Income Credit, 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 a foreign housing amount
- Not be used as a qualifying child making another person eligible for the earned income credit

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 sale of assets used in a trade or business. This interpretation included assets meeting the holding-period requirements of I.R.C. §1231; these assets are not subject to recapture rules of I.R.C. §§1245, 1250, 1252, and so on. In Rev. Rul. 98-56 (November 1998), the IRS announced they were reversing their position retroactively as follows:

> Section 32 of the Internal Revenue Code allows an earned income credit 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 (sows, boars, beef cattle, horses, cull dairy cows) that are §1231 property are not disqualified income.

In 2002, the EIC is denied to all taxpayers with an excess of $2,550 of taxable and nontaxable interest income, dividends, net capital gains (excluding those from §§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 Part II) and gains recaptured as ordinary income (Form 4797 Part III) are not included in disqualified income.

There are three tests for a qualifying child: relationship, residency, and age. Any child who meets all three of the following conditions is a qualifying child:

1. The child is your:
   - Son, daughter, adopted child, stepchild, grandchild, or foster child

- Brother, sister, stepbrother, stepsister, or a descendant (such as a child, including an adopted child) of any such individual, but only if you cared for that person as your own child

**Note.** An **adopted child** is any child placed with you 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 your son, daughter, stepchild, or adopted child. A **foster child** is any child you cared for as your own child **and** who is placed with you by an authorized placement agency.

2. The child is under age 19 at the end of 2002, under age 24 at the end of 2002 and a full-time student, or any age at the end of 2002 and permanently and totally disabled.

3. The child lives with you in the United States for over half of 2002.

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

The following are additional changes to the EIC for 2002 and beyond:

- The EIC phaseout ranges (both beginning and ending) for married joint filers will increase by another $1,000 starting in 2005, and another $1000 increase in 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 income. Previously, it included compensation excluded from income.
- In 2002 Earned Income Tax Credit will not be reduced by AMT.
- The residency requirement for a foster child is changed so that the child "has to live with the taxpayer for more than six months rather than for the entire year."

### EIC Reminders for Farmers

If earned income is negative, there is no credit. Therefore, a farmer with a negative Schedule F net farm profit would not get a credit unless there were wage and Schedule C income more than enough to offset the loss on Schedule F, or the optional method of reporting self-employment income is used. A farmer with a negative net farm profit may use the optional method of reporting up to $1,600 of self-employment income to collect an EIC that would partially or wholly cover the self-employment tax and also provide **one** quarter of social security coverage, providing disqualified income (such as interest and dividends), earned income, and MAGI 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 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 (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 self-employment (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 the credit amount for one qualifying child. The maximum that a taxpayer can receive throughout the year with his or her pay is $1,503, regardless of the total number of children a taxpayer may have. A taxpayer may be able to claim a larger credit but must file their 2002 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).

## Child Tax Credits

For the taxable year 2002, a $600 credit is allowed for each qualifying child under 17 years of age. 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 MAGI (or fraction thereof) in excess of the following thresholds, as shown in Table 5.

**Table 5. Child Tax Credit Phaseout Based on AGI**

| | Threshold Starting | Completely Gone |
|---|---|---|
| Married joint return | $110,001 | $121,001 |
| Single or head of household | 75,001 | 86,001 |
| Married separate return | 55,001 | 66,001 |

**Example 3.** Jack and Jill have two eligible children and file a joint return. Their 2002 AGI is $120,000, which exceeds the threshold by $10,000. They must reduce their credit by $50 for each $1,000 over the threshold, or $50 times 10 equals $500. Their child tax credit for 2002 is $600 times 2 less $500 or $700.

The maximum tax credit per child increases from $600 to $1000 in 2010, in steps increasing in 2005, 2009, and 2010. The requirement necessary to make this credit refundable was changed in 2001. Prior law said the additional child credit was refundable to families with three or more qualifying children, only to the extent that taxpayer's social security tax exceeded earned income credit. The 2001 Act says child credit is refundable up to the greater of (1) 10% of earned income over $10,350 (for 2002, COLA adjusted) or (2) the extent to which the taxpayer's social security tax exceeds his or her income credit (if there are three or more qualified children). This percentage is increased to 15% for the years 2005 and after.

**Example 4.** Mary has two eligible children, and her earned income is $21,000 for 2002. She has neither other nonrefundable credits nor other income. Her 2002 tax is calculated by subtracting $6,900 for standard deduction (HH) and three personal exemptions at $3,000 ($9,000), resulting in $5,100 of taxable income. This is in the 10% bracket for 2002, so Mary has $510 of tax liability ($5,100 times 10%). Under the 2001 Act rule, Mary is allowed a **refundable** credit in 2002 equal to the lesser of (1) $1,200 (2 × $600) or (2) $1,065 (($21,000 – $10,350) × 10%). Mary's new child tax credit consists of $1,065 refundable credit and $135 nonrefundable credit.

Beginning in 2001, the refundable child tax credit was no longer reduced by the amount of the excess of taxpayer's minimum tax over their regular income tax.

## Child-Care and Dependent-Care Credits

An individual taxpayer maintaining a household in 2002 for a dependent under 13 or a dependent or spouse who is physically or mentally incapable of caring for themselves may get a child- and dependent-care credit of up to 30% of employment-related expenses. Those care expenses cannot exceed $2,400 for one qualifying individual ($4,800 for two or more). This credit is decreased by 1% for each $2,000 (or fraction thereof) of AGI over $10,000, but the percentage never goes below 20%. This means that the credit rate is reduced to 20% for eligible taxpayers with AGIs over $28,000. The maximum credit for individuals with AGIs under $10,001 would be $720 for one and $1,440 for two qualifying individuals.

**Example 5.** Charlie Care has a 2002 AGI of $34,000, employment-related dependent-care expenses of $3,000 and one qualifying dependent. Because his AGI exceeds the limit of $28,000, his percentage rate will be 20%. But his care expenses also exceed the limit of $2,400, thus his credit is only $480 ($2,400 × 20%)

The 2001 Act increased the maximum percentage from 30% to 35% for tax years beginning after December 31, 2002. It also increased the AGI limit for taking the maximum credit to $15,000 rather than $10,000. This change means the credit is reduced to 20% for all eligible taxpayers with AGIs over $43,000. Also, the employment-related expense dollar limits were increased to $3,000 for one and $6,000 for two qualifying individuals, thus maximizing the credit at $1,050 for one and $2,100 for two individuals.

## Adoption Tax Benefits

A $10,000 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 between $150,000 and $190,000. 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 (1) regular tax and AMT, less (2) other nonrefundable credits and foreign tax credits.

In addition to the adoption credit, employer paid or 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

In Table 6 the benefits, restrictions, and limitations on several tax incentives for participants in higher education are presented.

**Table 6. Education Incentive Programs**

| | Hope Credit | Lifetime Learning Credit |
|---|---|---|
| Tax incentives | Per student:<br>100% of first $1,000 and 50% of second $1,000 used for tuition and fees for higher education for at least half-time students incurring expenses the tax year | Per taxpayer:<br>20% of first $5,000 (20% of first $10,000 after 2002) 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 | · Only for first 2 postsecondary years<br>· May not be claimed in same year as an education IRA distribution (changed after 2001 if credits are not claimed for expenses used to generate IRA payouts)<br>· Maximum of 2 tax years<br>· Nonrefundable<br>· Not allowed for persons claimed as dependents on another taxpayer's return | · May not be claimed in the same tax year for the same person as claimed for the Hope credit<br>· May not be claimed in same year as an education IRA distribution (changed after 2001 if credits are not claimed for expenses used to generate IRA payouts)<br>· Nonrefundable |
| MAGI limits | Phaseout range starts at $41,000 and ends at $51,000 for singles; the range is $82,000 to $102,000 for joint returns; and the credit is not available to married filing separately. | Phaseout range starts at $41,000 and ends at $51,000 for singles; the range is $82,000 to $102,000 for joint returns; and the credit is not available to married filing separately. |

| Coverdell Education Savings Account (Education IRA) | |
|---|---|
| Tax incentives | · Up to $2,000 of nondeductible contribution (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<br>· Liberalized expense items including elementary, secondary, special needs, and technology purchases<br>Caution: Any balance remaining after beneficiary reaches 30 or dies is deemed distributed within 30 days.<br>In 2002 and after, the age 30 distribution rule does not apply to special-needs |

| | |
|---|---|
| | beneficiary. |
| Restrictions | · 10% penalty plus tax on unqualified withdrawals<br>· Cash contributions only<br>· No contributions after account holder attains age 18<br>(In 2002, the age 18 contribution rule does not apply to special-needs beneficiary.) |
| 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 filing separately.<br>In 2002, only individuals have phaseouts, corporations and other entities may contribute regardless of AGI. |
| Deadline for contribution | In the year 2002 and thereafter, contribution deadline is April 15 (not including extensions) of the following year and distributions will not be subject to additional tax if made on or before June 1 of the year following contribution. |

| **Student Loan Interest Deduction** | |
|---|---|
| Tax incentives | An above-the-line adjustment to gross income rather than an itemized Schedule A deduction: up to $2,500 for 2002 and after for interest paid on loans for higher education expenses while at least half-time student.<br>Deduction is allowed with respect to interest paid over any period of time. |
| Restrictions on a qualifying loan | · No deduction if student is allowed as dependent on another taxpayer's return<br>· No double benefits, as with home equity loans |
| MAGI limits | Phaseout range starts at $50,000 and ends at $65,000 for singles; the range is $100,000 to $130,000 for joint returns; and the deduction is not available to married filing separately. |

| Qualified Tuition Program | | |
|---|---|---|
| Qualified tuition program | Sponsored by a state to purchase tuition credits or save for payment of higher education expenses.<br>(For 2002, must be state-sponsored or an educational institution meeting requirements.) | |
| Taxation of earnings used for higher education in state-sponsored program | For 2002, distributee excludes earnings from taxation. | For 2002, if not used for qualified expense, the distributee is taxed on earnings and there is a 10% penalty (some exceptions). |
| Beneficiary changes | The definition of family members includes first cousins in 2002 and thereafter. | |
| Coordination with Lifetime Learning and Hope educational credits. | In 2002 and thereafter, 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. | |

| 2002 Deduction of Higher Education Expenses (Above-the-Line Benefits) | |
|---|---|
| Deductible expenses | Qualified higher education expenses are defined the same as for the Hope credit. |
| Deductible maximum | For 2002 and 2003, $3,000 is the maximum amount deductible. |
| AGI limits (once exceeded the deduction is eliminated). | Limits are $65,000 for singles or head of household and $130,000 for married filing jointly taxpayers. |
| Ineligible taxpayers | · Married filing separately and taxpayers that **may** be claimed by someone else<br>· Taxpayers that have claimed a Hope or Lifetime Learning credit for the year for the same student |
| Eligible taxpayers | Taxpayers under the above AGI limits are eligible. Taxpayer 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. |

## Estimated Tax Rules

The minimum threshold after subtracting income tax withholding and credits for estimated tax payments was increased to $1000, effective for tax years after 1998. 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.

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 officially follows the federal definition of gross income from farming.

The 2001 Act delays 20% of the corporate estimated tax payment that will be due on September 15, 2004, until October 1, 2004.

## Retirement Plan Contributions

In the tax year 2002, taxpayers have both increased opportunities and rewards for contributing to retirement plans. Table 7 gives the increased limits in all plans over last year's limitations.

Roth IRAs and traditional IRAs have a 50% increase in contribution limit to $3000 maximum. The deductible IRA phaseout AGI limits for employee's covered at work are as follows (dependent upon filing status):

| | |
|---|---|
| Single, head of household | $34,000 – $44,000 |
| Married filing jointly | $54,000 – $64,000 |
| Married filing separately | $0 – $10,000 |

**Table 7. Limitations on Contributions**

| Year | IRAs Traditional Roth | Simple | 457 | 401(k) 403(b) SEP | Defined Contribution | Defined Benefit Plan [1] | Compensation Limit | Stock Bonus & Profit Share |
|---|---|---|---|---|---|---|---|---|
| 2001 | $2,000 | $6,500 | $8,500 | $10,500 | $35,000 | $140,000 | $170,000 | 15% |
| 2002 | $3,000 | $7,000 | $11,000 | $11,000 | $40,000 | $160,000 | $200,000 | 25% |
| 2003 | $3,000 | $8,000 | $12,000 | $12,000 | COLA[2] | COLA | COLA | 25% |

[1]Maximum annual benefit to be funded.
[2]Cost of living adjustment.

### Additional Contributions

Catch-up or additional contributions are made possible by the 2001 Act for individuals aged 50 and over to certain retirement plans. 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 §457 plan participants in their last 3 years before retirement. Limits for catch-up contributions for the next 4 years are given in Table 8 for certain retirement plans.

**Table 8. Catch-up Contribution Limits**

| Year | IRA | SIMPLE | 401(k), 403(b), 457, and SEP |
|---|---|---|---|
| 2002 | $ 500 | $ 500 | $ 1,000 |
| 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. Starting in the year 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 MAGI and the maximum annual contribution eligible for the credit is $2,000. There are limits on MAGI, dependent upon the taxpayer's filing status. The MAGI is determined without adjustments to AGI for §911, §931 and §933 ("foreign" tax 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 §401(k) plans, §403(b) annuities, §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 above. There is an exception that excludes distributions from a Roth IRA. The MAGI-based credit rates for 2002 to 2006 are given in Table 9.

**Table 9. Credit Rates Based on MAGI 2002–2006**

| Joint Return | | Head of Household | | All Other Filers | | Credit |
|---|---|---|---|---|---|---|
| Over | Not Over | Over | Not Over | Over | Not Over | Percentage |
| $ 0 | $30,000 | $ 0 | $22,500 | $ 0 | $15,000 | 50 |
| 30,000 | 32,500 | 22,500 | 24,375 | 15,000 | 16,250 | 20 |
| 32,500 | 50,000 | 24,375 | 37,500 | 16,250 | 25,000 | 10 |
| 50,000 | | 37,500 | | 25,000 | | 0 |

## 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 is effective for courses beginning in 2002 and remains until changed or until January 1, 2011.

## Deduction for Teacher's Expenses

In 2002 and 2003 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 the taxpayer's 1040 line 23 (revised). 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.

### Five-Year Carryback of Net Operating Losses (NOL s)

The 2002 Act temporarily extends the NOL carryback period to 5 years (formerly 2 years) for NOLs arising in taxable years ending in 2001 and 2002. Taxpayers are not forced to use the longer carryback period. Taxpayers may elect out of the 5-year period, but the election is irrevocable. Taxpayers may have to make two elections: one to not have the 5-year carryback, and one to waive the carryback entirely. This does not affect farm NOLs that already qualify for the 5-year carryback.

## LONG-TERM CAPITAL GAINS RATES

Capital gains taxation rates on some assets held over 5 years were changed in 2001 because of provisions of the 1997 Tax Act. The maximum tax rate on adjusted net capital gain has been reduced to 18% (8% for income in the 10% and 15% taxable income brackets) after December 31, 2000. To be eligible for this rate, the asset needs to have been held 5 years. The 20% and 10% rates will still apply to assets held the regular holding period of 12 (or 24) months. For taxpayers in the 10% or 15% bracket, the holding period begins as normal with the date of acquisition. For taxpayers in a taxable income bracket in excess of 15%, only assets acquired after December 31, 2000, qualify so these higher-bracket taxpayers will not benefit from the reduced rate until 2006 and then only on assets acquired after December 12, 2000. However, these higher-bracket taxpayers could have elected under §311(e) to treat the asset as having been sold and reacquired for its fair market value on January 1, 2001, in order to be eligible for the 18% rate 5 years from that date. Gain had to be recognized on Form 4797 or Schedule D (1040), and taxes had to be paid (losses were disallowed under that option). Taxpayers had until the extended due date of their 2001 return to make this election. The election made under §311 used the statement on the top of an amended return "Election under Section 311 of the Taxpayer Relief Act of 1997." A few taxpayers benefited from this election on their 2001 filings. Marketable securities used the closing market price on January 2, 2001, to determine market value and other capital assets needed to be supported by an appraisal or other form of documenting market value.

Notice 2002-58 provides for a discretionary extension of time if a taxpayer failed to make an election for one or more eligible assets on their original or amended return (within 6 months) or did not file an original return on which a deemed sale election could have been made. Requests for this relief will be granted if the IRS feels the taxpayer acted reasonably and in good faith and if it does not prejudice the interest of the government. An example of a case in which a taxpayer might want to apply for this relief is where they had some expiring NOLs or an asset with basis near market value, and they expected a substantial increase in value over the next 5 years.

**Planning Pointer.** Taxpayer should also consider that capital gains rates could be reduced by future legislation and that their income tax bracket in the future years could be below the rates paid today; there is an implied interest cost of paying taxes in advance.

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 §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 remains at 28%.

Cattle (dairy or breeding) and horses (breeding, sport, work, or draft) must be held 24 months to qualify for the 8%, 10%, or 20% 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.

A taxpayer receiving capital gains distribution dividends no longer reports this first on Schedule B but enters them directly on Schedule D. If the taxpayer otherwise would not be required to file a Schedule D, these distributions may be entered directly on Form 1040, check the box and calculate the alternative capital gains tax on the worksheet provided in the IRS instructions.

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.

## 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 the 15% taxable income bracket. Noncorporate taxpayers will compute their net capital gains tax by applying capital gain income to the 15% taxable income bracket in the following order:

1. Unrecaptured I.R.C. §1250 gain; 25% maximum is reduced to 15%.
2. Collectibles and other 28% rate gain assets;28% maximum is reduced to 15%.
3. Adjusted net capital gain–property held over 5 years; 20% maximum is reduced to 8%.
4. Adjusted net capital gain–remainder after (3); 20% maximum is reduced to 10%.
5. Adjusted net capital gain in excess of the 15% taxable income bracket is taxed at 20%.
6. Apply the 25% net capital gain tax to any unrecaptured I.R.C. §1250 gain exceeding the 15% bracket.
7. Apply the 28% net capital gain tax to any 28% rate gain assets exceeding the 15% bracket.

**Example 6.** Mr. and Mrs. F. P. Moor file a joint return, and their 2002 15% taxable income tax bracket goes to $46,700. Their taxable income after personal exemptions and itemized deductions is $51,500, exceeding the 15% bracket by $4,800, as shown in Table 10. Their taxable income includes $6,000 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. Of this amount, $2,000 is from cattle held over 5 years. The $6,000 unrecaptured I.R.C. §1250 gain and the $3,500 capital gain on collectibles is all taxed at 15%. The $4,800 of ANCG in excess of the 15% bracket is taxed at 20%. The $2,000 of 5-year gain is taxed at 8%, leaving $3,200 of ANCG to be taxed at 10%.

**Table 10. Calculation of Total Taxable Income**

| | | Tax On | Tax Rate |
|---|---|---|---|
| Ordinary income | | $25,500 | 10% or 15% |
| Gain on farm building sale (unrecaptured §1250 gain) | | 6,000 | 15% |
| Gain in sale of antiques | | 3,500 | 15% |
| Gain on sale of dairy cattle (ANCG, $10,000 total) | | | |
| Held over 5 years | | 2,000 | 8% |
| Held less than 5 years | | 3,200 | 10% |
| Subtotal | $46,700 | | |
| Amount in excess of 15% bracket | | 4,800 | 20% |
| Total taxable income | $51,500 | | |

## Netting Capital Gains and Losses

The following rules apply to the netting of capital gains and losses for tax years ending after May 6, 1997:

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 (20%).
2. Gains and losses are netted within the three 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 20% group.
4. A net loss from the 20% 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 and/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 Schedule D exceed capital gains. Only a maximum of $3,000 of any such net capital loss may be deducted in determining gross income of 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 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, Schedule D; the long-term in Part II. In either event, they 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 are deductible.

## Inherited Property Rules

Recent year's legislation did not change the step-up in basis rule that gives decedent's property a new basis equal to its fair market value (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 held 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 holding period.

### Capital Gains and AMT, Flowthrough Entities, and Small Business Stock

The new, 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. The gain from property held over five years must be separately stated by these flow-through entities.

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 20% maximum capital gains tax rate (if the required holding period has been met).

## SALE OF TAXPAYER'S PRINCIPAL RESIDENCE

The Tax Relief Act of 1997 (TRA '97) increased the exclusion of gain from the sale of a principal residence to $250,000 ($500,000 for joint filers), on sales and exchanges made after May 6, 1997. The old rollover of gain provision (I.R.C. §1034) and the $125,000 of gain exclusion, including the 55 years of age requirement (old I.R.C. §121), were repealed and replaced with a new exclusion (new I.R.C. §121).

The 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 beginning May 7, 1997. Earlier sales do not count. Use of the old exclusion prior to May 7,1997, does not affect the availability of the new exclusion. Married taxpayers filing joint returns get 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 married filing jointly but 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 after May 6, 1997, and within 2 years of the current sale, if the current sale was due to a change in place of employment, health, or unforeseen circumstances.

**Example 7.** Mr. and Mrs. Move sold and moved out of their first home March 1, 2002, because of a change in employment. They began renting and living in that home on June 28, 2000, but did not buy it until August 4, 2000. They lived in the home for 611 days but owned it for only 574 days. Their partial exclusion is based on the portion of the 2-year (730 days) ownership requirement that they lived in the house (574 days), the shorter of the two requirements. Their partial exclusion for 2002 is $393,150 (574 ÷730 = .7863; .7863 × $500,000 = $393,150).

Gains from insurance proceeds and other reimbursements for homes destroyed or condemned after May 6, 1997, qualify 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 included in the exclusion but would be recognized as gain from the sale of I.R.C. §1250 property.

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 Schedule D. 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 you have received a Form 1099-S.

A taxpayer that does not meet the 2-year ownership test and/or the 2-year use requirement will be eligible for a partial exclusion if the principal residence was in qualified use on August 5, 1997, and is sold before August 6, 1999. As illustrated earlier, the partial exclusion is based on the lesser of days of qualified ownership or days of qualified use during the 5-year period ending on the sale date, divided by 730 days.

# INCOME AVERAGING FOR FARMERS

Individual taxpayers with certain farm income may elect to use a new 3-year method of income averaging for tax years beginning on or after January 1, 1998. "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 year's 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.

## Elected Farm Income

The EFI is taxable income attributed to any farming business and designated to be included in the election. This also includes an owner's share of net farm income from an S corporation (including wages), partnership, or limited liability company (LLC) but not 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 net operating losses must also be included. A "farming business" includes nursery production, sod farming, the production of ornamental trees and plants, as well as the production of fruit, nuts, vegetables, livestock, livestock and 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 I.R.C. 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 either SE tax or AMT. Note that this provision may result in tax savings from income averaging being offset by increases 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 each base year) and what type of farm income (ordinary or capital gains) to include in EFI. Schedule J is used to compute and report the tax from income averaging.

**Example 8.** Dairy farmers Mr. and Mrs. B & B Goodyear have a substantial increase in farm income in 2002. Receipts are up and costs are down. Mrs. Goodyear works off-farm. When Schedule F profits of $38,000 and $20,000 of gains from raised cow sales are combined with nonfarm income and deductions, taxable income is $70,700. They file a joint return. Their taxable income for 2002 and the previous 3 years is as shown in Table 11 (note that each year includes $20,000 of raised cow sales).

**Table 11**

| Year | Taxable Income |
|---|---|
| 2002 | $70,700 |
| 2001 | 27,900 |
| 2000 | 39,400 |
| 1999 | 25,200 |

The Goodyear's elect to income average in 2002. 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 ($70,700 – $46,700). They decide to use $24,000 of their 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 2000 their 15% tax bracket ended at $43,850 and their taxable income was $39,400, leaving $4,450 of the 15% rate bracket available for EFI from the current year. Therefore, $3,550 ($8,000 – $4,450) added to the 2000 base year income will be taxed at 28%.

**Question 2.** Should the Goodyears reduce EFI to avoid the 28% tax bracket in 2000?

**Answer 2.** For each $1 of EFI subject to the 28% tax rate in 2000, $2 is taxed at 15% in the other base years. Therefore, the marginal tax rate for the Goodyear's EFI is 19.33% ([.15 + .15 + .28] ÷3). If they put less than $24,000 in the 2002 EFI, their 2002 taxable income will exceed $46,700 and their marginal tax rate will be 27%.

**Question 3.** How much income tax will the Goodyears save by income averaging in 2002?

**Answer 3.** They will save 12% (27% rate minus 15% rate) on the first $13,350 (3 × $4,450) or $1,602, and 7.67% (27 – 19.33) on the remaining $10,650 of EFI or $817, for a total tax reduction of $2,419.

## Base-Year Losses

The IRS made a major change (retroactive to 1998) to allow 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 9.** Sam had a $45,000 Schedule F loss in 2000. He and his wife filed a joint return and claimed 5 exemptions (including three children). Taxable income was calculated as shown in Table 12.

**Table 12**

| | |
|---|---|
| Schedule F | ($45,000) |
| Standard deduction | (7,350) |
| Exemptions | (14,000) |
| Taxable income | ($66,350) |

Sam's NOL for 2000 would be $45,000. This NOL must be removed from taxable income leaving ($21,350) to be used as "base year income" for 2000 on Sam's Schedule J.

**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, 2002 farm business gains of a taxpayer in a 27% income tax bracket could be eligible for a 10% 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 Schedule F, this income qualifies for income averaging. Final regulations make this true also if the farm owner does not materially participate but receives share rental income (properly reported on Form 4835). This is a change from prior interpretation. For crop share rents received after January 1, 2003, the lessor needs to have a written crop share lease agreement. Cash rental income reported on Schedule E 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 Schedule F are qualified. Sales of raised dairy and breeding livestock reported on Form 4797 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 §1231 losses in the base years?

**Answer 5.** Final regulations indicate that I.R.C. §1231 gains would be taxed as long-term capital gains rate for the prior year. The §1231 loss of that prior year remains fully deductible from ordinary income.

**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 can only 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 an 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, base year's income, deductions, and credits are not affected by the additional income allocated to that year (for example, the taxable portion of social security benefits or the allowable Schedule A Itemized Deductions). In essence, 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' 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 you may have to override your tax preparation software in order to print the 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 to even out (and marginal tax rates) in anticipation of income averaging in future years. Note that evening out base period income has become more difficult with tax brackets being reduced by 0.5% each year.

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

**Answer 11 .** Yes, because income averaging does not affect the calculation of tentative AMT on Form 6251. AMT is the excess of tentative AMT over the regular income tax. Therefore, as income averaging reduces regular tax, the potential for an AMT tax liability increases.

**Question 12.** Will any increased AMT resulting from income averaging be available as an AMT credit in future years?

**Answer 12.** The AMT resulting from income averaging will not always give an AMT credit for future years. Only adjustments and preferences that are deferral items create an AMT credit. If there are no such deferral items, or such items have already been reflected in an AMT credit calculated before income averaging has been used, no additional AMT credit will be created.

## Planning Guidelines and Information

Implement economically sound income tax management practices throughout the year rather than using income averaging as the only tax management strategy. Use tax management practices that reduce taxable income before income averaging is elected.

**Planning Pointer.** If the taxable income in a base year, is less than the ANCG of that year, elected *ordinary* farm income carried to that year will be taxed at the net capital gains rate until adjusted taxable income of that base year equals that year's ANCG.

Income averaging should be used to transfer as much as possible of high-bracket income 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 if and how much 2002 farm income should be averaged:

- The 2002 AGI, ordinary income, and capital gain attributed to farming, personal exemptions, and the standard (or itemized) deduction (see Table 13)
- Taxable income from his or her 1999, 2000, and 2001 tax returns
- Taxable income tax brackets for 2002 and the 3 prior years (see Table 14)

### Priority of Goals

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 elected farm income.

Then, load the oldest base year followed by an equal amount in the other base years.

Finally, 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.

**Table 13. Personal Exemption Deduction and Standard Deduction**

| Item | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|
| Personal Exemption Deduction | 2,750 | 2,800 | 2,900 | 3,000 |
| Standard Deduction: | | | | |
| Single | 4,300 | 4,400 | 4,550 | 4,700 |
| Married filing jointly | 7,200 | 7,350 | 7,600 | 7,850 |
| Head of household | 6,350 | 6,450 | 6,650 | 6,900 |
| Married filing separately | 3,600 | 3,675 | 3,800 | 3,925 |

**Table 14. Top End of Taxable Income Tax Brackets**

| Bracket | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|
| Single: | | | | |
| 15% [1] | $25,750 | $26,250 | $27,050 | $27,950 |
| 28% [2] | 62,450 | 63,550 | 65,550 | 67,700 |
| 31% [2] | 130,250 | 132,600 | 136,750 | 141,250 |
| 36% [2] | 283,150 | 288,350 | 297,300 | 307,050 |
| Married filing jointly: | | | | |
| 15% [1] | 43,050 | 43,850 | 45,200 | 46,700 |
| 28% [2] | 104,050 | 105,950 | 109,250 | 112,850 |
| 31% [2] | 158,550 | 161,450 | 166,450 | 171,950 |
| 36% [2] | 283,150 | 288,350 | 297,300 | 307,050 |
| Head of household: | | | | |
| 15% [1] | 34,550 | 35,150 | 36,250 | 37,450 |
| 28% [2] | 89,150 | 90,800 | 93,600 | 96,700 |
| 31% [2] | 144,400 | 147,050 | 151,600 | 156,600 |
| 36% [2] | 283,150 | 288,350 | 297,300 | 307,050 |
| Married filing separately: | | | | |
| 15% [1] | 21,525 | 21,925 | 22,600 | 23,350 |
| 28% [2] | 52,025 | 52,975 | 54,625 | 56,425 |
| 31% [2] | 79,275 | 80,725 | 83,225 | 85,975 |
| 36% [2] | 141,575 | 144,175 | 148,650 | 153,525 |

[1]The tax rate for 2002 is 10% on the first $6,000 for singles or married filing separately; on the first $12,000 for married filing jointly; and on the first $10,000 for head of household.
[2]The rates above 15% are reduced by 0.5% for 2001 and 1.0% for 2002.

# CCC COMMODITY LOANS AND LOAN DEFICIENCY PAYMENTS

Low commodity prices are causing farm producers to use government programs that have not been used as much in the past few years. As 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 a binding election to treat these loans as income in the year received.If the producer has not made the I.R.C. §77 election, the CCC loan is treated the same as any other loan.

*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 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 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 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 option replaces the option of forfeiting the grain to the CCC under the old loan program.

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. That amount must generally be reported as an Agricultural Program Payment on Schedule F.

However, if the producer made a §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 on line 7a on Schedule F. 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.

## 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: Reconciling taxpayer records to the amounts reported on Form CCC-1099-G can be challenging:

- CCC loan activity is not reported on the 1099. Borrowings and program payments may be co-mingled 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 1099.

# PROVISIONS APPLYING PRIMARILY TO BUSINESS ACTIVITY

## Business Record Keeping

Record keeping is probably one of the tasks that farmers and small business operators do not like to deal with. 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 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 you must keep these business records to prove the income or deductions on a tax return. The period of time varies dependent upon an individual business situation (Table 15). The period of retention is never less that 3 years from the due date of the return and can be for lifetime. The taxpayer should always keep copies of their filed tax returns.

## 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 (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.

**Table 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 below 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 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 |

"Exclusive use" means only for business. If a farmer uses the family den, dining room, or his 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 provides examples that describe four situations in which a taxpayer's home office will qualify even if the use before 1999 did not qualify for the deduction.

**Form 8829, Expenses for Business Use of Your Home** , is not filed with Schedule F, 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.

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 non-office activities.

Schedule C filers who claim expenses for business use of the home must file Form 8829. Form 4562 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.

**Practitioner Caution** . When a taxpayer sells a home on which expenses for business use have been claimed, tax consequences may occur. The portion used as business is reported as the sale of I.R.C. §1250 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 only deductible if the travel is undertaken in the same trade or business as the one that qualifies the taxpayer for a deductible home office.

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

### Self-Employed Health Insurance Premiums

This tax provision allows self-employed taxpayers to deduct as an adjustment to income on 1040 a percentage of health insurance premiums paid. Also, if you pay premiums on a qualified long-term care contract for yourself, your spouse, or your dependents, you can include these premiums (subject to the annual limits stated previously). In 2002 the deduction is 70% (100% starting in 2003), with the balance subject to the 7.5% rule for those who itemize. 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. 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.

### Archer Medical Saving Program

The medical savings account (MSA) is a tax-exempt account with a financial institution in which employees of a small employer or self-employed taxpayers save money for future medical expenses. The program has been renamed as Archer MSAs and, again, extended until December 31, 2003. For details on this program see *Medical Savings Accounts* in IRS Publication 969.

### Employee Health and Accidental Insurance Plans

An employer can claim premiums paid on employee health and accident insurance plans as a business expense on Schedules F or C. 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.

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).

A written plan is not required if it is purchased through a third-party insurer. Self-insured plans must have a written plan 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.

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:

The spouse must be a bona fide employee with specific duties and the salary and benefits received must be proportionate to the duties.

The employer must file all payroll reports, withhold income and FICA taxes, and furnish a Form W-2 to the employee.

The advantages of paying the family health insurance premiums this way are a reduction of Schedule F or C net income, a reduction of combined taxable income, a potential reduction in self-

employment income, and a potential net tax savings. The disadvantages are additional bookkeeping, payroll tax deposits, a possible increase in social security taxes (if the employer's earnings are above the earnings base), and a potential reduction in social security benefits to the employer.

## 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 2002 standard mileage rate is 36.5 cents per mile for all business miles driven (leased as well as purchased vehicles; 2003 rate will be 36.0 cents). The standard mileage rate may not be used when the automobile has been depreciated using a method other than straight line, the car is used for hire, or two or more cars are used at once. 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

Lots of people and businesses will have cell phone expenses this year, and many more will have these expenses in the years to come as they see the benefits of being in contact with the world. 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. Memo 2001-165). Businesses must have a logbook or similar documentation for substantiation.

## Return Preparers Have to Issue Privacy Policy Statements

Under Regulation 16 CFR Part 313, effective July 1, 2001, 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 existing customers on that date must be provided with the notice and all new customers from that point forward. 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.

# CORPORATE AND PARTNERSHIP PROVISIONS

## Corporations

C or 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 2002 tax rates for small businesses are given in Table 16.

**Table 16. 2002 Corporate Tax Rates For Small Businesses** [1]

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

[1]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 on 100% of last year's tax (must be greater than $0).

Corporations that have elected S status are not a tax-paying entity but must file Form 1120S. 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 (less than $15 million of total gross receipts from 1995 through 1997 and not more than $22.5 million in any succeeding three-year period).

Farm family corporations with annual gross receipts exceeding $25 million in any year after 1985 must use accrual tax accounting. Nonfamily farm corporations with 3-year average annual gross receipts exceeding $1 million in any year after 1976 must use accrual tax accounting. 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.

### Schedules L, M-1, and M-2 on Form 1120

Starting with tax year 2002, small corporations, ones with less than $250,000 in gross receipts and less than $250,000 in assets, will no longer have to complete Schedules L, M-1, and M-2 of Form 1120; Parts III and IV of Form 1120-A; or Schedules L and M-1 of Form 1120S [IRB 2002-48]. Even though the IRS does not require these records, the companies will still want to maintain records dealing with assets, liabilities, and equity, in addition to the reconciliation needed to arrive at taxable income.

## 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. A family farm partnership with 10 or fewer partners will usually be considered to meet 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.

**Limited liability companies** with more than one member 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 Schedule E). For 2002, a partner who qualifies can deduct 70% 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. Paper Form 8453-P must still be filed by the partnership.

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

Farmers and participating landowners are receiving New York State and/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 §126. They include the Wetlands Reserve Program, the NYS Agricultural Non-Point Pollution Grant Program, the NYC 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. Payments for items that can be expensed on Schedule F, including soil and water conservation expenses, may not be excluded. A portion of a payment that increases annual gross receipts from the improved property more than 10% or $2.50 times the number of effected 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 in more than 10 and less than 20 years, a declining percentage of the excluded payment is recaptured.

## Conservation Reserve Payments (CRP)

Farmers enrolled in the CRP are compensated for converting erodible cropland to less intensive use. They receive annual CRP rental payments that are ordinary income. Whether the payments are Schedule F income subject to self-employment tax or are Schedule E or Form 4835 income not subject to self- employment tax depends on the following conditions:

If the taxpayer receiving CRP payments is materially participating in a farming business that includes the enrolled land, the CRP payments are Schedule F income. The Sixth Circuit has reversed the Tax Court (Wuebker) case, which had treated the CRP payments as non–self-employment income to be reported on Schedule E.

If the taxpayer is a nonparticipating landlord and the taxpayer hires someone to manage the CRP acreage, the payments are Schedule E income.

If the taxpayer was and is a nonmaterially participating crop-share lessor, before and after entering the CRP, the payments are Form 4835 income.

## The Wetlands Reserve Program (WRP)

Farmers and other landowners may be receiving permanent or nonpermanent easement payments for enrolling land in the WRP where its use is limited to hunting, fishing, periodic grazing, haying, and managed timber production. Permanent easements may be a lump sum payment or range from 5 to 30 annual payments. Nonpermanent easement payments must be extended over 5 or more years. 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 10.** 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 1955, is $20,000. True reduces the basis to $0 and realizes a $30,000 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 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 the same as perpetual or permanent easement payments. The IRS and the Tax Court say 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 Schedule F 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 be deducted as soil and water conservation expenses or depreciated as improvements. Income and expenses associated with managing and maintaining the WRP land are reported on Schedules F or C.

# 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, net operating losses and basis in assets, which may result in tax liability for the taxpayer in future years.

## 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 (Debt Discharged after 4/9/86)

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 (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 be (a) in the business of lending money, (b) not related to the farmer, (c) did not sell the property to the farmer, and (d) did 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.

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 regardless of the amount of 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. 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 (FSA) Recapture of Previously Discharged Debt

Some farm owners were required to give the 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 debt for tax

purposes at the time of the workout, then a 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 discharged debt 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 TAX-FREE (DEFERRED) 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 the rules [Reg. §1.1031(k)-1].

## Rules and Requirements

Generally, in order to have a deferred exchange, the transaction must 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 swaps (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. 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 so 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.

## Farm Business Personal Property

"Like-kind" is interpreted to mean "like-class" for personal property. "Like-class" means that both the relinquished and replaced properties are in the same general asset class or same product class.

Most personal property used in a farm business is included in product class 3523, Farm Machinery and Equipment. 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 general asset classes. Livestock of different sexes are not property of a like-kind, but exchanges of same sex livestock have qualified as tax-free exchanges.

### Rules for Depreciation

IRS Announcement 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 should be followed.

**Example 11.** Under rules *prior* to Notice 2000-4

- Farmer Pat paid $100,000 for a combine in 1996.
- Pat depreciated it as 7-year property using MACRS 150% declining balance.
- In 1999 Pat traded the combine and $40,000 cash for a tractor.
- Calculation of the basis in the new tractor is as shown in Table 17.

**Table 17. Calculation of Basis**

| | | |
|---|---|---|
| Beginning combine basis | | $100,000 |
| 1996 depreciation | $100,000 x 10.71% | –10,710 |
| 1997 depreciation | $100,000 x 19.13% | –19,130 |
| 1998 depreciation | $100,000 x 15.03% | –15,030 |
| 1999 depreciation | $100,000 x 12.25% x 1/2 | –6,125 |
| Ending basis | | 49,005 |
| Boot cash for the tractor | | 40,000 |
| Basis in new tractor | | $89,005 |

- Calculation of Pat's total 1999 depreciation on these two assets is as shown in Table 18.

**Table 18. Calculation of Depreciation**

| | | |
|---|---|---|
| Combine from above | | $ 6,125 |
| Tractor | $89,005 x 10.71% | 9,532 |
| | | $15,657 |

**Example 12.** 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 combine in 1999.

- Pat depreciated it as 7-year property using MACRS 150% declining balance.
- In 2002 Pat traded the combine and $40,000 cash for a tractor.
- Calculation of the total 2002 depreciation on these two assets is as follows.

| | | |
|---|---|---|
| 2002 (fourth-year depreciation) on combine that was sold and has left the farm: | | |
| Combine sold (left the farm) | $100,000 x 12.25% | $12,250 |
| 2002 (first-year depreciation) on tractor that is on the farm: | | |
| Tractor on farm | $40,000 x 10.71% | 4,284 |
| Total depreciation | | $16,534 |

The result is a first-year greater depreciation for Pat than under pre-2000 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 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, 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's software can not handle this, this year Pat may have to go back to the paper and pencil method until his software gets updated.

## Other Deferred-Exchange Rules and Requirements

**IRS Form 8824** is used as a supporting statement for like-kind exchanges reported on other forms, including Form 4797 (Sale of Business Property) and Schedule D (Capital Gains and Losses). A separate Form 8824 should be attached to Form 1040 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.

# DEPRECIATION AND COST RECOVERY

The Job Creation and Worker Assistance Act of 2002 made substantial changes to this area by allowing taxpayers to claim a 30% Special Depreciation Allowance (SDA) on qualifying property placed in service under a binding contract after September 10, 2001 (even though enacted March 9, 2002). Other than this 30% SDA (discussed below) and Announcement 2000-4, regarding like-kind exchanges (see 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 years following. This reference is for practitioners and taxpayers who want to apply depreciation rules to maximize after-tax income. 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*

## Depreciable Assets

A taxpayer is allowed cost recovery or depreciation on purchased machinery, equipment, buildings, and on purchased livestock acquired for dairy, breeding, draft, and sporting purposes unless reporting on the accrual basis and such livestock are included in inventories. 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 now has two opportunities to recover the lost depreciation: It may be recovered by filing an amended return or by following a procedure for automatic change to a permissible accounting method for depreciable property (Rev. Proc. 97-37). A correction procedure is also available to taxpayers whose depreciation or amortization deduction claimed is more than the allowable amount (Rev. Proc. 97-27). Form 3115, Application for Change in Accounting Method, must be filed with the IRS by the end of the tax year and a copy attached to the taxpayer's return for the tax year that the correction in depreciation is made. A fee is required when too much depreciation has been claimed. Procedures 99-27 and 98-60 carry detailed, line-by-line instructions on how to complete Form 3115.

Expensing the purchase of "small assets" is not an option according to the Tax Court (T.C. Memo 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.

**Practitioner Note.** Do not rely on unused I.R.C. §179 deduction to bail you out upon audit, because this election to expense is only allowed on a timely filed tax return.

### MACRS Classes

The MACRS class life depends on the asset depreciation range (ADR) midpoint life of the property, as shown in Table 19.

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 below. See also Table 20.

**Table 19. 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. 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 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 or work horses (12 years old or less)

#### 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.

**Table 20. ACRS, MACRS, and MACRS Alternative Depreciation System (ADS) Recovery Periods for Common Farm Assets**

| | Recovery Period (Years) | | |
|---|---|---|---|
| **Asset** | **ACRS** | **MACRS** | **ADS** |
| Airplane | | 5 | 6 |
| Auto (farm share) | | 5 | 5 |
| Calculators, copiers, and typewriters | | 5 | 6 |
| Cattle (dairy or breeding) | | 5 | 7 |
| Citrus groves | 5 | 15 | 20 |
| Communication equipment | | 7 | 10 |
| Computer and peripheral equipment | | 5 | 5 |
| Cotton ginning assets | | 7 | 12 |
| 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(1) | 15 |
| Helicopter (agricultural use) | 5 | 5 | 6 |
| Hogs (breeding) | 3 | 3 | 3 |
| Horses (nonrace, less 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(2) | 20 |
| Paved lots | 5 | 15 | 20 |
| Property with no class life | 5 | 7 | 12 |
| Rental property (nonresidential real estate) | 19 | 39(3) | 40 |
| Rental property (residential) | 19 | 27.5 | 40 |
| Research property | 5 | 5 | 12 |
| Sheep (breeding) | 3 | 5 | 5 |
| Silos | 5 | 7 | 12 |
| Single purpose livestock structure (housing, feeding, storage, and milking facilities) | 5 | 10** | 15 |
| Single purpose horticultural structure | 5 | 10** | 15 |
| Solar property | 5 | 5 | 12 |
| Storage (apple, onion, potato) | 5 | 20 | 25 |

| | | | |
|---|---|---|---|
| Tile (drainage) | 5 | 15 | 2( |
| 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 the 13,000 lbs) | 3 | 5 | 5 |
| Vineyard | 5 | 10[(2)] | 2( |
| Water well | 5 | 15 | 2( |
| Wind energy property | 5 | 5 | 12 |

[(1)]If placed in service before 1989, recovery period is 7 years.
[(2)]If placed in service before 1989, recovery period is 15 years.
[(3)]If placed in service before May 13, 1993, recovery period is 31.5 years.
[(4)]No class life specified; therefore, 12-year life assigned.

## Cost Recovery Methods and Options

Accelerated cost recovery methods for MACRS property are shown in Table 21. Depreciation on farm property placed in service after 1988 is limited to 150% declining balance (DB) rather than the 200% available for nonfarm property. 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 alternative minimum tax purposes are discussed in this section under Additional Depreciation Rules 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 straight line.

**Table 21. 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 with crossover to SL |
| 15- and 20-year | 150% DB with crossover to SL |
| 27.5- and 39(31.5)-year | Straight line *only* |

[1]See exception for orchards and vineyards above.

The MACRS law does not provide for standard percentage recovery figures for each year. However, the IRS and several of the tax services have made tables available, such as Table 22.

**Table 22. 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.)

| | 3-Year Class | | 5-Year Class | | 7-Year Class | | 10-Year Class | | 15-Yr. Class | 20-Yr. Class |
|---|---|---|---|---|---|---|---|---|---|---|
| Recovery Year | 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 |
| 12–14 | | | | | 5.90[2] | 4.46 |
| 16 | | | | | 2.95 | 4.46 |
| 17–20 | | | | | | 4.46 |
| 21 | | | | | | 2.24 |

[1]Rounded to two decimals, see Pub. 946 for more precise 20-yr. class rates.
[2]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. A half-year of recovery may be taken in the year of disposal. 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.

**Example 13.** V. Sharp placed $106,000 worth of 7-year MACRS property in service. He could expense $24,000 and claim $8,782 of depreciation ($106,000 – 24,000 = $82,000 × .1071 = $8,782) under the half-year convention. If $56,000 of Sharp's property was placed in service in the last quarter and the $24,000 I.R.C. §179 election is applied to this $56,000, $32,000 is left to be used in the 40% test. Thus, $32,000 ÷ ($106,000 – 24,000) = .39, which is less than 40%, so Sharp avoids the mid-quarter rules. However, if his depreciable items had totaled $100,500, and $56,000 was placed in service in the last quarter, he would be caught by the 40% rule, even if he applied the $24,000 I.R.C. §179 to the items placed in service in the last quarter. That is, $32,000 ÷ ($100,500 – 24,000) = .42, 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 Alternative Depreciation

The MACRS alternative depreciation system (ADS) is required for some property and is an option for the rest. It is a straight-line 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.

## Election to Expense Depreciable Property

The I.R.C. §179 expense deduction continues at $24,000 for property placed in service in 2002. The deduction was $20,000 for 2000, and it increases to $25,000 in 2003. The expense deduction is phased out dollar for dollar for any taxpayer that places over $200,000 of property in service in any year, with complete phaseout at $224,000. Eligible property is defined as I.R.C. §1245 property to which I.R.C. §168 (accelerated cost recovery) applies. 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 $24,000 limit applies to the partnership and also 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 $24,000 may be expensed because of the $24,000 limitation. Any allocations in excess of $24,000 are lost forever, which is a different result from the limitation discussed below. The same concept applies to 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 $24,000 in 2002.

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 Schedules C or F 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 are also included.

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 post-1986 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 Schedule F.

Every business owner who has purchased MACRS property should consider the I.R.C. §179 expense deduction because only New York investment tax credit will be lost when it is used. It 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."

## 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 2002. 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 2000 (7-year property), 150% DB for 7 years for equipment purchased in 2001, and could now select SL 7-year recovery for all machinery purchased in 2002.

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, straight line over 7 years on 7-year property, and straight line over 15 years on most 10-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" (6000 lbs or less) placed in service in 2002 remains at $3,060 for the first year (but see section below if SDA is claimed), $4,900 for the second year, $2,950 for the third year, and $1,775 for each succeeding year. If the business use percentage is less than 100%, these limits are reduced accordingly. Cellular telephones acquired after 1989 are listed property. Computers are listed property unless they are used only for business.

## 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 purposed due to prior year ruled discussed below.) 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 using Table 23.

**Table 23. 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 | SL, ADS life |
| ADS | 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 that allowed under MACRS ADS straight-line depreciation.

## Special Depreciation Allowance (30% Additional First-Year Depreciation)

As a result of the Job Creation and Worker Assistance Act of 2002 there is 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 Special Depreciation Allowance, or SDA. This 30% depreciation is in addition to the I.R.C. §179 direct expense deduction of $24,000. Of course, these deduction possibilities do not increase the total amount of depreciation to be claimed over the life of the asset but they do speed up the deduction into the year of acquisition (essentially accelerating deductions from future years).

### Qualified Property

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

- Only the cash paid to boot (not any trade-in value) is eligible for this 30% SDA calculation.
- The asset was acquired and placed in service after September 10, 2001 (and before September 11, 2004), and there was no written binding contract for acquisition of the asset in effect before September 11, 2001. The property must be placed in service prior to January 1, 2005.

- The asset has a depreciable life of 20 years or less. This means that fixtures, vehicles, machinery and equipment are all eligible, as well as farm buildings and barns. However, commercial buildings and residential rental property do not qualify. Property that is water utility property [as defined in I.R.C. §168(e)(5)], computer software other than computer software covered by I.R.C. §197, or qualified leasehold improvement property also qualifies.
- The original use of the asset must commence with the taxpayer after September 10, 2001 (i.e., the asset must be new rather than used). See additional detail below under "What Constitutes New?"
- The property must be used over 50% for the business (especially a consideration for vehicles, snowmobiles, ATVs, etc.).

### 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., he does the reconditioning) those capital improvement expenditures are eligible for SDA.

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 SDA is mandatory on eligible purchases. If not claimed, basis will still be reduced under the "allowed or allowable rules."

The taxpayer is allowed to "elect out" of the use of SDA on qualifying purchases. However, this election is made on a class by class basis. As with other elections, the election out of SDA may be made on an amended return filed within 6 months of the original due date of the return (see exception for 2001 under "Possible Amended Return Needed" below). After 6 months of the original due date of the return, a taxpayer can revoke an election out of the 30% additional first-year depreciation only with the prior written consent of the Commissioner.

### Impact of Use of ADS Depreciation

If the taxpayer a fruit grower or vineyardist who is required to use ADS depreciation because they have elected out of UCR (discussed below), they are ineligible for this extra 30% depreciation. However, if the taxpayer simply elects to use ADS to stretch the useful life (rather than being required to do so), he or she could still claim SDA on otherwise qualifying property. In addition, there are certain nonfarm situations where the use of ADS is required and in these situations SDA is not available.

### Luxury Car Limits Modified

To accommodate SDA on eligible lightweight vehicles, the amount of first-year depreciation allowed on *new* light-weight trucks and passenger vehicles was increased from $3,060 to $7,660 (you must pro-rate for business use percentage). However, this increased limit is only available if SDA is used. If the taxpayer elects out of SDA for this class of property, or the vehicle is used, the previous limit of $3,060 still applies. In either event, the depreciation limitation is reduced by multiplying it by the vehicles business use percentage.

### Interaction with I.R.C. §179

The SDA is in addition to the I.R.C. §179 deduction on qualifying property. I.R.C. §179 is deducted first and then the remaining basis is eligible for SDA, as shown in the table below.

Sam purchased a new tractor for $85,000 on December 15, 2001, and wishes to maximize depreciation deductions. The calculations are shown in Tables 24 and 25.

### Alternative Minimum Tax

The SDA is 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 SDA.

**Table 24. MACRS Depreciation**

| | |
|---|---|
| Original cost | $85,000 |
| Less: I.R.C. §179 | 24,000 |
| Balance | $61,000 |
| | × 30% |
| SDA | $18,300 |
| Balance for MACRS ($85,000 – $24,000 – $18,300) | $42,700 |
| 7-year MACRS factor | × 10.71% |
| MACRS depreciation | $4,573 |

**Table 25. Total Depreciation for 2001**

| | |
|---|---|
| I.R.C. §179 | $24,000 |
| SDA | 18,300 |
| MACRS | 4,573 |
| Total depreciation | $46,873 |

### Possible Amended Return Needed Because of Purchases after 9/10/01

Because the SDA provision is retroactive, it may be necessary to amend 2001 tax returns to claim the SDA. However, the IRS has ruled that it is not necessary to amend in order to elect out of SDA for any tax return filed before June 30, 2002. On these returns, the failure to claim SDA will be deemed a valid election out unless the 2001 return is amended to claim the SDA by the due date (excluding extensions) of the tax return for the next succeeding tax year. At the top of the amended return the taxpayer must include the statement "Filed Pursuant to Rev. Proc. 2002-33."

Furthermore, there is a special provision that allows the 2001 SDA to simply be claimed on the 2002 tax return as a change in accounting method (filing Form 3115). The rule for use of Form 3115 that had previously required reductions in taxable income in excess of $25,000 to be spread over 4 years has been eliminated (Rev. Proc. 2002-19). Therefore, any amount of 2001 SDA may just be deducted in total on the 2002 tax return. Form 3115 filed under this revenue procedure should have the statement: "Automatic Change Filed Under Rev. Proc. 2002-33" legibly printed or typed on the appropriate line. File Form 3115, Application for Change in Accounting Method, with the return for the year following the year the property was placed in service. The original Form 3115 must accompany the tax return. The taxpayer must also file a signed copy of Form 3115 with the IRS National Office.

## 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.

When assets are sold, gain to the extent of all prior depreciation on all I.R.C. §1245; 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 straight-line 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 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 straight-line 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 ITC on any amount expensed under I.R.C. §179 should be considered.

Using straight line 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 straight line is treated as ordinary income at the time such I.R.C. §1250 property is sold. However, the tax savings will be realized 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 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 Schedule F. However, partnerships and S corporations will transfer the §179 expense election to Schedule K, rather than combining it with other items on Form 4562. Furthermore, §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 Schedule SE if the partner meets the test for the §179 deduction to be taken (i.e. business income limitation and overall $24,000 limit).

## Uniform Capitalization Rules for Fruit Growers and Nurserymen

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 U.S., 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. Nurserymen could use the farm-price method to establish their preproductive costs of growing trees, vines, and ornamentals. Capitalization requires the recovery of orchards, vineyard, and ornamental tree preproductive period expenses over 10 years, straight line.

If growers elect not to capitalize, they must use ADS to recover the costs of trees and vines (20-year straight line) and all other depreciable assets placed in service. Only the preproductive period growing costs may be expensed. As discussed above, this required use of ADS also prevents the taxpayer from claiming the 30% SDA.

### 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. A complete depreciation and cost recovery record is needed to supplement Form 4562. 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 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 following page). Form 3800 is used to claim the credit for the current year, to apply carryforward from prior years, and 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 [I.R.C. § 46(e)(i)]. 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 investment tax credit (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 [I.R.C. §45(a)(1)] 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 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 is used for computing ITC; Form 4255 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 only qualify 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.

### Reforestation

Qualified reforestation expenses consist of up to $10,000 ($5,000 if married filing separately) of the direct expenses of planting or replanting a forest or woodlot held for timber or wood production. Direct expenses include site preparation, seedlings, labor, and depreciation of equipment used. These are the same expenses that qualify for amortization. Deductible operating costs, all costs reimbursed through government cost-sharing programs, and all costs associated with planting Christmas trees are excluded. The basis of any depreciable reforestation expense must be reduced by 50% of ITC claimed.

### Energy

Business energy investment credit is equal to 10% of the basis of qualified solar and geothermal energy equipment placed in service during the tax year. Active solar devices for either space heating or water heating would qualify under the solar category if put to original use by the taxpayer. The basis of any qualifying equipment must be reduced by 50% of ITC claimed.

## Other General Business Credits (GBCs)

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

The 2001 Act provides after December 31, 2001, 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. The facility to be qualified 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 is reduced by the credit claimed.

### Pension Plan Credit for Startup Costs for Small Businesses

Starting in 2002, the 2001 Act offers a nonrefundable income tax credit for 50% of the first $1,000 in administrative and retirement education costs for any small business that sets up a new qualified defined-benefit or defined-contribution plan. Eligible plans would also include a §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 now applies to qualifying individuals who start to work no later than December 31, 2003) is available to employers on first-year employee wages paid. 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 eight targeted groups, including qualified SSI recipients, recipients of aid to families with dependent children (IV-A recipients), certain food stamp recipients, high-risk youth living in empowerment zones, economically disadvantaged ex-felons, and certain disabled workers and veterans. Qualification rules were modified for IV-A recipients and veterans.

### Welfare-to-Work Credit

The Welfare-to-Work Credit is available to employers on qualified wages paid to long-term family assistance recipients who start to work no later than December 31, 2003 (extended). 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 wage 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 under a IV-A program. Employers cannot get work opportunity credit and welfare-to-work credit on the same employee.

### Credit for Increased Research Expenditures

The credit for increased research expenditures (formerly the Research and Development Credit) has a 5-year extension to June 30, 2004, and amounts to 20% of qualified research expenditures.

### Disabled Access Credit

The disabled access credit may be claimed 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 general business credits include those for new markets tax, low-income housing, alcohol fuels, enhanced oil recovery, renewable electricity production, empowerment zones, Indian employment, and employer FICA tax on tips.

# A REVIEW OF FARM BUSINESS PROPERTY SALES

Because farm taxpayers are affected by preferential capital gain 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 amongst gains from sales of property used in the farm business that are eligible for capital gain treatment, gains subject to recapture of depreciation, and Schedule F 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 must be used to report gains and losses on sales of farm business property. Schedule D 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 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 discussion below 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 Sec. 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 unrecaptured net §1231 losses for the 5 most recent prior years. A taxpayer that claimed a net §1231 loss on the 1998, 1999, 2000, or 2001 return and has a net §1231 gain for 2002 must recapture the losses on the 2002 return (if they have not already been used against §1231 gains in earlier years). Losses are to be recaptured in the order in which they occurred. Any current year §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 gains 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 §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 straight-line depreciation was used, the gain to the extent of depreciation claimed after 1969 that exceeds what would have been allowed under straight-line depreciation is recaptured as ordinary income. No recapture takes place when only straight-line depreciation has been used. A taxpayer may shift such real property to straight-line depreciation without special consent. In addition, gain to the extent of SL depreciation on §1250 assets sold after May 6, 1997, is called unrecaptured §1250 gain and is taxed at a maximum rate of 25%.

General-purpose farm buildings (including 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 straight line 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 straight line on ACRS 15-, 18-, and 19-year property.

**Example 15.** A general-purpose farm building was purchased in 2000 for $20,000. Regular MACRS was used until the building was sold for $23,000 in 2002. Accumulated depreciation totaled $2,861. Total gain was therefore $5,861, as shown in Table 26. SL depreciation would have been $2,000, so 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 (10% or 20%).

**Table 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** | |
| Straight-line 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 |

### 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: sixth year after acquisition of the land, 80%; seventh year, 60%; eighth year, 40%; and ninth year, 20%. Table 27 gives an illustration.

**Table 27**

| | |
|---|---|
| Farmland acquired April 1, 1996, cost | $100,000 |
| Soil and water expenses deducted on 1997 tax return | 8,000 |
| Land was sold May 15, 2002, for | 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 six years, so the gain is divided; $8,000 × .80 = $6,400 is ordinary gain and $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 Schedule D by Farmers

All sales of farm business properties are reported on Form 4797 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 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.

If the I.R.C §1231 gains and losses reported on Form 4797 result in a *net gain*, net §1231 losses reported in the prior 5 years must be recaptured as ordinary income by transferring §1231 gain equal to the nonrecaptured losses to Part II. Any remaining gain is transferred to Schedule D and combined with capital gain or loss, if any, from disposition of capital assets. If the §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.

## 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. 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 Schedule F. Receipts from the sale of "bob" veal calves, feeder livestock, slaughter livestock, and dairy heifers *raised for sale* are entered on Schedule F, line 4. Sales of livestock purchased for resale are entered on line 1 of 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 if sales are reported on 4797 or 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:

*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 and these holding periods were not changed by recent Acts. Emus and ostriches are currently excluded from the IRS definition of §1231.

*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. Because Part III is for recapture, purchased §1231 livestock that produce a gain when sold are be entered in Part III where they are taxed as I.R.C. §1245 property. Sales of raised §1231 livestock that are held for dairy, breeding, sport, or draft purposes are entered in Part I. All purchased §1231 livestock (held the required holding period) that result in a *loss*when sold is 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 4797. 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 Table 28.

**Table 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 over 1 year or less | 4797, Part II |

## Gifts and Below-Market Sales

If a taxpayer sells an asset at below-market value, they in essence have a sale and a gift. A taxpayer should always determine fair market value and file the appropriate sale 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 2002 threshold of $11,000 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 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.

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 less mortgage assumed by buyer, plus any mortgage assumed in excess of adjusted tax basis). Form 6252 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 Publication 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 and capitalized expenditures also are 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 son, Hank, for $180,000. The cows are valued at $80,000, the machinery 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 on 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/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.

In no instance will the resale rule 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 (see section on Alternative Minimum Tax). Manufacturers of tangible personal property are not able to use the installment method to report income from sales to their dealers in tax years beginning after August 5, 1998.

## General Rules Still in Effect

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 even though an individual partner may have a loss and recognize it in the year of sale.

The capital gains rules in effect when an installment payment is received and reported determines how the income is treated. However, a change or increase in the capital gain holding-period requirement during an installment sale would not move a long-term gain to a short-term gain.

**A 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 fair market value of property received instead of cash. The "basis" of the contract is the same as the remaining basis of the underlying property.

**A 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 fair market value and the "basis" of the obligation if the parties are unrelated [I.R.C. §§453B(f)(1) and 453B(a)(2)].

**Grain and other farm inventory property,** including livestock held for sale, may be included in a cash basis taxpayer's installment sale and it no longer requires an AMT adjustment in the year of sale.

## 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 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 Table 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:

All sales and exchanges in which the seller financing does not exceed $4,217,500 (in 2002, indexed thereafter) must have an interest rate of the lesser of 100% of the AFR or 9% (compounded semiannually).

All sale-leaseback transactions are subject to rates equal to 110% of AFR.

The sale or exchange of the first $500,000 of land between related persons, (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.

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.

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.

The AFR can be the current month's rate or the lower of the 2 preceding months' rates.

**Table 29. Recent Applicable Federal Rates (AFR)**

| Term | Compounding Period | Sept. 2002 | Oct. 2002 | Nov. 2002 [1] |
|---|---|---|---|---|
| Short-term (<3 yrs) | Annual | 2.13% | 2.03% | |
| | Monthly | 2.11% | 2.01% | |
| Mid-term (3–9 yrs) | Annual | 3.75% | 3.46% | |
| | Monthly | 3.69% | 3.41% | |
| Long-term (>9 yrs) | Annual | 5.23% | 4.90% | |
| | Monthly | 5.11% | 4.79% | |

Source: http://www.irs.ustreas.gov/prod/ind_info/index.html
[1] Not available at press time.

# 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 Schedule F. If the landowner does not meet any one of the material participation tests (*Farmers Tax Guide*, Pub. 225), then they can report their share of the crop on Form 4835 rather than as cash rent on Schedule E 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 Schedule E and not included in net earnings from self-employment. Crop and livestock share rents are reported on Form 4835 and flow through to Schedule E. However, there are two exceptions (the second of which is very important to farm operators):

Rentals received in the course of the trade or business of a *real estate dealer* are included in net earnings from self-employment.

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.

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.

Income and expenses from the rental of personal property (not leased with real estate) is reported on Schedule C or C-EZ. Net profit from 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 opinion 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 above, which could cause the rental income to be subject of 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:

Make sure there is a formal written and signed rental agreement and a FMV rental rate for buildings separate from farm land, with at least annual payments.

Deduct the taxes, interest, and insurance on the rented property on the owner's Schedule E.

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.

The farm operator must file Form 1099 for all rent payments made in excess of $600.

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 would not only cause additional SE tax to be paid but could also affect eligibility for social security benefits of those landowners collecting benefits prior to age 65.

The farm operator's spouse cannot avoid material participation for purposes of the passive activity rules. The participation by a spouse (operator) is treated as participation by the taxpayer. Consequently, any income derived from the property in which he or she materially participates is not treated as passive activity income.

## Valid Tax Lease or Conditional Sales Contract

To determine if 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. Generally, an agreement will be a conditional sales contract rather than a lease for tax purposes if any of the following are true:

The agreement applies part of each payment toward an equity interest.

The lessee gets title to the property upon payment of a stated amount under the contract.

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.

The lessee pays much more than the current fair rental value of the property.

The lessee can purchase the property at a nominal price compared to the value of the property at the time of purchase.

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.

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 leverage lease of newly purchased equipment, where 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:

When the lessee places the property in use, the investment of the lessor must be at least 20% of the cost of the property.

The lease term includes all renewal or extension periods at fair rental value at the time of the renewal or extension.

No lessee may purchase the property at a price less than its FMV when exercised.

Lessee may furnish none of the cost of the property.

The lessee may not lend to the lessor any of the money or guarantee indebtedness to acquire the property.

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 "one-year rule" which treats an expenditure as a capital expenditure (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.

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, may be computed using MACRS class lives and the SL method (for regular tax purposes these facilities qualify for 5-year amortization). Prior to TRA 97, longer ADS lives were required.

## 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. Effective for tax years ending after May 6, 1997, 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, 2001 tax legislation increased the exemption amount by $4,000 for married taxpayers filing jointly and surviving spouses, and increased it by $2,000 for other individuals (but not trusts). The exemption is phased out at a rate of 25% of AMTI exceeding specific levels, as shown in Table 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.

**Table 30. AMT Exemption and Phaseout**

| Filing Status | Maximum Exemption | AMTI Exemption Phaseout Threshold |
|---|---|---|
| Joint & qualifying widow(er) | $49,000 | $150,000 |
| Single & heads of household | 35,750 | 112,500 |
| Married filing separately | 24,500 | 75,000 |

The AMT exemption for children under age 14 has been increased to the child's earned income plus $5,500 for 2002. This amount is indexed for inflation. The annual exemption cannot exceed $35,750.

## Alternative Minimum Taxable Income (AMTI)

AMTI is calculated on Form 6251 by starting with Form 1040 taxable income before subtracting personal exemptions. Any NOL carryforward used in calculating the regular tax is added, and itemized deductions disallowed on Schedule A for higher-income taxpayers are now allowed.

### Adjustments and Preferences

The first category below 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.

Exclusion items are standard deductions or certain itemized deductions from Schedule A, including most medical deductions, 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.

The depreciation adjustment is the net difference between accelerated MACRS depreciation and that allowed for AMT. This continues to be a major adjustment item on farm tax returns. However, both the I.R.C. §179 deduction and the 30% SDA are allowed in calculating AMTI. (See a discussion of this topic in the Depreciation and Cost Recovery Section.)

Adjusted gain or loss from dispositions reported in Forms 4797 or Schedule D and Form 4684 that have a different basis for AMT than for regular tax (because of the accumulated depreciation adjustment).

Incentive stock option adjustments, passive activity adjustments, AMTI from estates and trusts, tax-exempt interest from private activity bonds.

Accelerated depreciation on real and leased property and amortization of certified pollution control facilities placed in service before 1987.

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, modified AGI or taxable income from a business) must be recalculated based on alternative tax AGI.

## Alternative Tax Net Operating Loss Deduction (ATNOLD)

The deduction of alternative tax net operating loss (ATNOLD) is the last step in calculating AMTI. The alternate 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 carryforwards 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:

The regular tax NOL is adjusted to reflect the adjustments required by the AMT rules.

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 above adjustments 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 Schedule D apply the appropriate capital gains rates by completing Part IV of Form 6251. Then, the AMT foreign tax credit is 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).

## 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. The general business credit limitation is calculated on Form 3800, not on Form 6251.

Foreign tax credit is allowed in the calculation of AMT. The Job Creation and Worker Assistance Act of 2002 extends the relief provisions of the 1999 Act to taxpayers for tax years through 2003 by permitting the personal nonrefundable credits (such as the education credits) to offset both the regular tax and the minimum tax. The 2001 Tax Relief Act made permanent the ability to offset AMT by both the Child Tax Credit and the Earned Income Credit.

The other credits, including investment credit, can be carried forward to the extent 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 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 preference 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.

## The 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 tax 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, the orphan drug credit, and the electric vehicle credit.

# INFORMATIONAL RETURNS

## Informational Forms (Often Issued or Received by Farmers)

### Form 1099-MISC

Form 1099-MISC must be filed by any person engaged in a trade or business, on each non-employee 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 at $10 or more. Payments made for nonbusiness services and to corporations are excluded. When payments of $600 or more are made to the same individual for independent 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, and by any taxpayer if in the course of a trade or business $600 or more of interest is paid to a non-corporate recipient.

### Form 8300

The recipient of Form 8300 reports cash transactions of over $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, in a single or related transaction. Cash includes all currency and specific monetary instruments with a value of less than $10,000 (cashier's checks, bank drafts, traveler's checks, and money orders). The report must be filed within 15 days after receiving $10,000.

## Filing Dates and Penalties

The 1099's 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, 45 days in advance of the due date of the return.

# 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 $84,900 for 2002. There is no cap on the amount of earnings subject to Medicare tax. FICA and SE-tax percentage rates remain the same as in 2001. The total rate is divided into two components representing the social security and Medicare tax. The maximum 2002 social security tax is $5,263.80 (employer's share), up $279.00 from 2001. See Table 31 for the 2002 through 2003 social security and Medicare tax rates.

**Table 31. Social Security Tax Table**

| Year | Soc. Sec. | Medicare | Soc. Sec. | Medicare | Soc. Sec. | Medicare |
|---|---|---|---|---|---|---|
| 2001 | $80,400 | Unlimited | 6.20 | 1.45 | 12.40 | 2.90 |
| 2002 | 84,900 | Unlimited | 6.20 | 1.45 | 12.40 | 2.90 |
| 2003 | 87,300[2] | Unlimited | 6.20 | 1.45 | 12.40 | 2.90 |

[1]Paid by both employer and employee.
[2]Projected.

Employers use separate social security and Medicare tax withholding tables. Forms 941 and 943 require social security and Medicare taxes to be reported separately. The SE tax on long Schedule SE is also computed separately.

## Two Deductions for Self-Employed

Self-employed taxpayers deduct from taxable income, on line 29 Form 1040, one-half of SE taxes that can be attributed to a trade or business. 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.

Self-employed taxpayers deduct 7.65% from SE income when computing net earnings from self-employment. This is achieved by multiplying total profit from Schedules C and/or F by 0.9235 on Schedule SE. This adjustment is made before applying the social security and Medicare tax earnings base. Taxpayers reporting less than $84,900 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 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 nonfarmers 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 $870 in 2002 . 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 $3,480 any time during 2002 will provide four quarters of coverage.

**Example 17.** Ima Cow has $2,800 of 2002 gross farm income netting only $1,300 of net farm income. He would pay SE tax of $1,300 × .9235 × .153 = $184.00. The optional method would result in $1,600 × .153 = $245 of self-employment and still earning only one quarter of coverage. Ima may have an additional benefit using this method and paying the SE tax that being to increase income for earned income credit.

## 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 piece work 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 by 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 working 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 also are covered by social security. Sole proprietors and husband-wife partnerships that hire their children less than 18 years old need not pay social security tax on them nor FUTA if 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. Under an agreement between the United States and Canada, signed in 1997 and retroactive to January 1, 1996, the United States or Canadian social security benefits are taxed exclusively in the country

where the recipient resides. This will result in a higher tax for some recipients and refunds for others.

**The 85% rules** apply to single taxpayers, heads of household, married 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.

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

Eighty-five percent of the taxpayer's social security benefit

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. Four thousand five hundred dollars ($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 lessor 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 payments are excluded from gross income.

## Reduction of Benefits

When a person's wage and self-employment earnings exceed the earnings limit, social security benefits of the working beneficiary and dependents are reduced by a percentage of the excess earnings. In 2002 the annual earnings limit for those less than age 65 is $11,280, and for those age 65 to 70 earnings are now unlimited because of the 2000 legislation. For those aged 70 and older there are also no reductions. The reduction of benefits is one-half of excess earnings when less than age 65. The 2002 cost of living increase in benefits was 2.6% (2003 estimate 1.4%).

## Retirement Planning Considerations

Although the earnings cap for those workers over 65 who are getting social security benefits was eliminated as of January 2000, those under 65 still have to stay under $11,280 in earnings in 2002 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 in to the category not to be counted in earned income for social security, but 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 and Schedule SE.

## "Nanny Tax" Social Security Domestic Employment Act

This act allows the payment of employment taxes for domestic workers (baby-sitters, yard workers, house cleaners) to be reported on the employer's income tax return. The wage threshold for reporting and paying social security taxes was raised to $1,300 annually. During 2002, you can give your employee as much as $100 a month for expenses to commute to your home by public transportation or $185 a month qualified parking expense allocation without the repayment counting as cash wages.

Household employers use Schedule H (Form 1040) to report and pay social security, Medicare, FUTA (threshold still $1,000), and withheld income taxes. The quarterly return Form 942 is no

longer used. Farmers may treat wages paid to domestic workers under the new $1,300 annually threshold rules rather than the $150 and $2,500 agricultural wage thresholds, by filing Schedule H.

Household employers must include an employer identification number (EIN) on forms they file for their employees, like Forms W-2 and 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 www.irs.gov.

The 1995 law exempted household workers under the age of 18 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. The number, when issued, will begin with a "P" followed by 8 digits with no dashes. New York State also allows use of the PTIN.

## Rules for Farm Labor Regulations

Dale Arrison Grossman and Jason D. Minard have updated the rules for agricultural employers. 2002. This is reported in Farm Employment Issues for Tax Professionals (E.B.2002-20, Department of Agricultural, Resource, and Managerial Economics, Cornell University, Ithaca, New York). A copy of this publication was provided to registered students in the Cornell 2002 Income Tax Schools. Others may order it from the authors previously mentioned. The Farm Employment publication contains the materials covered in previous editions of this Income Tax Reference Manual, including withholding taxes, FICA, collection of wages, federal unemployment tax (FUTA), workers compensation, new hire reporting, and many other federal and New York State labor regulations for Farms and Small Businesses.

# NEW YORK STATE INCOME TAX

The New York State 2002 to 2003 Budget Bill was passed in May 2002. The bill included some new tax cuts for individuals and businesses:

- Effective for the tax year 2002, a new long-term care insurance credit is available for 10% of the premium cost of long-term care. The prior subtraction modification will no longer be available.
- Effective after March 31, 2002, a taxpayer will be allowed a credit for the removal, permanent closure, and installation of a new below-ground or above-ground residential fuel oil tank. The credit cannot exceed $500 on oil tanks used to provide heating fuel for single to four-family residences in New York State.

## Tax Amnesty

Taxpayers with outstanding liabilities will be given a limited opportunity to settle those liabilities without penalties and with a reduction in the appropriate rate of interest. The tax amnesty will apply to the personal income tax, sales and compensating use tax, corporate franchise taxes other than the bank and insurance taxes, and various excise taxes. The amnesty will apply to taxable periods prior to December 31, 2000, or, in the case of the sales tax or excise taxes with quarterly returns, periods prior to February 28, 2001. Under the estate tax, amnesty applies for liabilities prior to February 1, 2000. Amnesty participants can receive a waiver of certain penalties and a 2% reduction in the applicable interest rate relating to unpaid liabilities. Beginning April 1, 2003, the interest rate applicable to all liabilities will increase by 2% for all taxpayers. Amnesty will not be granted to taxpayers under criminal investigation, taxpayers who have been convicted of a tax-related crime, taxpayers who are parties to administrative proceedings with the Tax Department, or taxpayers with more than 500 employees. A taxpayer who was granted amnesty under either the 1994 or 1996 to 1997 programs are not eligible for those taxes for which amnesty was previously given. The amnesty period will begin sometime this state fiscal year (April 1, 2002, through March 31, 2003). The Tax Department Web site will provide information on relevant dates, forms, and procedures.

## Farm Property School Tax Credit

This credit has been extensively taught and included in this manual for the last 5 years and is omitted this year because there were no changes. Refer to previous manuals, and for more information on the Farm Property School Tax Credit, see New York State Publications 51 and 51.1 for questions and answers.

## New York State School Tax Relief (STAR)

The New York State school tax relief (STAR) program provides a partial exemption from school property taxes for owner-occupied primary residences. Senior citizen property owners must be 65 years of age or older, as of December 31, 2002 (advancing 1 year annually), and must provide their latest available federal or state income tax return, not to exceed $60,000 AGI, reduced by any distributions from an IRA or individual retirement annuity.

A separate budget bill, 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. The current maximum income of $60,000 will be indexed annually based on the rate of inflation used to index social security benefits. Individuals will be allowed to authorize their assessors to have the Tax Department verify their incomes for purposes of qualifying for enhanced STAR. The Department will be required to prepare a report for the Office of Real Property Services that determines eligibility for enhanced STAR based on income tax return information. These changes are effective for school years and assessment periods beginning in 2003 and thereafter. The March 1, 2003, income limit for “enhanced” STAR seniors will be $62,100.

The "enhanced" STAR senior citizen exemption is a $50,000 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, 2003, in most towns. This is the "taxable status date," but deadlines vary so most taxpayers should apply earlier.

The "basic" STAR program is available to all primary residence homeowners regardless of age. The full value assessment exemption is $30,000 in the school year 2002 to 2003. 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.

## New York Tuition Savings Program

A taxpayer may contribute up to $5,000 per year exempt from New York personal income tax to a 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 earned receives tax-free treatment until withdrawn. Nonqualified withdrawals are subject to income tax and a 10% penalty. New York State contributions to all accounts for any beneficiary are subject to a lifetime maximum of $100,000.

## Standard Deductions and Exemptions

The standard deductions and exemptions for 2002, based on tax status, are shown in Table 32.

**Table 32. New York State Standard Deductions and Exemptions for 2002**

| Standard Deduction | | 2002 |
|---|---|---|
| Tax Status: | Joint(surviving spouse) | $13,400 |
| | Head of household | 10,500 |
| | Single | 7,500 |
| | Married filing separately | 6,500 |
| | Dependent filers | 3,000 |
| Exemption | | 1,000 |

A New York State exemption is not available for either the taxpayer or the spouse.

## Itemized Deductions

Taxpayers who file joint federal returns and separate New York returns must divide itemized deductions between them as if their federal taxable incomes had been determined separately. Taxpayers who do not itemize deductions on their federal returns may not itemize on their New York State returns. Itemized deductions of higher-income taxpayers are subject to limitations and are reduced by the sum of two percentages. The first percentage becomes effective at New York adjusted gross income (NYAGI) levels, dependent on the taxpayer's filing status, and the second becomes effective at NYAGI levels above $475,000.

## Supplemental Tax for Taxpayers with NYAGI Exceeding $100,000

Taxpayers with NYAGI exceeding $100,000 pay a special tax computed on a worksheet. The purpose of this tax is to remove the benefits of the lower tax brackets (the "tax table benefit"). Between NYAGI of $100,000 to $150,000, the benefits of the rates below the top rate are completely phased out.

## Rates

There are three separate rate tables for (1) married filing jointly and qualifying widow(er), (2) single, married filing separately and estates and trusts, and (3) head of household (Table 33). Filing status conforms to federal status except that when the New York resident status of spouses differs, separate returns must be filed.

**Table 33. New York State Income Tax Table**

**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 |

[1] Single, married filing separately, and estates and trusts rates are the same but brackets are exactly half of the above numbers.

## 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 27.5% of the federal EIC for taxable years beginning in 2002. However, the credit percentage may return to the 20% rate if the federal government takes certain actions related to funds used to support the increase in EIC. 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.

## Credit for Child and Dependent Care (CDC)

For tax years beginning in 2002, taxpayers with NYAGI of $25,000 or less will be allowed a NY CDC credit of 110% of the federal child and dependent care 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. However, these increased percentage will return to 1999 applicable percentage if the federal government takes certain actions related to funds used to support the increase in the child-care credit.

## Gross Receipts Tax Credit

For tax years ending after January 1, 2000, owners, beneficiaries (estates and trusts) that are owners, partners, or New York S Corporation shareholders of an industrial or manufacturing business (IMB) are allowed a credit against the tax imposed under Article 22 of the Tax Law. The credit is equal to the sum of the taxes imposed under §§186-a, 186-c, 189, and 189-a of Article 9 of the Tax Law for gas, electricity, water, and refrigeration used or consumed in New York State, for which taxes were paid or passed through to the IMB during the year. New York State farmers can claim "gross receipts" taxes paid to their energy suppliers on the New York State DTF-623 tax form. This is a refundable tax credit on taxable years 2000 and thereafter until 2006. Farmers must contact their electric, natural gas, steam, water, or refrigeration suppliers to get the amount of New York gross receipt's tax paid over the current tax year. With their account number in hand, the business operator should contact their utility suppliers to determine the amount of gross receipts tax paid. Farmers then can claim the Industrial or Manufacturing Business Credit (IMB) on their state return as a credit or refund. The credit cannot be carried over (why would one want to?). The credit amount transfers from DTF-623 to the appropriate lines on their state return depending on the type of business entity filing. The tax credit is about 2.35% of the electricity expense paid and a little less for natural gas used on the farm. The one-page form and instructions can be downloaded at http://www.tax.state.ny.us/pdf/2000/misc/dtf623_2000.pdf. For further information, see New York State Office of Tax Policy Technical Services Division Bulletin TSB-M-00(3)I.

## College Tuition Tax Credit/Deduction

Beginning with tax year 2001, full-year resident taxpayers may claim on 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. You must file Form IT-200 or Form IT-201 to get the "credit" from IT-272. You 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 New York State 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 postsecondary 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. The credit and itemized deduction are phased in over a 4-year period beginning in tax year 2001.

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 you are married and filing separate returns, see Spouses Filing Separately in the next section.

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 you may claim a credit. Full-year New York State residents may claim a refund of any college tuition credit that is in excess of their New York State tax liability.

### Spouses Filing Separately

If a taxpayer and spouse are filing separate returns, they can each claim their own credit. 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 applicable percentage of qualified tuition expenses times 4%.
- For taxpayers with expenses of less than $5,000, the credit equals the lesser of the applicable percentage of qualified tuition expenses or $50.

Applicable percentages of qualified tuition expenses are 25% in tax year 2001, 50% in 2002, 75% in tax year 2003, and 100% in 2004 and thereafter. In the tax year 2002 the credit will be as shown in Table 34.

**Table 34. 2002 College Tuition Credit Ranges**

| Tuition Expense Range | Credit Range (Column 1 x 50% x 4%) |
|---|---|
| $0 to $ 2,500 | $0 to $50 |
| $2,500 to $ 4,999 | $50 |
| $5,000 to $ 10,000 | $100 to $ 200 |

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. Both the credit and the deduction should be calculated to determine which provides the greater tax benefit. Table 35 gives the deduction range for the $0 to $10,000 expense range. However, you cannot claim both the credit and the deduction. The college tuition itemized deduction is also available to nonresident and part-year resident taxpayers.

**Table 35. 2002 College Tuition Itemized Deduction Ranges**

| Tuition Expense Range | Deduction Range (Column 1 x 50% x your income tax rate %) |
|---|---|
| $ 0 to $10,000 | $ 0 to $342.50 |

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.

## Empire Zone Credits

The Empire Zone Program Act changed the term *economic development zone* to *empire zone*. New York has about 62 Empire Zones located throughout the state. The Act provides certain new businesses with two new tax credits that began on or after January 1, 2001: the qualified empire zone enterprises (QEZE) for credit on real property taxes and the QEZE tax reduction credit. (See New York Tax Law §§14, 15, 16, 606(I)(1), 606(bb), and 606(cc) for more details.) For information on the zone locations and boundaries, call (800)782-8369, check on the Web at www.empire.state.ny.us, or look up the information in Publications 26 and 30. In addition, certain taxpayers may be eligible for the QEZE sales and use tax exemption (see New York memo TSM-M-00(6)S).

## Green Buildings Credit

This credit allows developers and building owners to deduct from state taxes eligible expenses associated with design, construction, rehabilitation, and maintenance of buildings with high-energy efficiency and high environmental standards. Commercial and residential structures must be placed in service after January 1, 2001, and be greater than 20,000 square feet. Taxpayers must apply to the Department of Environmental Conservation for a credit certificate. The taxpayer will also have to obtain an eligibility certificate issued by a licensed architect or engineer certifying the project meets certain green building standards. There are six tax components eligible for the credit (H.B. 1389). In addition to the building component, the credit is based on costs paid for fuel cells, photovoltaic modules, and air conditioning equipment with approved refrigerants used in the building.

## Residential Petroleum Tank Replacement Credit

The residential petroleum tank replacement credit is amended by requiring that the oil tank be removed or permanently closed and replaced with a new oil tank in order to receive a credit of up to $500 for related costs. The credit is also extended an additional year through December 31, 2003. The pre-existing separate credits of up to $250 in costs for tank removal, up to $250 for costs of permanent tank closure, and up to $250 for purchase and installation costs of a new tank, are no longer allowed. The amendments apply to the 2002 and 2003 tax years, but only for existing tanks removed or closed after March 31, 2002.

## New Information Authorization Form

The New York State Tax Department has a new form, similar to the federal Form 8821, Tax Information Authorization. If the taxpayers did not mark the "Yes" box on the filed return, authorizing the Tax Department to discuss their income tax return with the paid preparer who prepared it, the taxpayers may use the DTF-280 to authorize their paid preparer to represent them or receive confidential information relevant to their return. Taxpayers may also use this form to change or revoke the paid preparer's authorization on a previously filed return.

The department's Form DTF-280, Tax Information Authorization, is used to authorize the department to communicate orally or in writing, with a designated person other than the taxpayer regarding confidential tax information. This form is not a power of attorney; it does not give the appointee authority to act on the taxpayer's behalf to obligate or bind him or her before the department. Taxpayers should use Form POA-1, Power of Attorney, to designate their legal representative.

## Qualified Long-Term Care Insurance

Effective for taxable years beginning on or after January 1, 2002, the long-term care insurance subtraction modification was repealed and replaced with a credit. The credit is equal to 10% 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. The credit is also available to employers who pay premiums for qualifying policies for their employees. Policies that qualified for the credit in the tax year 2001 also qualify for the new substation modification.

## New York State Personal Income Tax and Estate Tax Relief

Tax relief is provided under the New York State Tax Law for victims of the September 11 terrorist attacks. For tax year 2000 and after, New York State will forgive the New York State, New York City, and Yonkers income tax liabilities of decedents who died as a result of the September 11, 2001, terrorist attacks against the United States. The new law also provides estate tax relief for the estates of these victims. Also, those affected by the terrorist attacks have extended filing and payment deadlines for taxpayers both within and outside New York State. References for the New York State relief and extensions can be found at: www.tax.state.ny.us.

## 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.

## 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 5-year or longer life class earns full credit after 5 years, even if a longer straight line 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 1992 be carried over to taxable years beginning on or after 2002. 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 once in 1 of the first 4 years. A business is new during its first 4 years in New York State. Only proprietorships and partnerships qualify. 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 New York investment credit and retail enterprise credit as well as to report early disposition of qualified property.

Employment incentive tax credit (EITC) is available to regular corporations that qualify for NYIC and increases at least 1% during the year. The credit is 1.5% of the investment credit base if the employment increases less than 2%, 2% if the increase is between 2 and 3%, and 2.5% if the increase is 3% or more for each of the 2 years following the taxable year in which NYIC was allowed. The additional credit is available to newly formed as well as continuing corporations. The credit may not be used to reduce tax to less than the minimum taxable income base or the fixed dollar minimum, whichever is higher. Any remaining unused credit may be carried forward to the next 7 taxable years.

The EITC and economic development zone credit that applies to C corporations was expanded to sole proprietorships, partners of partnerships, shareholders of S corporations, and beneficiaries of estates and trusts. The credits are available to those entities that make investments eligible for the investment tax credit and in the years following the investment increase their employee numbers.

## Rehabilitation Credit for Historic Barns

New York taxpayers are allowed a credit (as defined in I.R.C. §47) of 25% of their qualified rehabilitation expenses to restore barns originally constructed on or before 1936. The New York State requirements for this credit follow the federal regulations, which were covered earlier in this workbook.

For newly constructed or reconstructed agricultural structures, New York's real property Tax Law §483 allows a 10-year property tax exemption from any increase in the property's assessed value resulting from the improvement. See the local assessor or board of assessors to determine eligibility and file an application for exemption. In addition, for those rehabilitated historic barns, which do not qualify for the 10-year exemption, there is a district exemption that requires the approval of the local taxing authorities and school district. Again, contact the local assessor for qualification rules and application. The owner cannot receive both the 10-year exemption and this new assessment reduction.

## 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.

## New York State SingleFile

The New York State Department of Taxation and Finance and Department of Labor jointly developed a "SingleFile" program to simplify reporting requirements for employers. It combines the Quarterly Unemployment Insurance Report (Form IA-5) and Quarterly Combined Withholding and Wage Return Reporting (Form NYS-4), enabling employers and their agents to report state withholding tax, wage, and unemployment information on a single form. The forms are NYS-45 and NYS-45-ATT in place of Forms IA-5, NYS-4, and NYS-4-ATT. The filing and payment rules for making withholding tax payment have not changed. For further details see NYS-50 available on the New York Web site: www.tax.state.ny.us.

## New Hire Reporting

To facilitate the accurate and prompt determination of child-support obligations, Chapter 81 of the law requires all employers to report to New York State Department of Taxation and Finance identifying information about each newly hired or rehired employee in New York State. Employers have 20 calendar days from the hiring date to provide the employee and employer name, address, and ID numbers (see NYS Notice 97-10). The Immigration and Naturalization Service (INS) Form I-9 is available from (800) 870-3676 or www.ins.gov. Form W-4, new for 2002, for income tax withholding is also available from the IRS or online at www.irs.gov.

## Estimated Tax Rules

New York residents with New York source income are required to make payments of estimated tax if they expect to owe, after withholding and credits, at least $300 of New York tax (per jurisdiction) and if withholding and credits are expected to be less than the smaller of (1) 90% of the tax for the year or (2) 100% of the tax on the prior year's return (provided a return was filed and the taxable year consisted of 12 months).

For individuals, estates and trusts (except farmers and fishermen) whose NYAGI in the prior year is more than $150,000 ($75,000 if married filing separately) they must pay 110% of the prior

year's state and, if applicable, city resident or nonresident tax or 90% of the current year's tax to avoid a penalty for underpayment of estimated tax.

Farmers and fishermen may use the preceding year's tax as a method of determining the required annual payment without regard to the above limitation. The definition of farmers and fishermen for estimated tax purposes was changed so that Federal Gross Income rather than NYAGI is used in determining whether at least two-thirds of the person's income is from farming.

## 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:

- Late-breaking tax legislation
- Problems encountered by other Cornell Tax School practitioners
- Tax issues affecting New York State filers
- Dates of next year's Cornell educational schools