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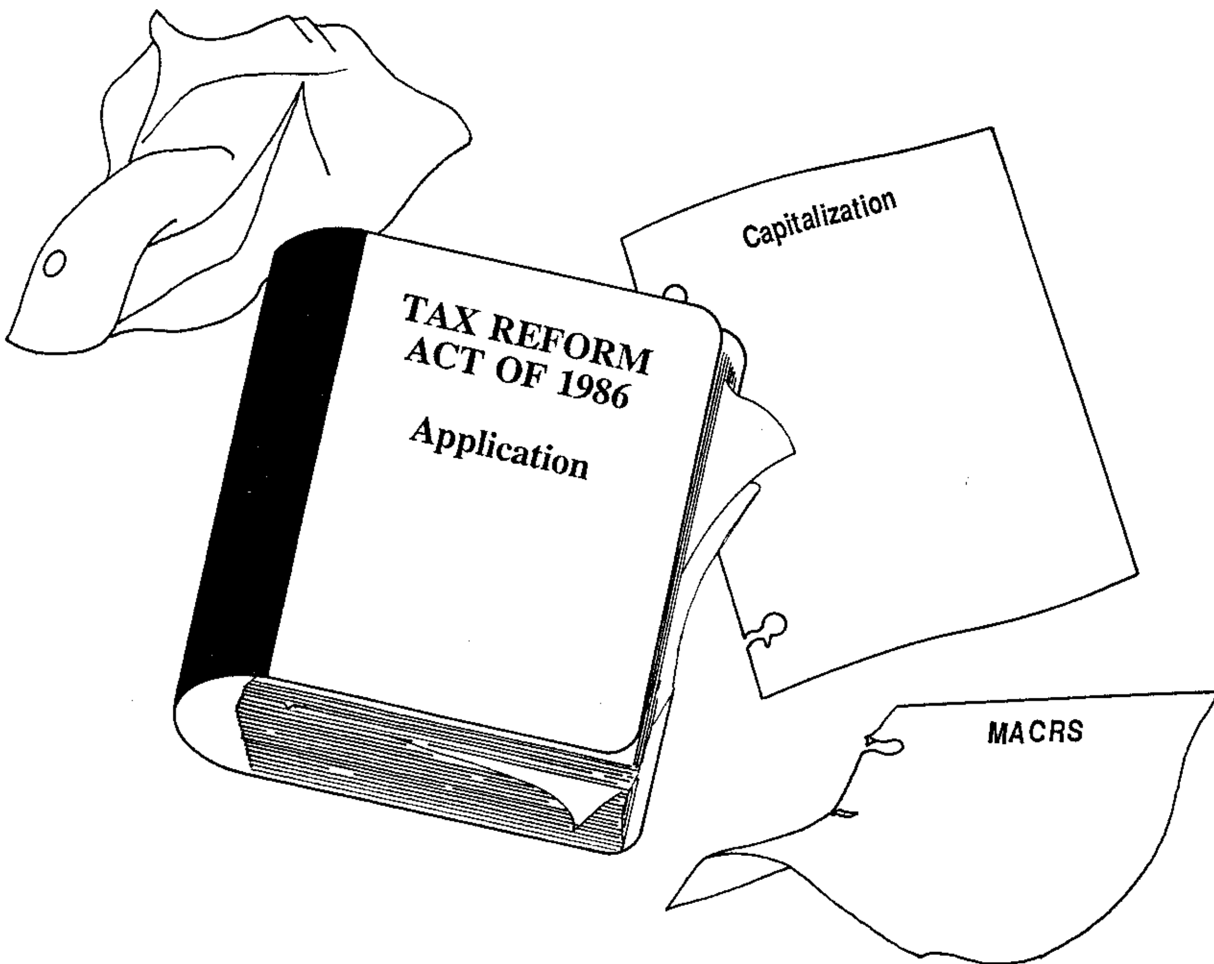
NOVEMBER 1987 A.E. EXT. 87-28

FARM INCOME TAX MANAGEMENT AND REPORTING MANUAL



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1987 TAX FORMS NEEDED BY NEW YORK FARMERS

Here is a list of the more important 1987 income tax forms needed by farmers. Many of the forms have been revised for 1987.

Federal Forms

1040 - U.S. Individual Income Tax Return
- Schedule A & B - Itemized Deductions and Dividend and Interest Income
- Schedule D - Capital Gains and Losses
- Schedule E - Supplemental Income Schedule
- Schedule F - Farm Income and Expenses
- Schedule R - Credit for Elderly and Permanently and Total Disabled
- Schedule SE - Computation of Social Security Self-Employment Tax

1040A - For non-itemizers, less than $50,000 taxable income, other limitations

1040EZ- For single filers with no dependents, income under $50,000, wage income only, interest under $400, and no dividends

1040X - Amended U.S. Individual Income Tax Return

943 - Employer's Annual Tax Return for Agricultural Employees

1099 - Information returns to be filed by person who makes certain payments of $600 or more: 1099-INT interest payments; 1099-MISC to report rents, royalties, prizes, awards, payments to fishing boat crews, medical and health care payments, and nonemployee compensation; 1099-G statement for recipients of certain government payments

1096 - Summary and transmittal form for 1099's and 1087's

W-2 - Wage and Tax Statement; W-3 - Transmittal of Income and Tax Statement

1065 - U.S. Partnership Return

3468 - Computation of Investment Credit and Business Energy Credit (Schedule B)

3800 - General Business Credit

4136 - Computation of Credit for Federal Tax on Gasoline, Special Fuels, and Lubricating Oil

4255 - Investment Credit Recapture (undated)

4562 - Depreciation: use to report depreciation, cost recovery, Section 179 expense election, and listed property

4562A - Depreciation of Property Placed in Service after December 31, 1986

4684 - Casualties and Thefts

4797 - Supplemental Schedule of Gains and Losses

4835 - Farm Rental Income and Expense

6251 - Alternative Minimum Tax Computation - completely revised

New Federal Forms (there are others)

8606 - Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions

8582 - Passive Activity Loss Limitations

8598 - Computation of Deductible Home Mortgage Interest

8615 - Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000

New York State Forms

IT-201 - Income Tax Resident Return (individual, joint or separate)

IT-201ATT - Summary of Other Credits and Taxes

IT-201X - Amended Resident Income Tax Return (only acceptable method)

IT-204 - Partnership Return

IT-212 - Investment Credit and Recapture Schedule

IT-220 - Minimum Income Tax Computation Schedule

IT-250 - Maximum Tax on Personal Service Income

IT-2102 & IT-2103 - Wage and Tax Statement, and Reconcilation Form

IT-2102.1 & IT-2102.4 - Informational Return and Transmittal Form

IT-399 - Depreciation Schedule (to compute and compare New York depreciation with ACRS)

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1987 FARM TAX AND INCOME SITUATION

Tax Reform Application

The Tax Reform Act of 1986 has been "cussed" and discussed since becoming law on October 22, 1986. Some have praised it for providing tax simplification and a more equitable system of taxation. Others have described it as very complex, extremely complicated, and a law that has placed additional accounting requirements on thousands of taxpayers and their practitioners. There is some truth in all of these claims and growing evidence to support the latter.

The year of talking, planning, and preparation is nearly over. The year of application is about to begin. Recognition and complete understanding of all the tax changes that affect individuals and small businesses will not be achieved in a day or in this first application year. Our objective is to review, discuss, and emphasize the changes that will affect most New York farm taxpayers. These topics include capitalization of preproductive period expenses, new MACRS depreciation, a revised alternative minimum tax system, and the numerous federal and state tax changes that affect individual taxpayers.

New York State passed two tax laws in 1987: The Tax Reform and Reduction Act of 1987 and the Business Tax Reform and Rate Reduction Act of 1987. Each will affect the tax returns and tax bills of farmers.

The 1987 Farm Income Situation

Average net operating incomes of New York dairy farmers will be higher in 1987 than in 1986. Financial data from a small sample of New York ELFAC dairy farms showed average net operating income up 39 percent for the first eight months of 1987 when compared with the same period in 1986. This does not mean that all dairy farmers will realize more net farm income in 1987 and many that do will not have taxable incomes. Farm milk prices and dairy farm incomes are expected to decline in 1988.

Look for somewhat higher 1987 net operating incomes on livestock, potato, and grape farms. Poultry and cash-crop farm incomes will be down unless growers received an increase in government payments.

Tax Reform's Affect on Farmers

A Cornell study of tax return data from 120 dairy farms indicates that the loss of the capital gain exclusion on sales of dairy cattle will, on the average, more than offset the increased exemptions and standard deduction, leading to larger taxable incomes and tax. Loss of investment credit will also tend to increase federal tax bills. The impact will be greater on the larger and more profitable dairy farms where the loss of the capital gain exclusion is more important and there are less likely to be large IC carry forwards.

The two 1987 New York tax laws, when combined with the automatic carryover of federal provisions such as slower depreciation and the loss of the capital gain exclusion, will also impact the tax bills of farmers. The New York tax data for the 120 dairy farms shows that loss of the capital gain exclusion will be partly offset by the elimination of the minimum tax for most New York dairy farmers. Lower rates and the higher standard deduction will tend to lower taxes, but the reduction in investment credit will tend to increase taxes, particularly for the farms with higher taxable incomes.

FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

Standard Deduction

The TRA of 1986 eliminated the ZBA and replaced it with a standard deduction which, when used, is subtracted from AGI on the tax return. The fact that there is no longer a ZBA built into the tax tables must be remembered when comparing tax rates and estimating tax liabilities in different years.

Basic Federal Standard Deduction, 1987 and 1988

Filing Status	1987	1988
Married filing jointly; surviving spouse	$3,760	$5,000
Head of household	2,540	4,400
Single individuals	2,540	3,000
Married filing separately	1,880	2,500

Beginning in 1989 the basic standard deduction amounts will be adjusted for inflation.

Each taxpayer over age 65 or blind will receive an additional $600 deduction if married and filing a joint or separate return and $750 if single or head of household. A taxpayer who is both elderly and blind will double the additional deduction. Also, taxpayers age 65 and over or blind taxpayers will receive the 1988 basic standard deduction in 1987. The following table provides common examples.

Federal Standard Deductions for Elderly and Blind Taxpayers, 1987 and 1988

Status	Basic Deduction	Additional Deduction	Total Standard Deduction
a. Married taxpayers filing jointly, both 65 or older	$5,000	$1,200	$6,200
b. Status *a* plus one spouse is blind	5,000	1,800	6,800
c. Married filing separately, age 65	2,500	600	3,100
d. Head of household, age 65	4,400	750	5,150
e. Single, age 65 or over	3,000	750	3,750
f. Single, age 65 and blind	3,000	1,500	4,500

Personal Exemption Increases

The 1987 personal exemption is $1,900, up from $1,080 in 1986. It will increase to $1,950 in 1988, $2,000 in 1989, and be indexed to inflation starting in 1990.

Starting in 1988, the benefit of the personal exemption is phased out for taxpayers with specific high levels of taxable income (see 1988 Tax Rate Schedule). The additional personal exemption for the elderly and blind has been eliminated and partially offset with higher standard deductions.

Dependents Lose

Individuals that can be claimed as dependents on another taxpayer's 1987 return have lost their personal exemption. The so called double exemption is gone and there is no option to allow the dependent to use his or her own exemption if the parent or guardian doesn't need it.

Furthermore, the qualified dependent's basic standard deduction is limited to the greater of $500 or the individual's earned income. If a qualified dependent receives more than $500 of unearned income in 1987, the excess is taxable income. If the dependent receives more than $500 of earned income plus additional unearned income, all unearned income is taxable. If there is less than $500 of earned income, the balance will offset unearned income.

The $500 rule for qualified dependents limits only the basic standard deduction. It does not restrict the use of the additional deductions for elderly taxpayers.

Another new rule places additional disadvantages on funneling investment income to children. Beginning in 1987, taxable unearned income in excess of $500 received by a dependent child under age 14 will be taxed at the parent's marginal rate even if the income is from earnings on gifts received prior to 1987. This $500 taxable income exclusion is in addition to the child's $500 personal exemption. Therefore, a child with no earned income can receive up to $1,000 of unearned income before being subject to the parent's potentially higher tax rate.

1987 Tax Rates and Changes for 1988

Tax rates have been lowered substantially for high taxable income bracket taxpayers. In 1986 the top tax rate was 50 percent, it is now 38.5 percent and in 1988 it will fall to 28 percent plus a surcharge. Moderate taxable income level taxpayers ($25,000 to $45,000) could save $400 to $1,200 in 1987 from the lower rates. Low income level taxpayers will benefit more from the increase in the standard deduction.

1987 Tax Rate Schedules

Single Taxpayers		Married Filing Joint Return	
Taxable Income	Tax	Taxable Income	Tax
$0-$1,800	11%	$0-$3,000	11%
1,801-16,800	$198 + 15% over $1,800	3,001-28,000	$330 + 15% over $3,000
16,801-27,000	$2,448 + 28% over $16,800	28,001-45,000	$4,080 + 28% over $28,000
27,001-54,000	$5,304 + 35% over $27,000	45,001-90,000	$8,840 + 35% over $45,000
54,001 & over	$14,754 + 38.5% over $54,000	90,001 & over	$24,590 + 38.5% over 90,000

The 1987 tax brackets for married taxpayers filing separate returns are one-half the size of those for joint filers. Rates for surviving spouses are the same as for married filing joint returns. A separate schedule for heads of household falls in between those for joint returns and single taxpayers.

In 1988 there will be two basic taxable income brackets at 15 and 28 percent for all taxpayers. A third bracket with a 33 percent tax rate is caused by the required phase out of the 15 percent rate for high income taxpayers.

1988 Tax Rate Schedules

Single Taxpayers		Married Filing Joint Return	
Taxable Income	Tax	Taxable Income	Tax
$0-$17,850	15%	$0-$29,750	15%
17,851-43,150	$2,677.50 + 28% over $17,850	29,751-71,900	$4,462.50 + 28% over $29,750
43,151-89,560	$14,239.50 + 33% over $43,150	71,901-149,250	$16,264.50 + 33% over $71,900
89,561 & over	28% + surcharge*	149,251 & over	28% + surcharge*

*Five percent surcharge for the phase-out of personal exemptions for taxpayers in this top income bracket.

The five percent surcharge applied to the top income bracket takes away the tax benefit attributed to personal exemptions. It is the lesser of 28 percent of all personal exemptions claimed or five percent of taxable income in the top bracket.

Earned Income Credit

Earned Income Credit has been increased, the phase-out percentage has been reduced, and starting in 1988, the income range eligible for maximum credit has been extended. Earned Income Credit is to be adjusted for inflation annually.

Changes in Earned Income Credit, 1986-1988

Year	Maximum Earned Income	Credit Percent	Maximum Credit	Phase-Out AGI Range	Phase-Out Percent
1986	$5,000	11	$550	$6,500 - 11,000	12 2/9
1987	5,714	14	800	6,925 - 15,432	10
1988	5,714*	14	800*	9,000 - 17,000*	10

*Subject to change due to inflation adjustment.

Eligibility rules have not changed. The taxpayer must maintain a home, have a dependent child, file a joint return if married, and have a 12 month tax year.

Watch for regulations that will prescribe how and when employers are to notify employees not subject to income tax withholding about their potential eligibility for Earned Income Credit.

Itemized Deductions Restricted

State and local sales taxes are eliminated from itemized deductions. State income and property taxes are still deductible.

Personal interest is phased out over a five year period. Sixty-five percent is deductible in 1987, 40 percent in 1988, 20 percent in 1989. Personal interest excludes business interest, investment interest, and interest from passive activities.

Mortgage interest on the taxpayer's principal and second home is deductible providing the debt does not exceed the cost basis unless it is used for educational and medical expenses.

Investment interest is deductible to the extent of net investment income. Investment interest is interest paid on debt incurred to buy investment property. Investments in passive activities, activities in which the taxpayer actively participates, including the rental of real estate, do not qualify. Net investment income is gross investment income (including gain from sales) less investment expenses (excluding interest). Investment interest disallowed because of the net income limitation may be carried forward to the next tax year and subjected to the same limitation test.

Medical expense deductions are subject to a higher floor, 7.5 percent of AGI. TRA of 1986 clarified the inclusion of capital expenditures for accommodating the physically handicapped as deductible medical expenses.

Adoption expenses no longer qualify as itemized deductions.

Charitable deductions for away from home travel expenses are no longer allowed unless there is no element of personal pleasure, recreation or vacation connected with it.

Moving expenses are now itemized deductions.

Miscellaneous Deductions Subject To Two Percent AGI Limit

1. Unreimbursed employee business expenses including employment-related educational expenses, work clothes, dues, fees, and work-related small tools and supplies.

2. Professional dues, fees, books, magazines, and journals.

3. Job searching expenses.

4. Legal, accounting, and tax counsel fees.

5. Hobby expenses not exceeding hobby income.

6. Office-in-the-home expenses.

7. Safe deposit box rental.

8. Fees paid to IRA custodian, and certain expenses of a partnership, grantor trust, or S corporation that are incurred for the production of income.

Business Meal and Entertainment Expenses

A new 80 percent rule limits the amount of qualified business meal and entertainment expenses that may be deducted. Qualified expenses must be reduced by 20 percent.

Meal expenses must be directly related to the active conduct of the taxpayer's trade or business (i.e. an organized business meeting or a meal at which business is discussed). A meal taken immediately preceding or following a business meeting will qualify if it is associated with the active conduct of the taxpayer's trade or business.

Entertainment expenses must also be directly related to the active conduct of a trade or business to be 80 percent deductible. Deductions for tickets are limited to their face value, before application of the 80 percent rule.

Travel expenses are no longer deductible as a form of education. Charitable travel expenses away from home are not deductible if the taxpayer receives a significant amount of personal pleasure from the trip. No deduction is allowed for travel or other costs of a meeting in connection with the taxpayer's investment activities.

Employee Awards

TRA of 1986 includes specific rules and limits on excluding employee achievement awards from gross income. An employee achievement award is tangible personal property excluding cash, gift certificates and equivalent items, transferred by an employer to an employee for length of service or safety achievement. The award must be made as part of a meaningful presentation and cannot be "payment of disguised compensation".

A length of service award will not qualify if made to an employee with less than six years of service or to an employee who has received a qualified length of service award within the last five years.

Safety achievement awards may be made to no more than 10 percent of eligible employees per tax year. All employees except managers, administrators, clerical workers, and other professionals are eligible.

Employers may deduct the cost of a qualified employee achievement award that does not exceed $400 to the same employee in one tax year. A $1,600 annual deduction limitation applies when the same employee receives more than one qualified award.

Business Use of Home

Home office expense deductions are now limited to a modified net income from the business use of the home. The modified net income is the gross business income minus the business share of mortgage interest, real estate taxes, casualty losses; and the business expenses other than those related to the business use of the home.

Deductions for home office use will be disallowed if a portion of the taxpayer's home is leased or rented to his or her employer. An independent contractor is subject to this provision. Furthermore, all home office expenses that increase the net loss of the related business activity are not deductible.

Health Insurance Premiums

Twenty-five percent of health insurance premiums paid by self-employed taxpayers are deductible as an adjustment to income on 1040. The payments must be limited to health insurance coverage of the taxpayer and/or the spouse and dependents. The deduction may not exceed earned income and the insurance plan must meet nondiscrimination criteria. The amount deducted is included in income subject to self-employment tax. A taxpayer eligible for coverage in a 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.

Other Changes

The Schedule W deduction allowed working spouses when both had earned income is gone.

Income averaging is no longer available.

All unemployment compensation benefits received after 1986 are includable in gross income. The limited base amount exclusion is gone.

The opportunity for non-itemizers to claim charitable deductions has ended.

The political contribution credit has been repealed.

Nonbusiness casualty losses are subject to a new requirement. A taxpayer covered by insurance must now file an insurance claim for reimbursement of damaged or stolen property before the casulty loss will be allowed. Any reimbursement will reduce the casualty loss.

Prior rules that reduced each personal casualty by $100 and total annual casualty losses by 10 percent of AGI are still in effect. Casualty losses are not subject to the new two percent of AGI limit.

Scholarships and fellowships can no longer be totally excluded from taxable income. Degree candidates may exclude the cost of required tuition, fees, books, supplies, and equipment. No amount of a grant earmarked for room, board or other nonqualified expenditures is excludable. The rule applies to all types of scholarships and grants regardless of their source or origin.

Non-degree candidates have no exclusions. The new rule applies to fellowships and scholarships received on or after January 1, 1987 except those granted before August 17, 1986.

The $1,000 life insurance interest exclusion formally available to a surviving spouse has been repealed for deaths occurring after October 22, 1986.

Estimated tax payments are required for taxpayers that will owe $500 or more in estimated tax for the year, and expect total income tax withheld will be less than the smaller of:

1. 90 percent of the tax shown of the current year's tax return, or

2. 100 percent of the tax on last year's return.

Dependents at least five years old need Social Security numbers. Taxpayers must list the dependent's Social Security number on Form 1040 or 1040A on all returns due after December 31, 1987. Taxpayers are subject to a $5.00 penalty for each missing or incorrect Social Security number. Social Security form SS-5 is used to apply for a Social Security number.

Tax planning suggestion: As the standard deduction increases substantially between 1987 and 1988, many taxpayers will find it advantageous to discontinue itemizing deductions in 1988. These taxpayers should consider and evaluate the economics of making 1988 donations, charitable deductions, and other qualified Schedule A deductions before the end of 1987.

PROVISIONS APPLYING PRIMARILY TO BUSINESS ACTIVITY

There are many changes in the TRA of 1986 that will affect the taxation of businesses. Only those affecting most business taxpayers and not covered in detail elsewhere in the manual are included here.

Capital Gains

The 60 percent capital gain exclusion ended on December 31, 1986. This applies to capital gains of all kinds. For farmers, it means that all gains on livestock, real estate, and other farm property will be taxed as ordinary income for sales made after 1986 (except for dairy buyout cattle). In 1987, the top marginal rate on capital gain income is 28 percent, even though the top marginal rate on ordinary income is 38.5 percent. In 1988 and later, capital gain income will not be exempt from the five percent surcharge to offset the benefits of the 15 percent bracket and personal exemptions for higher income taxpayers.

There is no exception in the new law that would allow favorable capital gains treatment for timber sales. The gain from the sale of timber after December 31, 1986 is subject to the same rates as other capital gain. However, the taxpayer who elected to treat the cutting of timber as a disposition under Sec. 631(a) before January 1, 1987 may now revoke that election on a one time basis without special permission.

Capital Losses

For tax years beginning after 1986, net short-term capital losses and net long-term capital losses will be combined for the purpose of offsetting ordinary income. The previous rule that required $2.00 of net long-term capital loss to offset $1.00 of ordinary income has been eliminated. Therefore, net short-term capital losses and net long-term capital losses may be used to offset up to $3,000 of ordinary income ($1,500 for married filing a separate return). Any excess capital losses may be carried forward and retain their character as short or long-term losses.

Discharge of Indebtedness When the Taxpayer is Solvent

The provision that allowed solvent taxpayers to elect to exclude income from the discharge of "qualified business indebtedness" from gross income by electing to reduce the basis of depreciable property was repealed for discharges after December 31, 1986. (See later section for treatment of solvent farmers).

Tax Year of Partnerships, S-Corporations, and Personal Service Corporations

For taxable years beginning after 1986, S-Corporations and Personal Service Corporations are required to adopt the calendar year unless the corporation can establish, to the satisfaction of the Secretary of the Treasury, a business purpose for using a different taxable year.

Partnerships are required to adopt the same taxable year as that of the partners owning a majority interest in partnership profits and capital unless a business purpose for a different year can be established. In some cases, a partnership may have to adopt a calendar year. The rules are complicated.

In all cases, deferral of income for three months or less will no longer satisfy the business purpose rule.

Hobby Loss Rule Change

The Sec. 183(d) presumption that states the number of years a taxpayer must show a profit for the profit presumption to be in his or her favor has been changed from two to "three or more of the five previous taxable years". This change is effective January 1, 1987 and does not apply to horse farming activities which continue to be two profit years out of seven.

PROVISIONS APPLYING TO CORPORATIONS

There are many provisions in TRA 1986 that apply to corporations. Only a few are covered in this manual.

Tax Rates

Effective for taxable years beginning on or after July 1, 1987, corporate tax rates are:

Taxable Income	Tax Rate
Not over $50,000	15%
Over $50,000 but not over $75,000	25%
Over $75,000 but not over $100,000	34%
Over $100,000 but not over $335,000	39%*
Over $335,000	34%*

*Result of phaseout of benefits of lower rate by applying a five percent surcharge to income over $100,000, the surcharge not to exceed $11,750.

Corporations with a tax year that begins before and ends after July 1, 1987 will need to make two sets of tax calculations: (1) Tax on the entire income will be computed using 1986 rates, and (2) be computed again using 1987 rates (see table above). Then a blended tax will be calculated by weighting each tax by the portion of the year before and after the rate change.

PROVISIONS SPECIFIC TO AGRICULTURE

Expensing of Soil and Water Conservation Costs

Beginning in 1987, in order to be expensed rather than capitalized, soil and water conservation costs must be consistent with a conservation plan approved by the USDA Soil Conservation Service or by a comparable state agency. Costs for draining or filling of wetlands or land preparation for center pivot irrigation systems may not be expensed. Carry overs from previous years are not affected by the rules of TRA 1986.

Expensing of Land Clearing Repealed

Any amounts paid or incurred after 1985 for land clearing are not eligible for expensing. Such costs must be added to the land's basis. Routine brush clearing for land already farmed will not be affected.

Dispositions of Converted Wetlands or Highly Erodible Croplands

Any gain on the disposition of converted wetlands or highly erodible crop-land is treated as ordinary income rather than capital gain. Any loss on such

dispositions is treated as long-term capital loss. The definitions of "converted wetlands" and "highly erodible cropland" are contained in the Food Security Act of 1985. The provision applies to land converted to farming after March 1, 1986.

<u>Limitation on Certain Prepaid Farming Expenses</u>

The limitation applies to prepaid expenses of cash basis taxpayers to the extent they exceed 50 percent of the deductible farming expenses of the taxable year (other than the prepaid expenses).

There are two exceptions to the 50 percent test for a "qualified farm related taxpayer":

1. Extraordinary circumstances such as a government crop diversion program.

2. If the 50 percent test is satisfied on the basis of aggregating the prepaid expenses and the farming expenses for the previous three years.

A "farm related taxpayer" is one (i) whose principal residence is on a farm, (ii) who has a principal occupation of farmer or (iii) who is a member of the family of a taxpayer described in (i) or (ii).

This provision is effective for amounts paid or incurred after March 1, 1986 in taxable years beginning after that date. For calendar year taxpayers the provision became effective in 1987.

<u>Alternative Minimum Tax Relief for Insolvent Farmers</u>

Some relief from the alternative minimum tax for insolvent farmers was provided by Congress and the President in April 1986. An insolvent farmer who sells farmland does not need to include the 60 percent capital gain exclusion on <u>land</u> in the computation of alternative minimum tax (AMT) to the extent of the insolvency. The exclusion from AMT applies only to land, not to the capital gain excluded on buildings or other depreciable property. To qualify, the land must have been transferred to the creditor in cancellation of indebtedness or sold or exchanged under threat of foreclosure. To qualify as a farmer, a taxpayer must have received at least 50 percent of annual gross income in the three previous years from farming. To meet the insolvency requirement, the taxpayer must, immediately before the transaction, have had an excess of liabilities over the fair market value of his assets.

<u>Tax Treatment of Discharge of Certain Indebtedness of Solvent Farmers (IRC Section 108(g))</u>

Discharge of "qualified farm indebtedness" of solvent taxpayers will be treated the same as debt discharge for insolvent taxpayers if the discharge occurs after April 9, 1986. Formerly, debt discharged for a solvent taxpayer had to be included in income unless the taxpayer chose to reduce the basis of depreciable assets. If the debt discharged was greater than the basis of depreciable assets, the remainder had to be included in income. The change would apply the insolvent taxpayer rules (which are more favorable to the taxpayer) to solvent farmers.

Solvent taxpayers also would be allowed to reduce their basis in land (after reducing other tax attributes, as described in IRC Section 108 and Section 1017) in return for not including discharge of qualified farm indebtedness in income.

DEPRECIATION AND COST RECOVERY

The Tax Reform Act of 1986 replaced the accelerated cost recovery system (ACRS) with the modified accelerated cost recovery system (MACRS). MACRS provides for eight classes of recovery property, two of which may be depreciated only with straight line. The new system applies to property placed in service after 1986, but could have been elected for property placed in service after July 31, 1986. MACRS provides for less accelerated depreciation on most property than did ACRS, but there are exceptions.

Pre-MACRS property will continue to be depreciated under the ACRS or pre-ACRS rules. Therefore most taxpayers will be dealing with MACRS, ACRS, and the depreciation rules that apply to property acquired before 1981. This bulletin concentrates on the MACRS rules but some ACRS information is included. Additional information on ACRS and pre-ACRS rules can be found in prior issues of this manual or the Farmers Tax Guide.

Depreciable Assets

A farm operator is allowed cost recovery or depreciation on machinery, equipment, buildings, and on purchased livestock acquired for dairy, breeding, draft, and sporting purposes unless he is reporting on the accrual basis and such livestock are included in his inventories. Depreciation or cost recovery must be claimed by the taxpayer who owns the depreciable asset. A farmer cannot depreciate property that he is renting or leasing from others. He may depreciate the cost of most capital improvements made to leased property.

Depreciation or cost recovery is not optional. It should be claimed each year on all depreciable property. An owner who neglects to take depreciation when it is due is not allowed to recover the lost depreciation by claiming it in a later year. Lost depreciation may be recovered by filing an amended return.

Beginning in 1987, farmers will be required to capitalize pre-productive expenses if the pre-productive period is more than two years. Such capitalized expenses will be depreciated when the productive period starts. Taxpayers other than farmers are also subject to new capitalization rules.

MACRS Classes

The MACRS class life depends on the ADR midpoint life of the property. For some items, the ADR midpoint life was specifically changed by TRA 1986. For example, autos and light duty trucks were given an ADR life of five years which moves them from the 3-year ACRS to the 5-year MACRS class.

MACRS Class	ADR Midpoint Life
3-year	4 years or less
5-year	More than 4 but less than 10
7-year	10 or more but less than 16
10-year	16 or more but less than 20
15-year	20 or more but less than 25
20-year	25 or more other than 1250 property with an ADR life of 27.5 or more
27.5-year	Residential rental property
31.5-year	Non-residential real property

MACRS is similar to ACRS in that assets are placed in one of the eight 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.

Three-year property. The 3-year MACRS class includes:

1. Section 1245 property with an ADR class life of four years or less. This includes over-the-road tractors. It also includes hogs for breeding purposes but not cattle, goats or sheep held for dairy or breeding purposes because the ADR class life of these animals is greater than four years.

2. Section 1245 property used in connection with research and experimentation. Few Farmers will have this type of property.

3. Race horses more than two years old when placed in service and all other horses more than 12 years old when placed in service.

Five-year property.

1. All purchased dairy and breeding livestock (except hogs and horses included in the 3 or 7-year classes).

2. Automobiles, light trucks (under 13,000 lbs. unladen), and heavy duty trucks.

3. Computers and peripheral equipment.

Seven-year property.

1. All farm machinery and equipment.

2. Single purpose livestock and horticultural structures, silos, grain storage bins, fences, paved barnyards, water wells, and drain tiles.

3. Breeding or work horses.

Ten-year property.

There appears to be no farm property included in the 10-year class.

Fifteen-year property.

1. Depreciable land improvements such as sidewalks, roads, drainage facilities and fences. Does not include land improvements that are explicitly included in any other class. (Farm fences are in the 7-year class.)

2. Orchards, groves, and vineyards when they reach the production stage.

Twenty-year property.

Farm buildings such as general purpose barns and machine sheds.

27.5-year property includes residential rental property.

31.5-year property includes non-residential real property.

ACRS, MACRS and Alternative MACRS
Recovery Periods for Common Farm Assets

	Recovery Period		
Asset	ACRS	MACRS	Alternative MACRS
Airplane	5	5	6
Auto (farm share)	3	5	5
Calculators	5	5	6
Cattle (dairy or breeding)	5	5	7
Citrus groves	5	15	20
Communication Equipment	5	7	10
Computer and peripheral equipment	5	5	5
Computer software	5	7	12*
Copiers	5	5	6
Cotton ginning assets	5	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	7	15
Helicopter (agricultural use)	5	5	6
Hogs (breeding)	3	3	3
Horses (non-race, less than 12 years of age)	5	7	10
Horses (non-race, 12 years of age or older)	3	3	10
Logging equipment	5	5	6
Machinery (farm)	5	7	10
Mobile homes on permanent foundations (farm tenants)	10	15	20
Office equipment (other than calculators, copiers or typewriters)	5	7	10
Office fixtures	5	7	10
Office furniture	5	7	10
Orchards	5	15	20
Paved lots	5	15	20
Property with no class life	5	7	12
Rental property (non-residential)	19	31.5	40
Rental property (residential)	19	27.5	40
Research property	5	5	12*
Sheep (breeding)	3	5	5
Single purpose agricultural structure	5	7	15
Single purpose horticultural structure	5	7	15
Solar property	5	5	12*
Tile (drainage)	5	15	20
Tractor units for use over-the-road	3	3	4
Trailer for use over-the-road	5	5	6
Truck (heavy duty, general purpose)	5	5	6
Truck (light, less the 13,000 lbs.)	3	5	5
Typewriter	5	5	6
Vineyard	5	15	20
Wind energy property	5	5	12*

*No class life specified. Therefore, 12-year life assigned.

Cost Recovery Methods and Options

Accelerated cost recovery methods for MACRS property are shown below. In addition, there are two straight line options for the classes eligible for rapid recovery. Straight line may be taken over the MACRS class life or, using alternative MACRS depreciation system, over the ADR midpoint life. Note that the ADR midpoint life is not the same for all items in the same MACRS class.

The Technical Corrections bill of 1987 (not passed at the time this was written) provides for a fourth option which is 150 percent declining balance over the ADR midpoint life. This is the same depreciation required for alternative minimum tax purposes, which is discussed on page 42.

Class	Most Rapid Method Available
3, 5, 7 and 10-year	200% declining balance with switch-over to SL
15 and 20-year	150% declining balance with switch-over to SL
27.5 and 31.5	Straight line only

Unlike ACRS, the law does not provide for standard percentage recovery figures for each year. However, several of the tax services have computed, to the nearest hundredth of a percent, their versions of annual percentages. One set of these is shown below.

Annual Recovery (Percent of Original Depreciable Basis)

Recovery Year	3-Year Class (200% d.b.)	5-Year Class (200% d.b.)	7-Year Class (200% d.b.)	10-Year Class (200% d.b.)	15-Year Class (150% d.b.)	20-Year Class (150% d.b.)
1	33.33	20.00	14.29	10.00	5.00	3.75
2	44.44	32.00	24.49	18.00	9.50	7.22
3	14.82*	19.20	17.49	14.40	8.55	6.68
4	7.41	11.52*	12.49	11.52	7.69	6.18
5		11.52	8.93*	9.22	6.93	5.71
6		5.76	8.93	7.37	6.23	5.28
7			8.93	6.55*	5.90*	4.89
8			4.45	6.55	5.90	4.52
9				6.55	5.90	4.46*
10				6.55	5.90	4.46
11				3.29	5.90	4.46
12					5.90	4.46
13					5.90	4.46
14					5.90	4.46
15					5.90	4.46
16					3.00	4.46
17						4.46
18						4.46
19						4.46
20						4.46
21						2.25

*Year to switch to straight line

Half-Year and Mid-Month Conventions

MACRS, like ACRS, provides for a half-year convention in the year placed in service regardless of the recovery option chosen. Unlike ACRS, 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 and 31.5-year classes is subject to a mid-month convention in the year placed in service.

Alternative MACRS Depreciation

Alternative MACRS depreciation is required for some types of property and is a straight line system based on the alternative MACRS recovery period. Farmers who are subject to capitalization of preproductive expenses, discussed more fully later, may elect to avoid capitalization but if they do so they must use alternative MACRS on all property. The recovery periods are, in general, the ADR midpoint lives.

Election to Expense Depreciable Property

The Section 179 expense deduction is continued under MACRS but jumps to $10,000 in 1987 rather than the $5,000 under ACRS (which was scheduled to increase to $10,000 by 1990). The $10,000 will be phased out for any taxpayer who places over $200,000 of property in service in any year. At $210,000 the Sec. 179 election is completely phased out.

The amount of the Section 179 expense election is limited to the amount of taxable income of the taxpayer that is derived from the active conduct of a trade or business during the year. Taxable income for the purpose of this rule is computed without regard to the Section 179 deduction. Any disallowed Section 179 deductions are carried forward to succeeding years.

Gains from the sale of Section 179 assets are treated just like Section 1245 gains. The amounts expensed are recaptured as ordinary income in the year of sale. The Section 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, the Section 179 expense recapture is invoked no matter how long the property was held for business use.

With the repeal of federal investment credit effective for 1986, only the New York IC will be lost when Section 179 is used. This makes Section 179 a more attractive and important tax management option for 1987 and future tax years. Every farmer who has purchased MACRS property in 1987 should consider the $10,000 expense deduction. It should not be used to reduce taxable income below the 1987 standard deduction unless an additional reduction in 1987 self-employment income is worth more than depreciation in a future tax year. Also, the taxpayer must be sure not to use more 179 deduction than the amount of taxable income from the conduct of an active trade or business.

Mid-quarter Convention

If more than 40 percent of the year's depreciable assets (other than 27.5 and 31.5-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. The assets placed in service during the last quarter will earn only 12.5 percent rather than 50 percent of a year's depreciation. The

determination of whether the mid-quarter convention applies is made before the Section 179 deduction is made. It appears that once the determination is made that the mid-quarter convention applies to the taxpayer, the Section 179 election could be applied to the property acquired in the last quarter to minimize the impact of the mid-quarter convention.

Example: Ed placed $100,000 worth of property in service during 1987. If this was all 7-year property, 1987 depreciation would be $14,286. But if $50,000 of the property was placed in service in the last quarter, Ed would be subject to the mid-quarter convention rules. Depreciation of the $50,000 would be $1,785. If the remaining $50,000 had been placed in service during the second quarter, it would be depreciated using a mid-quarter convention in that quarter and depreciation would be $8,925. Total depreciation would be $8,925 + $1,785 = $10,710 vs. the $14,286 that would have been available had not the mid-quarter convention been triggered.

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. Taxpayers do not have the option to establish subdivisions of a property class. For example, if a farmer purchased a new tractor, a silo, and built a dairy barn in 1987, all belong in the 7-year property class. The farmer may not recover the tractor over seven years with rapid recovery and the single purpose agricultural structure over seven years with SL. However, the taxpayer may choose a different recovery option for property in the same MACRS class acquired in a subsequent year. For example, a farmer could choose fast recovery for a farm auto purchased in 1987 (5-year property) but choose straight line for five years for a pickup truck purchased in 1988. Keep in mind that fast recovery would be used on any other 5-year property purchased in 1987 and the straight line option used on the pickup would be required on all 5-year property purchased in 1988.

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 seven years on 7-year property, and straight line for 20 years on 20-year property.

Anti-Churning Rules

A set of anti-churning rules are designed to prevent a taxpayer from taking advantage of MACRS on property first acquired and placed in service under ACRS. Usually, MACRS will result in slower writeoff so there is no incentive to churn, but there are exceptions. For example, property that was 5-year ACRS and is now 5-year MACRS property will get a faster writeoff under MACRS.

Some Special Rules on Auto and Listed Property

There are special rules for depreciation on automobiles and other "listed property" acquired after June 18, 1984. TRA of 1986 changed the depreciation allowance for "luxury" autos (see discussion on page 20).

Additional Rules

Accelerated depreciation in excess of 150 percent becomes an income adjustment subject to inclusion in alternative minimum taxable income.

Salvage value is disregarded when computing MACRS recovery. MACRS rules allow half a year's deduction in the year of disposition of property acquired after December 31, 1986. Recovery may be claimed in the year of disposition (based on the months held in that year) on 27.5 and 31.5-year property.

Gain to the extent of MACRS deductions whether rapid or SL on all Section 1245 3, 5, 7, 10 and 15-year MACRS property is ordinary income. Property in the 20-year class will be eligible for capital gains treatment if straight line recovery is used. However, this is of dubious value unless special treatment for capital gains returns.

The costs of leasehold improvements are recovered under the same rules that apply to an owner of property.

Choosing Recovery Options

Taxpayers will always be better off using rapid recovery on 3, 5, 7, 10, and 15-year MACRS property, assuming the recovery deductions can be used to reduce taxable income and do not create an AMT adjustment that results in AMT liability. The taxpayer who will not be able to use all the deductions in the early years may want to consider one of the straight line options.

With the loss of the 60 percent capital gain exclusion (January 1, 1987), a major reason for avoiding fast MACRS recovery on 20-year property no longer exists. The use of straight line depreciation will not give preferential treatment to gains from sales. When depreciable property is sold after December 31, 1986, the entire gain will be ordinary income regardless of the depreciation method used. The excess of rapid recovery over straight line depreciation on real property is still subject to the alternative minimum tax. 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. The scheduled reduction in tax rates for 1988, increase in exemptions, and time value of money make 1987 depreciation more valuable than that used in later years. However, depreciation claimed to reduce taxable income below the standard deduction is depreciation wasted.

ACRS Recovery Percentages

Recovery percentages for ACRS property commonly held by farmers are shown in the following tables.

FAST (REGULAR) RECOVERY PERCENTAGES FOR ACRS 3, 5, & 10-YEAR PROPERTY

	Type of Property		
Recovery Year	3-Year	5-Year	10-Year*
	percentage		
1	25	15	8
2	38	22	14
3	37	21	12
4	--	21	10
5	--	21	10
6	--	--	10

*Nine percent for recovery years 7 through 10.

FAST (REGULAR) RECOVERY FOR ACRS 19, 18, AND 15-YEAR PROPERTY EXCEPT LOW-INCOME HOUSING

Recovery Class	Recovery Year	Month in First Year the Property is Placed in Service											
		1	2	3	4	5	6	7	8	9	10	11	12
		The applicable percentage is:											
19 yrs.	1	8.8	8.1	7.3	6.5	5.8	5.0	4.2	3.5	2.9	1.9	1.1	0.4
	2	8.4	8.5	8.5	8.6	8.7	8.8	8.8	8.9	9.0	9.0	9.1	9.2
	3	7.6	7.7	7.7	7.8	7.9	7.9	8.0	8.1	8.1	8.2	8.3	8.3
	4	6.9	7.0	7.0	7.1	7.1	7.2	7.3	7.3	7.4	7.4	7.5	7.6
	5	6.3	6.3	6.4	6.4	6.5	6.5	6.6	6.6	6.7	6.8	6.8	6.9
	6	5.7	5.7	5.8	5.9	5.9	5.9	6.0	6.0	6.1	6.1	6.2	6.2
	7	5.2	5.2	5.3	5.3	5.3	5.4	5.4	5.5	5.5	5.6	5.6	5.6
	8	4.7	4.7	4.8	4.8	4.8	4.9	4.9	5.0	5.0	5.1	5.1	5.1
18 yrs.	2	9	9	9	9	9	9	9	9	9	10	10	10
	3	8	8	8	8	8	8	8	8	9	9	9	9
	4	7	7	7	7	7	8	8	8	8	8	8	7
	5	7	7	7	7	7	7	7	7	7	7	7	7
	6	6	6	6	6	6	6	6	6	6	6	6	6
	7	5	5	5	5	6	6	6	6	6	6	6	6
	8	5	5	5	5	5	5	5	5	5	5	5	5
	9	5	5	5	5	5	5	5	5	5	5	5	5
	10	5	5	5	5	5	5	5	5	5	5	5	5
15 yrs.	3	9	9	9	9	10	10	10	10	10	10	10	10
	4	8	8	8	8	8	8	9	9	9	9	9	9
	5	7	7	7	7	7	7	8	8	8	8	8	8
	6	6	6	6	6	7	7	7	7	7	7	7	7
	7	6	6	6	6	6	6	6	6	6	6	6	6
	8	6	6	6	6	6	6	5	6	6	6	6	6
	9	6	6	6	6	5	6	5	5	5	6	6	6
	10	5	6	5	6	5	5	5	5	5	5	6	5
	11-15	5	5	5	5	5	5	5	5	5	5	5	5
	16	0	0	1	1	2	2	3	3	4	4	4	5

Reporting Depreciation and Cost Recovery

Form 4562 is used to report the Section 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 Section 179 expenses are combined on 4562 and entered on line 16 of Schedule F. However, partnerships will transfer the 179 expense election to Form 1065 rather than combining it with other items on 4562.

STRAIGHT LINE DEPRECIATION OPTIONS FOR ACRS 3, 5, 10, 15, 18, & 19-YEAR PROPERTY

Straight Line Option	1st Year	Intermediate Years	Last Year
3-year class options			
3 years	1/6	1/3 in each of next 2 years	1/6
5 years	1/10	1/5 in each of next 4 years	1/10
12 years	1/24	1/12 in each of next 11 years	1/24
5-year class options			
5 years	1/10	1/5 in each of next 4 years	1/10
12 years	1/24	1/12 in each of next 11 years	1/24
25 years	1/50	1/25 in each of next 24 years	1/50
10-year class options			
10 years	1/20	1/10 in each of next 9 years	1/20
25 years	1/50	1/25 in each of next 24 years	1/50
35 years	1/70	1/35 in each of next 34 years	1/70
15-year class options			
15 years	1/180 per mo.	1/15 in each of next 14 years	balance
35 years	1/420 per mo.	1/35 in each of next 34 years	balance
45 years	1/540 per mo.	1/45 in each of next 44 years	balance
18-year class options			
18 years	1/216 per mo.*	1/18 in each of next 17 years	balance
35 years	1/420 per mo.*	1/35 in each of next 34 years	balance
45 years	1/540 per mo.*	1/45 in each of next 44 years	balance
19-year class options			
19 years	1/228 per mo.*	1/19 in each of next 18 years	balance
35 years	1/420 per mo.*	1/35 in each of next 34 years	balance
45 years	1/540 per mo.*	1/45 in each of next 44 years	balance

*If acquired after June 22, 1984, use half this amount for the month of acquisition.

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 submit the complete list of items included in the taxpayer's depreciation and cost recovery schedules.

One important reason for adequate depreciation records is the computation of any depreciation or cost recovery recapture upon the disposition of property used in the farm business. This requirement is discussed elsewhere in the manual in more detail.

LUXURY AUTOS, LISTED PROPERTY, AND SUBSTANTIATION OF BUSINESS EXPENSES

Depreciation and Investment Credit for Luxury Automobiles

The 1986 Act placed additional restrictions on deductions for business automobiles which will be in the 5-year MACRS class. The limits apply to autos and other 4-wheeled vehicles manufactured primarily for use on public streets, roads, and highways weighing 6,000 pounds or less (unladen); placed in service after 1986 and used over 50 percent for business. The limit on depreciation for passenger vehicles placed in service after 1986 will be $2,560 for the first year, $4,100 for the second year, $2,450 for the third year, and $1,475 for each succeeding year. If business use is less than 100 percent, the depreciation deductions will be reduced proportionately. If business use drops to 50 percent or less, the difference between the depreciation taken and depreciation with straight line over 5 years must be recaptured. The $2,560 first year limit also applies to the Section 179 expense election.

For vehicles placed in service after April 2, 1985 and before January 1, 1987, IC was limited to $675. If the reduced IC was elected rather than the reduced basis, the IC limit was $450. Depreciation or the Section 179 deduction was limited to $3,200 in the first year and $4,800 in later years.

For vehicles placed in service after June 18, 1984 and before April 3, 1985, Investment Credit was limited to $1,000 unless the taxpayer elected the reduced IC, in which case IC was limited to two-thirds of what it would otherwise be. The ACRS deduction was limited to $4,000 the first year (Section 179 election was also limited to $4,000) and $6,000 for succeeding years. The limits applied <u>before</u> the percentage allocation to business versus personal was made.

Property Not Predominately Used in a Business (Code Section 280F)

The pre-1987 rules on "listed property" continue to apply to listed property placed in service after 1986. If the more than 50 percent test is met MACRS depreciation will be allowed on the income producing portion of the property subject to the caps discussed above. Use of the property for the production of income (not from a trade or business) can be counted in determining the amount eligible for ACRS, but not for meeting the more than 50 percent test.

If the more than 50 percent test is met in the year the property is placed in service, but not met in a subsequent year, there will be recapture of depreciation and Section 179 expense election in excess of that which would be allowable under the applicable straight line method.

Autos not used more than 50 percent for business must be depreciated with 5-year straight line including the half year convention in the year placed in service. The depreciation and 179 caps discussed above also apply and are applied before the business versus personal allocation is made.

Substantiation of Business Expenses

For tax years beginning after 1985, the Section 274(d) rules as revised by the 1985 law, apply to local travel and to listed property as defined in Section 280F(d)(4) as well as to the expenses covered by the substantiation rules in 1985 and earlier. In general, listed property includes automobiles, other property used as a means of transportation, property of a type generally used for purposes of entertainment, recreation or amusement, and computer or peripheral equipment.

Temporary regulations (1.274-5T and 6T) were issued in November 1985 relating to substantiation of expenses for listed property. For tax years beginning in 1986 and later, the taxpayer must be able to substantiate each item of expenditure by "adequate records" or "sufficient evidence corroborating his own statement". A contemporaneous log is not required but a record of expenses and the business purpose made at or near the time of expenditure, supported by documentary evidence has a degree of credibility not present with a statement prepared later.

It is not possible to state exactly what records and substantiation are required to establish that the expenditure was made and the business purpose for it, but a combination of a log and receipts normally would be required. A cancelled check alone will not be sufficient in many cases.

In the absence of "adequate records", what constitutes "sufficient evidence ...." seems to be rather vague. In some cases, records from a sample of the week, month or year may be sufficient.

Form 4562 asks the following questions: Do you have evidence to support the business use claimed? If yes, is the evidence written? There are several questions about each vehicle and several questions for employers who provide vehicles for use by employees.

There is a rather long list of vehicles that are specifically exempted from the automobile rules: Combines, flatbed trucks, cement mixers, refrigerated trucks, etc. Pickups are not exempt.

The substantiation requirements do not apply to certain vehicles used in connection with the business of farming if no more than 75 percent of the total costs of the vehicle are deducted as a farm expense. If the vehicle is also available for personal use by employees, the value of the personal use must be included in the employee's gross income.

Personal Use by Employee of Employer Owned Vehicles

If an employer has a written policy that prohibits personal use of company owned vehicles but requires (for bonafide noncompensatory business reasons) that the vehicle be used for commuting, then the substantiation rules of 274(d) do not have to be met with respect to such vehicles. But, the value of the use of the vehicle for commuting must be included in the employee's income.

RESIDENTIAL ENERGY CREDITS

The Tax Reform Act of 1986 did not extend residential energy credits that expired in 1985. Unused credit can be carried forward through taxable years ending before January 1, 1988. To claim the carryover credit, the taxpayer must complete Form 5695. Residential energy credits are then claimed on the back of Form 1040. To be claimed, the credit must be at least $10.

CAPITALIZATION RULES AFFECTING FARMERS

The Tax Reform Act of 1986 requires farmers to capitalize (rather than expense) the costs of producing dairy and beef cattle replacements, fruit trees and vines, and other plants that have a preproductive period of more than two years. Capitalization rules take effect with tax years beginning in 1987. The decision on which set of capitalization rules to use this year and in future years must be made before 1987 returns are filed.

Dairy Farmers and Cattle Producers

Dairy farmers and cattle producers have little chance of surpassing the two year preproductive period requirement. The temporary regulations [Temp Reg. Sec. 1.263A-1T(c)(4)(ii)(B&C)] define the preproductive period of replacement cattle. "The preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation." "The preproductive period ends at the time the animal is ready to perform the primary function intended to be performed by that animal." (i.e., when a heifer calves). The General Explanation of the Tax Reform Act of 1986 prepared by the staff of the Joint Committee on Taxation includes the following example: -- *"the preproductive period of a cow to be used for breeding or dairy purposes would begin when the cow is conceived and end when it drops its first calf."*

The intent of Congress was to have the preproductive period begin before birth so that some of the tax shielding advantages previously available to cattle breeders would be eliminated. These included expensing the costs of embryo transplanting, implanting, etc. Unless and until the preproductive period is redefined in final regulations, assume it begins at the date of acquisition for purchased replacements and at the date of the dam's conception for raised replacements.

Dairy and beef cattle producers who raise replacements will find it essentially impossible to be excluded from capitalization by claiming a preproductive period of less than two years. The remaining options are to accept and use one of the approved methods of capitalization or to use the alternative depreciation system for all depreciable assets placed in service beginning with 1987.

Capitalization of Preproduction Period Expenses

A farmer who accepts capitalization will deduct the costs of growing replacement heifers from expenses normally reported on Schedule F, accumulate these costs for the duration of the preproductive period, and recover the capitalized costs through depreciation once the animal begins production. When the animal is sold or removed from the herd, it will be a Section 1245 transaction and the unrecovered capitalized costs become the basis. Gain to the extent of depreciation claimed becomes ordinary income. If the animal is held for two years or more, additional gain is capital gain without exclusion and losses are treated as capital losses. Section 1245 gains and losses do not affect self-employment income.

The temporary regulations do not include specific dollar amounts or guidelines that farmers may use to establish costs of production. The capitalization rules "apply to all costs incurred in connection with the production of real and personal tangible property". In other words, the cattle producer is expected to allocate a reasonable percentage of all applicable Schedule F expenditures to the cost of producing replacements. Few if any farmers keep the detailed enterprise records that would enable an actual accounting of the costs of production

and most would be unable to determine reasonable estimates. Fortunately IRS provides two alternative inventory methods.

The temporary regulations permit the use of "the farm price method" and "the unit-livestock method" in establishing the costs of producing dairy or beef cattle replacements. The farm price method is the same as using current market values or prices (e.g., fresh dairy heifers might be priced at $900, bred heifers $600, etc.). Values would vary from year to year with changes in market prices.

The unit-livestock method is based on the average cost of raising an animal in a particular class. The costs assigned may be based on reasonable estimates that approximate the costs of raising replacements to various stages of maturity. This method would be preferred by most farmers if acceptable cost estimates were lower than market values.

The unit-livestock method is currently used by some farmers to value inventories for accrual accounting. When used for inventory valuation, unit prices and classifications are subject to IRS approval upon examination of the farmer's return. Once selected, the classes and values can be changed only with IRS approval.

Cost of Production Guidelines

IRS will not publish specific cost of production estimates that dairy and beef farmers may use to determine preproductive period expenses. Taxpayers electing the unit-livestock method will have to be prepared to defend the numbers they use.

The best evidence will be records that show how much the taxpayer spent and allocated to raising replacements. Our estimates of the Schedule F costs of raising dairy heifers from 0 to 25 months indicate a range of $400 to $800 may be reasonable. Farmers at the low end of this range will be those with little or no hired labor associated with the youngstock enterprise, low amounts of borrowed capital, little depreciation, and low feed costs. Farmers at the upper end of the range will have hired labor and possibly paid management involved with raising heifers. The high cost enterprise may be supported with a substantial investment in new depreciable assets and borrowed capital.

Once a reasonable estimate of the cost of raising a heifer to freshening age is established, the farmer must select a method of determining the total annual preproductive expenses for the entire youngstock herd. Two methods have been suggested.

1. Divide the total estimated cost of raising a heifer by the average age at freshening (months) to determine the average monthly cost. Multiply the average monthly cost by the number of heifer months for the current year, e.g. $600 ÷ 25 months = $24 x 1,000 heifer months = $24,000. This method is based on the assumption that there is no appreciable difference in the monthly cost of raising heifers in the first and second years.

2. Make different cost estimates for raising heifers to freshening age to 12 months of age and 3 months of age. If it costs $600 to raise a heifer to 25 months, $300 to 12 months, and $100 to 3 months,the monthly costs of raising each class can be readily determined, e.g. $600 - $400 = $200 ÷ 14 months = $21.43/month for months 12 through 25, $300 - $100 = $200 ÷ 8 months = $25.00/month for months 4 through 11, etc.

Market Value Guidelines

Taxpayers who elect the farm-price method must rely on market prices less estimated direct costs of disposition to determine preproductive period expenses. IRS suggests using current prices at the nearest livestock market. Average market prices published by the State Crop Reporting Service are likely to be accepted. However, the price of milk cow replacements, ($860, September 1987), is the only relevant price available. Prices of yearlings and calves would have to be estimated or determined independently. Direct disposition costs include hauling and commissions.

Additional Problems

Here are several additional problems associated with capitalizing preproductive period expenses:

1. There is no designated line on Schedule F to exclude preproductive period expenses. Adjustments to farm deductions must be made before entering them on Schedule F or a total adjustment must be entered on line 35.
2. It will be difficult for some farmers to determine how many animals to capitalize. To be practical, a replacement animal cannot be inventoried until it is born. Only heifers held for replacements should be counted. Bulls are placed into service in less than 24 months. Heifers raised and sold as yearlings are excluded from capitalization rules.
3. Replacements placed in production during 1987, 1988, and 1989 will have a different basis for cost recovery. Only those born on or after January 1, 1987 will accumulate a full cost basis (e.g. 25 months @ $24 = $600). Animals freshening in 1987 may average six months of accumulated costs. Raised animals placed in production in 1988 may average 18 months.
4. All raised dairy and beef cattle replacements must be placed on the depreciation schedule. DDB MACRS will lead to additional accounting and potential AMT income adjustment.
5. The Section 179 expensing election is apparently not available for recovering capitalized preproductive period expenses.

Alternative Depreciation

Most farmers may elect out of capitalizing preproductive period expenses by selecting the alternative MACRS depreciation system. The alternative system requires longer asset lives, straight line depreciation, and affects all depreciable farm assets placed in service starting with 1987. Large corporations, large partnerships, and certain tax shelters already required to use accrual accounting cannot elect out of capitalization.

If a farmer elects to use the alternative system it must be used in all the farming businesses owned by the taxpayer and those owned by his or her spouse and children under age 18. This means that a farmer owning a dairy, cash crop, and poultry business must place all newly acquired depreciable assets on the alternative system if he or she elects not to capitalize. A large crop farmer who owns a small breeding herd must elect to use or not to use it for the entire farming operation, not just the cattle enterprise.

Making the Election

The election must be made in the first year after 1986 that the farmer engages in a farming business. In other words, all current farmers must make

their decision to capitalize or use alternative MACRS before the 1987 return is filed. This will be particularly difficult for the farmer who does not have any 1987 expenses subject to capitalization.

The election not to capitalize preproductive period expenses is made by checking the appropriate "yes" box on top of Schedule F or E. If the farmer ignores the election and does not capitalize preproduction expenses on the 1987 return, he or she will be deemed to have elected out of capitalizing preproductive expenses. The farmer with no current preproductive period property could be inadvertantly locked into alternative MACRS for the rest of his or her farming career. Unless this provision is changed all farmers need to make a well informed decision concerning capitalization on their 1987 returns. Once the election to use the alternative system is made the farmer is locked into it. It is revocable only with the consent of the commissioner.

Farm taxpayers who elect to use alternative MACRS are not exempt from the Section 1245 property rules when they sell raised dairy and breeding livestock. Any gain to the extent of preproductive period costs that would have been capitalized without the election, must be recaptured as ordinary income when the animal is sold. This rule will cause no additional tax liabilities for farmers under the TRA of 1986 unless the 28 percent tax bracket is exceeded in 1987.

After 1987 it will make little difference whether the 1231 gain is subject to recapture or is Schedule D income unless the rules are changed.

Tax Management Implications

Dairy farmers and beef cattle producers currently raising replacement cattle must capitalize the costs of raising these animals or elect to use the alternative MACRS depreciation system starting this year.

Both options cause a substantial delay in cost recovery which produces an increase in taxable income and additional taxes for dairy farm businesses. The option to capitalize the costs of raising heifers results in an additional income and self-employment tax liability spread over a seven year adjustment period. The option to elect the alternative depreciation system produces additional income and social security taxes over an adjustment period of 16 years or more.

The following conditions make the alternative MACRS option appear more favorable:

1. High preproductive period costs per replacement.
2. A relatively high ratio of raised heifers per cow.
3. A relatively low ratio of depreciable assets purchased to annual costs of raising replacements.
4. Combined average tax rate in years 1 and 2 greater than in 3 through 7.
5. Dairy farming is primary farm enterprise.

The following conditions make the capitalization option more favorable:

1. Ratio of depreciable assets purchased to annual costs of raising replacements is high (e.g., low preproductive period costs, low heifer to cow ratios and/or high capital purchases).
2. Combined average tax rates in years 1 and 2 less than in years 3 through 7.
3. Non-dairy enterprises are a substantial part of the farm business.

Animals, including dairy heifers, purchased for resale by a farmer with not more than $10 million of gross receipts are not subject to capitalization. The temporary regulations apparently exclude cattle purchased for replacements if they freshen within two years of purchase. This will generate new interest in selling calves and buying replacements as a tax management strategy.

Fruit Growers and Nurserymen

"The preproductive period of a plant 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." [Temp. Reg. 1.263A-1T(c)(4)(ii)(B)].

"The preproductive period of plants grown in commercial quantities in the U.S. shall be based on the weighted average preproductive period for such plant, determined on a nationwide basis." [Temp. Reg. 1.263A-1T(c)(4)(ii)(D)].

Plants subject to capitalization rules will include fruit trees, vines, ornamental trees and shrubs, and sod providing the preproductive period is 24 months or more. An evergreen tree which is more than six 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 costs of replacement trees and vines do not have to be capitalized.

Suggestions for Growers

The costs of trees, vines, and plants that do not reach the productive stage for two or more years have always been subject to capitalization. Growers have had the option to capitalize all preproductive period expenses under the old law but few used it.

Fruit growers who choose to capitalize will need to establish reasonable estimates of the preproductive costs of trees and vines. The farm-price method would be difficult for growers to apply but could be used by nurserymen to establish their preproductive costs of growing trees, vines, and ornamentals.

Capitalization will delay the recovery of orchard, vineyard, and ornamental tree preproductive period expenses for 15 years. Small fruit plants and related expenses subject to capitalization may be depreciated in seven years.

If growers elect alternative MACRS the cost of trees and vines are still subject to depreciation (20 year straight line). Only the preproductive period growing costs may be expensed.

Capitalization Rules Applied to Nonfarmers

In general, all costs that are incurred in the production of real or tangible personal property, or in acquiring property for resale, are to be capitalized by taxpayers with average annual gross receipts of $10 million or more. Intangible oil and gas well drilling costs are excluded and there are other exceptions.

DAIRY TERMINATION PROGRAM PAYMENTS

TRA of 1986 preserved the 60 percent capital gain exclusion for otherwise eligible cattle sold before September 1, 1987 as part of the Dairy Production Termination Program. (The Technical Corrections Bill will change the date to October 1, 1987.)

Questions concerning the acceptable date of sale have been raised by DTP participants who received herd sales proceeds after September 1987. If the dairy farmer met the conditions of his or her DTP contract by disposing of the entire dairy herd on or before September 30, 1987, he or she sold the herd within the specified period of time.

IRS notice 87-26 released February 27, 1987 provides Dairy Production Termination Program participants an opportunity to report part of the government payments received for not producing milk on Form 4797 rather than 1040F. The amount of the DTP government (CCC) payment that may be shifted from 1040F to 4797 is the value of the dairy herd lost from selling it for slaughter rather than for dairy purposes. Although notice 87-26 refers specifically to 1986 returns, we will apply it to 1987 and future years. DTP farmers who sold their dairy herds in 1986, and filed their 1986 returns without making the CCC income adjustment must file amended returns to take advantage of this provision. The potential tax savings will come from switching ordinary income to capital gain and reducing self-employment income.

It is possible that some DTP farmers may not benefit from both of these tax savings opportunities. This can occur when the alternative minimum tax exceeds the regular income tax or self-employment income is not reduced below the maximum earnings base. The 60 percent capital gains exclusion will not trigger 1987 AMT because it is no longer a tax preference income item to be included in AMTI.

IRS will accept "USDA Agricultural Prices" as evidence of the value of the dairy herd. The applicable average New York milk cow prices are shown below. Although IRS provides no guideline for determining values of calves and heifers, they should be included in the calculation.

Average 1987 Monthly New York Milk Cow Replacement Prices

Month	Price	Month	Price	Month	Price
January	$790	April	$830	July	$860
February	$790	May	$840	August	$860
March	$810	June	$850	September	$860

Source: New York Crop Reporting Service.

IRS does not prohibit a DTP farmer from using dairy values higher than those reported in "Agricultural Prices". If higher prices are used, the DTP taxpayer must gather specific evidence to justify them. Prices from two or more local comparable herd dispersals probably would be acceptable.

The recommended way of reporting the CCC income, identified as compensation for selling the herd at slaughter prices, is to include it in the price received for the cattle. Report each class of cattle on 4797 at its dairy replacement value. The balance of the CCC payments are Schedule F income. A note of explanation showing the calculation of this balance should be included on Schedule F.

The once active DTP farmer must report all future DTP payments (net of compensation for reduced cattle values), as Schedule F and self-employment income even when no longer self-employed.

TAX TREATMENT OF GENERIC COMMODITY CERTIFICATES AND RELATED CCC LOAN TRANSACTIONS

The 1986 and 1987 wheat and feed grain programs provide for issuance of generic commodity certificates denominated in dollars to farmers who participate in these programs. The certificates may represent either set aside payments or deficiency payments.

The taxability of the value of the certificates is rather complicated due to an interaction with Commodity Credit Corporation (CCC) loan transactions. The situation has been made even worse by USDA regulations issued in October 1986 and Revenue Ruling 87-17 issued in February 1987, but revoked in October 1987.

CCC Loans

A taxpayer may place grain under CCC loan, using the grain as security. The taxpayer has the option of treating the loan as income in the year the loan is received. Once he has elected this option, in the future he must continue to treat all CCC loans as income in the year received. Under this option, the amount of the CCC loan that is reported as income becomes the basis of the grain. When the grain is sold, he will have either gain or loss to report, depending on whether the grain is sold for more or less than the basis.

If the taxpayer does not elect to report the loan as income, there is no income to report until the grain is sold. The taxpayer has the option of forfeiting the grain to CCC in return for cancellation of the loan. Normally, a taxpayer would forfeit only if the market price of grain never exceeded the loan rate during the period of the loan which is usually nine months. There is also a three year reserve program. If the grain is forfeited, the amount of the loan becomes income to the taxpayer at the time of forfeiture.

Income From Certificates

The producer has several options for disposing of a generic certificate:

1. Cash in the certificate for face value at the ASCS office within 10 working days of the first transfer deadline.

2. Sell the certificate to someone else. The proceeds may be more or less than the certificate's face value, but in general the certificates sell at premium.

3. Use the certificate to redeem grain from previous years stored under CCC loan.

4. Put current year grain under loan, receive the current loan rate and redeem it immediately using certificates. This is sometimes called "PIK and roll."

Under option (1), if the certificate is cashed in the year received, the face value of the certificate (less any Gramm-Rudman reduction) will be reported as income. Under option (2), the face value of the certificate would be reported as income in the year received and the premium would be reported as income in the year that the certificate is sold. Under options (3) and (4), the value of the certificate will be reported as income in the year received. In addition there will be tax consequences related to the loan paid off when the grain is redeemed and to the sale of the grain. The tax consequences will differ depending on whether the taxpayer had included the loan in income the year the loan was received.

Unfortunately, for 1986 returns the tax consequences also depended on whether one adhered to USDA regulations and Revenue Ruling 87-17. The USDA issued regulations in October 1986 relative to the payment of CCC loans with commodity certificates. The regulations provide that there is (1) a CCC loan; (2) a sale of the grain under loan to CCC at the loan price per bushel; (3) a repayment of the loan with the sale proceeds and (4) a repurchase of the grain by the farmer with the certificates. However, the procedure actually followed in the ASCS offices appears to be that the farmer received the loan and then paid it off with the certificates. There was no sale and repurchase. Only those farmers who have elected to report the loan as income should have taxable income from the transaction. Many knowledgeable agricultural tax specialists believe that the "sale" created by the USDA regulations is fictional.

The IRS, relying on the USDA regulations, issued Revenue Ruling 87-17 which in effect makes the loan proceeds taxable in the year the grain is redeemed with certificates. For a farmer who had sold his 1985 grain in 1986 and then was required to report the CCC loan payoff and redemption on 1986 grain as income in 1986, the result is a doubling up of income and potentially a substantial tax bill in 1986 even though he did not sell the redeemed grain in 1986. The same problem could have existed in 1987.

The USDA regulations apparently were designed to prevent farmers from being assessed a CCC penalty for taking grain out of the three year reserve. In solving that problem, which did not apply to grain under nine month loans, a tax problem was created for all farmers who do not treat CCC loans as income.

Apparently many taxpayers did not follow the USDA regulations and Revenue Ruling 87-17 when they filed their 1986 returns. They were faced with filing amended returns and paying additional tax or delaying in hope that administrative or legislative action would alter the USDA regulation. The delay proved to be the best strategy because IRS, after being nudged by taxpayers and Congress, issued Revenue Ruling 87-103 in October 1987.

Tax Treatment Under USDA Regulations and IRS Ruling 87-103

In a situation where the certificate is used to redeem grain under CCC loan, the producer will be concerned about the tax treatment of the certificate, the tax treatment of the loans and the tax treatment of the commodity. We will first assume that the loan was not treated as income in the year that it was received.

Example: C.G. has 20,000 bushels of 1986 corn under loan at $2.00 per bushel = $40,000. A certificate worth $9,000 was received in 1986. C.G. redeems part of the corn (6,000 bu.) at the posted county price (PCP) of $1.50. This reduces the loan by 6,000 x $2.00 = $12,000. Note that the loan is reduced by $3,000 more than the value of the certificate. C.G. then sold the corn in 1987 for $1.60 per bushel x 6,000 = $9,600.

C.G. will report the $9,000 certificate as income on his 1986 tax return. The difference between the amount of loan canceled and the value of the certificate ($12,000 - 9,000 = $3,000) is reported as 1986 income. When the corn is sold in 1987, there will be $9,600 income from the sale of corn. The total income reported will be $9,000 + 3,000 + 9,600 = $21,600 (plus the sale of the remaining corn).

Now assume that the $40,000 loan had been reported as income. We are primarily interested in the loan on the 6,000 bushels that were redeemed. The basis of those bushels is 6,000 x $2.00 = $12,000. When this grain is sold for

$1.60 per bushel = $9,600 there will be a loss of $12,000 - $9,600 = $2,400. Total income reported will be the $9,000 certificate + $12,000 loan included in income + $3,000 excess of the loan cancelled over the value of the certificate - $2,400 loss = $21,600 (plus the sale of the remaining corn).

If the transactions in the C.G. example occur with respect to 1987 rather than 1986 corn, the tax results will be the same as those described above under the two methods of reporting.

Tax Treatment of Purchased Certificates

It is legal to sell generic certificates and many of them have been sold at a premium over the face value. The purchaser of a certificate has a basis equal to the purchase price, not the face value. If the purchased certificate is used to redeem CCC grain, the tax consequences are similar to those described above. However, if the certificate was purchased at a premium it will have a basis higher than the face value and this will affect the gain or loss when the certificate is used to pay off the CCC loan. In the example above, suppose that C.G. had purchased the $9,000 certificate for $10,000. When it was used to pay off the $12,000 loan, there was a gain of $2,000 rather than $3,000.

GENERAL BUSINESS CREDIT

Effective for tax years beginning after December 31, 1983, "regular" investment credit (repealed January 1, 1986 except for a few items), business energy investment credit, targeted jobs credit, alcohol fuels credit, and ESOP credits are all part of Section 38, General Business Credit. In 1986 and later, the credit allowable is limited to tax liability up to $25,000 plus 75 percent of the taxpayer's net tax liability exceeding $25,000. Special rules apply to married individuals filing separate returns, controlled groups, certain persons (Section 46(e)(1)) and estates and trusts.

FEDERAL INVESTMENT CREDIT

Investment Credit

The regular investment credit was repealed for property placed in service after December 31, 1985 unless there was a binding contract in effect on that date (transition property). Investment credit carryovers from 1985 and earlier years may still be used but only 82.5 percent of that left over from 1986 may be carried to 1987 and 65 percent of that left after 1987 may be carried to 1988 and later years. This applies to taxpayers with a calendar year. For noncalendar year taxpayers, the limitation on carryovers will be calculated by a formula that reflects the portion of their tax year that falls after July 1, 1987.

For transition property, investment credit will be allowed according to the following schedule:

ADR Class Life	Property must be placed in service by:
Less than 5 years	June 30, 1986
5 or 6 years	December 31, 1986
7 to 19 years	December 31, 1988
20 years or more	December 31, 1990

If investment credit is claimed on transition property, the basis for depreciation must be reduced by 100 percent of the investment credit.

The material included here on the regular investment credit is largely for background on understanding investment credit for purposes of handling carryovers and recapture.

Until 1986, federal investment tax credit was one of the most important features of farm tax reporting and tax management. The regular credit (Sec. 45(a)(1)) was 10 percent of the amount of qualified investment. There are more liberal allowances for rehabilitated buildings and they remain in effect for 1986 and later years. The credit is a direct reduction against income tax liability. If the credit 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 credit claimed is fully earned, the credit must be recomputed to determine the amount to recapture.

Form 3468 is used for computing the credit, but records showing credit claimed on individual property should be a part of the depreciation record. Filing a 3468 for every year that a taxpayer has investments in eligible property is the only way to claim the credit even though the potential credit may be used against another tax year. Copies of prior years' forms can be used to keep track of the running balance of credit available. Form 3800 is used for claiming carry forwards.

Rehabilitated Buildings

The credit for rehabilitated buildings was modified by TRA 1986. The rehabilitation credit is 10 percent for a qualified rehabilitated building and 20 percent for a certified historic structure. The building (other than a certified historic structure) must have been first placed in service before 1936. The new rules will apply to rehabilitated property placed in service after 1986. As usual, there are some transitional rules.

The basis for depreciation must be reduced by 100 percent of the investment credit claimed.

The rehabilitation must be "substantial", that is, qualified rehabilitation expenditures during the 24-month period ending on the last day of the taxable year must exceed the greater of the adjusted basis of the property or $5,000.

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. Furthermore, the credit is available for all types of buildings that are used in business or productive activities except buildings that are used for residential purposes. However, the credit may be earned on a certified historic structure that is 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.

A building will qualify for purposes of meeting Section 48(g)(1)(A)(iii) (the 75 percent rule) if:

(i) 50 percent or more of the existing exterior walls of the building are retained as exterior walls,

(ii) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls, and

(iii) 75 percent or more of the existing internal structural framework of such building is retained in place.

Unused Investment Credit

It is important to maintain an accurate accounting of investment credit. If allowable credit for the tax year exceeds the limitation based on tax liability, the unused credit should be carried back to offset tax paid in the three previous years, then carried forward to offset tax in 15 future years.

A special provision allows qualified farmers to elect to carry back a portion of existing IC carry forwards for as much as 15 years. The carry back is limited to the smallest of (a) 50 percent of existing carry forwards, (b) the taxpayer's net tax liability for the carry back period, or (c) $750. The carryback amount is not subject to the 17.5 percent 1987 reduction. The election must be made on the return for the first taxable year beginning after 1986. Knowledgeable tax specalists believe that $2 of IC is used up for each $1 tax saved by using the carryback election.

The amount of carryback allowed is treated as a payment of tax on the 1987 return.

The FIFO rule, in effect for tax years ending after 1975, provides that carry over credits are used first starting with the oldest, current year credits are used next, carry backs are used last starting with the oldest.

Carryovers to 1987 will be reduced by 17.5 percent and carryovers to 1988 will be reduced by 35 percent.

Recapture of Credit

Disposition of an asset before the expiration of the estimated useful life or the ACRS class life may result in recapture of part or all of the credit taken. A disposition occurs when the taxpayer ceases to own the property or uses it in a nonqualifying manner. Just about any method of disposing of the property requires recomputation and possible recapture. An exception occurs when the taxpayer dies. In that case, no adjustment is necessary.

To recompute the credit, substitute the actual years the asset was held for the estimated life (or the ACRS class life). If the recomputed credit is less than the credit actually used, the difference must be recaptured using Form 4255. If some of the credit originally claimed has not been used (is part of unused balance), reduce the unused balance. If acquisitions in more recent years have changed the balance of unused credits applicable to any year the unearned credit was used, those credits may be used to reduce the recapture.

The recapture provisions for ACRS property acquired after 1980 are different from those for qualified property acquired before 1981 and for post 1980 non-ACRS property. Disposition of non-ACRS property requires recomputation of investment credit if the property was held for a period which placed it in a life-category shorter than the category used in the original computation of investment credit.

The recapture for ACRS property depends on year-by-year calculations rather than on life-categories as used in non-ACRS property. The investment credit holding period for ACRS property depends on the date actually placed in service, not July 1 as assumed by the half-year convention for depreciation purposes.

Disposition of ACRS property requires recapture according to the percentages in the following table:

If the recovery property ceases to be Section 38 property within the period:	The recapture percentage is: For 15-year, 10-year and 5-year property	For 3-year property
One full year after placed in service	100	100
More than one but less than two full years after placed in service	80	66
More than two but less than three full years after placed in service	60	33
More than three but less than four full years after placed in service	40	0
More than four but less than five full years after placed in service	20	0

Examples of how to recompute investment credit to determine how much credit must be recaptured can be found in the Farmer's Tax Guide.

The recapture rule causes confusion in the case of farm property transferred between father and son or other related parties. Generally, when a father disposes of property on which he has taken investment credit by selling it to his son (or giving it to his son) the father must recompute the credit and the amount not earned will be recaptured.

Reforestation Expenditures

Effective January 1, 1980, a taxpayer may elect seven year amortization on up to $10,000 of qualifying reforestation expenditures each year. Under previous law, such expenditures were capitalized and recovered through a depletion allowance when the timber was harvested 15 or more years later. Under the new law, the taxpayer may also claim 10 percent investment credit on qualifying reforestation expenditures that could be amortized, even if the taxpayer does not amortize the expenditures. The credit does not apply to Christmas trees. The Tax Reform Act of 1986 does not put an end to investment credit for reforestation expenses.

FEDERAL BUSINESS ENERGY INVESTMENT CREDIT

The computation of the business energy credit is made on Schedule B, Form 3468, Business Energy Investment Credit.

Qualifying Energy Property

The Tax Reform Act of 1986 modified the percentages for qualifying energy property as follows, depending on the date placed in service:

-- Biomass property will receive a 10 percent credit during 1987 and no credit if placed in service after 1987.

-- Solar equipment will receive a 12 percent credit during 1987 and 10 percent 1988. Ocean thermal equipment will receive a 15 percent credit 1986 through 1988. Geothermal equipment will receive 10 percent in 1987 and 1988.

There are also some transitional rules.

Few farmers will be able to collect BEIC on property acquired after 1985. Active solar devices for either space heating or water heating would qualify under the solar category.

Property eligible for the business energy investment credit that is also ACRS property has the same rules for qualified investment and recapture that apply to regular investment credit on ACRS property. There are some special recapture rules for the business energy credit related to failure to make adequate repayments of loan principal.

Amount of Credit

The energy credit from 3468B is combined with the regular credit on 3468 and the total is subject to the limitations described on page 31 of this manual. If a taxpayer has one of the other credits in the general business credit group, Form 3800 will be required.

A REVIEW OF FARM BUSINESS PROPERTY SALES

The 1986 Tax Reform Act did not eliminate the distinction between gains from sales of property used in the farm business eligible for capital gain treatment and gains subject to recapture of depreciation. Therefore, it still is important to understand the difference between these two types of gains. Form 4797 will continue to be used to report sales of property used in the farm business.

In 1987 and later the 60 percent capital gain exclusion that was in effect in 1986 and earlier no longer applies (except for sales of dairy buyout cattle). In 1987, capital gains, including those from sales of 1231 property, will be taxed at the maximum rate of 28 percent.

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 farm business property. Schedule D is used to accumulate capital gains and losses. The 1987 Schedule D has been revised to reflect the elimination of the capital gains exclusion. 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.

1. Section 1231 - Includes gains and losses on farm real estate and equipment held at least six months, cattle and horses held 24 months, other livestock held 12 months, casualty and theft losses and other involuntary conversions, qualified sales of timber, and unharvested crops sold with farmland which was held six months. There are instances, however, when gain on livestock, equipment, land, buildings, and other improvements is treated specifically under Section 1245, 1250, 1251, 1252, and 1255.

   Note: For tax years beginning in 1986 and later, net Section 1231 gains are treated as ordinary income to the extent of unrecaptured net Section 1231 losses for the five most recent prior years beginning with 1982. In other words, a taxpayer that claimed a net Section 1231 loss on the 1982, 1983, 1984, 1985 or 1986 return and has a net Section 1231 gain for 1987, must recapture the losses on the 1987 return. Losses are to be recaptured in the order in which they occurred.

2. Section 1245 - This is the depreciation recapture section. Farm machinery, purchased breeding, dairy, draft and sporting 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 or cost recovery taken after 12/31/61 for equipment and 12/31/69 for livestock. Gain will also be ordinary income to the extent of Section 179 expense deductions and the basis reduction required after 1982.

   Tangible real property (except some Section 1250 buildings and their structural components) used as an integral part of farming is 1245 property. Single purpose livestock and horticultural structures are 1245 property if placed in service after 1980. Nonresidential 15, 18, and 19-year ACRS property becomes 1245 property if fast recovery has been used. Other tangible real property includes silos, storage structures, fences, paved barnyards, orchards and vineyards.

3. Section 1250 - Farm buildings and other depreciable real property held over six months and sold at a gain are reported in this section unless the assets are 1245 property. If other than straight line depreciation was used on

non-ACRS property, 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 non-ACRS real property to straight line depreciation without special consent.

If regular (fast) recovery has been used on ACRS 15, 18, and 19-year real property other than residential property, all gain due to depreciation or cost recovery will be ordinary income. In effect, this property becomes 1245 property. Again, no recapture of depreciation occurs when an ACRS straight line option is used.

The law allows a different ACRS option to be used on a substantial improvement than on the original building. If fast recovery has been used on either the building or a substantial improvement to it, gain will be ordinary on the entire building to the extent of fast recovery and any remaining gain will be capital gain. For residential real estate, gain will be ordinary only to the extent that fast recovery deductions exceed straight line on 15, 18, and 19-year property.

Corporate dispositions of ACRS real property after 1984 are subject to a recapture as ordinary income of 20 percent of straight line depreciation claimed.

4. Section 1252 - Gain on the sale of land held less than 10 years will be part ordinary and part capital gain when soil and water or land clearing expenditures after December 31, 1969 have been expensed. If the land was held five 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 five and less than 10 years, part of the soil and water and land clearing expenses will be recaptured. The percentages of soil and water conservation or land clearing expenses subject to recapture during this time period are: 6th year after acquisition of the land 80 percent, 7th year 60 percent, 8th year 40 percent, and 9th year 20 percent.

   Here is an illustration:

Farmland acquired, 1983 cost	$30,000
Soil and water expenses deducted on 1984 tax return	$2,000
Land was sold in 1987 for	$37,000

   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 $30,000. The gain of $7,000 would normally be all capital gain. But, the land was not held for more than five years, so the gain is divided; $5,000 qualifies as capital gain, $2,000 is ordinary gain.

5. Section 1255 - If government cost sharing payments for conservation have been excluded from gross income under the provisions of Section 126, the land improved with the payments will come under Section 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 percent for each additional year the land is held. There is no recapture after 20 years.

Livestock Sales

The majority of livestock sales in New York State 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 sold 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 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.

Breeding, Dairy, Draft or Sporting Livestock

Livestock held for breeding, dairy, draft or sporting purposes are classified into two groups according to length of holding periods:

1. Cattle and horses held two years or more, and other breeding livestock held one year or more. Animals in this group are 1231 livestock.

2. Cattle and horses held less than two years, and other breeding livestock held less than one year. These sales do not meet holding period requirements.

Most dairy animals will meet the two year holding period requirement. Major exceptions are raised youngstock sold with a herd dispersal and the sale of cows that were purchased less than two 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 1231 Livestock

Sales of 1231 livestock are entered in Part I or Part III of Form 4797. Since Part III is for recapture, only purchased 1231 livestock that produce a gain upon sale will be entered in Part III where they become 1245 property. Sales of raised 1231 livestock will be entered in Part I. This will include all raised cattle and horses two years of age and older that are held for breeding, dairy, draft or sporting purposes. All purchased 1231 livestock that result in a loss when sold are also entered in Part I.

Reporting Sales of Livestock Not Meeting Holding Period Requirements

Breeding, dairy, draft or sporting 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 two years of age and purchased cattle held for dairy or breeding but held for less than two years.

Tax Management Considerations

The holding period on livestock and depreciation and cost recovery recapture on purchased 1231 livestock will continue to have an effect on the amount of tax liability resulting from the sale of dairy and breeding livestock in 1987.

Taxpayers in a marginal bracket above 28 percent in 1987 will pay a maximum of 28 percent on gain treated as capital gain but will pay a higher rate on ordinary income due to depreciation recapture. Gains from eligible dairy buyout cattle will be eligible for the 60 percent capital gain exclusion.

Use of 4797 and Schedule D by Farmers

All sales of farm business properties (except casualties and thefts) are reported on form 4797 to separate 1231 gain and loss from recapture of depreciation, cost recovery, Section 179 expense deduction and basis reduction. Casualty and theft gains and losses are reported on 4684 and transferred to 4797.

If the 1231 gains and losses reported on 4797 result in a net gain, net 1231 losses reported in the prior five 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 4797 and then transferred to Form 1040.

SUMMARY OF REPORTING MOST COMMON FARM BUSINESS PROPERTY

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

INSTALLMENT SALES

The installment sale method of transferring ownership of farm business property continues to be an important business and tax management strategy. The proportionate disallowance rules included in TRA of 1986 do not apply to farm property. However, the loss of the 60 percent capital gains exclusion will affect all installment sale payments received after 1986.

Proportionate Disallowance Rule

The purpose of the new restriction on the use of installment sales is to prevent taxpayers from postponing recognition of gain on that portion of the sale that has been used as collateral to obtain cash. The proportionate disallowance rule is complicated because it is difficult to determine the exact relationship between a taxpayer's borrowings and installment sales.

Calculating allocable installment indebtedness (AII) is the main step in determining the amount of disallowance.

$$\text{Allocable Installment Indebtedness} = \left(\frac{\text{Outstanding Face Amount of (OFA) Applicable Installment Obligations}}{\text{OFA of all installment obligations} + \text{Adjusted basis all other assets}} \right) \left(\text{Taxpayers Indebtedness} \right) - \text{AII from prior years}$$

Applicable installment obligations are any installment obligations from (1) the sale of personal property reported on the installment method by a taxpayer who regularly sells such property on the installment plan; (2) the sale of real property held for sale to customers in the ordinary course of a trade or business; or (3) the sale of real property used in the taxpayer's trade or business or held for the production of rental income, provided the selling price exceeds $150,000.

The taxpayer's indebtedness is determined by calculating the actual dollar amount of indebtedness for each quarter and taking the average of the four quarters. All debt including accounts payable are to be included.

Example: S.S. Speculator has total installment obligations of $40,000 at the end of 1987. The face value of her only installment obligation subject to the disallowance rule is $20,000. Her basis in all other assets is $80,000 and her average quarterly indebtedness is $60,000. There is no installment indebtedness from a previous year.

$$\left(\frac{\$20,000}{\$40,000 + \$80,000} \right) \times \$60,000 - 0 = \$10,000$$

S.S. Speculator's allocable installment indebtedness is $10,000 and is treated as payment received in 1987.

Exemptions From the Rule

The following installment sales are not subject to the proportionate disallowance rule:

1. Installment sales before March 1, 1986.

2. Installment sales of property used or produced in the trade or business of farming including farmland, machinery, crops, livestock (held for breeding or slaughter).

3. Installment sales of real property used in the taxpayer's trade or business or held for the production of income if:
   a) the sale occurred before August 17, 1986 or
   b) The selling price is $150,000 or below.

4. Installment sales of undeveloped land held for investment only.

Other Non-Qualifying Sales and Exclusions

Property sold on a revolving credit plan may not be reported on the installment method. All payments must be reported in the year of sale. Publicly traded stocks and securities may not be reported using the installment method.

Recaptured depreciation does not qualify for the installment sale. For installment sales made after 6/6/84, that portion of the gain attributed to recaptured depreciation of Section 1245 and 1250 property must be excluded. The full amount of recaptured depreciation is reported as ordinary income in the year of sale regardless of the size of payments received.

The amount of recaptured depreciation reported as ordinary income in the year of sale is added to the property's basis for the purpose of computing the gross profit ratio. This adjustment is critical in order to avoid double taxation of installment payments.

Here is an example: Carl Cropper sells his corn drying facility (Section 1245 property) to M.W. Grainer for $90,000 on January 1, 1987. The adjusted basis was $50,000, total gain $40,000, depreciation claimed $30,000. Grainer will make five annual payments of $18,000 plus interest. Under the installment method, $30,000 of the $40,000 gain is recaptured depreciation and ordinary income for 1987. The $10,000 balance is capital gain, (Section 1231). Cropper's gross profit ratio is determined as follows: $50,000 adjusted basis plus $30,000 recaptured depreciation equals $80,000 installment basis. The $90,000 contract price less $80,000 installment basis equals $10,000 gain divided by $90,000 gives a gross profit ratio of 11.1 percent. The capital gain to report each year of the installment sale is $2,000 ($18,000 x 0.111). If the basis had not been increased by the amount of recaptured depreciation, the gross profit ratio could have been calculated incorrectly at 33.3 percent showing an annual reportable gain of $6,000.

Installment Sale Resale Rules

Every farm and business family should understand the installment sale resale rules before agreeing to a sales contract. Gain will be triggered for the initial seller when there is a second disposition by the initial buyer, and the initial seller and buyer are closely related. 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 two 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 two 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, or by any short sale.

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), 3) nonliquidating sales of stock to an issuing corporation. Closely related person would include spouses, parent, children, and grandchildren, but not brothers and sisters.

Imputed Interest Rules

Imputed interest rules applicable to certain debt instruments including installment sales are covered under IRC Section 1274 and Section 483. There are several special rules and numerous exceptions that complicate the understanding and application of imputed interest rules. Following is our understanding of the rules most applicable to farm business property installment sales made after 6/30/85.

1. All sales and exchanges after 6/30/85, where seller financing does not exceed $2.8 million, must have an imputed interest rate of the lesser of 100 percent of the AFR or nine percent (compounded semi-annually). The acceptable test or stated interest is the same.

2. Sales exceeding $2.8 million are subject to an imputed interest rate equal to 100 percent of the AFR.

3. The sales or exchanges of land between related persons, (brothers, sisters, spouse, ancestors or lineal descendants), must have a test or stated rate of six percent or interest will be imputed at seven percent. This rule applies to the first $500,000 of land between related people in one calendar year.

4. The imputed interest rules do not apply to the sale of personal use property, annuities, patents, and any other sale that does not exceed $3,000.

5. Imputed as well as stated interest can be accounted for on the cash accounting basis on sales of farms not exceeding $1 million and any other installment sale not exceeding $250,000.

The AFR (applicable federal rate) is the lower of the computed six-month rate or the monthly rate. The monthly rate can be the current month's rate or the lower of the two preceding months' rate. The September 1987 monthly AFR was 7.08 percent (short-term, not over three years), 8.15 percent (mid-term, three to nine years), 8.58 percent (long-term, over nine years).

ALTERNATIVE MINIMUM TAX

TRA of 1986 replaced the add-on minimum tax for corporations with a new alternative minimum tax, and expanded the AMT on individuals. The changes described here pertain to individuals unless indicated otherwise.

The 1986 revisions in AMT rules are extensive requiring more calculations and adjustments than under prior law. AMT will cause taxpayers and preparers some of their biggest headaches over the next year. The new AMT resembles a separate but parallel tax system. Separate calculations of many types of income and deductions including depreciation will be required for many taxpayers. The good news is limited. There will be no capital gains exclusion to include as tax preference income. Some taxpayers will receive postponement of tax benefits rather than permanent removal.

Higher Rates and Exemption Phaseout

The AMT flat rate has been increased from 20 percent to 21 percent. The basic exemptions remain unchanged. A new exemption phaseout reduces the exemption at a rate of 25 percent of AMT income exceeding specific levels. If the taxpayer's AMTI exceeds the exemption he or she will have an AMT liability.

Alternative Minimum Tax Exemption and Phaseout

Filing Status	Maximum Exemption	AMTI Phaseout Range	Phaseout Percent
Joint & qualifying widow(er)	$40,000	$150,000-310,000	25
Single & heads of household	30,000	112,500-232,500	25
Married filing separately	20,000	75,000-155,000	25

Alternative Minimum Taxable Income

The new AMTI is calculated by starting with taxable income rather than adjusted gross income. Income and deduction adjustments are then added rather than subtracted, and tax preference items are included.

Here are the adjustments that must be added to TI.

1. Standard deduction or
2. Certain itemized deductions from Schedule A including most medical deductions, miscellaneous deductions subject to two percent rule, state and local income taxes, the difference between qualified housing interest and residence interest.
3. Depreciation on personal property placed in service after 1986 that exceeds 150 percent declining balance using alternative MACRS years of life (i.e. 150 percent declining balance alternative MACRS depreciation is the fastest method allowed for calculating AMTI). There are some exceptions including property depreciated under the unit-of-production method, and property subject to transition rules for MACRS. The depreciation adjustment is the net difference between accelerated MACRS depreciation and that allowed for AMT which enables unused slow depreciation occurring in late years to offset rapid depreciation in the same year. The Section 179 expensing election deduction is allowed in calculating AMTI.

4. The difference between the regular tax deduction for circulation and research and experimental expenditures and the allowable AMT deduction based on 10 year amortization.
5. The difference between the regular tax deduction for mining exploration and development costs and 10 year amortization allowed for AMTI.
6. Incomplete long-term contract cost calculated using the completed contract method less those using the percentage of completion method.
7. Cost recovery for pollution control facilities amortized over 60 months less alternative MACRS allowed for AMTI.
8. Entire gain from installment sales subject to the new proportional disallowance rules and other property held primarily for sale in the ordinary course of the business. Exceptions include property used in farming, personal property not used in a trade or business.
9. The difference between the regular income tax gain or loss and the AMTI gain or loss when there is a taxable exchange. A difference will occur when the basis for AMTI is more than the basis for regular tax because of different depreciation allowances.
10. A difference in allowed losses including losses from all tax shelter farm activities. Losses cannot be offset by gains.
11. The difference between passive activity losses allowed for AMTI and those allowed for regular tax.
12. Personal exemptions will become an adjustment if Section 107(b)(2) of the Technical Corrections Bill of 1987 is passed.

Preference Items included in AMTI:

1. Accelerated depreciation of real and personal property placed in service before 1987 remains a tax preference subject to AMT as does amortization of certified pollution control facilities.
2. The appreciated portion of capital gain gifts claimed under charitable contributions. The appreciated portion is the difference between the property's fair market value and its basis.
3. Incentive stock options - the difference between the exercise price and fair market value.
4. Tax-exempt interest from private annuity bonds.
5. Intangible drilling costs.
6. The excess of the tax depletion allowance over the adjusted basis of the property.
7. Reserves for losses on bad debts of financial institutions.

AMT Net Operating Loss Deduction

The AMT net operating loss is limited to 90 percent of AMTI and is calculated and deducted after all adjustments and deductions are completed. The regular tax NOL is added to TI on line 2 of Form 6251. The AMT NOL is calculated the same as the regular NOL except:

1. Taxable income is adjusted as it is adjusted in computing AMTI.
2. Taxable income is reduced by the preference items included in calculating the regular tax NOL.

The deduction of AMT NOL is the last step in calculating alternative minimum taxable income. Schedule A (Form 1045) can be used to calculate the AMT NOL providing the above exceptions are included.

The AMT NOL absorption rules for tax years beginning after 1986 are the same as for regular tax. The rules are different for tax years prior to 1987.

Tentative Minimum Tax

The minimum tax exemption reduced by the 25 percent phase out is subtracted from AMTI before the 21 percent rate is applied. 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 although the amount that can be used to reduce AMT is limited.

Alternative Minimum Tax

Tentative minimum tax less the regular income tax equals AMT. Regular income tax excludes several miscellaneous taxes including tax on lump-sum distributions, accumulated earnings tax, and tax on certain built-in gains of S corporations. Regular income tax is reduced by the foreign tax credit (but not business tax credits) before it is entered on line 18 Form 6251.

Investment Credit

Foreign tax credit is still the only credit allowed in the calculation of AMT. The other credits, including investment credit, can be carried forward to the extent they do not provide a tax benefit because of the AMT.

Corporate Alternative Minimum Tax

The new Corporate AMT is very similar to the AMT for individuals. It replaces the old corporate add-on minimum tax. The exemption is $40,000 reduced by 25 percent of the amount of AMTI that exceeds $150,000. The tax rate is 20 percent.

Although some of the AMT adjustments are different on the corporate return, the major ones including depreciation are the same. An adjustment for business untaxed reported profits or "book income" is also required by corporations. In 1987 through 1989, AMTI must be increased by 50 percent of the amount by which adjusted net book income exceeds AMTI before the effect of any NOL's. After 1989 the adjustment will be plus 75 percent. In general, the book income used in computing the adjusted net book income is the net income or loss on the taxpayer's applicable financial statement.

A corporation can use investment credit to reduce regular income tax below AMT to the extent regular tax exceeds 75 percent of tentative AMT, or IC can instead be used in an amount equal to 25 percent of the taxpayer's tentative AMT, whichever is greater. In applying this rule, the corporation maintains a single IC account for both regular and AMT purposes. Another rule limits the use of credits and NOL's to a 90 percent reduction of applicable AMT liability.

NET OPERATING LOSSES

Many New York farmers will sustain a net operating loss in 1987 which may be carried back to recover taxes paid in former years or carried forward to reduce taxes to be paid in future years. The net operating loss is the taxpayer's loss for the year modified to remove some of the other tax benefits (IRS Section 172). The calculation of a net operating loss, and its application to recover taxes in another year, is a complex process governed by strict rules of procedure.

How to Report a Net Operating Loss (NOL)

A farmer who has a net business loss, that is a negative Net Farm Profit on Schedule F (1040), should enter the loss on line 18 of page 1, 1040, as a negative figure. If, as a result, deductions exceed all ordinary income for the year this taxable loss, after adjustments may be used to offset taxes paid in other tax years. The amount of the loss which may be carried forward or back is called a net operating loss. Losses on the sale of farm assets may also be included in a NOL. The NOL is not to be considered when calculating net earnings from self-employment for the year to which the NOL is carried.

The opportunities and consequences of carrying a NOL back should always be considered first. If the NOL is carried back it must be carried back three years, then to each succeeding year, if necessary, to use it up. A 1987 NOL would be first carried back to 1984, then to 1985, 1986, and then forward to 1988 and in order to 2002 if necessary. The carry forward provision is 15 years. A taxpayer may elect to forego the entire carry back period. The election must be made by the due date for the return of the NOL year for which the election is made by attaching a statement to the return. If there is more than one operating loss to be carried to the same tax year, the loss from the earliest year is applied first.

In making a claim for an NOL, a concise statement showing how it was computed must be filed with the return for the year the NOL is used. For a carry back year the statement can be filed with a Form 1045 or 1040X. Form 1045 (or Form 1139 for a corporation) must be filed within one year after the close of the NOL year. Form 1040X may be filed within three years of due date for the NOL year return. Schedule A (Form 1045) serves as a convenient NOL computation form.

A partnership (or small business corporation) is not allowed to claim an NOL, but each partner may use his or her share of the business NOL to determine his/her individual loss. A regular corporation's NOL is handled similar to an individual's but the modifications and adjustments are calculated differently.

Step One - How to Calculate a Net Operating Loss

To determine NOL for the year, adjustments must be made by adding the following items to the taxable loss reported on Form 1040. This step must be completed in order to determine how much loss can be applied to another year's return.

1. Personal exemptions.

2. Nonbusiness deductions (ZBA or itemized deductions) that exceed nonbusiness income.

3. The long-term capital gain exclusion. (Not relevant after 1986 uunless taxpayer sold dairy buyout cattle.)

4. Capital losses in excess of capital gains.

5. NOL carry overs or carry backs from other taxable years.

Example: D.T. Farmer shows an $18,900 loss on Schedule F. The farm loss is combined with other income and deductions on Form 1040 to show a taxable income on line 36 of ($19,560).

Income:		
Part-time salary		$ 1,000
Interest income		600
Dividends		300
Capital gain from Schedule D (1040)		6,000
Supplemental gains (Form 4797)		900
Farm loss		(18,900)
Total Income		$(10,100)
Deductions:		
Standard deduction (or itemized deduction)	$3,760	
Personal exemptions (3)	5,700	
Total Deductions		- 9,460
Taxable Income		$(19,560)

No net operating loss was carried over to 1987 from a prior year.

The following adjustments are made to compute the current year's NOL:

Taxable Income		($19,560)
Personal exemptions	$5,700	
Excess of nonbusiness deductions over nonbusiness income ($3,760 - 900 = $2,860)	2,860	
Total adjustments		$ 8,560
Net Operating Loss, 1987		$11,000

The above example does not illustrate the adjustment required when capital losses exceed capital gains. Also note that because of the required adjustments the $18,900 Schedule F loss was trimmed to an $11,000 NOL.

Step Two - How to Carry Back the NOL

The full NOL must be carried to the earliest eligible year. If the NOL is equal to or less than the AGI less the standard deduction (or itemized deductions) for that year, deduct the full NOL as in Step Three. However, if the NOL is greater than the AGI less the standard deduction (or itemized deduction), the NOL must be compared to modified taxable income to determine how much of the available NOL may be used.

Modified taxable income is taxable income for that eligible year adjusted as follows (unincorporated tax person):

1. The long-term capital gains exclusion must be included in income.

2. The capital loss deduction is limited to the amount of capital gains included in gross income.

3. Personal exemption deductions are not allowed.

4. Modified taxable income must be computed before any NOL deduction from the loss year and all later years.

5. Itemized deductions based on or limited by a percentage of income (e.g., medical deductions) must be recomputed based on the AGI after modifications 2, 3, and 4 above. Charitable deductions are excluded from this rule.

6. The charitable deduction must be recomputed using a limit based on an AGI modified by rules 2, 3, and 4 and by removing NOL carry backs.

Example: If D.T. Farmer carries his 1987 NOL of $11,000 back to 1984 where he had a taxable income of $12,380, the full NOL will be used. If 1984 taxable income had been less than $11,000, the adjustments listed above would have been applied to determine the modified taxable income. If 1984 modified taxable income was $8,000, D.T. would deduct only $8,000 of his 1987 NOL on the 1984 return.

Step Three - Determining Amount of Refund

In determining the amount of refund due when a carry back is made to a prior year, the taxable income for that year must be recomputed. After the NOL is deducted, itemized deductions based on a percentage of AGI must be recomputed. The income tax liability for that year, minimum tax, alternative minimum tax, and tax credits claimed must be refigured.

Example: D.T. Farmer determines his 1984 refund as follows:

Adjusted gross income on 1984 return	$18,780
Less 1987 NOL	-11,000
Adjusted gross after carry back	$ 7,780
Minus deductions	- 2,400
Tax table income after carry back	$ 5,380
Tax liability on $5,380 after carry back	217
Tax liability on 1984 return	1,705
Tax paid on 1984 return (net of IC)	$ 705
Less tax liability after carry back	217
Refund on 1984 Return	$ 488

D.T. Farmer paid no minimum tax or AMT in 1984 but $1,000 of investment credit was used to reduce the 1984 tax liability. If there had been no investment credit used in 1984, the tax paid would have been $1,705 and D.T. would be eligible for a $1,598 refund. Since only $705 of income tax was actually paid in 1984, the 1984 refund will be $705 - 217 = $488. However, the $1,000 investment credit originally used is freed by the NOL and is now an unused investment credit balance of $1,000 that may be carried back to 1981.

Step Four - Carry Over Unused NOL to Subsequent Year

Under the alternative assumption, D.T. Farmer's 1984 modified taxable income was $8,000 which limited 1987 NOL used in 1984 to $8,000. The amount of unused NOL, $3,000, is carried over to the 1985 return.

PASSIVE ACTIVITY LOSSES

Section 469, added to the IRC by TRA of 1986, strikes another blow to traditional "tax shelters". It places new and significant limits on the use of tax losses to shelter business and investment income. Unfortunately some retired farmers and owners of rental property will lose deductions under the new legislation.

The Rule

Passive activity losses (and credits) can only be used to offset passive activity income. Losses from passive activities cannot be deducted against any other income. Excess losses can be carried forward and used to reduce future passive activity income.

The use of passive losses will be phased out over a four year period. The percentages disallowed are: 1987, 35 percent; 1988, 60 percent; 1989, 80 percent; 1990, 100 percent. The phaseout applies only to activities in which the taxpayer was engaged before TRA 1986 was passed.

A passive activity includes:

1. Any trade or business in which the taxpayer does not materially participate. Working interests in oil and gas property are excluded.

2. Any rental activity (see $25,000 loss allowance).

3. Limited partnership interest.

Material participation occurs when the taxpayer is involved in the operation of the activity on a regular, continuous, and substantial basis. This definition is based on standards under Code Sections 1402(a) (self-employment tax) and 2032A (farm valuation - estate tax) but existing precedents are not intended to control the passive activity rule. Material participation is to be determined separately for each taxable year.

The taxpayer's principal trade or business is more likely to receive his/her material participation but a secondary trade or business will not automatically be called a passive activity. The taxpayer's presence at the farm or place of business will be an important factor. A farmer who receives self-employment income will generally be treated as materially participating even if she/he contributes no physical labor.

Cattle feeding activities are likely to come under close IRS scrutiny. Formal and nominal participation in management without independent discretion and judgment do not constitute material participation. A meaningful and relevant management role without regular and continuous involvement will not establish material participation either.

The types of farm management decisions that may be relevant if made on a regular, continuous, and substantial basis include:

1. Crop rotation, selection, and pricing.

2. The incursion of embryo transplants and breeding practices.

3. The purchase, sale, and leasing of capital assets.

4. Selection of herd and crop managers who act on behalf of the taxpayer.

A special rule for retiring farmers allows them to qualify under material participation so they may escape the passive loss rules. If they were previously participating under standards defined in Section 2032A(b)(4) or (5) they meet the passive activity requirements of material participation.

Code Section 2032A provides the requirements and limitations pertaining to agricultural use valuation of farm real property for estate tax purposes. It is one of the most complicated provisions in the tax code. In general, 2032A says that if a person was materially participating in the business for five of the eight years prior to retirement or total disability, that person is considered as materially participating from that date until death.

A closely held C corporation or personal service corporation is treated as materially participating if one or more shareholders, owning in the aggregate more than 50 percent of the outstanding stock of the corporation, materially participate. The passive loss rules are less restrictive for C corporations (excluding PC's) and it is possible for nonpassive income and passive loss activities to be offset within the same corporation.

An estate or trust is treated as materially participating in an activity (or as actively participating in a rental estate activity) if an executor or fiduciary, in his capacity as such, is so participating.

A special real estate rental rule allows an individual taxpayer to use real estate rental activity losses in which he/she actively participates to offset up to $25,000 of nonpassive income. The $25,000 exemption is reduced by 50 percent of the amount by which the taxpayers AGI exceeds $100,000.

Active participation only requires participation in major management decision making and will be much less difficult to establish than material participation. Major management decisions include approving new tenants, selecting rental terms, approving repairs and capital expenditures. An individual whose interest in the rental activity is less than 10 percent will not qualify as actively participating.

Disposal of the entire interest in a passive activity in a taxable disposition, means that loss, including nondeducted losses from prior years from that activity can be deducted against any kind of income.

More tax planning will be required to save after tax income with passive activities. The full effect of Section 469 will not be recognized and all the tax management opportunities will not be identified until final Treasury regulations are issued. In the meantime, much of the planning will focus on ways to create passive income to cover passive losses.

INFORMATIONAL RETURNS

There are no major changes affecting the 1987 filing requirements and penalties associated with informational returns except for real estate brokers.

Provisions

1. Form 1099-MISC must be filed by any person engaged in a trade or business, on each nonemployee paid $600 or more for services performed during the year. Rental payments, royalties, prizes, awards, and fishing boat proceeds must also be reported when one individual receives $600 or more.

2. Payments made for nonbusiness services and to corporations are excluded.

3. Farmers should include payments made to independent contractors, veterinarians, crop sprayers, repair shops, and building contractors. Payments made for feed, seed, fuel, supplies, and other merchandise are excluded.

4. 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 clearly show that a fixed and determinable amount was for merchandise.

1099-MISC is also used to report the occurance of direct sales of $5,000 or more of consumer goods for resale.

Other Information Returns

1098 - Used by recipient to report $600 or more of mortgage interest from an individual on any mortgage during the year. Applies to real estate developers as well as those in the trade or business of lending money.

1099-B - Required for all real estate transactions closings occurring after December 31, 1986. Also used by other brokers and barter exchanges.

1099-G - Used to report agricultural program payments by USDA, discharge of indebtedness by federal government, state tax refunds, and unemployment compensation.

1099-INT - Payer reports interest payments (not interest on an IRA, SEP or DEC).

8300 - Recipient reports cash payments over $10,000 received in related transactions, in the course of operating a trade or business.

8308 - Partnership reports the sales or exchange of partnership interest involving unrealized receivables or substantially appreciated inventory items.

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 on or before February 28. The penalty for failure to file with the IRS and the penalty for failure to file a copy with the payee are consolidated ($50 penalty for each failure). Failure to include all the required information is a $5.00 penalty. Additional penalties are imposed for intentional disregard.

Backup Income Tax Withholding is still required when the payee fails to provide a TIN.

THE SOCIAL SECURITY TAX SITUATION AND MANAGEMENT OPPORTUNITIES

Increases in social security (FICA) taxes and self-employment taxes have placed a higher priority on exploring opportunities to reduce the burden of these taxes through wise tax management.

The Current Tax Burden

The maximum earnings base for employees as well as self-employed taxpayers increased 4.3 percent to $43,800 for 1987 following a 6.1 percent increase in 1986. Social Security (FICA) rates remain at 7.15 percent for both employers and employees in 1987 but will take a substantial five percent increase in 1988. The maximum combined FICA tax was $6,006 in 1986. In 1987 it will be $6,263, up 4.3 percent from last year. Next year the maximum combined FICA tax will top $6,840 if the earnings base increases four percent.

Currently (1987) self-employed individuals pay an effective rate of 12.3 percent (14.3 less 2.0 credit) that will generate a maximum of $5,387 self-employment tax. This is an increase of $221 or 4.3 percent following a 10.5 percent increase in 1986. The 1988 effective rate increases to 13.02 percent and if the earnings base goes up four percent, the maximum self-employment tax will exceed $5,930.

Social Security Tax Table

		FICA Tax Rate		Self-Employment Tax		
Year	Earnings Base	Employer	Employee	Specified Rate	Credit	Effective Rate
1986	42,000	7.15	7.15	14.3	2.0	12.3
1987	43,800	7.15	7.15	14.3	2.0	12.3
1988	*	7.51	7.51	15.02	2.0	13.02
1989	*	7.51	7.51	15.02	2.0	13.02
1990 & later	*	7.65	7.65	15.3	0.0	15.3

*To be recalculated each year to reflect the change in the CPI.

After 1989, the credit against the self-employment tax will be discontinued. Self-employed taxpayers will be allowed a deduction from taxable income of one-half of the self-employment taxes paid that can be attributable to a trade or business. Or, they may deduct from self-employment income 7.65 percent of net earnings from self-employment when computing the self-employment tax.

Income Subject to The Self-Employment Tax

The self-employment tax is generally computed on the net earnings of a trade or business. For farmers this is the net profit shown on the bottom line of Schedule F. The tax for 1987 is computed on the first $43,800 of net earnings from the trade or business.

Wage Payment to Spouse or Children

If the person is a sole proprietor (not a corporation and not a partnership unless the partnership is solely owned by mother and father), wages paid to a spouse, or to a son or daughter under age 21 at the end of the calendar year, are not subject to Social Security taxes.

The wages paid have to be reasonable for the services performed and the services must be actually performed and detailed work and payment records kept.

Many farm wives provide labor for the business but are not paid a wage. The following example shows the favorable effect on the husband's self-employment tax of a $10,000 wage paid to the wife for services to the business.

Example: Net farming income before payment	$28,000	
Self-employment tax before payment (1987)		3,444
Salary to wife	-10,000	
Net farm income after payment of salary to wife	$18,000	
Self-employment tax after payment		2,214
Self-employment tax savings =		$1,230

The $10,000 payment to the wife does not directly save federal income taxes because it would be included as income on a joint tax return. However, it does qualify for an IRA retirement contribution by the spouse.

Noncash Payments to Employees

Social Security tax does not have to be paid on payments that are other than cash for agricultural labor. So, wage payments to agricultural labor in crops or livestock are not subject to Social Security tax. This technique could be used for children who are working on the farm but are over age 21 or for other agricultural labor. When payments are made in kind and not in cash, the following conditions should be met.

1. Physical possession of the crop or livestock should be given to the employee.

2. Pre-arranged sales should be avoided.

3. The employees should be instructed to decide the time, place, and terms of the sale rather than simply adding them to the employer's marketing activity [Revenue Ruling 79-207].

In summary, the employee should be given complete possession and control, and the sale or other disposition of the "in kind" payment should be at the discretion of the employee and independent of that of the employer.

Taxation of Social Security Benefits

Some Social Security and railroad retirement benefits will be included in gross income but the inclusion is limited to the lessor of:

A. one half of the benefits received, or

B. half of the excess of the sum of the taxpayer's adjusted gross income, 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, and $25,000 for all other individuals.)

Example: Joe and Mary Retiree provide you with the following information. How much of their benefits are taxable in 1987?

S.S. benefits received (joint return)	$14,000
AGI	38,000
Tax exempt interest	2,000

Lesser of: A. One-half of benefits ($7,000) or
B. 38,000 + 7,000 + 2,000 = 47,000. Half of the excess over $32,000 equals $7,500

Answer: $7,000 (lower of A or B) of the benefits of this couple will be included in gross income in 1987.

Reduction of Benefits

Farmers and other self-employed taxpayers and wage earners will have their social security benefits reduced if they exceed the earnings limit. When a person's wage and self-employment earnings exceed the earnings limit, his or her social security benefits are reduced by 50 percent of the excess earnings.

Reduction of Benefits for Self-Employed & Wage Earners

Age (years)	1987 Earnings Limit	Reduction of Social Security Benefits
Less than 65	$6,000	.50 of excess earnings
65 to 70	8,160	.50 of excess earnings
70 and over	0	none

The earnings limit is calculated on an annual basis except in the year of retirement it is calculated on a monthly basis. In the year the individual reaches age 70 the earnings and the part of the year prior to the birthday are used in calculating the earnings limit.

Total wages and self-employment income are included as earnings. Some farm receipts are excluded from self-employment income. "Actions taken after the initial month of entitlement to sell a crop or product if the crop or product was completely produced or created in or before the month of entitlement do not cause the income from the sale to be characterized as self-employment income. This rule does not apply to income received by an individual from a trade or business of buying and selling products produced or made by others; for example, a grain broker." [26 CFR Sec. 404-429]

The above rule appears to exclude from self-employment income; cattle (held for sale), grain, fruit and other crops held over and sold in the year or years following retirement. It does not exclude Dairy Termination Program payments received from the CCC.

Eligibility for Benefits

Two different tests are used to determine 1) when an individual retires and becomes eligible for social security retirement benefits, and 2) whether a person has self-employment income after retirement that will reduce benefits.

The "substantial services" test is used to determine if and when an individual retires and is eligible for benefits. An individual will not be considered retired if he or she is providing substantial services. Time, nature of services, prior services, presence of paid management, type of business and capital invested are factors considered.

The material participation test is used to determine if the retiree is receiving self-employment income. In general, rental income from real estate and personal property leased with the real estate, including crop shares, do not constitute self-employment income. If there is an arrangement for the retired owner to provide labor and management services, there is material participation.

INDIVIDUAL RETIREMENT ARRANGEMENTS

New rules for 1987 and later may reduce or eliminate the deduction that some taxpayers may take for IRA contributions. The limits on contributions generally are the same as in 1986. In other words, each taxpayer may contribute the lesser of $2,000 or earned income to an IRA. However, in the situation where either the taxpayer or the spouse is an active participant in an employer retirement plan and adjusted gross income is above prescribed levels, the amount that my be deducted is partially or wholly eliminated. If non-deductible contributions are made, the earnings on the non-deductible part of the IRA will accumulate on a tax-deferred basis. The complications introduced by having an IRA with two different types of tax treatment when withdrawals are made in later years may make taxpayers reluctant to make non-deductible contributions to an IRA.

IRA deductions are phased out for taxpayers covered by an employer's retirement plan with AGI's (computed without the IRA deduction) in the following ranges:

Filing Status	Deduction is reduced if AGI is within the phaseout range of
Single or head of household	$25,000 - 35,000
Married, joint return or qualifying widow(er)	40,000 - 50,000
Married, separate return	0 - 10,000

If AGI is above the top end of the range, no deduction for an IRA contribution can be taken.

Any taxpayer with AGI above the minimum level for phaseout must determine whether he, she, or the spouse is covered by an employer retirement plan. W-2's issued at the end of 1987 will have a "Pension Plan" box to be checked by the employer. Coverage under either Social Security or Railroad Retirement is not considered to be an employer retirement plan. A Keogh or SEP is an employer plan. A person receiving benefits from a previous employer's plan is not an active participant in that employer's plan.

Within the phaseout range the "partial deduction" is calculated by subtracting AGI from the top of the range and multiplying the result by 20 percent.

Example: Married, filing jointly; AGI = $46,000.

$50,000 - 46,000 = $4,000 of AGI qualified for partial deduction
$4,000 x .20 = $800 = allowable deduction

The deduction is rounded upward to the nearest $10. If the computed deduction is greater than zero but less than $200, a $200 deduction is allowed. On a joint return each spouse is allowed a deduction of the computed amount (assuming earned income of each is at least that much). However, if one spouse contributed less than the allowed amount, the other spouse is not permitted to deduct the amount unused by the first spouse.

Spousal IRA's

Prior to 1987 a spouse with earned income of any amount was prevented from having a spousal IRA and was limited to an IRA deduction based on his/her own earned income. This presented spouses with one or more but less than $250 of earned income from taking advantage of the $250 spousal IRA. In 1987 and later, a spousal IRA may be created for spouses with less than $250 of earned income.

Spousal IRA's are subject to the phaseout rules. The partial deduction is computed as in the previous example and the resulting amount is deductible by the working spouse. Then a second partial deduction is computed using a factor of 0.225. The difference between this result and the first result may be deducted for the spousal IRA.

Example: $4,000 of AGI qualified for partial deduction x .225 = $900.

The deduction for the working spouse would be $800 and the remaining $100 would be deductible for the non-working spouse. Not more than $800 could be contributed to either IRA.

Distributions from Deductible and Non-Deductible IRA's

A taxpayer who has both deductible and non-deductible contributions in an IRA will have distributions that are taxable (from the deductible portion and earnings on both the deductible and non-deductible portions) and non-taxable (from the non-deductible portion). Non-deductible contributions to IRA's must be reported on Form 8606. "Non-deductible IRA Contributions, IRA basis, and Non-Taxable IRA Distributions." If non-deductible contributions are not reported, at the time of distribution all withdrawls will be treated as taxable.

Simplified Employee Pensions

The maximum amount that may be contributed to a SEP is the lesser of $30,000 or 15 percent of the employee's compensation.

Beginning in 1987, some employees can elect to make contributions to the SEP. If the employee elects to make the contribution to the SEP, it is not included in the employee's taxable income but it is included in wages for employment tax purposes. The maximum amount that may be contributed to the SEP in this manner (on a tax deferred basis) is $7,000 in 1987. Such plans have a number of limitations. One is that the employer maintaining the plan must have had no more than 25 employees in the previous taxable year.

In 1987 and later the employer contributions and the elective deferrals under a SEP are excludable from the employee's gross income, rather than being treated as a deduction by the employee.

NEW YORK STATE INCOME TAX

New York passed two tax laws in 1987 to reduce the tax windfall that the State would have received as a result of the Federal Tax Reform Act of 1986. The Tax Reform and Reduction Act of 1987 (NYTRRA 1987) was signed by the Governor in April and the Business Tax Reform and Rate Reduction Act of 1987 (BTRA 1987) was signed in August. NYTRRA included many changes that will affect the tax bills of individuals, including most farmers. BTRA 1987 primarily affects the corporate tax but includes an important provision relative to investment credit for individuals.

NYTRRA 1987 largely accepts the changes in TRA 1986 relative to the elimination of the capital gain exclusion, limitations on itemized deduction, etc. It reduces the tax windfall primarily by gradually lowering rates and increasing the standard deduction and personal exemption between 1987 and 1991. There are many other changes, some of which are phased in and others that are fully effective in 1987.

Exemptions and Standard Deductions

The standard deductions are increased gradually between 1987 and 1990 while the exemption is increased to $1,000 in 1988 and will remain at that level.

Year	1986	1987	1988	1989	1990
	Standard Deduction ($)				
Tax Status:					
Joint	3,000	5,300	8,500	9,500	13,000
Single	2,600	3,600	5,000	6,000	7,500
Head of household	3,000	4,600	6,000	7,000	10,500
Married filing separately	1,000	2,650	4,250	4,750	6,500
	Exemption ($)				
	850	900	1,000	1,000	1,000

Married persons filing separately each will receive one-half of the joint standard deduction. The standard deduction of a dependent individual whose federal exemption is zero will be $2,800 in 1987-89 and $3,000 in 1990 and later.

Beginning in 1988, an exemption is not counted for either the filer or the spouse. This makes the increase in the standard deduction from 1987 to 1988 somewhat misleading. Most of the increase is offset by the loss of one exemption for a single filer and two exemptions for joint filers.

Two Earner Provisions

The option to file separately on the same return for those who filed jointly for federal purposes is eliminated beginning in 1987. In 1987 only, there will be a deduction of 10 percent of the lower spouses earned income (up to a maximum deduction of $3,000) similar to the Federal Schedule W adjustment eliminated by TRA 1986.

Itemized Deductions

For taxpayers who filed jointly for federal but are required to file separate New York returns, itemized deductions will be divided between them as if their federal taxable incomes had been determined separately.

In 1988 and later itemized deductions of higher-income taxpayers will be subject to limitations.

Credits and Family Adjustment

The household credit will remain at the 1986 level through 1989. In 1990 it will be cut in half and in 1991 it will disappear under NYTRRA 1987. The child care credit remained until 1988 but was eliminated beginning in 1989. However, BTRA restored the child care credit.

The family adjustment and the tax on the family adjustment are eliminated beginning in 1987.

Investment Credit

Investment credit was eliminated by NYTRRA 1987 for acquisitions after 1988. Unlimited carryforward was maintained. However, BTRA 1987 restored investment credit, which will be available at four percent for acquisitions after 1986, rather than the former six percent. (For corporations, the rate will be five percent.) Carryforwards are limited to seven years for IC earned after 1986. Credits earned before 1987 may be carried to tax years beginning before 1994.

Rates

Beginning in 1987 there will be three separate rate tables for (1) married individuals filing jointly and surviving spouses, (2) single individuals, married individuals filing separately, and estates and trusts and (3) heads of households. Filing status will conform to federal status except that when the New York resident status of spouses differs, separate returns must be filed.

The law is written in terms of the rates to be in effect at the end of the phase-in period which will be 1991. Rates for that year are:

New York State Tax Rates, 1991

Filing Status	New York Taxable Income	Rate
Married filing jointly & surviving spouse	Not over $27,000	5.5%
	Over $27,000	7.0
Single, married filing separately estates & trusts	Not over $12,500	5.5
	Over $12,500	7.0
Head of household	Not over $19,500	5.5
	Over $19,500	7.0

However, there is a gradual phase-in. The rates for 1987 are:

Married Filing Jointly and Surviving Spouse*

If the New York taxable income is:

Over	Not Over	Tax		
$ 0	$ 1,700	2%	of amount over	-0-
1,700	5,000	$ 34 plus 3%	" " "	$ 1,700
5,000	8,300	133 plus 4%	" " "	5,000
8,300	11,700	265 plus 5%	" " "	8,300
11,700	15,000	435 plus 6%	" " "	11,700
15,000	18,300	633 plus 7%	" " "	15,000
18,300	23,300	864 plus 8%	" " "	18,300
23,300		1,264 plus 8.75%	" " "	23,300

Single, Married Filing Separately and Estates and Trusts

If the New York taxable income is:

Over	Not Over	Tax		
$ 0	$ 1,000	2%	of amount over	-0-
1,000	3,000	$ 20 plus 3%	" " "	$ 1,700
3,000	5,000	80 plus 4%	" " "	3,000
5,000	7,000	160 plus 5%	" " "	5,000
7,000	9,000	260 plus 6%	" " "	7,000
9,000	11,000	380 plus 7%	" " "	9,000
11,000	14,000	520 plus 8%	" " "	11,000
14,000		760 plus 8.75%	" " "	14,000

Head of Household

If the New York taxable income is:

Over	Not Over	Tax		
$ 0	$ 1,200	2%	of amount over	-0-
1,200	3,400	$ 24 plus 3%	" " "	$ 1,200
3,400	5,600	90 plus 4%	" " "	3,400
5,600	7,800	178 plus 5%	" " "	5,600
7,800	10,000	288 plus 6%	" " "	7,800
10,000	12,400	420 plus 7%	" " "	10,000
12,400	15,400	588 plus 8%	" " "	12,400
15,400		828 plus 8.75%	" " "	15,400

*The income tax forms and instructions refer to surviving spouse as qualifying widow(er) with dependent child.

The maximum tax on personal service income has been eliminated, effective in 1987. However, in 1987 and 1988 there is a tax on part or all of the unearned income of individuals with a New York adjusted gross income exceeding $100,000. In 1987, the tax rate will be three percent and in 1988, it will be two percent. The formula for computing unearned income is rather complicated.

Household Credit

The household credit increased for tax years beginning in 1986. Single taxpayers with household gross income up to $28,000 and all other taxpayers with income up to $32,000 qualify providing they cannot be claimed as a dependent on another taxpayer's return. Household gross income is total NYAGI for both spouses plus additional taxable income for other members of the household.

In 1987 the amount of household credit for single taxpayers ranges from $75 (less than $5,000 of HGI) to $20 for taxpayers with $25,000 to $28,000 of HGI. A new separate schedule allows more credit for married taxpayers, heads of household, and surviving spouses, plus additional credit ($5 to $15) for additional exemptions. The maximum credit for a married couple with less than $5,000 of HGI is $90 plus $15 for each personal exemption less one.

Real Property Tax Credit

The Real Property Tax Circuit Breaker Credit section of the New York tax law was modified by NYTRRA 1987. However, the tax credit computations and limits appear to be the same for 1987 as for 1986. Few farm or nonfarm real estate owners will qualify. Owners of real property valued in excess of $85,000 are excluded. Here are other rules and limitations:

1. The household gross income limit is $18,000.

2. The maximum adjusted rent is now an average of $450 a month but the taxpayer must occupy the same residence for six months or more to claim rent paid for credit. Credit for renters is computed the same as for owners.

3. Real property tax credit is the lesser of the maximum credit or 50 percent of excess real property taxes. Taxpayers age 65 and older who elect to include the exempt amount of real property taxes will receive no more than 25 percent of excess real property taxes. Excess real property taxes are computed by multiplying household gross income times the applicable percentage and deducting the answer from real property taxes.

Partial Table for Computing Real Property Tax Credit, 1987

Household Gross Income	Applicable Rate	Maximum Credit	
		Under 65	65 & Over
$0 - $ 1,000	0.035	$75	$375
5,001 - 6,000	0.045	65	290
10,001 - 11,000	0.055	55	205
15,001 - 16,000	0.065	45	120
17,001 - 18,000	0.065	41	86

Pass and Tuition Deduction

The tuition deduction for higher education is eliminated for tax years beginning after 1986. Pass is eliminated after 1987.

Deductions and Credits That Have Not Changed

Itemized Deductions and Separate Returns

If the taxpayer does not itemize deductions on the federal return, he or she cannot itemize on the New York State return.

Spousal IRA's Allowed

A spousal IRA deduction claimed on a joint federal return is allowed on the New York return. If separate returns are filed, each spouse's deduction must equal the amount contributed to his or her own account.

Child and Dependent Care Credit

Twenty percent of the federal child care credit may be used to offset New York State personal tax liability. The amount of credit used may not exceed the tax liability for the year. The credit is not allowed against the minimum tax.

Solar and Wind Energy Credit

New York State Solar and Wind Energy Credit amounting to 55 percent or qualified costs up to $2,750 of credit, is available to homeowners through 1986. The credit is a direct reduction of tax liability and may be carried forward if it exceeds tax liability in any year. The maximum credit limitations apply to each principal residence owned by a taxpayer during the eight year period ending in 1986. The credit is claimed by filing Form IT-218.

The credit is earned on the costs of purchasing and installing qualified active and passive solar and wind energy systems first used in the taxpayer's principal residence. The energy credit is not allowed on equipment and insulation that is part of the conventional heating, cooling, insulating or electrical systems of a home. It may be prorated between two or more owners of a home or condominium providing the home is their principal residence.

If the solar or wind energy system qualifies for federal residential energy credit, the New York State energy credit will be reduced by the amount of federal credit allowed until the combined energy credits do not exceed 55 percent of the qualified investment or $6,750, whichever is less.

Other Credits allowed against the New York personal income include investment credit, credit for sales tax paid on catalytic agents, mortgage recording tax credit, research and development credit, and resident credit for other state income taxes paid.

Review of New York State Farm Business Tax Problems and Opportunities

ACRS and New York State Depreciation

The provision that uncoupled New York from federal ACRS expired at the end of 1984 but the resulting tax reporting implications are not at all favorable.

1. New York State will recognize (accept) ACRS or MACRS depreciation on assets placed in service on or after January 1, 1985.

2. ACRS depreciation taken on assets that were placed in service from 1982 through 1984 (while the uncoupling provision was in effect) will not be recognized by New York State and an adjustment to Section 167 depreciation is

still required. The required adjustment to federal taxable income which implies that a separate New York schedule is required, follows:

Step 1: add the amount allowable as a deduction under IRC Section 168 (ACRS)

Step 2: subtract the depreciation allowable under IRC Section 167 as if it were still in effect.

The basis of an asset may not be adjusted when NYS depreciation is less than federal. The federal basis must be used to compute NYS depreciation and to determine gain or loss on disposition. However, the law allows a modification to federal AGI in the year of disposition on an asset where NYS depreciation has been different than federal. This enables a taxpayer claiming less NYS depreciation than allowed under ACRS to decrease federal AGI for state purposes in the year of disposition. If NYS depreciation were greater than federal, the modification would be an increase in AGI.

Farmers and their tax advisors are encouraged to use initiative and wisdom in computing and documenting acceptable state depreciation deductions that will be the same as federal ACRS deductions.

<u>New York State Investment Credit Will Be Four Percent Beginning in 1987</u>

The credit for individuals will be four percent on qualified tangible personal property acquired, constructed, reconstructed or erected on or after January 1, 1987. 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 three years will earn four percent NYIC. The fact that pickups are now 5-year MACRS property will not change the disallowance of NYIC for farmers.

Five-year ACRS or MACRS property that qualifies for NYIC earns full credit after five years, even if a longer straight line option is elected. Ten year ACRS property and 15, 18, and 19-year ACRS real property also earn full NYIC after five years of qualified use. 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 seven years. There is no provision for carryback of NYIC. Unused NYIC claimed by a new business is refundable for tax years beginning on or after January 1, 1982. But, the election to claim a refund of unused credit can be made only once in one of the first four years. A business is new during its first four 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 taxpayers 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, retail enterprise credit and to report early disposition of qualified property.

Employment incentive tax credit is available to regular corporations that qualify for NYIC and increase employees one percent during the year. The credit is an additional one-half of the regular NYIC for each of the three 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 the franchise tax below the flat-fee minimum ($250).

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 six percent. The primary 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 carry over of net operating losses are used to reduce minimum taxable income. NYIC cannot be used to reduce the minimum income tax.

The primary item that triggered New York minimum tax for farmers was the 60 percent capital gain exclusion. With the elimination of the exclusion, fewer New York farmers will pay minimum tax.

Payment of New York State Income Taxes Withheld and Informational Returns

Although income tax withholding is not mandatory for agricultural employers, it may be wise management policy. An employer who expects to withhold less than $800 (beginning 1/1/86) semiannually is required to file and deposit the tax on July 31 and January 31. Monthly returns and deposits are required by employers withholding from $800 to $7,500 semiannually.

New York State law is essentially identical to the federal law requiring informational returns on payments of $600 or more to New York taxpayers.