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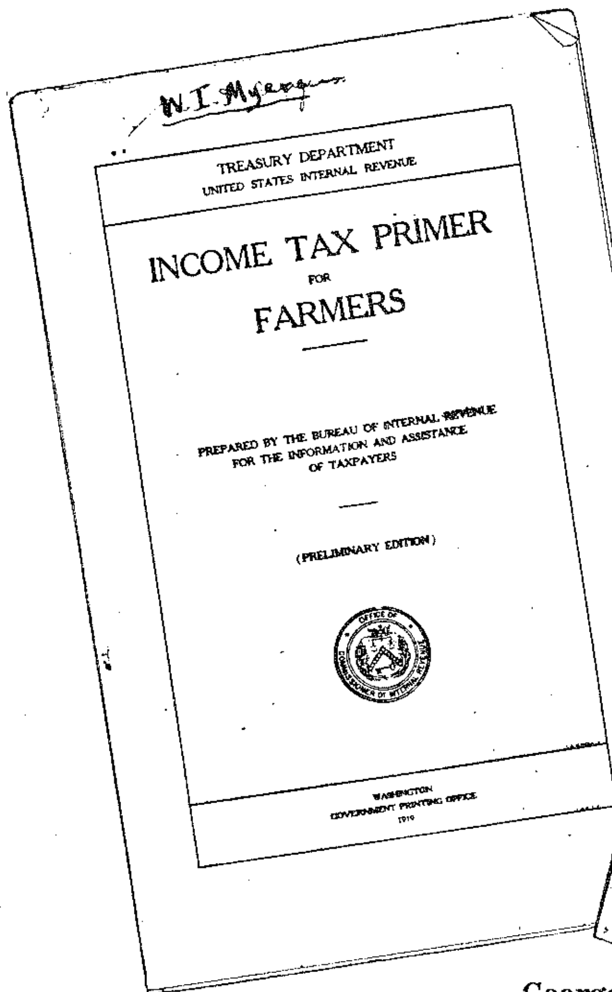
A.E. FILE

November 1988 A.E. Ext. 88-24

FARM INCOME TAX MANAGEMENT AND REPORTING MANUAL



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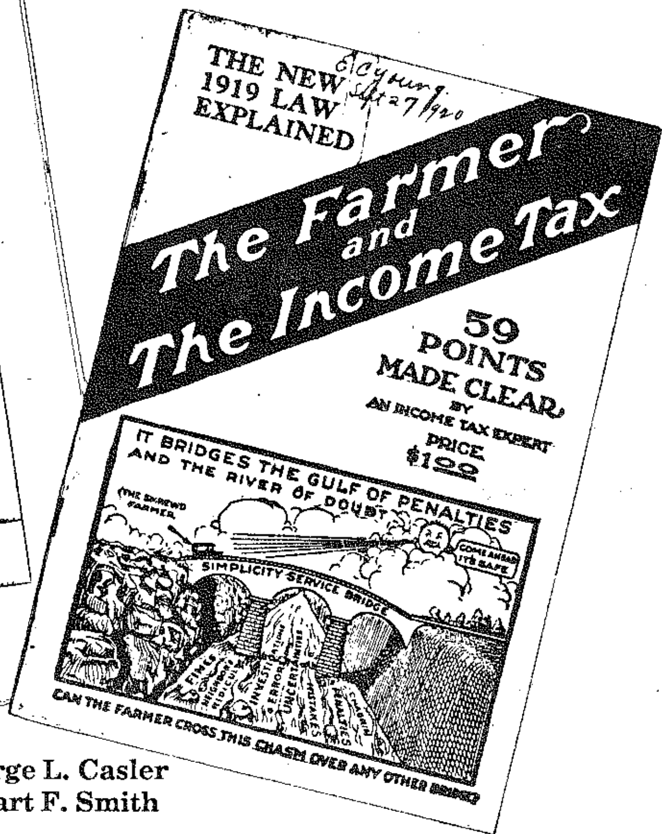

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1988 TAX FORMS NEEDED BY NEW YORK FARMERS

Here is a list of the more important 1988 income tax forms needed by farmers. Several of the forms have been revised for 1988.

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 (and Reconcilliation of Forms 1099-B)
- Schedule E - Supplemental Income Schedule
- Schedule F - Farm Income and Expenses
- Schedule R - Credit for Elderly or the Disabled
- Schedule SE - Computation of Social Security Self-Employment Tax

1040EZ- Income Tax Return for single filers with no dependents, income under $50,000, interest under $400, other limitations
1040A - For non-itemizers, less than $50,000 taxable income, other limitations
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. (See page 52 for details.)
1096 - Annual Summary and Transmittal of U.S. Information Returns
W-2 - Wage and Tax Statement; W-3 - Transmittal of Income and Tax Statement
W-5 - Earned Income Credit Advance Payment Certificate
W-9 - Request for Taxpayer Identification Number: used to provide TIN to individual filing 1099, use SS-4 to obtain employer ID
1065 - U.S. Partnership Return
3800 - General Business Credit
4136 - Computation of Credit for Federal Tax on Gasoline, and Special Fuels
4255 - Recapture of Investment Credit (including Energy Investment Credit)
4562 - Depreciation and Amortization: use to report depreciation, cost recovery, Section 179 expense election, and listed property
4684 - Casualties and Thefts
4797 - Gains and Losses From Sales or Exchanges of Assets Used in a Trade or Business and Involuntary Conversions
4835 - Farm Rental Income and Expense [Crop and Livestock Shares (not cash) Received by Landowner]
6251 - Alternative Minimum Tax Computation - Individuals
6252 - Computation of Installment Sale Income
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
8801 - Credit for Prior Year Minimum Tax

New York State Forms

IT-201 - Resident Income Tax Return (long form, comparable to Federal Form 1040)
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 (recapture or early disposition schedule included)
IT-220 - Minimum Income Tax
IT-399 - New York State Depreciation (with instructions)
IT-2102 & IT-2103 - Wage and Tax Statement, and Reconcilation Form
IT-2102.1 & IT-2102.4 - Informational Return and Transmittal Form

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1988 FARM TAX AND INCOME SITUATION

Recent Tax Legislation

The 1988 Tax Bill (TAMRA 1988) was passed by Congress on October 22 and signed by President Reagan on November 11. What began as a Technical Corrections Bill more than one year ago developed into an important revenue bill that will increase taxes $4.1 billion over a three year period.

The new law affects tax reporting beginning in 1989 but some changes are retroactive to 1988 and even to 1987. Here are some of the major changes included in TAMRA 1988 that will affect farmers and individual taxpayers. The material beginning on page 2 reflects only a few of the many changes included in the 1988 legislation.

-- Dairy and beef farmers will be exempt from capitalization rules beginning in 1989. In return all farmers will be restricted to 150 percent declining balance on 200 percent DB property.

-- Farmers will no longer pay the diesel-fuel tax for off highway use.

-- Drought assistance payments received by farmers will not have to be reported until the year following the drought.

-- MACRS depreciation periods on single purpose agricultural structures, orchards and vineyards will be charged for assets placed in service after 1988.

-- Taxpayers using their homes as their offices will not be able to deduct the monthly base cost of the first telephone line into the residence.

-- The TRA 1986 provision that required individuals to report certain mutual fund expenses as miscellaneous deductions is delayed until after 1989.

-- Research and development tax credits, and the jobs tax credit were extended.

-- A taxpayers' bill of rights provision intended to strengthen a taxpayer's position when fighting IRS was included.

TAMRA 1988 is the second important piece of federal tax legislation in less than 12 months. The first was the Revenue Act of 1987, part of the Omnibus Budget Reconciliation Act, which became law on December 22, 1987. Important provisions affecting tax years of partnerships and S corporations and social security coverage are reviewed in this publication.

The 1988 Farm Income Situation

Average net operating incomes of New York dairy farmers will not be as high as they were in 1987 but the good managers will realize higher 1988 farm profits than expected earlier this year. Beef and poultry farmers are expected to improve their net incomes in 1988 while hog farm incomes will decline.

One of the greatest opportunities for tax management occurs in the year of a major asset sale. Farm numbers in New York State have declined 18 percent in the last five years. Approximately 1,750 farmers have sold out or discontinued farming each year since 1983. The rate at which farm assets are sold is not expected to decrease in the foreseeable future.

FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

Standard Deduction

A greater number of farmers, small business owners, and individual taxpayers will find it advantageous to elect the 1988 standard deduction rather than itemizing deductions. The 1988 standard deduction has increased 33 percent for married taxpayers filing a joint return, and 18 percent for single taxpayers.

Beginning in 1989 the standard deduction will be increased when the CPI for the preceding calendar year exceeds the CPI for 1987. The 1989 estimates in the following table are based on a four percent projected increase in CPI from 1987 to 1988.

Basic Federal Standard Deduction for 1988 and Estimates for 1989

Filing Status	1988	1989 Estimate*
Married filing jointly; surviving spouse	$5,000	$5,200
Head of household	4,400	4,580
Single individuals	3,000	3,120
Married filing separately	2,500	2,600

*Unofficial estimates based on projected four percent increase in CPI from 1987 to 1988.

Each taxpayer over age 65 or blind receives an additional $600 standard 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 receives double the additional deduction. The additional deductions for age and blindness cannot be claimed for dependents. The following table provides common examples.

Federal Standard Deductions for Elderly and Blind Taxpayers, 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

The additional deduction as well as the basic standard deduction will be subject to the inflationary adjustment beginning in 1989.

Personal Exemption Increases

The 1988 personal exemption is $1,950, up from $1,900 in 1987. It will increase to $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 was eliminated beginning in 1987.

Dependents

Individuals that can be claimed as dependents on another taxpayer's return may not claim a personal exemption. The so-called double exemption was eliminated in 1987 and there is no option to allow the qualified dependent to use his or her own exemption if the parent or guardian doesn't need it. A qualified dependent is one that meets all of the five dependency tests for gross income, support, individual tax return (married dependent), citizenship or residence, and relationship or member of household.

A qualified child or student dependent's basic standard deduction is limited to the greater of $500, or the individual's earned income up to his or her standard deduction. A single child or student dependent who has $3,000 or more of earned income in 1988 gets the $3,000 standard deduction regardless of the amount of unearned income. The single student dependent with more than $500 but less than $3,000 of 1988 earned income will receive a standard deduction equal to earned income while unearned income becomes fully taxed.

The single student dependent with less than $500 of earned income will get the $500 minimum standard deduction. The amount of adjusted gross income exceeding $500 becomes taxable income. In this case the standard deduction shields some unearned income (if there is any).

The $500 rule for qualified dependents limits only the basic standard deduction. It does not restrict the use of the additional deductions for blind and elderly taxpayers. Therefore, a blind dependent child, age 14 or older with no earned income and more than $500 of unearned income, will receive a standard deduction of $1,250. (TMARA 1988, effective beginning in 1987.)

Taxable unearned income in excess of $500 received by a dependent child under age 14 is now taxed at the parent's marginal rate. 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.

1988 Tax Rates

Individual tax rates were lowered substantially by TRA of 1986. In 1986 the top rate was 50 percent, in 1987 it was cut to 38.5 percent. It is now 28 percent plus a five percent surcharge that applies to taxable income in given ranges.

There are two basic taxable income brackets at 15 and 28 percent for all 1988 taxpayers. Two deviations in the 28 percent bracket push the maximum rate to 33 percent. The first is the required phase-out of the 15 percent rate for moderate and high income taxpayers. The second is the phase-out of personal exemptions for higher income taxpayers (see 1988 Tax Rate Schedules on next page).

High income taxpayers will save 10 to 15 percent on their 1988 income tax bills compared to 1987 while low income taxpayers who itemize deductions could pay more.

Examples:

Joe and Mary Procitizen plan to file a joint return and report a 1988 taxable income of $70,000 after $10,000 of itemized deductions and exemptions.

They reported the same in 1987. Their federal income tax was $17,590 in 1987 and will drop to $15,732.50 for 1988, a savings of $1,857.50 or 11 percent.

Bill and Jill Bluecollar earned $38,000 in both 1987 and 1988. They file a joint return. Their itemized deductions plus three exemptions were $11,000 in 1987 and increased to $11,050 for 1988. Their federal income tax was $3,934 in 1987 and will increase $109 to $4,043 for 1988.

1988 Tax Rate Schedules

Single Taxpayers		Married Filing Joint Return & Surving Spouses	
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. For each taxable income increase of $10,920 in this bracket, one personal exemption is lost.

The five percent surcharge applied to the top income bracket takes away the tax benefit attributed to personal exemptions. The surcharge is the lesser of 28 percent of all personal exemptions claimed or five percent of taxable income in the top bracket. Beginning with 1989 the tax income brackets will be broadened for inflation if the CPI for the preceding calendar year exceeds the CPI for 1987.

Earned Income Credit

Earned Income Credit has been increased, the phase-out percentage has been reduced, and the AGI range eligible for maximum credit has been extended to $9,850 starting in 1988. EIC is not entirely phased out until AGI exceeds $18,566. Earned Income Credit is to be adjusted for inflation annually.

Changes in Earned Income Credit, 1987-1988

Year	Maximum Earned Income	Credit Percent	Maximum Credit	Phase-Out AGI Range	Phase-Out Percent
1987	$6,078	14	$851	$6,925 - 15,432	10
1988	6,243	14	874	9,850 - 18,566	10

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.

<u>Form W-5, Earned Income Credit Advance Payment Certificate</u> must be used by any employee eligible for EIC to elect advanced payments from his or her employer. EIC payments made by an employer to his or her employee offset the employer's liability for federal payroll taxes. Use IRS tables to determine advanced payments of EIC. An employer's failure to make required advanced EIC

payments is subject to the same penalties as failure to pay FICA taxes. Employers of farm workers do not have to make advance payments to farm workers paid on a daily basis (IRS Pub. 225).

A notice must be furnished to employees about refundable earned income credit. For services performed after December 31, 1986 every employer shall furnish to each employee who did not have income taxes withheld Notice 797 or a statement that contains the exact wording of Notice 797, *"You may be eligible for a refund on your federal income tax return because of the Earned Income Credit (EIC)."* The notice may be attached to the employee's 1988 W-2 or given to the employee within one week before or after February 1, 1989. Employees who have claimed exemption from withholding on Form W-4 or W-4A do not have to be notified.

Itemized Deductions

A taxpayer should itemize if total itemized deductions are greater than his or her standard deduction. Here are some of the important changes from TRA of 1986 that taxpayers must remember when itemizing deductions.

State and local sales taxes are no longer qualified itemized deductions. State income and property taxes are still deductible.

Personal interest is being phased out over a five year period. Forty percent is deductible in 1988, 20 percent in 1989, and 10 percent in 1990. Personal interest excludes business interest, investment interest, interest from passive activities, interest on deferred estate tax, and qualified residence interest. Personal interest includes interest on car loans, educational loans, and credit card debt.

Home mortgage interest (qualified residence interest) on the taxpayer's principal and second home is an itemized deduction providing the mortgage does not exceed the following limitations:

1. $1 million ($500,000 if married filing separate return) to buy, build or remodel a home reduced by home mortgage outstanding before October 14, 1987. (This is called "acquisition indebtedness".) Interest on home mortgages acquired prior to this date is deductible.

2. The lesser of $100,000 ($50,000 if married filing a separate return), or the fair market value minus the acquisition indebtedness qualifies for home equity indebtedness. Home equity indebtedness may be used for personal expenditures.

Mortgage interest that exceeds these limits must be included with personal interest and will be reduced by the phase-out rules.

Investment interest is deductible on the 1988 return to the extent of net investment income plus the lesser of $10,000 or the excess of investment interest over net investment income, times 40 percent. The phase out percentage goes to 20 in 1989 and 10 in 1990. 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 1988 net income limitation may be carried forward to the 1989 return. The limitation changes to net investment income after 1990.

Medical expenses that exceed 7.5 percent of AGI are itemized deductions not subject to the additional two percent AGI limit. "Medical expenses" are broadly defined to include payments made for nearly all medical and dental services, therapeutic devices and treatments, home modifications and additions made primarily for medical reasons, travel and lodging expenses associated with qualified medical care trips, legal fees required to obtain medical services, medicine and prescribed drugs, special schooling and institutional care, and qualified health insurance premiums.

Handicapped taxpayers' business expenses for impairment related services at their place of employment are itemized deductions not subject to the 7.5 percent or two percent AGI limits.

Moving expenses are itemized deductions. Use Form 3903 to report moving expenses and Form 4782 to report employer reimbursements.

Other itemized deductions not subject to the two percent AGI limit are charitable deductions, state income and property taxes, and personal casualty losses. This list is not complete.

Miscellaneous Deductions Subject To Two Percent AGI Limit Include:

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.

9. The regulation that requires shareholders of mutual funds and other publicly offered regulated investment companies to claim allocated expenses as itemized deductions subject to the two percent AGI limit was delayed until after 1989 by TAMRA 1988.

Business Meal and Entertainment Expenses

An 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.

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 applicable nondiscrimination requirements like those affecting employer provided health insurance. The amount deducted is included in income subject to self-employment tax and may not be included in medical expenses claimed as itemized deductions. A taxpayer eligible for coverage in an employer's subsidized health insurance plan may not deduct insurance premiums he or she pays even if it is the taxpayer's spouse that is the employee.

Other Reminders for Individual Taxpayers

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.

Nonbusiness casualty losses are subject to a claim filing 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.

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. 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.

Employee Awards - Employee achievement awards of tangible personal property excluding cash, gift certificates, and equivalent items, for length of service or safety achievement are excluded from the employee's gross income, but are deductible expenses for the employer providing the aggregate cost of qualified plan awards made to the same employee does not exceed $600. The maximum is $400 for nonqualified plan awards. Low value "de minimus fringe" awards are not subject to these limitations.

Interest Allocation Rules

According to TRA86, interest expense is divided into six categories: (1) trade or business, (2) investment, (3) passive activity, (4) qualified residence interest, (5) interest on federal estate tax and (6) personal interest. Interest paid in categories (1) and (5) is fully deductible while interest in the other categories may be partially or completely disallowed. Therefore, the taxpayer must allocate interest according to use of the debt on which the interest is paid. The taxpayer who deposits loans in an account from which funds are expended for various purposes such as paying for items for which the money was borrowed, paying farm expenses, and paying living expenses may be faced with great difficulty in complying with the interest allocation rules.

The allocation rules can be avoided by (1) not mixing the proceeds of a loan with the proceeds of other loans or with money from other sources (2) always using the proceeds of a loan for only one purpose or for purposes that are in the same category and (3) always using the proceeds from the sale of an asset to which debt is allocated to pay off the debt or to make only one new expenditure.

The following statements taken from the 1988 Illinois Farm Income Tax Schools Workbook summarize the interest allocation rules:

"(1) The interest allocation rules categorize interest according to the use of the debt on which the interest is paid. In general, **the purpose of the rules is to determine the expenditure to which each debt should be attributed.**

(2) In principle, the interest allocation rules require a taxpayer to determine in which basket to place the interest paid on each dollar of debt outstanding on each day of the tax year.

(3) However, many of the dollars of debt and many of the days the debt is outstanding can be grouped together so that the allocation task is less onerous.

(a) **As long as all the proceeds of a debt are used for only one expenditure, there is little difficulty in attributing that debt,** and **therefore the interest on that debt, to the single expenditure.**

(b) **Complexities arise**, however, if the proceeds of a debt are used for more than one expenditure or if the proceeds of a debt are commingled with other money.

(c) Further complexities arise if there is a change in the use of an asset that was purchased with the debt or if the asset is sold and the proceeds are not used to retire the debt.

(4) In general, Temp. Reg. §1.163-8T resolves these complexities by arbitrarily setting rules that resolve ambiguities in allocating interest and making assumptions that simplify the allocation process."

Four rules are used to determine the use of borrowed money for the purpose of deciding to which category the interest expense is allocated. From the Illinois Workbook:

"(1) If the proceeds of the loan are received in cash and used to purchase something within 15 days of the loan, the item purchased will determine the classification of the interest paid on the loan.

(i) Loan proceeds that are not distributed directly from the lender to the borrower are treated as if they were spent by the borrower for the item or service provided by the third party who received the proceeds from the lender.

(ii) Debt that is assumed with the purchase of an asset is treated as if it were spent on that asset.

(2) If the proceeds of the loan are placed in an account, such as a bank account, the interest paid on the loan is classified as investment interest, whether or not the account bears interest, until the proceeds are withdrawn from the account. **Exception:** if the proceeds are withdrawn within 15 days and the taxpayer chooses, the loan proceeds are treated as if they were never in the account.

(3) If the proceeds of the loan are held by the taxpayer as cash for more than 15 days, the proceeds are presumed to have been used for a personal expenditure. **Observation:** The interest on a loan that was held as cash for more than 15 days will always be personal interest. Therefore, the only way to get rid of that personal interest is to pay off the loan with unborrowed funds.

(4) If the proceeds of the loan are used to pay off another debt, then the proceeds are allocated to the item to which the original debt was allocated."

PROVISIONS APPLYING PRIMARILY TO BUSINESS ACTIVITY

Only those changes from TRA 1986 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 1988 and later, capital gain income is not 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 TRA 1986 that allows 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 partner or partners owning a majority interest in partnership profits and capital. If no partners own a majority interest, or if the majority of partners do not have the same tax year, the partnership must adopt the tax year of its principal partners. If neither of these applies, the partnership must adopt a calendar year.

A partnership, S Corporation or personal service corporation may adopt a "natural business year". Rev. Proc. 87-32 provides a test to determine a natural business year. It's not simple.

OBRA 1987 provides a "Section 444 election" which allowed a partnership, S corporation, or personal service corporation to elect, for its first tax year beginning after 1986, to retain the last tax year it had beginning in 1986 or to elect to change its tax year if the result is a deferral period of not more than three months. The election is allowed only if the deferral period is the shorter of three months or the deferral period of the tax year being changed. The election is made by filing Form 8716 "Election to have a Tax Year Other Than a Required Tax Year". In return for retaining deferral, partnerships and S corporations must make a "required payment". Personal service corporations are required to distribute certain amounts to owner-employees.

The requirements do not apply if a business purpose for a different year can be established. 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 was 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. Carryovers 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 cropland 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.

Limitation on Certain Prepaid Farming Expenses

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.

Alternative Minimum Tax Relief for Insolvent Farmers

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. This provision will now be useful only to someone filing an amended return for a year in which the 60 percent capital gain exclusion existed. 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.

Tax Treatment of Discharge of Certain Indebtedness of Solvent Farmers (IRC Section 108(g))

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 applies 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.

Diesel Fuel Excise Tax

Farmers have been paying federal excise tax on all diesel fuel purchased since April 1, 1988. RA of 1987 repealed prior law that allowed tax-free sales of diesel fuel for farming and other nonhighway use.

Farm tax experts thought farmers could qualify for a refund when taxes paid exceeded $1,000 per quarter as provided in IRC Section 6427(i)(2). IRS says farmers and fishermen do not qualify for quarterly refunds, they are regulated by IRS Section 6427(C). In other words farmers may claim the excise tax paid on nonhighway diesel fuel as a tax credit on Form 4136, Computation of Credit for Federal Tax on Gasoline and Special Fuels. The present law dictates that Form 4136 be filed with the annual tax return where the fuel tax credit reduces total taxes payable.

The 1988 Tax Law repealed the 1987 law effective January 1, 1989. Therefore, farmers will be allowed to purchase diesel fuel on a tax-free basis. The seller and the purchaser each must file an annual information return covering the transactions. The purchaser (farmer) will detail the nontaxable use of the fuel that was purchased tax-exempt.

There is a special one time opportunity to receive a refund (with interest) of the diesel fuel excise tax paid by farmers during 1988 by a yet undefined procedure that must be followed before July 1, 1989.

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.

Farmers are required to capitalize pre-productive expenses if the pre-productive period is more than two years (unless they elect not to capitalize, which triggers a requirement to use straight line depreciation). 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 in 1988. Single purpose agricultural structures and orchards and vineyards placed in service after 1988 will be 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

Asset	Recovery Period 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.
**Class life under review by IRS.

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.

TAMRA of 1988 provides for a fourth option which is 150 percent declining balance over the ADR midpoint life. This provision appears to be retroactive to 1987. This is the same depreciation required for alternative minimum tax purposes, which is discussed on page 45.

Class	Most Rapid Method Available
3, 5, 7 and 10-year	200% declining balance with switch-over to SL (Farm assets placed in service after 1988 will be limited to 150 percent DB)
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 available under MACRS in the amount of $10,000. 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 all trades or businesses of the taxpayer 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. (MRA88 limits the deduction of current and carryover amounts to $10,000 in any year.)

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 than prior to 1987. Every farmer who has purchased MACRS property in 1988 should consider the $10,000 expense deduction. It should not be used to reduce taxable income below the 1988 standard deduction unless an additional reduction in 1988 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 1988. If this was all 7-year property, 1988 depreciation would be $14,290. 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 $14,290 that would have been available had not the mid-quarter convention been triggered.

<u>MACRS Property Class Rules</u>

For 3, 5, 7, and 10-year MACRS property, the same recovery option <u>must</u> 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 1988, 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 have chosen fast recovery for a farm auto purchased in 1987 (5-year property) but have chosen 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.

<u>Anti-Churning Rules</u>

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.

<u>Some Special Rules on Auto and Listed Property</u>

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.

<u>Additional Rules</u>

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 preferential 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 time value of money makes 1988 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

Recovery Year	Type of Property		
	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.

CAPITALIZATION RULES AFFECTING FARMERS

Capitalization rules went into effect in 1987 and continue for the 1988 tax year. Farmers are required 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. Farmers may elect not to capitalize their preproductive period expenses by checking YES on line G Schedule F in the first year they are subject to the capitalization rules, and using alternative MACRS depreciation on all newly acquired depreciable assets. TAMRA 1988 repeals capitalization rules for livestock producers starting in 1989.

Changes Affecting Farmers in 1988

Changes have been made in the capitalization rules affecting farmers and legislation has been introduced to repeal capitalization rules for livestock producers. Regardless of the outcome of repeal legislation, farm capitalization rules continue for the 1988 tax year.

Revised regulations and safe harbor values were announced in IRS Notice 88-24. Current rules and regulations are summarized here.

1. IRS safe harbor values may be used by dairy and beef farmers in lieu of using actual preproductive period expenses or costs determined using qualified inventory valuation methods. IRS safe harbor values are $540 per dairy cow replacement and $340 per beef cow replacement. The use of safe harbor values is optional. Dairy and beef farmers may continue to use actual costs of production or qualified inventory valuation methods.

2. IRS safe harbor values may be adopted by amending the 1987 tax return or farmers who elected to capitalize in 1987 may adopt them for the first time on their 1988 return. The amended 1987 income tax return must be filed no later than the due date, including extensions, of the income tax return for the second tax year ending after December 31, 1986. This is a recent change and gives calendar year farmers until March 1, 1989 (April 15 if they filed an estimate by January 16) to adopt safe harbor values for 1987 and to file their amended returns. The date had previously changed from September 12, 1988 to October 3, 1988.

3. Farmers that elected not to capitalize in 1987 or ignored the election but continued to claim preproductive expenses on their 1987 Schedule F may revoke that election only by adopting safe harbor values for 1987 on timely filed amended returns. These farmers cannot initiate the use of safe harbor values on their 1988 or later returns. If they adopt safe harbor values for 1987 they must be used in 1988.

4. Farmers that capitalized preproductive costs in 1987 may initiate the use of safe harbor values on an amended 1987 return or on their 1988 return. The change to safe harbor cannot be made after the 1988 return is filed. If safe harbor values are adopted for 1987 they must be continued for 1988.

5. A farmer who had no preproductive cattle expenses in 1987 may delay the decision to capitalize, and the decision to adopt safe harbor values until the first tax year in which such expenses occur (i.e. 1988).

6. Safe harbor values may be used for dairy and beef calves purchased as replacements but the amount used in the first tax year must be the greater of the purchase price or one fourth of the safe harbor value.

7. Safe harbor values may not be used by corporations, partnerships, or tax shelters required to use accrual accounting.

Schedule F has been revised to allow a "does not apply" response on line G and a subtraction of all capitalized preproductive period expenses on lines 37 and 38.

Safe Harbor Value Accounting and Procedures

Farmers electing the use of safe harbor values shall subtract from otherwise deductible Schedule F expenses a total of $540 per dairy replacement and $340 per beef cow replacement, over a three tax year period. The safe harbor value is allocated as follows:

Annual Allocation of Cattle Safe Harbor Values for
Tax Years Beginning in 1988 and 1989

Tax Year	Dairy Cow Replacement	Beef Cow Replacement
First:		
Year of birth	$135	$ 85
Second:		
One year after birth	270	170
Third:		
Two years after birth	135	85
Total	$540	$340

The allocation begins with the tax year in which the animal is born regardless of day or month of birth, and ends in the third tax year even if the animal has not reached production. The year a replacement dairy or beef calf is purchased would be treated the same as the year of birth. No allocation is made for tax years preceding the tax year of safe harbor adoption. The total allocation for one tax year is subtracted from Schedule F expenses on lines 37 and 38 (1988 1040-F). When a cow replacement completes its preproductive tax life (second or third tax year after birth), recovery of the capitalized safe harbor values begin through depreciation.

Example 1

S.H. HARRIE decides to elect capitalization and use safe harbor values beginning with 1987. His raised dairy heifer inventory at the end of 1987 and 1988 is as follows:

	1987	1988
A. Calves born this year and held for replacements	31	35
B. Heifers in herd born last tax year	32	30
C. Heifers in herd born two years ago	14	32

Harrie's 1987 and 1988 preproductive period expenses are calculated as follows:

	1987 No. x Value = Amount	1988 No. x Value = Amount
Inventory lines A plus C	45 x $135 = $ 6,075	67 x $135 = $ 9,045
Inventory line B	32 x $270 = 8,640	30 x $270 = 8,100
Total Preproductive Period Expenses	$14,715	$17,145

Harrie's 1987 inventory includes only the preproductive animals on hand at the end of the year. Heifers that reached production or left the herd during 1987 are excluded. There are no heifers with a capitalized cost basis to enter on the 1987 depreciation schedule. The 1988 and subsequent year capitalization accounting procedures must include the heifers that calved during the year.

In 1988 the group of 14 heifers (1987 line C) moves into production with a basis of $1,890 (14 x $135). Also 16 from 1988 line C start production in 1988 with a capitalized basis of $6,480 (16 x $405) for depreciation. The rest of the capitalized expenses will be recovered through cost recovery beginning in 1989, 1990, and 1991.

Example 2

Assume S.H. Harrie bought two additional one month old heifer calves in 1988 and paid $250 each. They will be in his youngstock herd for more than 24 months and must be capitalized since he elects to capitalize raised heifers. Their 1988 preproductive period expenses are $250 each or $500 because the purchase price exceeds the first year safe harbor value allocation. Harrie will use safe harbor values in the second and third tax years. After their preproductive tax period life each of these animals will have a basis of $655 ($250 + $270 + $135).

Example 3

Assume S.H. Harrie elected capitalization on his 1987 tax return, adopted the unit livestock method of estimating preproductive costs and allocated $600 per head over a three year period. Harrie decides to switch to lower safe harbor values in 1988 but does not want to file an amended 1987 return. Harrie may apply safe harbor values starting with his 1988 heifer inventory. The preproductive period costs determined for the 1987 return will be part or all of the basis for the replacements in the 1987 youngstock herd.

Review

A farmer who adopts 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. Farmers who elect out of capitalization are also subject to Sec. 1245 recapture rules. When raised dairy and breeding livestock are sold, any gain to the extent of preproductive period costs that would have been capitalized must be recaptured as ordinary income. Safe harbor values may be used if this calculation is required.

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.

<u>The election not to capitalize</u> preproductive period expenses is made by checking the "YES" box on line G Schedule F. IRS asks this question on line G of the 1988 Schedule F; *"Do you elect, or did you previously elect, to currently deduct certain preproductive period expenses?"* The acceptable answers are; does not apply, yes, no.

The farm taxpayer who elects to capitalize using safe harbor values or acceptable costs of production must check <u>no</u> on line G. The farmer who grows no animals or plants subject to the capitalization rules checks <u>does not apply</u>. Once the election to, or not to, capitalize has been made the taxpayer is locked in. The election is revocable only with the consent of the commissioner.

<u>Some cattle are excluded from capitalization.</u> Animals, including dairy heifers, purchased for resale and held less than 24 months by a farmer with not more than $10 million of gross receipts are not subject to capitalization. All animals held primarily for slaughter are excluded from capitalization. The regulations exclude cattle purchased for replacements if they freshen within two years of purchase. This has generated new interest in selling calves and buying replacements as a tax management strategy.

<u>Tax Management Suggestions for Dairy Farmers and Beef Cattle Farmers</u>

Farmers currently raising replacement cattle must capitalize the costs of raising these animals or elect to use the alternative MACRS depreciation system.

Both options cause a substantial delay in cost recovery which produces an increase in taxable income and additional taxes. 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. Straight line depreciation plus Section 179 are high enough to manage taxable income.
2. A relatively high ratio of raised heifers per cow i.e. high culling rates.
3. A relatively low ratio of depreciable assets purchased to capitalizable preproductive period expenses.
4. Combined average tax rate in years 1 and 2 greater than expected in 3 through 7.
5. Electing out of capitalization will not have a detrimental effect on other farm enterprises and businesses.

The following conditions make the capitalization option more favorable:

1. Ratio of depreciable assets purchased to capitalizable preproductive period costs is high (e.g., farm is in expansion phase, culling rates are low, many replacements are purchased).
2. Combined average tax rates in years 1 and 2 less than expected in years 3 through 7.
3. Non-cattle enterprises are a substantial part of the farm business.
4. Carryover balance of unused investment credit adequate to manage higher taxable income in short run.

The decision of whether to capitalize or to elect alternative MACRS depreciation should not be based on the effect it will have on this year's taxes alone. It should result from careful consideration of the likely levels of net farm income, purchases of depreciable farm assets, numbers of youngstock to be raised, and available tax credits and deductions.

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. TAMRA 1988 repeals uniform capitalization rules for free-lance authors, photographers and artists (excluding the production of films and videotapes) effective starting with 1987.

GOVERNMENT PROGRAMS: GENERIC COMMODITY CERTIFICATES AND RELATED CCC LOAN TRANSACTIONS

In recent years 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 payment 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 was made even worse by USDA regulations issued in October 1986 and Revenue Ruling 87-17 issued in February 1987, but revoked in October 1987 by Ruling 87-103.

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.

The table below shows the income tax treatment of various dispositions of CCC loans and grain.

	Treatment of CCC Loan when Received	
Disposition of the Loan or Grain	Treated as Income (i.e. taxpayer made IRC Sec. 77 election)	Treated as Loan (i.e. taxpayer did not make IRC Sec. 77 election)
Loan paid by forfeiting grain	No further income to be reported	Amount of loan reported as income
Grain redeemed by paying off loan with cash	Farmer has basis in grain equal to loan	Farmer has a zero basis in the grain
Redeemed grain is sold	Farm has income (loss) equal to sale price less amount of loan, which is the basis in the grain	Farmer has income equal to sale price
Redeemed grain is fed	Farmer has a feed deduction equal to amount of the loan, which is his basis in the fed grain	Farmer has no deduction

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 certificates 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 has included the loan in income the year the loan was received. During the summer and fall of 1988, the posted county price has been above the loan rate so there was no incentive to use certificates to redeem CCC grain.

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 is was received.

Example: Corn Grower has 20,000 bushels of 1987 corn under loan at $2.10 per bushel = $42,000. A certificate worth $9,000 was received in 1988. C.G. redeems part of the corn (5,000 bu.) at the posted county price (PCP) of $1.80. This reduces the loan by 5,000 bu. x $2.10 = $10,500. Note that the loan is reduced by $1,500 more than the value of the certificate. C.G. then sold the corn in 1988 for $2.00 per bushel x 5,000 = $10,000.

C.G. will report the $9,000 certificate as income on his 1988 tax return. The difference between the amount of loan canceled and the value of the certificate ($10,500 - 9,000 = $1,500) is reported as 1988 income. When the corn was sold in 1988, there was $10,000 income from the sale of corn. The total income reported will be $9,000 + 1,500 + 10,000 = $20,500 (plus the sale of the remaining corn).

Now assume that the $42,000 loan had been reported as income. We are primarily interested in the loan on the 5,000 bushels that were redeemed. The basis of those bushels is 5,000 x $2.10 = $10,500. When this grain is sold for $2.00 per bushel = $10,000 there will be a loss of $10,500 - $10,000 = $500. Total income reported will be the $9,000 certificate +$10,500 loan included in income + $1,500 excess of the loan cancelled over the value of the certificate - $500 loss = $20,500 (plus the sale of the remaining corn).

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. has purchased the $9,000 certificate for $10,000. When it was used to pay off the $10,500 loan, there was a gain of $500 rather than $1,500.

OTHER GOVERNMENT PROGRAMS

Disaster Payments and Crop Insurance

The Disaster Assistance Act of 1988 substantially revised the disaster payments that had been available to farmers. The 1988 Act, among other things, provides (1) Emergency livestock assistance and (2) Emergency crop loss assistance. Emergency livestock assistance includes the emergency feed program which in some cases provides for donation or sale at reduced prices of feed to farmers from CCC stocks and the emergency feed assistance program which provides for cash payments to farmers. The crop loss assistance program provides for cash payments to farmers whose crop loss in 1988 was at least 35 percent.

It is likely that some New York farmers will receive benefits from these programs. Such benefits, including the value of donated feed, will produce taxable income. Some New York farmers will collect crop insurance because of drought and other calamities.

Normally, cash basis farmers are required to report disaster payments and crop insurance benefits in the year the payments are received. Under the Agricultural Act of 1949, there is an exception that allows such benefits to be reported in a later year if the taxpayer can show that under normal business practice, the income from the crop for which the benefits were received would have been reported in a later year. (There is no provision to allow payments received in a year later than the loss occurred to be reported in an earlier year.) According to TAMRA 1988, payments received under the 1988 act are eligible for the same delay in reporting. Actually, many of these payments are likely to be received in 1989.

The taxpayer makes the election to report in a later year by attaching a statement to his return indicating the election is being made under Sec. 451(d).

Conservation Reserve Program

Under this program, farmers bid to retire highly erodible land for 10 years. Land in the Conservation Reserve Program is not treated as rental property. CRP payments will be self employment income subject to SE tax unless the taxpayer can find a way not to materially participate in the operation of his CRP land.

The Social Security Administration states that CRP payments are not earned income for the annual earnings test if they are received in a year after the person became eligible for SS benefits. CRP payments are earned income if received in the year a person becomes eligible for SS benefits. The landowner might still be eligible for benefits under the monthly earnings test.

<u>Dairy Termination Program Payments</u>

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 (TCB88 should extend 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 provided 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. DTP farmers who sold their dairy herds and filed their tax 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.

The recommend 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.

DROUGHT SALES OF LIVESTOCK

Sales of livestock in excess of normal sales due to drought may be eligible for postponement of reporting for tax purposes. There are two sets of rules.

Dairy, draft and breeding animals are eligible for a two year postponement if the proceeds are used to purchase the same type of animals within two years. The livestock do not have to be located in a Federally declared disaster area. The taxpayer will have a basis in the replacement animals equal to the animals sold plus the amount that the cost of the replacement livestock exceeds the proceeds from the sale. The taxpayer makes the election under Sec. 1033(e) by attaching a statement to his return which explains the circumstances and the amount of gain deferred.

In the case of livestock held for sale, the postponement is for one year. The sale must have been caused by a drought which caused the area to be declared a disaster area by the Federal government. This election also applies to animals held for draft, dairy, breeding or sporting purposes and held more than two years in the case of cattle and horses and one year in the case of other livestock (TAMRA 1988 makes these animals eligible regardless of the holding period). The election is made under Sec. 451(e). The amount eligible for delay in reporting is the excess of sales over the sales the taxpayer would normally make and must be documented. The deferred gain is reported in the subsequent year and there is no requirement that animals be replaced.

GENERAL BUSINESS CREDIT

General business credit (GBC) is a combination of "regular" investment credit (generally repealed January 1, 1986), business energy credit, jobs credit, alcohol fuels credit, research credit, and low-income housing credit. Form 3800 is used to claim GBC for the current year, to apply carryforward GBC from prior years, and to claim carryback GBC from future years. 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 limits apply to married persons filing separate returns, controlled corporate groups, estates and trusts, and certain investment companies and institutions [Sec. 46(e)(i)].

FEDERAL INVESTMENT CREDIT

Review

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 investment credit was repealed for property placed in service after December 31, 1985 unless it is credit earned on transition property or qualified reforestation expenses. The regular credit (Sec. 45(a)(1)) is 10 percent of the amount of qualified investment. There are more liberal allowances for rehabilitated buildings and they remain in effect for 1987 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.

Investment credit carryovers from 1986 and earlier years may still be used but only 65 percent of that left over from 1987 may be carried to 1988 and later years. The special 15 year carryback provision is still available to farmers if they amend their 1987 tax returns. See <u>Unused Investment Credit</u> for more information on the carryover and carryback rules and provisions.

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.

Transition Property

Transition property is qualified IC property acquired or constructed pursuant to a written contract that was binding as of December 31, 1985. Property with an ADR midpoint life of less than seven years must have been placed in service prior to 1987, property with an ADR midpoint life of seven through 19 years must be placed in service before 1989, and property with an ADR midpoint life of 20 years or more must be placed in service before 1991 to qualify as transition property eligible for IC. Equipment incorporated into a qualified plant or structure at a later date may also be eligible as transition property.

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

Reforestation Expenses

Qualified reforestation expenses consist of up to $10,000 of the direct expenses of planting or replanting a forest or woodlot held for timber or wood production. Direct expenses include site preparation, seedlings, labor, tools, and depreciation of equipment used. These are the same expenses that qualify for seven year amortization. Excluded are operating costs that are deductible on an annual return, all costs that have been reimbursed through government cost-sharing programs, and all costs associated with planting Christmas trees. The basis of any depreciable reforestation expense must be reduced by 50 percent of IC claimed.

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 rehab expenditures during a 24-month period selected by the taxpayer must exceed the greater of the adjusted basis of the property or $5,000. Qualified ITC expenditures are not limited to those incurred during the 24 month "substantial test period". All qualified expenditures for the current tax year should be included.

Qualified rehab expenditures are incurred by the taxpayer on the date such expenses would become expenses under accrual accounting. A taxpayer acquiring an unused building under rehabilitation may be able to claim rehab credit on rehab expenses incurred by the transferor.

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

A special provision of TRA 1986 allowed qualified farmers and steel companies to elect to carry back a portion of existing IC carry forwards for as much as 15 years. IRS Announcement 88-88 was released during the summer to inform more taxpayers of this special provision.

IRS Announcement 88-88:

"Many farmers with unusable investment tax credit carryovers did not take advantage of a special provision in the 1986 Tax Reform Act. Under the provision, a farmer may use up to $1,500 of the carryforward in 1987 to get an actual cash benefit of half that amount (up to $750) even if there was no 1987 tax to offset -- the farmer can receive a refund if the credit exceeds the 1987 taxes owed. Neither the portion used in 1987 nor the other half given up may be used as an investment tax credit carryforward to any future years.

Qualifying farmers must have earned at least half of their gross income from farming in 1984, 1985, and 1986, and the credit carryover must have come from the farming business. This one-time refundable 1987 credit is limited to the smallest of (1) $750, (2) half of the investment credit carryovers, or (3) the total tax liability (not including minimum tax or self-employment tax, and minus credits other than the credit for fuel taxes) for the 15-year period before the earliest year from which an unused credit is included in the existing carryovers (but in no event will such 15-year period begin before 1962 or end after 1985).

Individual farmers who wish to use this special provision but have already filed their 1987 tax return may still claim the credit any time within three years by filing an amended return on Form 1040X, Amended U.S. Individual Income Tax Return. They should show the amount of this special credit and the letters "QFE" (qualified farmers' election) to the left of line 14 and include the amount with their estimated tax payments on line 14. Farmers who are organized as corporations, estate or trusts should follow similar procedures using the appropriate forms."

Here are two major points or limitations associated with this provision.

1. The farm taxpayer will use up $2 of IC carryover for each $1 of refund. If qualified for the maximum $750 of refund, the taxpayer will use up $1,500 of unused investment credit.

2. The refund is limited to the regular income tax liability (taxes paid plus taxes offset by fuel tax credits) during the 15-year carryback period.

A farmer who will be able to use up IC by carrying it forward to the 1988 tax return and other years in the near future will get more value than 50 cents on the dollar. A farmer who has accumulated so much IC that he/she may never be able to use it should apply for the $750 refund.

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

Carryover of unused IC, except reforestation credits, to 1987 was reduced by a percentage equal to the number of months in that tax year that fall after June 30, 1987, divided by the total number of months in the tax year, times 35. For 1987 calendar year taxpayers, the applicable reduction was 17.5 percent. The amount of the 1987 reduction may be added to the carryover to 1988 under the following rules (IRS Pub. 572, December 1987).

1. When all of the reduced IC carryover is used in the 1987 tax year, none of the reduction is carried over to 1988.

2. When only a portion of the reduced carryover is used in 1987 because of limited tax liability, the unused carryover plus a corresponding proportion of the reduction may be carried over to the 1988 tax year. The corresponding proportion of the reduction is determined by dividing the unused carryover by the total reduced carryover (see the following example).

3. When no amount of the reduced IC carryover can be used in 1987, the entire credit before the reduction is carried over to 1988.

Carryover of unused IC, except reforestation credits, to 1988 must be reduced by 35 percent. This reduction may not be added to any carryback or carryover to another tax year. Any unused balance of reduced 1988 IC may be carried over to 1989 and future years without further reduction.

Examples:

1. L.B. Credit carried forward $3,000 of unused IC to 1987. His 1987 federal income tax liability was $2,500. He is a calendar year taxpayer. L.B. reduced his $3,000 of carryover by 17.5 percent ($525) leaving $2,475 of available credit for 1987. L.B.'s 1987 tax was reduced to $25. Since there is no unused portion of IC to carryover to 1988 there is no corresponding proportion of the $525 reduction available for use in 1988.

2. I.C. Surplus carried over $25,000 of unused IC to 1987. Her 1987 federal income tax liability was $10,125. She is a calendar year taxpayer. I.C. reduced her $25,000 of carryover by 17.5 percent or $4,375, leaving $20,625 available for 1987 tax reduction. I.C.'s 1987 tax liability was reduced to $0 leaving a $10,500 balance of unused IC after the 17.5 percent reduction. I.C.'s carryover to 1988 is $10,500 plus a corresponding proportion of the $4,375 reduction. The proportion is $10,500/$20,625 or 50.9 percent. I.C.'s carryover to 1988 is $10,500 + $2,227 (4,375 x 0.509) = $12,727.

   In 1988 I.C. Surplus has an income tax liability of $9,400. Her carryover is reduced by 35 percent leaving 65 percent of $12,727 or $8,273 available in 1988. I.C.'s 1988 tax is reduced to $1,127 and the IC surplus is gone.

3. N.T. Lastyear carried over $4,800 of unused IC to 1987 but had no federal income tax liability in 1987. Nevertheless, he followed the instructions on Form 3800 and reduced his carryforward by 17.5 percent to $3,960 ($4,800 x 0.825). N.T. may carryover the entire $4,800 to 1988 where it will be reduced 35 percent.

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.

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 to decrease tax, 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 and Pub. 572.

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.

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:

-- Solar equipment will receive a 10 percent credit in 1988 (it was 12 percent in 1987). Ocean thermal equipment will still receive a 15 percent credit through 1988. Geothermal equipment will continue to receive 10 percent in 1988. (TAMRA 1988 extended these three credits through 1989 at the 1988 rates.)

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

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 under General Business Credits. 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. Capital gain income is not exempt from the five percent surcharge.

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 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 1983, 1984, 1985, 1986 or 1987 return and has a net Section 1231 gain for 1988, must recapture the losses on the 1988 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. It also applies to depreciation claimed on capitalized production costs and to amounts which would have been capitalized if the taxpayer had not elected out of capitalization. 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.

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, 1984 cost	$40,000
Soil and water expenses deducted on 1985 tax return	$3,000
Land was sold in 1988 for	$50,000

   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 $40,000. The gain of $10,000 would normally be all capital gain. But the land was not held for more than five years, so the gain is divided; $7,000 qualifies as capital gain, $3,000 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, purchased 1231 livestock that produce a gain upon sale will be entered in Part III where they become 1245 property. Sales of raised animals on which costs were capitalized are also reported in Part III as are animals on which preproductive costs would have been capitalized if the taxpayer had not elected to do so. 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.

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, preproductive costs not subject to capitalization rules (1231 Property)	4797, Part I
b) Purchased and raised subject to capitalization rules, sale results in gain (1245 Property)	4797, Part III
c) Purchased and raised subject to capitalization rules, 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 Revenue Act of 1987 repealed the proportionate disallowance rules for tax years beginning in 1988, and made the installment sales method unavailable to dealers of real and personal property on dispositions made after 1987. Beginning in 1988 all payments received from a dealer disposition of property must be reported as received in the year of sale.

A dealer disposition is: 1) any disposition of real property held by the taxpayer for sale to customers in the ordinary course of a trade or business; and 2) any disposition of personal property by a taxpayer who regularly sells such property on the installment plan.

Exceptions: A dealer disposition does not exclude property used or produced in the trade or business of farming from the installment method. The sale of time shares and residential lots are allowed providing the "dealer" elects to pay interest on the tax attributed to payments received in future years.

New Rules for Nondealers of Real Property (except farms)

Installment sales of nonfarm real property used in the taxpayer's trade or business, or held for the production of rental income, and sold for more than $150,000 are called "nondealer real property installment obligations" (NRPIO's). When the balance of deferred payments on NRPIO's made during the year exceeds $5 million at the end of the year, interest must be paid on the deferred income tax.

When a nondealer sells real property used in a trade or business or for the production of rental income for more than $150,000 and then uses the installment sales contract as security for a loan, the loan proceeds received are treated as installment payments received for tax purposes.

Old Rules Still in Effect

Losses cannot be reported on the installment sale method. A partnership may use the installment sale method of reporting gain on the sale of partnership property even though an individual partner may realize a loss and recognize it in the year of sale.

The loss of the 60 percent capital gains exclusion affects all installment sale payments received after 1986. The law in effect when an installment payment is received and reported determines how the income is treated. However, a change or increase in the capital gain holding period requirement during an installment sale would not move a long-term gain to a short-term gain.

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 (TRA 1986).

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. Remember that Section 179 expenses and capitalized expenditures are treated as Section 1245 dispositions. 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.

<u>Here is an example</u>: Carl Cropper sells his corn drying facility (Section 1245 property) to M.W. Grainer for $90,000 on January 1, 1988. 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 1988. 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 11.11 percent. The capital gain to report each year of the installment sale is $2,000 ($18,000 x 0.1111). 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.

<u>Installment Sale Resale Rules</u>

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.

<u>Imputed Interest Rules</u>

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 October 1988 monthly AFR was 8.24 percent (short-term, not over three years), 8.83 percent (mid-term, three to nine years), 9.07 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 for individuals. The changes described here pertain to individuals unless indicated otherwise. TAMRA 1988 made many changes in the AMT rules, most of which are not discussed here.

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 this year and in future years. 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 is no capital gains exclusion to include as tax preference income. Some taxpayers will receive postponement of tax benefits rather than permanent removal. Form 8801 is used to calculate credit for prior year minimum tax.

Higher Rates and Exemption Phaseout

The AMT flat rate has been increased from 20 percent to 21 percent. The basic exemptions remain unchanged. An 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

AMTI is calculated by starting with taxable income rather than adjusted gross income. Any NOL carryforward used in calculating the regular tax is added. Income and deduction adjustments are then added and tax preference items are included.

Here are the adjustments that must be added to TI. The first two categories are adjustments treated as "exclusions". AMT due to exclusions is not eligible for a credit against the following year's regular tax.

1. Standard deduction or 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. (These are lines 4a and c through h on Form 6251.)

2. Personal exemptions (due to TAMRA 1988 and retroactive to 1987).

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 later 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 costs 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 of property held primarily for sale in the ordinary course of the business. Dealer installment sales are not an adjustment because these cannot be reported on an installment basis for regular tax purposes. Exceptions include property used in farming and 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.

<u>Preference Items</u> - The first three are treated as "exclusions".

1. 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.

2. Tax-exempt interest from private activity bonds.

3. The excess of the tax depletion allowance over the adjusted basis of the property.

4. Accelerated depreciation of real and leased personal property placed in service before 1987 remains a tax preference subject to AMT as does amortization of certified pollution control facilities.

5. Incentive stock options - the difference between the exercise price and fair market value.

6. Intangible drilling costs.

7. Reserves for losses on bad debts of financial institutions.

<u>AMT Net Operating Loss Deduction</u>

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 farm and nonfarm taxpayers will sustain a net operating loss in 1988 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 business 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. The NOL calculation steps and rules of procedure have not been changed by recent tax legislation and are not included in this publication. The Illinois Farm Income Tax Workbook contains an excellent NOL chapter including illustrations and worksheets. IRS Pub. 334 contains a section on NOL's. Following are general rules and guidelines to consider before computing an NOL.

A net farm loss on Schedule F or net business loss on Schedule C is not equal to a <u>net operating loss</u>. The NOL is usually less than but it could be greater than the net business loss. Business losses must be combined with all other income, losses, and deductions on 1040 to determine if there is a <u>taxable loss</u>. The taxable loss, after adjustments, determines how much NOL is available to carryback and carryover to other tax years.

The opportunities and consequences of carrying an 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 1988 NOL would be first carried back to 1985, then to 1986, 1987, and then forward to 1989 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 year the NOL occurred by attaching a statement to the return. Once the election is made it is irrevocable for that tax year. If the election is not made by the applicable date, the NOL will be considered absorbed as if it had been carried back, even if it had not been claimed in a carryback year. 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.

The NOL is <u>not</u> to be considered when calculating net earnings from self-employment for the year to which the NOL is carried.

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.

PASSIVE ACTIVITY LOSSES

Section 469, added to the IRC by TRA of 1986, struck another blow to "tax shelters." It places new and significant limits on the use of tax losses to shelter business and investment income as well as salary and wage income. 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 (October 22, 1986).

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 (or the spouse) is involved in the operation of the activity on a regular, continuous, and substantial basis.

Regulations at Sec. 1.469-5T list seven tests for material participation. Meeting any one of these means that the taxpayer materially participates in the activity.

1. The individual participates for more than 500 hours in the taxable year.

2. The individual is the sole participant in the activity for the year.

3. The individual spends more than 100 hours on the activity during the year and no other individual spends more time on the activity than does this individual.

4. The individual spends less than 500 hours in each of several activities (excluding rental activities) but spends more than 500 hours total in all of them and more than 100 hours in each. (The IRS calls these "significant participation" activities, a term which has no legislative history.)

A problem with each of these four tests will be substantiation of the hours spent.

5. A person who has materially participated (without regard to test no. 5) in an activity for five of the past 10 years will be considered a material participant in the current year.

6. An individual who has materially participated in a personal service activity for at least three years will be treated as a material participant for the rest of his/her life.

7. An individual who participates in the activity for 100 hours or more may be treated as a material participant if based on all the facts and circumstances, the person participates on a regular, continuous and substantial basis.

Relative to the facts and circumstances in #7, the regulations set out the following rules:

1. The fact that an individual satisfies a material participation test under another section of the code, such as IRC Sec. 1402 (self-employment tax) or IRC Sec. 2032A (special use valuation) has no bearing on the material participation test for these passive activity rules. **Exception.** If an individual is treated as materially participating under IRC Sec. 2032A(b)(1)(C)(ii) because he or she meets the requirements of IRC Sec. 2032A(b)(4) or (5), the individual is treated as materially participating for purposes of the passive activity rules. Sec. 1.469-5T(h)(2).

   IRC Sec. 2032A(b)(4) treats a retired or disabled farmer as materially participating if he or she materially participated for 5 out of the 8 years preceding retirement or disability. IRC Sec. 2032A(b)(5) treats the surviving spouse of a farmer as materially participating if the farmer met requirements at the time of death and the surviving spouse actively participates in the farm business.

2. Management activities of the taxpayer are not counted if:

   a. Anybody other than the taxpayer is compensated for management services; or

   b. Somebody provides more hours of management services than the taxpayer.

3. If the taxpayer participates 100 hours or less, he or she cannot be treated as materially participating under the facts and circumstances test.

The General Explanation includes the following helpful comments.

"**Since a limited partner generally is precluded from participating in the partnership's business** if he is to retain his limited liability status, Congress concluded that is should not be necessary to examine general facts and circumstances regarding material participation in this context. Therefore, under the Act, **a limited partnership interest is treated as intrinsically passive** (except as provided in regulations)."

"**Material participation** of a taxpayer in an activity is **determined separately for each taxable year.** In most cases, the material participation (or lack thereof) of a taxpayer in an activity is not expected to change from year to year, although there will be circumstances in which it does change."

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

"**Material participation by a corporation subject to the passive loss rule.** Special rules apply in the case of corporations that are subject to the passive loss rule. A corporation that is subject to the passive loss provision is treated as materially participating in an activity with respect to which one or more shareholders, owning in the aggregate more than 50% of the outstanding stock of the corporation, materially participate. Thus, for example, a corporation with five shareholders, each owning 20% of the stock, is treated as materially participating in an activity if three or more of the shareholders so participate. If one of the three shareholders who so participates owned only 5% of the stock, and as a result the three participating shareholders owned only 45% of the stock in the corporation, the corporation would not be treated as materially participating in the activity."

"A closely held C corporation subject to the passive loss provision that is not a personal service corporation (as defined for purposes of the provision) may also be treated as materially participating in an activity if it meets the standard set forth in Section 465(c)(7)(C), disregarding clause (iv). This standard generally is satisfied if (i) for the prior 12-month period, at least one full-time employee of the corporation provided sufficient services in active management with respect to the activity, (ii) during the same period, at least three full-time non-owner employees provided sufficient services directly related to the activity, and (iii) the amount of business deductions by the taxpayer attributable to the activity exceeded 15% of gross income from the activity for the taxable year."

The types of farm management decisions that may be relevant to material participation if made on a regular, continuous, and substantial basis include: (1) Crop rotation, selection, and pricing, (2) the incursion of embryo transplant or breeding expenses, (3) the purchase, sale, and leasing of capital items such as cropland, animals, machinery and equipment, (4) breeding and mating decisions, (5) selection of herd and crop managers who act on behalf of the taxpayer.

A farmer who receives self-employment income will generally be treated as materially participating even if she/he contributes no physical labor.

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

Real Estate Rental

A special real estate rental rule allows an individual taxpayer (natural person) 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 modified 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, and approving repairs and capital expenditures. An individual whose interest in the rental activity is less than 10 percent will not qualify as actively participating.

INFORMATIONAL RETURNS

There are no major changes affecting the 1988 filing requirements and penalties associated with informational returns.

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. Also used to report direct sales of $5,000 or more of consumer goods for resale.

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.

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. The person responsible for reporting is 1) the person responsible for closing, 2) the mortgagor, 3) the seller's broker, 4) the buyer's broker, or 5) any other person designated by regulation, in this order.

1099-G - Report of agricultural program payments, 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. Penalties for failure to file with the IRS and to provide a copy to the payee are consolidated ($50 penalty for each failure). Failure to include all required information is a $5.00 penalty. Additional penalties are imposed for intentional disregard.

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

THE SOCIAL SECURITY TAX SITUATION AND MANAGEMENT OPPORTUNITIES

Increases in social security (FICA) and self-employment tax rates, and increases in earnings subject to the tax 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 2.74 percent to $45,000 for 1988 following a 4.3 percent increase in 1987. Social Security (FICA) rates increased to 7.51 percent for both employers and employees in 1988 and will remain at 7.51 percent in 1989. The maximum combined FICA tax was $6,263 in 1987. In 1988 it will be $6,759, up 7.9 percent from last year. Next year the maximum combined FICA tax will be $7,210 if the earnings base increases to $48,000.

Currently (1988) self-employed individuals pay an effective rate of 13.02 percent (15.02 less 2.0 credit) that will generate a maximum of $5,859 self-employment tax. This is an increase of $472 or 8.8 percent over 1987. The 1988 effective rate remains at 13.02 percent.

Social Security Tax Table

Year	Earnings Base	FICA Tax Rate		Self-Employment Tax		
		Employer	Employee	Specified Rate	Credit	Effective Rate
1987	43,800	7.15	7.15	14.3	2.0	12.3
1988	45,000	7.51	7.51	15.02	2.0	13.02
1989	48,000	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 1988 is computed on the first $45,000 of net earnings from the trade or business. Low income farmers may use the optional method and report up to $1,600 of self-employment income when net income is less than $1,600. Nonfarmers have a similar option.

Wage Payment to Spouse/Children Changed by RA 1987

Cash wages earned by a person employed by his or her spouse are subject to Social Security coverage and FICA taxes beginning January 1, 1988.

Cash wages paid to individuals 18 years old and over working for their parent(s) are now subject to FICA taxes. Prior to 1988 sons and daughters under age 21 working for their parents were exempt from Social Security.

Farm employers must pay Social Security on their employees if they pay more than $2,500 to all agricultural labor during the year. This new $2,500 rule replaces the old $150 test if the annual payroll exceeds $2,500. The $150 test is still in effect for payrolls of $2,500 or less (i.e., any employee receiving $150 or more of cash wages is subject to Social Security even if the total cash payroll is less than $2,500). All employees are subject to Social Security if the annual cash payroll exceeds $2,500. The old 20 days test has been eliminated. (TAMRA 1988 exempts farm piece work labor from the $2,500 rule under a set of very restrictive conditions.)

The new law eliminates most of the tax management incentives formally associated with paying cash wages to family members. One remaining incentive is that an individual employed by their spouse can use his or her salary to buy an IRA that may reduce the current total marginal tax rate more than 15 percent. Remember however, deductible IRA contributions are taxed when distributed.

RA 1987 also extended Social Security coverage to a parent employed for domestic service by a son or daughter who has dependents under 18 or incapacitated dependents.

Beginning in 1988, director's fees are income when services are rendered not when paid or received. This will prevent postponement of payment until age 70 (Section 1402(a)).

<u>Noncash Payments to Employees</u>

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 paying the spouse, for children who are working on the farm but are over age 18 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.

<u>Taxation of Social Security Benefits</u>

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. one-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 1988?

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 1988.

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)	1988 Earnings Limit	Reduction of Social Security Benefits
Less than 65	$6,120	.50 of excess earnings
65 to 70	8,400	.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 in 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. A special provision [26 CFR Sec. 404-429] 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

Rules for 1987 and later years will 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 may 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. Also, the requirement to file Form 8606 in the year the nondeductible contributions are made discourage such contributions.

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 1988 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.

Announcement 88-38 provides a method by which certain taxpayers receiving social security benefits are to calculate the IRA deduction limits.

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 1988. 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 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 accepted 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 was eliminated beginning in 1987. In 1988 and later, the deduction of 10 percent of the lower spouses earned income (up to a maximum deduction of $3,000) that was available in 1987 is gone.

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 years itemized deductions of higher-income taxpayers are subject to limitations.

Investment Credit

Investment credit was eliminated by NYTRRA 1987 for acquisitions after 1988. Unlimited carryforward was maintained. However, BTRA 1987 restored investment credit, which is available at four percent for acquisitions after 1986, rather than the former six percent. (For corporations, the rate is five percent on the first $500,000,000 of investment credit base and four percent on any excess.) 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

There are now 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	Not over $27,000	5.5%
& surviving spouse	Over $27,000	7.0
Single, married filing separately	Not over $12,500	5.5
estates & trusts	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 1988 are:

Married Filing Jointly and Surviving Spouse*

If the New York taxable income is:

Over	Not Over	Tax		
$ 0	$ 6,000		3% of the excess over	$ 0
6,000	10,200	$ 180 plus	4% " " " "	6,000
10,200	14,600	348 plus	5% " " " "	10,200
14,600	18,800	568 plus	6% " " " "	14,600
18,800	24,800	820 plus	7% " " " "	18,800
24,800	34,000	1,240 plus	8% " " " "	24,800
34,000		1,976 plus	8.375% " " "	34,000

Single, Married Filing Separately and Estates and Trusts

If the New York taxable income is:

Over	Not Over	Tax
$ 0	$ 3,000	3% of the excess over $ 0
3,000	5,100	$ 90 plus 4% " " " " 3,000
5,100	7,300	174 plus 5% " " " " 5,100
7,300	9,400	284 plus 6% " " " " 7,300
9,400	12,400	410 plus 7% " " " " 9,400
12,400	17,000	620 plus 8% " " " " 12,400
17,000		988 plus 8.375% " " " 17,000

Head of Household

If the New York taxable income is:

Over	Not Over	Tax
$ 0	$ 3,800	3% of the excess over $ 0
3,800	6,000	$ 114 plus 4% " " " " 3,800
6,000	8,300	202 plus 5% " " " " 6,000
8,300	10,500	317 plus 6% " " " " 8,300
10,500	13,600	449 plus 7% " " " " 10,500
13,600	18,300	666 plus 8% " " " " 13,600
18,300		1,042 plus 8.375 " " " 18,300

*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 ($50,000 for married taxpayers filing separately and estates and trusts). In 1987, the tax rate was three percent and in 1988, it is two percent. If adjusted gross income exceeds $100,000, the additional tax is computed with the following formula:

$$\text{Unearned income} \times 0.02 \times \frac{\text{Lesser of \$100,000 or (NYAGI - 100,000)}}{100{,}000}$$

Household Credit

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 federal adjusted gross income (total for both spouses if separate returns are filed).

In 1988 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 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 tax credit computations and limits are the same for 1988 as for 1987. 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, 1988

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 will be eliminated for tax years beginning after 1988. Contributions to PASS were 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 Carryover

New York State Solar and Wind Energy Credit amounting to 55 percent or qualified costs up to $2,750 of credit, was available to homeowners through 1986. The carryover credit is claimed by filing Form IT-218.1, Solar and Wind Energy Credit Carryover.

Other Credits

Other credits allowed against the New York personal income include resident credit for income taxes paid to other states, accumulation distribution credit, investment credit, mortgage recording tax credit, and economic development zone credit.

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.

New York State Investment Credit is Four Percent Beginning in 1987

The credit for individuals is four percent (five percent for corporations) 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 it 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, few 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.