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FARM INCOME TAX MANAGEMENT AND REPORTING

Reference Manual

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1990 TAX FORMS NEEDED BY NEW YORK FARMERS

Here is a list of the more important 1990 income tax forms needed by farmers. Several of the forms have been revised (R) for 1990.

Federal Forms

- 1040 - U.S. Individual Income Tax Return (R)
  - Schedule A & B - Itemized Deductions and Dividend and Interest Income (R)
  - Schedule D - Capital Gains and Losses (and Reconciliation of Forms 1099-B) (R)
  - Schedule E - Supplemental Income Schedule (R)
  - Schedule F - Farm Income and Expenses
  - Schedule R - Credit for Elderly or the Disabled
  - Schedule SE - Computation of Social Security Self-Employment Tax (R)
- 1040EZ - Income Tax Return for single filers with no dependents, income under $50,000, interest under $400, other limitations
- 1040A - Nonitemizers, under $50,000 taxable income, other limitations (R)
- 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
- 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: used to report depreciation, cost recovery, Section 179 expense election, and listed property. (R)
- 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
- 8615 - Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000
- 8645 - Soil and Water Conservation Plan Certificate
- 8801 - Credit for Prior Year Minimum Tax
- 8824 - Like-Kind Exchanges

New York State Forms

- IT-201 - Resident Income Tax Return (long form)
- 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 Reconciliation Form
- IT-2102.1 & IT-2102.4 - Informational Return and Transmittal Form

1990 TAX LEGISLATION AND FARM INCOME SITUATION

1990 Tax Legislation

After a long hassle, Congress and the President agreed on a budget and tax package which they claim will reduce the deficit by $40 billion in the current fiscal year and $490 billion over a five-year period. The package includes, in addition to income tax provisions, changes in other taxes and cuts in some programs. Here is our understanding of the major income tax changes that will affect individuals.

The top tax bracket will be 31 percent. The bracket will begin at about $78,400 (the beginning of the 33 percent "bubble" in 1990) for joint filers and at $47,050 for single filers. The "33 percent bubble", which was due to the 5 percent surtax to take away the benefit of the 15 percent bracket for higher income taxpayers, is gone. Itemized deductions will be reduced 3 percent of the amount of adjusted gross income over $100,000 (but indexed to inflation).

Personal exemptions will be phased out for single filers with taxable incomes over $100,000 and joint filers with incomes over $150,000 (limits would be indexed). The alternative minimum tax rate will increase from 21 to 24 percent. The top rate on capital gain income will be 28 percent.

The medicare tax of 1.45 percent, which is now hidden in the social security tax, will be charged on a base as high as $125,000 rather than on just the social security base ($51,300 in 1990).

Higher Farm Incomes

Nationally, 1990 net cash farm income is predicted to hit a record high $60.8 billion, up 10 percent from 1989. Receipts from livestock products will be up 7 percent; crop sales will increase 3 to 4 percent.

Through the first nine months of 1990, prices received by New York dairy farmers are up 13 percent compared to the same period in 1989. Although 1990 last-quarter milk prices will average more than $2 per hundredweight below last fall's prices, total 1990 New York dairy farm receipts will be up approximately 10 percent. Operating expenses on New York farms may increase less than 5 percent in 1990, resulting in higher net farm incomes and larger 1990 income tax bills for many farmers.

Some dairy farmers may be paid for 12 1/2 months of milk for the first time in 1990. Sec. 1002.80(a) of the New York law regulating milk dealers reads:

> "On or before the last day of the month, each handler shall make payment to each producer for milk received from such producer during the first fifteen days of the month..."

This law became effective in 1990. Cash basis farmers must report this 25th milk check as income if received or constructively received in 1990. Prior to 1990, dairy farmers received payments for December's milk in January. The prospects of higher 1990 net farm incomes, additional milk receipts and a less profitable year ahead puts a high value on 1990 tax management.

TAX MANAGEMENT STRATEGIES FOR 1990

Here are some farm tax management suggestions that are appropriate strategies for the cash basis farmer to consider in years of higher-than-normal taxable income. The objective of tax management in a high-income year should be to increase after-tax farm profit by decreasing taxable income.

Strategies That Must Be Implemented Before Year's End

1. Pay up all operating bills and accounts so they can be included as 1990 cash expenses. It pays to borrow operating capital to increase business deductions when the after-tax cost of capital is less than the tax benefit of the deduction.

2. Buy feed, fertilizer, seed, and supplies for next year. Remember that prepaid expenses cannot exceed 50 percent of other deductible farm expenses in most situations. Year-end feed purchases must be a binding commitment made for business reasons to qualify.

3. Pay family labor and regular employees for all their services. Consider making noncash payments such as crops and livestock to eliminate FICA taxes and tax withholding. Pay or deposit federal employment taxes before January 1 so the farm share of FICA taxes can be a 1990 farm expense.

4. Make and pay for repairs. Consider capital purchases and improvements that will qualify under the $10,000 expense election. Avoid buying more than 40 percent of this year's depreciable property in the last quarter unless the mid-quarter convention works to the taxpayer's advantage. A taxpayer cannot use the $10,000 election to reduce the amount of last-quarter purchases to avoid the 40 percent rule, but once the determination is made that the rule applies, the $10,000 may be applied to last-quarter purchases to minimize the impact of the last-quarter rules.

5. Leasing rather than purchasing equipment that is placed in service during the last quarter may result in a 1990 deduction for lease payments that exceeds the amount that could be deducted as depreciation and interest. However, leasing may not be the least-cost alternative in the long run, so the decision of whether to lease or purchase a machine should not be based solely on the 1990 tax savings.

6. Farmers do not have much flexibility on the income side unless they sell commodities other than milk. However, even a specialized dairy farmer has some flexibility. For example, sale of cows that normally would be culled near year's end could be delayed until 1991.

Strategies That Can Be Elected Up To Filing Time

1. Maximize use of the $10,000 expensing election, and take rapid MACRS depreciation on the balance of qualified depreciable assets.

2. Postpone gains on involuntary conversions including cattle sold because of disease.

3. Claim net operating losses from prior years.

4. Contribute to tax-deferred retirement plans.

Remember that tax management strategies must be consistent with good business management policy in order to increase after-tax profits.

FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

Standard Deduction

The standard deduction is indexed to inflation and is adjusted annually. The 1990 standard deduction is 4.8 percent higher than the 1989 standard deduction. The 1991 estimates in the following table are based on a 5.8 percent projected increase in CPI from 1989 to 1990.

Basic Federal Standard Deduction for 1990 and Estimates for 1991

Filing Status	1990	1991 Estimate*
Married filing jointly; surviving spouse	$5,450	$5,770
Head of household	4,750	5,025
Single individuals	3,250	3,440
Married filing separately	2,725	2,880

*Estimates based on a 5.8 percent increase in CPI.

Each taxpayer over age 65 or blind receives the regular standard deduction plus an additional $650 deduction if married and filing a joint or separate return. The additional deduction is $800 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, 1990

Status	Basic Deduction	Additional Deduction	Total Standard Deduction
a. Married taxpayers filing jointly, both 65 or older	$5,450	$1,300	$6,750
b. Status *a* plus one spouse is blind	5,450	1,950	7,400
c. Married filing separately, age 65	2,725	650	3,375
d. Head of household, age 65	4,750	800	5,550
e. Single, age 65 or over	3,250	800	4,050
f. Single, age 65 and blind	3,250	1,600	4,850

The additional deduction is also subject to the inflationary adjustment.

Personal Exemption Increases

The 1990 personal exemption is $2,050, up from $2,000 in 1989. It will be indexed to inflation after 1990. It is projected to be $2,150 in 1991.

The benefit of the personal exemption is phased out for taxpayers with specific high levels of taxable income (see 1990 Tax Rate Schedule). Taxpayers are entitled to claim one exemption each for themselves, their spouses, and their dependents on their federal return.

1990 Tax Rates

Individual 1990 income tax brackets are wider than the 1989 brackets. The top of each bracket is 4.8 percent higher due to 1989 inflation.

There are still two basic taxable income brackets at 15 and 28 percent. Two deviations in the 28 percent bracket push the maximum rate to 33 percent. The first is the required phaseout of the 15 percent rate for moderate and high income taxpayers. The second is the phaseout of personal exemptions for higher income taxpayers (see 1990 Tax Rate Schedules below).

Taxpayers filing a joint return and reporting taxable income of $40,000 in 1989 and 1990 will save $195 from the 1990 bracket adjustments alone.

1990 Tax Rate Schedules

Single Taxpayers		Married Filing Joint Return & Surviving Spouses	
Taxable Income	Tax	Taxable Income	Tax
$0-$19,450	15%	$0-$32,450	15%
19,450-47,050	$2,915.50 + 28% over $19,450	32,450-78,400	$4,867.50 + 28% over $32,450
47,050-97,620	$10,645.50 + 33% over $47,050	78,400-162,770	$17,733.50 + 33% over $78,400
97,620 & over	28% + surcharge*	162,770 & over	28% + surcharge*

Unmarried Heads of Household		Married Filing Separate Returns	
Taxable Income	Tax	Taxable Income	Tax
$0-$26,050	15%	$0-$16,225	15%
26,050-67,200	$3,907.50 + 28% over $26,050	$16,225-39,200	$2,433.75 + 28% over $16,225
67,200-134,930	$15,429.50 + 33% over $67,200	39,200-123,570	$8,866.75 + 33% over $39,200
134,930	28% + surcharge*	123,570	28% + surcharge*

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

The rates for unmarried heads of household are more favorable than those for single taxpayers and married taxpayers filing separate returns. Single taxpayers who are maintaining a home for themselves and a dependent should qualify. Married taxpayers not living in the same household for the last six months of the year are treated as unmarried and may qualify as heads of household.

The 5 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 (0.28 x $2,050 = $574 per exemption for 1990), or 5 percent of taxable income in the top bracket. A nine-line worksheet is provided by IRS for the calculation of the surcharge and the total federal income tax. A married individual filing a separate return must include an exemption for his or her spouse when calculating additional tax liability resulting from the phaseout of personal exemptions.

Dependents

Taxpayers must report the social security numbers of all dependents two years old or older claimed on returns due in 1990 and later tax years.

Taxpayers may not claim an exemption for a dependent who has earned income of $2,050 or more unless it is for their child under age 19 or a full time student child under age 24. Individuals who can be claimed as dependents on another taxpayer's return may not claim a personal exemption on their own return.

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. The $500 rule limits the basic standard deduction but not 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 1990 unearned income, will receive a standard deduction of $1,300 ($500 + $800).

Investment or unearned income in excess of $1,000 received by a dependent child under age 14 is taxed at the parent's marginal rate if greater than the income tax using the child rates. A three-step procedure is required to compute the tax on Form 8615 unless an election is made to claim the child's unearned income on the parent's return where the excess over $1,000 will be taxed at the parent's marginal rate and unearned income greater than $500 but less than $1,000 will be taxed at 15 percent. This election cannot be made if the child has income other than interest and dividends or if estimated tax payments were made in the child's name.

Joint vs. Separate Returns

Married couples with two incomes who itemize deductions should consider filing separate returns. They may be able to save tax dollars because the 7 1/2 percent floor on medical deductions, the 2 percent floor on miscellaneous deductions and the 10 percent floor on casualty losses could be less on two individual incomes than on one joint income. Tax savings are most likely to occur when income is evenly split and one spouse can claim the majority of a deduction that is limited by percentage of AGI. Other factors favoring separate returns are: pre-divorce alimony may not be deducted on the joint return; more unreimbursed employee expenses and investment expenses may be deducted on the separate return (misc. deductions subject to 2 percent floor); married couples may not be claimed as dependents by another taxpayer if they file a joint return unless they are below the gross income filing requirements.

However, some benefits available to joint filers are not available on separate returns. The child and dependent care credit can only be claimed by filers of joint returns. Social Security benefits are protected with a higher threshold on the joint return. Married taxpayers filing separately may not claim the $25,000 rental activity loss to offset nonpassive income, and the alternative minimum tax exemption can be more effective on the joint return.

Itemized Deductions

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

Personal interest is being phased out. Ten percent is deductible in 1990. It will not be deductible after 1990. 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 phaseout rules.

Investment interest is deductible on the 1990 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 10 percent. After 1990 the deduction will be limited to the extent of net investment income. Investment interest is interest paid on debt incurred to buy investment property which does not include investments in passive activities, nor activities in which the taxpayer actively participates, including the rental of real estate. Net investment income is gross investment income (including interest, dividends, taxable portion of annuities, certain royalties and net gains but not net losses from sales) less investment expenses (excluding interest). Investment interest disallowed because of last year's limitation may be carried forward to the 1990 return.

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

Medical expenses that exceed 7.5 percent of AGI are itemized deductions not subject to the additional 2 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. The costs to acquire, train and maintain animals that assist individuals with physical disabilities are deductible.

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

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 2 percent AGI limit are charitable deductions, state income and property taxes, and personal casualty losses. This list is not complete.

Miscellaneous Deductions Subject To 2 Percent AGI Limit Include:

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

2. Reimbursed employee business expenses not substantiated to employer. The reimbursement is gross income and the expenses are subject to the 2 percent floor.

3. Professional dues, books, journals and safe deposit box rental.

4. Job searching expenses.

5. Legal, accounting, and tax counsel fees; clerical help and office rent associated with investment activities.

6. Hobby expenses not exceeding hobby income.

7. Office-in-the-home expenses.

8. Indirect miscellaneous deductions passed through grants or trusts, partnerships and S corporations.

Business Meal and Entertainment Expenses

The 80 percent rule still limits the amount of qualified business meal and entertainment expenses that may be deducted. Most 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.

Earned Income Credit

Earned Income Credit has been increased, and the AGI range eligible for maximum credit has been extended due to the adjustment for inflation. The dollar amount of EIC is rounded to the nearest multiple of 10 after being increased by inflation.

Changes in Earned Income Credit, 1988-1989

Year	Maximum Earned Income	Credit Percent	Maximum Credit	Phase-Out AGI Range	Phase-Out Percent
1988	$6,243 - 9,850	14	874	$9,850 - 18,566	10
1989	$6,500 - 10,240	14	910	$10,240 - 19,340	10
1990	$6,810 - 10,730	14	953.40	$10,730 - 20,264	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.

Form W-5, Earned Income Credit Advance Payment Certificate 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).

Notice 797 is no longer required by most farmers. Farm employers were required to furnish Notice 797 to employees exempt from income tax withholding for services performed beginning in 1987. The notice informed employees that they may have been eligible for a tax refund because of EIC. Employees who claimed exemption from income tax withholding did not have to be notified. Now nearly all farm employees who do not claim exemption are subject to income tax withholding.

Other Reminders for Individual Taxpayers

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

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 casualty loss will be allowed. Any reimbursement will reduce the casualty loss. Each personal casualty loss must be reduced by $100 and total annual casualty losses by 10 percent of AGI. Casualty losses are not subject to the 2 percent of AGI limit.

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 (must have been a 12-month return). Farmers who receive at least two-thirds of their total gross income from farming are exempt from estimated tax payments providing they file and pay their taxes by March 1st.

Employer-provided educational assistance exclusions have been extended. The $5,250 income exclusion for educational assistance paid by an employer under a qualified plan was extended through tax years beginning before 1/1/92. A qualified written plan must meet specific requirements including nondiscrimination and no benefits to highly paid employees.

Education assistance includes tuition, fees, books, supplies and equipment paid for by the employer. Meals, lodging, transportation, and supplies and equipment that are used by the taxpayer after the course of instruction do not qualify for the exclusion. The exclusion does not apply to payments for graduate instruction leading to a law, business, medical or similar advanced degree. Graduate teaching and research assistantships may be excluded from income under certain tuition reduction provisions.

Child Care Credit is a nonrefundable credit available to taxpayers who incur dependent care expenses so they may be gainfully employed. The credit ranges from

20 to 30 percent of employment-related child care expenses as taxpayer adjusted gross income declines from $28,000 and over to $10,000 and under. Employment-related expenses may not exceed $2,400 for one qualifying dependent and $4,800 for two or more. The maximum credit available ranges from $480 to $720 for one qualifying dependent. Double that amount for two or more dependents.

For tax years beginning in 1989 and later, the dependent child being cared for must be age 12 or less. Eligible work-related expenses claimed must be reduced by reimbursement received from the taxpayer's employer. The child care provider's TIN must go on the individual taxpayer's return unless the provider is a tax-exempt organization. An individual claimer must require the care provider to complete and provide form W-10 which contains all the information needed to fill out Form 2441 (Credit for Child and Dependent Care Expenses) or Schedule 2 of 1040A. Form W-10 (Dependent Care Provider's Identification and Certification) is kept by the claimer. The provider does not file Form W-10 with IRS.

Credit for the Elderly or the Disabled is a nonrefundable credit available to qualified individuals age 65 and older and permanently disabled taxpayers who have retired. The 15 percent credit is small to moderate for elderly taxpayers with very limited incomes. A single retiree with $10,000 or more of AGI and $3,750 or more of social security would receive no credit.

Business Use of Automobiles. Automobile expenses are deductible if incurred in a trade or business or in the production of income. Actual costs or the standard mileage rate method may be used. In general, the 1990 standard mileage rate is 26 cents per mile for all business miles driven. There is no longer a reduction in rate for over 15,000 miles and fully depreciated autos.

Rural mail carriers are allowed a special mileage rate equal to 150 percent of the basic standard mileage rate (39 cents for 1990). The special mileage rate applies to all business use of an automobile (including vans, pickups, and panel trucks) while performing "qualified services."

Scholarships and fellowships cannot 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.

Nondegree 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.

Gain on the Sale of Principal Residence may be rolled over into the purchase price of a new home when one spouse dies before the new home is purchased as long as the surviving spouse completes the purchase within the specified period of time. TAMRA88 also provided the $125,000 lifetime exclusion on the sale of a principal residence to a physically or mentally disabled taxpayer age 55 or over who fails to meet the prior use rule (three out of five years) providing he or she lived in the residence for at least one year and was moved to a licensed care facility anytime during the five-year period prior to the sale.

Series EE United States Savings Bonds

Beginning in 1990, taxpayers may purchase Series EE bonds and exclude all or a portion of interest on the bonds if the proceeds are used to pay qualified higher education expenses (tuition and fees) at eligible educational institutions. These

bonds are purchased at a discount, and the interest is not reported until the bonds are redeemed. The bondholder must be at least 24 years old. If all or part of the proceeds of the bonds are not used for qualified higher education expenses, the exclusion of the interest from taxable income will be partly or fully disallowed. The interest exclusion will be phased out for married taxpayers with modified adjusted gross incomes above $60,000 and individuals and heads of households with modified AGIs above $40,000. These amounts are indexed to inflation after 1990. Form 8818, Optional Form to Record Redemption of College Savings Bonds, may be used to maintain records needed to substantiate the interest exclusion.

While these bonds appear to be a good method for taxpayers to fund education expenses for their dependents, it is suggested that taxpayers fully acquaint themselves with the rules before purchasing the bonds.

Qualified Conservation Contribution

A donation of a perpetual conservation easement on a piece of real estate to a governmental unit or a land trust may result in a deduction as a "qualified conservation contribution" under Sec. 170(h). The donation of such an easement normally would reduce the value of the property. The decline in the value of the property due to the donation of the easement, as determined by a qualified appraiser (if it exceeds $5,000), is the amount that may qualify as a charitable contribution using Form 8283.

The taxpayer may not be able to deduct the full value of the qualified conservation contribution in the year that the easement is donated. The deduction will be limited to a percentage of adjusted gross income (probably 20 percent of AGI) under the rules that apply to all charitable contributions. Donations that exceed the limit based on adjusted gross income may be carried forward up to five years subject to the AGI limits in the carryforward years.

Interest Allocation Rules

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.

Complexities arise and allocation is required when loan proceeds are used in more than one expenditure category and when there is a change in use of an asset purchased with debt proceeds. The following guidelines are from IRS publication 545.

Interest paid on a loan is allocated according to the use made of the loan proceeds. The allocation is not affected by the use of secured property.

A deposit of loan proceeds in a taxpayer's account is treated as property held for investment until it is used for something else. Any interest paid on the loan before it is used is investment interest expense. When the proceeds of the loan are withdrawn from the account and used, interest is allocated based on the use of the funds.

Generally, loan proceeds that are deposited in an account are treated as used before any unborrowed amounts in the same account. Two or more loans deposited in the same account are allocated using the first in - first out convention. Interest paid on loans deposited in an account may be allocated to any expense paid within 30 days (before or after) of the loan deposit without regard to other allocation rules.

If loan proceeds are placed in an interest bearing account, the first expenses paid may be allocated to the interest earned. If loan proceeds are received in cash, any expense paid within 30 days of receiving the cash may be allocated to the loan. Otherwise, loans received as cash are treated as personal loans.

A line of credit or similar account that allows periodic borrowing under a single loan agreement is treated as a single loan if interest accrues at the same fixed or variable rate for all borrowings charged to the account. Borrowings subject to different interest rates are treated as different or separate loans.

When payments are made on loans that have been allocated to more than one use, the loan is treated as being repaid in the following order: (1) amounts allocated to personal use, (2) amounts allocated to investments and most passive activities, (3) amounts allocated to passive activities in connection with rental real estate in which the taxpayer actively participates, (4) amounts allocated to former passive activities, and (5) amounts allocated to a trade or business and certain low-income housing projects.

PROVISIONS APPLYING PRIMARILY TO BUSINESS ACTIVITY

Only those changes from TRA 1986 and later tax laws affecting most business taxpayers and not covered in detail elsewhere in the manual are included here.

Capital Gains

Capital gains do not receive preferential treatment. For farmers, all gains on sales of livestock, real estate, and other farm property used in the farm business are taxed as ordinary income. Capital gain income is not exempt from the 5 percent surcharge to offset the benefits of the 15 percent bracket and personal exemptions for higher income taxpayers.

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

Net short-term capital losses and net long-term capital losses are combined for the purpose of offsetting ordinary income. 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. TAMRA88 changed the rules (effective as if part of TRA86) so that a taxpayer will not lose the benefit of the capital loss deduction because of a negative taxable income.

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.

A "Section 444 election" allows a partnership, S corporation, or personal service corporation 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 tax deposit to compensate the government for the time value of the deferral. 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

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 was 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.

Business Use of Home

Home office expense deductions are 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. This provision has been extended through tax years beginning before 1/1/92.

Corporate Tax Rates

Corporate tax rates are the same for 1990 as for 1989. There is no indexing of brackets.

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 the 15 and 25 percent brackets by applying a 5 percent surcharge to income over $100,000, the surcharge not to exceed $11,750.

PROVISIONS SPECIFIC TO AGRICULTURE

Expensing of Soil and Water Conservation Costs

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. Form 8645, Soil and Water Conservation Plan Certification, is required. 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.

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

After the TRA86 and TAMRA88, some of the insolvent debtor rules are applied to solvent farmers for debt discharged after April 9, 1986. The discharged debt must be "qualified farm indebtedness". To meet the qualified farm indebtedness definition, (1) the debt must have been incurred directly in connection with the operation of the farm business, (2) 50 percent or more of the aggregate gross receipts of the farmer for the three previous years must have been attributable to

farming and (3) the discharging creditor must be (a) in the business of lending money and (b) not related to the farmer, did not sell the property to the farmer and did not receive a fee for the farmer's investment in the property.

These rules are quite restrictive and may prevent some solvent farmers from using tax attributes to offset discharge of indebtedness income (DII). For example, a farmer with DII who had purchased the real estate or other property from the lender who later cancelled part or all of the debt would not meet the QFI rules, at least for the DII related to this property.

Solvent farmers must reduce tax attributes in exchange for not reporting DII as income. Also, for solvent farmers, the basis reduction for property owned by the taxpayer must take place in the following order: (1) depreciable assets, (2) land held for use in the trade or business of farming and (3) other property. The limit on reducing the basis below the remaining debt does not apply to solvent taxpayers.

Unlike the rules for insolvent debtors, any DII remaining after the tax attributes have been reduced must be included in taxable income. In other words, if the DII exceeds the total of the tax attributes, all the tax attributes will be given up and the excess of DII over the tax attributes will be included in income and therefore may cause a tax liability.

Diesel Fuel Excise Tax

Farmers, operators of school and city buses, operators of vessels and certain aircraft, and other off-highway business users exempt from the 15.1¢ federal excise tax on all diesel fuel purchased effective January 1, 1989. Farmers and other business owners may use the exemption on fuel used off the highway. They must pay the tax on diesel fuel used in highway vehicles.

Farmers and other exempt purchasers who have paid $1,000 or more in diesel fuel excise tax during any of the first three quarters of a tax year may file for a refund on Form 843. The alternative is to file for a tax credit using Form 4136.

To avoid paying the tax wholesale distributors or dealers must have an exemption certificate signed by the exempt purchaser on file. IRS does not print and distribute copies of the exemption certificate but provides the content and acceptable form for an exemption certificate in Notice 88-132 and Pub. 225.

Dealers may not deliver tax exempt fuel to a storage tank with less than 250 gallons of capacity or to any vehicles fuel supply tank. Users who store exempt and nonexempt fuel in the same tank should indicate on their exemption certificate what quantity of the fuel delivered is for exempt use and pay the tax on the nonexempt fuel. Overstating projected tax-free needs or failing to pay tax on the additional gallons used for a nonexempt purpose will be considered to be an abuse of tax-free purchases. The tax on fuel purchased for exempt purposes and then used on the highway must be paid to IRS quarterly using forms 720 and 8743.

Information reporting of tax exempt transactions was to take effect in 1990 (IRC Sec. 4093(c)(4)). IRS has not issued the forms and instructions required to begin information reporting. Hence, farmers and other exempt purchasers must keep records showing the amount of exempt diesel fuel used, dates of purchase, name, address and registration number of the fuel supplier.

DEPRECIATION AND COST RECOVERY

The modified accelerated cost recovery system (MACRS) provides for eight classes of recovery property, two of which may be depreciated only with straight line and applies to property placed in service after 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 of trees and plants 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 are depreciated when the productive period starts. Taxpayers other than farmers are also subject to uniform 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	Nonresidential real property

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

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 (if placed in service before 1989), silos, grain storage bins, fences, paved barnyards, water wells, and drain tiles.

3. Breeding or work horses.

Ten-year property.

Prior to 1989, there was no farm property included in the 10-year class. Single purpose agricultural structures and orchards and vineyards placed in service after 1988 are in the 10-year class.

Fifteen-year property.

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

2. Orchards, groves, and vineyards when they reach the production stage if they were placed in service before 1989.

Twenty-year property includes farm buildings such as general purpose barns and machine sheds.

27.5-year property includes residential rental property.

31.5-year property includes nonresidential real property.

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

	Recovery Period		
Asset	ACRS	MACRS	Alternative MACRS
Airplane	5	5	6
Auto (farm share)	3	5	5
Calculators	5	5	6
Cattle (dairy or breeding)	5	5	7
Citrus groves	5	15	20
Communication Equipment	5	7	10
Computer and peripheral equipment	5	5	5
Computer software	5	7	12*
Copiers	5	5	6
Cotton ginning assets	5	7	12
Farm buildings (general purpose)	19	20	25
Farm equipment and machinery	5	7	10
Fences (agricultural)	5	7	10
Goats (breeding or milk)	3	5	5
Grain bin	5	7	10
Greenhouse (single purpose structure)	5	10**	15
Helicopter (agricultural use)	5	5	6
Hogs (breeding)	3	3	3
Horses (nonrace, less than 12 years of age)	5	7	10
Horses (nonrace, 12 years of age or older)	3	3	10
Logging equipment	5	5	6
Machinery (farm)	5	7	10
Mobile homes on permanent foundations (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	10***	20
Paved lots	5	15	20
Property with no class life	5	7	12
Rental property (nonresidential)	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	10**	15
Single purpose horticultural structure	5	10**	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	10***	20
Wind energy property	5	5	12*

*No class life specified. Therefore, 12-year life assigned.
**7 if placed in service before 1989.
***15 if placed in service before 1989.

Cost Recovery Methods and Options

Accelerated cost recovery methods for MACRS property are shown below. Depreciation on farm property placed in service after 1988 is limited to 150 percent declining balance rather than the 200 percent available for nonfarm property. There is an exception from the 150 percent declining balance rule for property placed in service before July 1, 1989 that was under construction or under a binding written contract before July 14, 1988. 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. TAMRA of 1988 provided for a fourth option which is 150 percent declining balance over the ADR midpoint life. This is the same depreciation required for alternative minimum tax purposes, which is discussed under Alternative Minimum Tax.

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

Class	Most Rapid MACRS Method Available
3, 5, 7 and 10-year	Nonfarm assets: 200 percent declining balance with switch-over to SL. Farm assets: 150 percent if placed in service after 1988. 200 percent if placed in service 1987 through 1988.
15 and 20-year	150 percent declining balance with switch-over to SL
27.5 and 31.5-year	Straight line only

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

Annual Recovery (Percent of Original Depreciable Basis)
(The 150% DB percentages are for 3, 5, 7 and 10 year class farm property placed in service after 1988.)

	3 Year Class		5 Year Class		7 Year Class		10 Year Class		15 Yr. Class	20 Yr. Class
Recovery Year	200% d.b.	150% d.b.	200% d.b.	150% d.b.	200% d.b.	150% d.b.	200% d.b.	150% d.b.	150% d.b.	150% d.b.
1	33.33	25.00	20.00	15.00	14.29	10.71	10.00	7.50	5.00	3.75
2	44.45	37.50	32.00	25.50	24.49	19.13	18.00	13.88	9.50	7.22
3	14.81	25.00	19.20	17.85	17.49	15.03	14.40	11.79	8.55	6.68
4	7.41	12.50	11.52	16.66	12.49	12.25	11.52	10.02	7.69	6.18
5			11.52	16.66	8.93	12.25	9.22	8.74	6.93	5.71
6			5.76	8.33	8.92	12.25	7.37	8.74	6.23	5.28
7					8.93	12.25	6.55	8.74	5.90	4.89
8					4.46	6.13	6.55	8.74	5.90	4.52
9							6.55	8.74	5.90	4.46
10							6.55	8.74	5.90	4.46
11							3.29	4.37	5.90	4.46
12-15									5.90	4.46
16									3.00	4.46
17-20										4.46
21										2.25

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 is phased out for any taxpayer who places over $200,000 of property in service in any year, with complete phaseout at $210,000.

In the case of partnerships, the $10,000 limit applies to the partnership and also to each partner as an individual taxpayer. A partner who has Sec. 179 allocation from several sources could be in a situation where not all of the 179 allocated to him/her could be used because of the $10,000 limitation. The same concept applies to S corporations and shareholders.

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. The deduction of current plus carryover amounts is limited to $10,000 in any year.

Based on an IRS Memorandum to Regional Counsel, Central Region, 9-14-88, wage and salary income would seem to qualify as taxable income from a trade or business.

Gains from the sale of Section 179 assets are treated 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 or if business use drops to 50 percent or less, the Section 179 expense recapture is invoked no matter how long the property was held for business use. The amount recaptured is the excess of the 179 deduction over the amount that would have been deducted as depreciation.

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 1990 should consider the $10,000 expense deduction. It should not be used to reduce adjusted gross income below the standard (or itemized) deductions plus exemptions unless an additional reduction in 1990 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. Assets placed in service during the first, second and third quarters will earn 87.5, 62.5 and 37.5 percent, respectively. The determination of whether the mid-quarter convention applies is made before the Section 179 deduction is made. 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 1990. If this was all 7-year farm property, 1990 depreciation would be $10,710. 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 $1,340. 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 $6,695. Total depreciation would be $6,695 + $1,340 = $8,035 vs. the $10,710 that would have been available under the regular mid-year convention.

Note that if the 40 percent rule is triggered, the depreciation on property acquired in the first and second quarters actually increases.

MACRS Property Class Rules

For 3, 5, 7, and 10-year MACRS property, the same recovery option must be used for all the property acquired in a given year that belongs in the same MACRS class. Taxpayers do not have the option to establish subdivisions of a property class. For example, if a farmer purchased a new tractor, forage harvester and combine in 1990, all belong in the 7-year property class. The farmer may not recover the tractor over seven years with rapid recovery and the other items over seven or ten 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 tractor purchased in 1989 (7-year property) but have chosen straight line for ten years for a combine purchased in 1990. Keep in mind that fast recovery would be used on any other 7-year property purchased in 1989 and the straight line option used on the combine would be required on all 7-year property purchased in 1990.

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 over 25 years on 20-year property.

Some Special Rules on Auto and Listed Property

There are special rules for depreciation on automobiles and other "listed property" acquired after June 18, 1984. TRA of 1986 changed the depreciation allowance for "luxury" autos. The maximum first year allowance is $2,660 for 1990. Cellular telephones were added to listed property for 1990.

Additional Rules

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

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

Gain to the extent of MACRS deductions whether rapid or SL on all Section 1245 3, 5, 7, 10 and 15-year MACRS property is ordinary income. Property in the 20-year class will be eligible for capital gains treatment if straight line recovery is used. However, this is of dubious value unless 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 taxed as 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 1990 depreciation more valuable than that used in later years. However, depreciation claimed to reduce taxable income below zero is depreciation wasted.

ACRS Recovery Percentages

Tables for rapid recovery of ACRS property are available in the Farmers Tax Guide and Publication 534. A table for straight line ACRS depreciation is shown on the next page.

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 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.

REVIEW OF UNIFORM CAPITALIZATION RULES

The preproductive costs of raising livestock are exempt from the uniform capitalization rules in tax years ending after December 31, 1988. The exemption does not apply to large farm corporations, partnerships or tax shelters that are required to use accrual accounting, or to the preproductive costs of establishing fruit trees, vines and other applicable plants.

Fruit Growers and Nurserymen

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.

"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)].

Fruit growers who choose to capitalize will need to establish reasonable estimates of the preproductive costs of trees and vines. The farm-price method could be used by nurserymen to establish their preproductive costs of growing trees, vines, and ornamentals. Capitalization requires the recovery of orchard, vineyard, and ornamental tree preproductive period expenses over 10 years. If growers elect not to capitalize, they must use alternative MACRS (20 year straight line) to recover the costs of trees and vines and all other depreciable assets placed in service. Only the preproductive period growing costs may be expensed.

Old Livestock Capitalization Rules Still in Effect

Livestock capitalization rules and elections adopted in 1987 and 1988 will affect 1990 records and depreciation claimed on Schedule F.

1. Dairy and beef farmers now exempt from the uniform capitalization rules who made the election to use alternative MACRS depreciation to avoid capitalization in 1987 and/or 1988, should have revoked the election on their 1989 return by checking the "does not apply" box and printing "PRIOR ELECTION FOR ANIMALS REVOKED" on line G of Schedule F. The revocation must be made on a 1989 return. Farmers who revoked the election should check "does not apply" on line G of their 1990 Schedule F.

2. Assets placed under alternative MACRS depreciation in 1987 and 1988 must remain under this method of cost recovery until fully depreciated or disposed of.

3. Preproductive period costs capitalized in 1987 and 1988 will remain on the depreciation schedule until the capitalized costs are fully recovered.

4. The sales of animals subject to capitalization rules are Section 1245 transactions. Unrecovered capitalized costs become the basis, and gain to the extent of depreciation claimed is ordinary income. Farmers who elected out of capitalization are also subject to the Section 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 if the election had

not been made, must be recaptured as ordinary income. IRS says you cannot use safe harbor values for this calculation.

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

An artist is defined as any individual whose personal efforts may be expected to create a picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print edition. The production of jewelry, silverware, pottery, furniture and household crafts is not considered the work of an artist for this purpose. Expenses paid or incurred by an employee do not qualify for this exemption.

CASUALTY LOSSES, GAINS, AND INVOLUNTARY CONVERSIONS

A casualty includes the damage or loss resulting from a sudden, identifiable, unexpected event such fire, flood, wind, lightning, freezing, earthquake and accidents.

Business Casualty Losses and Gains

Fire and storm losses of farm buildings, vehicles, equipment and purchased livestock will result in casualty losses or gains. The deductible loss is the lesser of the adjusted basis or loss in market value, minus any insurance received. When the insurance is greater than the loss in value or basis, there is a casualty gain that may be treated as an involuntary conversion. When calculating casualty losses and gains, the remaining basis is decreased by any insurance received.

Losses of raised crops and livestock are not deductible to the cash basis farmer because the value of these production items has not been reported as income. The costs of replacing raised crops is a business expense; crop insurance is ordinary income. Insurance proceeds from losses of raised dairy and breeding livestock are casualty gains.

Example: H.B. Lightning lost a hay barn to fire in July 1990. The barn, hay and machinery stored in the barn were a total loss. Here is a summary of the information required to calculate the casualty loss or gain.

Item	Market value loss	Tax basis	Insurance received	Casualty
Barn	$75,000	$2,000	$60,000	$58,000 gain
Hay, raised	1,000	0	1,000	NA
Machinery	30,000	10,000	30,000	$20,000 gain

Since the tax or adjusted basis is less than the loss in market value, the tax basis is subtracted from insurance received to determine the casualty loss or gain. H.B. has two casualty gains totaling $78,000. The $1,000 insurance proceeds from

raised hay is ordinary income. H.B.'s casualty gain is an involuntary conversion; he elects to postpone the gain since he plans to replace the barn and machinery. If he spends $80,000 to rebuild the barn, its basis will be $22,000 ($80,000 - $58,000). He has two years, or through the end of the 1992 tax year, to replace the property.

Involuntary Conversion

Casualty gains and gains from forced sales due to condemnation, threat of condemnation, disease and drought are involuntary conversions. Reporting gains of involuntary conversions may be postponed if replaced with property similar or related in service or use. The replacement period ends two years after the close of the year in which any part of the gain is realized.

Postponement of gains is an election that must be made on the tax return for the year in which the gain first occurred. Attach a statement to the return that explains what the gain is, how it was determined, and when it will be reported. Another statement is requested in the year the replacement property is acquired, explaining what it is and how its basis was determined. If the property is not replaced within the required time period, the return for the election year must be amended to report the gain realized.

Gains from the sale and death of any livestock because they are diseased (IRC Sec. 1033(d)) or dairy, draft and breeding livestock caused by drought (Sec. 1033(e)) are involuntary conversions.

Condemnations, Easements and Severance Damages

When part of a taxpayer's land is acquired through condemnation proceedings or an easement is applied, the land is involuntarily converted into money, and gain may be postponed by investing in like kind property. If the taxpayers can continue to use the land subject to an easement, he/she may not want to buy like kind property. In such cases, the easement award can be used to reduce basis. The excess over the basis of land subject to the easement is capital gain.

Severance damages are payments made to compensate the taxpayers for impairment of the use of property that remains after condemnation of adjacent property. Severance damages are used to reduce the costs of obtaining the severance award, costs associated with making the property usable, and special assessments made against the retained property. To the extent that the severance award exceeds these costs, it may be used to reduce the basis of the affected (noncondemned) property.

Personal Casualty Losses

Storm losses of shade trees, ornamentals, and damage to other nonbusiness real property may result in casualty losses or gains. A loss cannot exceed the basis of the property, the first $100 of each loss is not deductible, and nonbusiness casualty losses must exceed 10 percent of AGI before they become deductible. Expenses for cleaning up damaged property, repairs, replacement costs and other related costs are not deductible.

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. (Part of these payments is usually paid in cash and must be included in income.) The taxability of the value of the certificates is rather complicated due to an interaction with Commodity Credit Corporation (CCC) loan transactions.

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 certificate is cashed in the year received, the face value of the certificate 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. The Farmer's Tax Guide includes several examples of certificate-loan transactions.

OTHER GOVERNMENT PROGRAMS

Disaster Payments and Crop Insurance

The Disaster Assistance Acts of 1988 and 1989 provide for payments to farmers for weather-related losses in those years.

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.) TAMRA 1988 clarified that payments received under the 1988 Disaster Act are eligible for the same delay in reporting.

Congress did not enact a provision that would allow this type of delay in reporting income from the 1989 Disaster Act. However, on February 23, 1990, the Treasury issued a Temporary Regulation (1.451-6T) that allows this type of delay in reporting federal payments if they are received as a result of (1) the destruction of, or damage to, crops caused by drought, flood or any other natural disaster or (2) the inability to plant crops because of such a natural disaster. This regulation is effective for payments received after December 31, 1973.

Farmers who elected to report crop 1989 insurance proceeds received in 1989 as 1990 income should also treat 1989 disaster payments the same way. However, Regulation 1.451-6T was issued after many farmers had filed their tax returns, delaying the crop insurance proceeds but not the disaster payment. These taxpayers may file an amended return, but are not required to do so. For 1989, they will be allowed to defer crop insurance proceeds even though disaster payments are not deferred. The rules do not permit the opposite to be done.

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). The election applies to all crops from a farm. This leads to a confusing situation in cases where one crop, such as corn, normally is sold in the year following harvest, but another, such as soybeans, is sold in the year of harvest.

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. These payments should not be self-employment income to a landlord who is not materially participating in the operation of a farm business.

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.

Dairy Termination Program Payments

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 one could shift from 1040F to 4797 was the value of the dairy herd lost from selling it for slaughter rather than for dairy purposes. DTP farmers who sold their dairy herds in 1987 and filed their tax returns without making the CCC income adjustment must file amended returns before March 1, 1991 to take advantage of this provision. The potential tax savings will come from switching ordinary income to capital gain and reducing self-employment income.

DTP CCC income received in 1988, 1989 and 1990 may still be allocated to the value of dairy cattle sold under the rules in notice 87-26, but the 60 percent capital gains exemption would not apply.

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

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)].

Review of Federal Investment Credit

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

Until 1986, federal investment tax credit was one of the most important features of farm tax reporting and tax management. The regular 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 some rehabilitated buildings. The credit is a direct reduction against income tax liability. If the credit cannot be used in the year it is earned, it can be carried back and carried forward to offset tax liability in other years. If property is disposed of before credit claimed is fully earned, the credit must be recomputed to determine the amount to recapture.

Form 3468 is used for computing the credit, but records showing credit claimed on individual property should be a part of the depreciation record. Copies of prior years' forms can be used to keep track of the running balance of credit available. Form 3800 is used for calculating the availability of carryforwards, carrybacks and unused credit.

Transition property is qualified IC property acquired or constructed pursuant to a written contract that was binding as of December 31, 1985. Only 20- to 40-year ADR midpoint life property which includes general purpose farm buildings, orchards, vineyards and rental property is still eligible for IC under the transition property rules, and it must be placed in service before 1991 to qualify. If IC is claimed on transition property, the basis for depreciation must be reduced by 100 percent of the investment credit.

Qualified reforestation expenses are still eligible for regular investment credit. 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. 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 are excluded. The basis of any depreciable reforestation expense must be reduced by 50 percent of IC claimed.

Rehabilitated buildings (expenditures) credit is still available. 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. These new rules apply to rehabilitated property placed in service after 1986.

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.

Buildings other than certified historic structures qualify if rehabilitation costs are "substantial" and (1) 50 percent or more of the existing exterior walls of the building are retained as exterior walls, (2) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls, and (3) 75 percent or more of the existing internal structural framework of such building is retained in place.

The rehabilitation must be "substantial", that is, qualified rehabilitation 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.

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

Unused Investment Credit

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 later years. The special 15-year carryback provision that allowed qualified farmers to carryback up to $1,500 of IC to get up to $750 of refunds is still available to farmers if they amend their 1987 tax returns.

Unused IC may be carried over to the 1990 return with Form 3800. Carryovers to 1987 were reduced by 17.5 percent and carryovers to 1988 were reduced by 35 percent after making an adjustment by adding back the unused portion of the 1987 reduction. Therefore, the IC carried forward to 1990 from correctly filed 1987 and 1988 returns will again require a 35 percent reduction. Reforestation IC does not require the 35 percent reduction.

Recapture of Credit

Section 38 assets placed in service during 1985 and disposed of in 1989 are still subject to IC recapture rules if not held for five full years or 60 months. Assets disposed of earlier in 1990 than the date placed in service in 1985 will not meet the full five-year requirement, and 20 percent of IC claimed is subject to recapture.

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.

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. 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.

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. 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.

TAMRA '88 extended the rates on the following credits through September 30, 1990. The Revenue Reconciliation Act of 1990 has extended BEIC on solar and ocean thermal equipment through 12/31/91.

1. Solar equipment will receive a 10 percent credit.

2. Ocean thermal equipment will still receive a 15 percent credit.

3. Geothermal equipment will continue to receive 10 percent credit.

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.

The energy credit from 3468 is combined with other investment credits 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.

Other General Business Credits

Targeted Jobs Credit has been extended through December 31, 1991. The credit is equal to 40 percent of the first $6,000 of qualified first-year wages paid to employees from targeted groups. Targeted groups include handicapped individuals undergoing vocational training, an individual receiving federal, state or local social services (welfare) benefits, youth enrolled in qualified cooperative education programs, and qualified (economically disadvantaged) summer youth employees.

Low-Income Housing Credit is still available for low-income housing that is constructed, rehabilitated or acquired before January 1, 1992. The credit is

claimed over a ten-year period, and annual allowances vary with new vs. rehabilitated housing and changes in AFR. In June of 1990, the annual credit was 9.16 percent for qualified new construction or rehabilitation, and 3.93 percent for subsidized construction and acquisition of existing housing. Beginning in 1990, taxpayers qualifying for new low-income housing credit must enter into an agreement to maintain the low-income status for 30 years.

Credit for Qualified Research Expenditures is available through December 31, 1991. The credit is 20 percent of the excess of qualified research expense for the tax year over an average for the preceding four years. Qualified research expenditures include costs of developing new products, processes, models, software, formulas and technologies. Market and consumer research is excluded.

An Alcohol Fuel Credit may be claimed by taxpayers who blend or use gasohol and other alcohol fuels in their trade or business. The credit is 60 cents per gallon when the blend is 190 proof or more. This credit continues through 1991.

LIKE-KIND EXCHANGES

The following is taken directly from the 1990 Farmer's Tax Guide.

Like-Kind Exchanges Between Related Parties

New rules limit whether certain exchanges made between related parties after July 10, 1989 are nontaxable. These rules affect both direct and indirect exchanges. As with other like-kind exchanges, when related parties exchange like-kind property, no gain or loss is recognized (included in income). Under the new rules, however, if either party disposes of the property within two years after the exchange, then the exchange is disqualified from nonrecognition treatment. The gain or loss must then be recognized as of the date of disposition of the property. The two-year holding period begins on the date of the last transfer of property which was part of the like-kind exchange.

Related parties. Under these rules, a related party includes a member of your family (spouse, brother, sister, parent, child, etc.) and a corporation in which you have more than 50 percent ownership.

Exceptions to the Related Party Rules. The following kinds of property dispositions are excluded from the new limits on nontaxable like-kind exchanges between related parties:

1. Dispositions due to the death of either related person,
2. Involuntary conversions, or
3. Exchanges or dispositions if it is established to the satisfaction of the IRS that the main purpose is not the avoidance of federal income tax.

New Form 8824. Beginning in 1990, if you exchange property in a like-kind transaction, you must file Form 8824, *Like-Kind Exchanges*, in addition to Schedule D (Form 1040) or Form 4797. The instructions for each form explain how to report the details of the exchange. Report the exchange even though no gain or loss is recognized.

For more information on like-kind exchanges, see *Like-Kind Exchanges* in Publication 544.

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 is 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 5 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 sales of farm business property. Schedule D is used to accumulate capital gains and losses. The treatment of gains and losses on disposition of property used in the farm business can be better understood after a review of IRS classifications for such property.

1. Section 1231 - Includes gains and losses on farm real estate and equipment held at least one year, 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 at least one year. 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 1985, 1986, 1987, 1988 or 1989 return and has a net Section 1231 gain for 1990, must recapture the losses on the 1990 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 one year 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, 1986 cost	$100,000
Soil and water expenses deducted on 1986 tax return	$8,000
Land was sold in 1990 for	$130,000

   During the time the land was owned, no capital improvements were made other than the soil and water expenses, so the adjusted tax basis at time of sale was $100,000. The gain of $30,000 would normally be all capital gain. But the land was not held for more than five years, so the gain is divided; $22,000 qualifies as capital gain, $8,000 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 elected not to do so during the years when livestock were required to be capitalized. Sales of raised 1231 livestock not subject to the capitalization rules 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 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 one year 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 one year or more	
a) Sale results in gain	4797, Part III
b) Sale results in loss	4797, Part I
6. Farmland, held for one year 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 one year	4797, Part II

INSTALLMENT SALES

The installment method of reporting may still be used by nondealers for the sale of real property or personal property (except depreciation recapture). It continues to be a practical and popular method used in transferring farms to the next generation. The installment method is required when qualified property is sold and at least one payment is received in the following tax year unless the seller elects to report all the sale proceeds in the year of disposition.

Taxable income from installment sales is computed by multiplying the amount received in any year by the gross profit ratio. The gross profit ratio is gross profit (selling price minus basis) divided by contract price (selling price less mortgage assumed by buyer). Form 6252 is used to report installment sales income. IRS publication 225 contains a chapter including an example on installment sales.

Rules Affecting Farmers

The installment sale/resale rules should be reviewed and understood before farmers or other taxpayers agree 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 spouse, parent, children, and grandchildren, but not brothers and sisters.

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.

Example: Frank Farmer sells his raised dairy cows, machinery and equipment to son, Hank, for $130,000. The cows are valued at $60,000, the machinery at $70,000. Hank will pay $10,000 down and $40,000 plus interest for three years. Frank's machinery and equipment has an adjusted basis of $32,000; its original basis was $100,000. Frank's gain on the sale of machinery and equipment is $38,000 ($70,000 - $32,000). The full $38,000 is recaptured depreciation since prior year's depreciation, $68,000, is greater. Frank must report $38,000 received from machinery in the year of sale. He will report the $60,000 cattle sale on the installment method.

When the sale of 1245 and 1250 property produces gain in addition to that which is recaptured, the amount of recaptured depreciation reported 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.

Recent Rules for Dealers and Nondealers of Real Property (except farms)

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. 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 is allowed providing the "dealer" elects to pay interest on the tax attributed to payments received in future years.

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" (NRPIOs). When the balance of deferred payments on these sales 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.

General 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).

A sale or exchange of an installment sale obligation results in a gain or a loss. The gain or loss is the difference between the "amount realized" and the "basis" of the obligation. The "amount realized" is the amount received by the seller, including fair market value of property received instead of cash. The "basis" is the excess of the unpaid balance of the obligation over the gain that would be reported on that unpaid balance if it were received.

A cancelation of all or part of an installment obligation is treated like a sale or other disposition of the obligation except gain or loss is calculated as the difference between the fair market value and the "basis" of the obligation.

Unstated and Imputed Interest Rules

If the installment sale contract does not provide an adequate interest rate, part of the principal payment must be treated as ordinary interest income by the seller and an interest deduction by the buyer. The amount of interest that must be recognized is called imputed interest.

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.

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 9 percent (compounded semiannually). 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. Sale-leaseback transactions of any amount are subject to interest rates equal to 110 percent of 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 6 percent or interest will be imputed at 7 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' rates.

The October 1990 monthly AFR was 7.87 percent (short term, not over three years), 8.48 percent (mid term, three to nine years), 8.76 percent (long term, over nine years). The comparable November 1990 monthly AFR rates are 7.75, 8.45 and 8.77 percent. The monthly AFR is currently below the semiannual rate, although monthly rates have been increasing since August when the long-term AFR dropped to 8.34 percent. The monthly long-term AFR hit a low of 7.91 percent in September compared to this year's high of 9.05 percent in May.

ALTERNATIVE MINIMUM TAX

The AMT resembles a separate but parallel tax system. Separate calculations of many types of income and deductions including depreciation are required for many taxpayers.

AMT may be created by either "adjustments" or "preferences". In either category, there are "exclusions" and "deferrals". Deferrals create a postponement of tax benefits rather than permanent removal and result in an AMT credit (Form 8801) in future years. Exclusions will never create an AMT credit.

AMT Rate and Exemption Phaseout

The AMT flat rate is 21 percent. The basic exemptions remain unchanged because they are not indexed. An exemption phaseout reduces the exemption at a rate of 25 percent of AMT income exceeding specific levels, as shown in the table below. If the taxpayer's AMTI exceeds the exemption, he or she will have a calculated AMT but will pay AMT only if it exceeds the regular tax.

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, which would be negative on Form 6251 when line 35 less line 36 of 1040 is negative, even though taxable income is zero on line 37 of 1040. 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 taxable income. The first category contains adjustments treated as "exclusions". AMT due to exclusions is not eligible for a credit against the following year's regular tax. The remaining adjustments are deferral items and are used in computing AMT credit in future years.

1. Exclusion items: Standard deduction or certain itemized deductions from Schedule A, including most medical deductions, miscellaneous deductions subject to the 2 percent rule, personal exemptions, state and local income taxes, personal interest and other interest adjustments. (These are lines 4a through h on Form 6251.) Items 2 through 11 are deferral items.

2. 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. If straight line is used for regular tax, it must be used for AMT. The Section 179 expensing election deduction is allowed in calculating AMTI.

3. The difference between the regular tax deduction for circulation and research and experimental expenditures and the allowable AMT deduction based on 10-year amortization.

4. The difference between the regular tax deduction for mining exploration and development costs and 10-year amortization allowed for AMTI.

5. Incomplete long-term contract costs calculated using the completed contract method less those using the percentage of completion method.

6. Cost recovery for pollution control facilities amortized over 60 months less alternative MACRS allowed for AMTI.

7. 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.

8. The difference (due to different depreciation allowances) between the regular income tax gain or loss and the AMTI gain or loss when there is a taxable exchange. Any AMT adjustment from the exercise of stock options after 12/31/87 also is included here.

9. A difference in allowed losses including losses from all tax shelter farm activities. Losses cannot be offset by gains.

10. The difference between passive activity losses allowed for AMTI and those allowed for regular tax.

11. AMTI from estates and trusts.

Preference Items - The first three are treated as "exclusions"; 4 and 5 are "deferral items".

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 and amortization of certified pollution control facilities placed in service before 1987.

5. Intangible drilling costs.

AMT Net Operating Loss Deduction

The deduction of AMT NOL is the last step in calculating alternative minimum taxable income. The AMT net operating loss is limited to 90 percent of AMTI and is calculated and deducted after all adjustments and preferences have been added in. 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. The regular tax NOL is adjusted to reflect the adjustments required by the AMT rules.

2. The AMT NOL is reduced by the preference items that increased the regular tax NOL.

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 phaseout 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 and Credits

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.

Foreign tax credit is 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.

The AMT calculation on Form 6251 appears to be inconsistent with the rule that does not allow a taxpayer to use business credits to reduce regular tax below AMT. This general business credit limitation is still in effect and is calculated on Form 3800.

Who Must File Test

Many more taxpayers are required to file Form 6251 than have an AMT liability. Form 6251 must be filed if the taxpayer is liable for AMT or if line 6 (TI plus all adjustments and preference items) is greater than the exemption on line 9 and there are adjustments or preferences other than those on lines 4a through g.

The AMT Credit

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

Part I of Form 8801 is used to compute the AMT that would have been paid in the previous year on the exclusion items if there had been no deferral items. This requires the computation of a "minimum tax credit net operating loss deduction" (MTCNOLD), which is calculated like the AMT NOL except that only the exclusion adjustments and preferences are included. It also requires computation of the minimum tax foreign tax credit on the exclusion items.

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

NET OPERATING LOSSES

Farmers and nonfarm taxpayers who sustain a net operating loss in 1990 may carry it back to recover taxes paid in former years or carry it 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 1989 Illinois Farm Income Tax Workbook contains an excellent NOL chapter including illustrations and worksheets. IRS Pub. 334 contains a section on NOLs. 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 net operating loss. 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 taxable loss. The taxable loss, after adjustments, determines how much NOL is available to carry back and carry over 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 1990 NOL would be first carried back to 1987, then to 1988, 1989, and then forward to 1991 and in order to 2005 if necessary. The carryforward provision is 15 years. A taxpayer may elect to forego the entire carryback 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.

Reasons to forego the carryback period include low income during the carryback period and investment tax credit used before the 35 percent reduction.

In making a claim for an NOL, a concise statement showing its computation must be filed with the return for the year the NOL is used. For a carryback 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 not 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 similarly 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, placed new and significant limits on the use of tax losses to shelter business and investment income as well as salary and wage income. The IRS has issued hundreds of pages of temporary and proposed regulations relative to passive losses (1.469-0T through 5T and 11T) and has plans to issue 1.149-6T through 10T.

The Rule

Passive activity losses (and credits) can only be used to offset passive activity income. Passive activity loss is defined as the excess of the aggregate losses from all passive activities over the aggregate income from all passive activities. 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 was phased out over a four-year period. In 1990, 100 percent of passive losses are disallowed. The phaseout applied only to activities in which the taxpayer was engaged before TRA 1986 was passed (October 22, 1986). Losses from activities in which the taxpayer became engaged after that date are 100 percent disallowed.

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 regardless of whether the taxpayer materially participates (see $25,000 loss allowance).

3. Any 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 (by tests 1 through 4) 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 comment:

> "**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."

<u>The types of farm management decisions</u> 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.

Aggregation and Separation of Activities

A May 1989 regulation requires separation of activities into four classes: (1) Oil and Gas, (2) Rental, (3) Professional Service, and (4) Other trade or business. The intent seems to be to prevent the taxpayer from combining activities in order to circumvent the rules.

Then the regulation tends to combine a taxpayer's interests in similar activities into a single activity. From the taxpayer's standpoint, this will make it difficult to recognize suspended losses upon disposition of one of the subactivities.

Election to Separate

A taxpayer may make a permanent election to separate undertakings which otherwise would be combined into a single activity (Sec. 1.419-4T(0)). For interests held in 1989, the election must have been made with the 1989 return. For interests acquired in future years, the election must be made with the return for the year in which the taxpayer acquires interest in the activity.

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 taxpayer's modified AGI exceeds $100,000. There are special rules for married taxpayers filing separate returns.

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.

Crop Share Farm Leases

In the past, "knowledgeable tax experts" have stated that crop share leases of farms did not qualify under the real estate rental active participation rules. The landlords typically did not "materially participate" in the operation of the farm and, if their share of the farm income when combined with their expenses produced a loss, it was a passive loss. These experts have changed their position and now believe that crop share leases where the landlord actively participates qualify as rental activities so that up to $25,000 of losses could be used to offset nonpassive income. Practitioners who have not taken advantage of this interpretation for their clients in previous years may want to consider filing amended returns for open years.

INFORMATIONAL RETURNS

Provisions

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

Farmers should include payments made to independent contractors, veterinarians, crop sprayers, repair shops, and building contractors that are not incorporated. Payments made for feed, seed, fuel, supplies, and other merchandise are excluded.

When payments of $600 or more are made to the same individual for independent services and merchandise, payments for the merchandise can be excluded only if the contract and bill clearly show that a fixed and determinable amount was for merchandise.

1099-A - Information Return for Acquisition or Abandonment of Secured Property. To be filed by lenders who acquire an interest in secured property for full or partial satisfaction of the debt or know that the secured property has been abandoned.

1099-S - Required to report the sale of one- to four-family real estate units. The person responsible for reporting is (1) the person responsible for closing, (2) the mortgage lender, (3) the seller's broker, (4) the buyer's broker, or (5) the buyer. Form 1099-B is used by brokers and for barter exchanges.

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

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

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.

8809 - Form to request extension of time to file informational returns with IRS. Recipients' copies must be filed on time.

Filing Dates and Penalties

The 1099s must be furnished to the person named on the return on or before January 31 and to the IRS on or before February 28.

There is now a single $50 per return penalty for failure to file correct and timely information returns. There is no penalty for inconsequential omissions and inaccuracies. The penalty is reduced when the failure is corrected on or before August 1. It is $15 if correction is filed within 30 days, $30 if filed after 30 days but on or before August 1. The penalty applies to each failure, and there is a total penalty cap for small businesses. If failure to file/include correct information is due to intentional disregard of the regulations, the penalty is $100 or 10 percent of the amount reported on the information return, whichever is greater.

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 to $51,300 for 1990. Social Security (FICA) rates for employers and employees increased to 7.65 percent in 1990. The maximum combined FICA tax will be $7,848.90, up $639.30 from last year. The earnings base is recalculated each year to reflect the change in the CPI.

Social Security Tax Table

Year	Earnings Base	FICA Tax Rate		Self-Employment Tax		
		Employer	Employee	Specified Rate	Credit	Effective Rate
1989	48,000	7.51	7.51	15.02	2.0	13.02
1990	51,300	7.65	7.65	15.3	0.0	15.3
1991	53,400	7.65	7.65	15.3	0.0	15.3

* $125,000 for medicare tax which is 2.9 percent combined FICA and S.E. rate.

The 2 percent credit on self-employment tax was discontinued in 1990 and replaced with a taxable income deduction and a self-employment income deduction.

New Deductions

1. Self-employed taxpayers may deduct from 1990 taxable income on line 25, Form 1040, one-half of self-employment taxes that can be attributed to a trade or business. The rationale for this tax deduction is that employees do not pay income taxes on the one-half of FICA taxes paid by their employer.

2. Self-employed taxpayers will deduct from self-employment income 7.65 percent of net earnings from self-employment when computing the tax. Prior to 1990, self-employment tax was generally computed on the net earnings of a trade or business. Beginning in 1990, self-employment income from Schedules C or F will be multiplied by 0.9235 on Schedule SE to achieve the 7.65 percent reduction of self-employment income. This adjustment is made before applying the $51,300 earnings base; therefore, taxpayers reporting $55,550 or more of self-employment income will not benefit from the deduction. This adjustment is allowed because employees do not pay social security tax on the value of their employer's share of FICA tax.

Farmer's Optional Method

Low-income farmers may still use the optional method and report up to $1,600 of self-employment income when net farm income is less than $1,600. Self-employed nonfarmers have a similar option. Self-employed workers should give serious consideration to using the optional method if they are not currently insured under the social security system.

Wages Paid to Spouse, Children and Farm Workers

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

wages paid to individuals 18 years old and over working for their parent(s) are also subject to FICA taxes.

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

Social Security coverage has also been extended to a parent employed for domestic service by a son or daughter who has dependents under 18 or incapacitated dependents. Domestic workers in private homes are covered during any calendar quarter in which they are paid cash wages of $50 or more.

Noncash Payments to Employees

Social Security tax does not have to be paid on payments that are other than cash for agricultural labor. So, wage payments to agricultural labor in crops, livestock and other commodities are not subject to FICA tax, and as they are payments received as employees, they are not subject to self-employment 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, and (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 a private letter ruling, IRS said the payment of wages with milk was not subject to the FICA tax, even though the employee chose the same milk market and milk hauler as the employer. IRS has also allowed wages to be paid with grain, calves and the services provided for livestock care. Not all of these types of rulings have favored the taxpayer. If the IRS disallows a noncash payment, the employer will have to pay the full FICA tax.

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

Taxation of Social Security Benefits

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

A. one-half of the benefits received, or

B. 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 but living together, and $25,000 for all others.)

Example: J. and M. Retirees received $14,400 in social security benefits.

One-half of S.S. benefits received (joint return)	$ 7,200	Tax exempt interest	$ 3,000
AGI (without soc. sec.)	24,500	Base amount	32,000

Calculation: $24,500 + 3,000 + 7,200 = $34,700;
$34,700 - $32,000 = $2,700; ÷ 2 = $1,350.
Include $1,350 since it is less than $7,200.

Reduction of Benefits

Farmers and other self-employed taxpayers and wage earners less than age 70 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, social security benefits of the working beneficiary and dependents are reduced by a percentage of the excess earnings.

Reduction of Benefits for Self-Employed & Wage Earners

	1990 Earnings Limit		Reduction of Social
Age (years)	Annual	Monthly	Security Benefits
Less than 65	$6,840	$570	One-half of excess earnings
65 to 70	9,360	780	One-third of excess earnings
70 and over	0	0	None

The earnings limit is calculated on an annual basis except in the year of retirement when 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 an earnings limit for that part of the year only.

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 the earnings limit; cattle (held for sale), grain, fruit and other crops held over and sold in the year or years following retirement. This income is not excluded from income subject to self-employment tax. Dairy Termination Program payments received from the CCC are included as earnings.

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.

TAX-DEFERRED RETIREMENT PLANS

The basic concept underlying tax-deferred retirement plans is that money placed in the plan, as well as the earnings on that money, are not taxed until the money is withdrawn after retirement. In return for this delay in the payment of the tax, many restrictions are placed on the plans.

Owner-operators of farms and other noncorporate businesses may choose from Keogh plans, individual retirement arrangements (IRAs), and SEP-IRAs as ways of participating in tax-deferred retirement plans.

Keogh Plans

Keogh plans include defined benefit as well as defined contribution plans. Defined benefit plans may allow much larger contributions to be made but require the services of an actuary to determine the amount of money to be contributed in order to provide a given retirement benefit. Defined contribution plans include profit sharing and money purchase plans as well as some less commonly used plans.

Keogh plans require that certain employees be covered along with the owner-operators. In general, these restrictions prevent the owners from covering themselves without covering at least full-time employees who have been with the business for a year. In addition, owner-operators cannot provide benefits for themselves and key employees that are far out of line with the benefits for other employees.

Individual Retirement Arrangements

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 nondeductible contributions are made, the earnings on the nondeductible 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 nondeductible contributions to an IRA. Also, the requirement to file Form 8606 in the year the nondeductible contributions are made discourages such contributions.

IRA deductions are phased out for taxpayers covered by an employer's retirement plan with AGIs (computed without the IRA deduction) in the ranges shown below. If AGI is above the top end of the range, no deduction for an IRA contribution can be taken.

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

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-2s issued at the end of 1990 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 IRAs

A spousal IRA may be created for spouses with less than $250 of earned income. Spousal IRAs 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 nonworking spouse. Not more than $800 could be contributed to either IRA.

Distributions from Deductible and Nondeductible IRAs

A taxpayer who has both deductible and nondeductible contributions in an IRA will have distributions that are taxable (from the deductible portion and earnings on both the deductible and nondeductible portions) and nontaxable (from the nondeductible portion). Nondeductible contributions to IRAs must be reported on Form 8606 "Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions". If nondeductible contributions are not reported, at the time of distribution all withdrawals 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.

Some employees can elect to make contributions to the SEP through a salary reduction program. 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 social security tax purposes. In 1990, the maximum amount that may be contributed to the SEP in this manner (on a tax-deferred basis) is the lesser of (1) 15 percent of compensation or (2) $7,979. 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. Another is that at least 50 percent of the employees must choose to contribute to SEP-IRAs.

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 a tax law in 1990 which substantially delayed the phase-in that was provided for in the Tax Reform and Reduction Act of 1987. The phase-in that was intended to be complete by 1991 will now be complete in 1994.

Exemptions and Standard Deductions

The 1990 law holds the 1990 standard deductions at 1989 levels and gradually increases them between 1991 and 1994 to the levels that NYTRRA 1987 intended for 1991.

	Year				
	1989 and 1990	1991	1992	1993	1994 and after
	Standard Deduction ($)				
Tax Status:					
Joint	$9,500	$10,200	$10,800	$12,350	$13,000
Head of household	7,000	7,700	8,150	10,000	10,500
Single	6,000	6,300	6,600	7,400	7,500
Married filing separately	4,750	5,100	5,400	6,175	6,500
Dependent filers	2,800	2,800	2,800	2,900	3,000
	Exemption ($)				
	1,000	1,000	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 is $2,800 in 1989-92, $2,900 in 1993, and $3,000 in 1994 and later. An exemption is not counted for either the filer or the spouse.

There is no provision in the new law to waive the penalty for underpayment of estimated tax where the underpayment results solely from enactment of the new standard deduction amounts or the new tax rates. Therefore, in order to avoid owing a penalty, taxpayers who based their 1990 estimates on the original 1990 standard deduction amount must amend their September 17, 1990 and January 15, 1991 estimated tax payments to take into account the new amounts. However, taxpayers who based their 1990 estimate on 100 percent of their 1989 tax need not amend their 1990 estimate.

Itemized Deductions

For taxpayers who filed joint federal returns 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. Taxpayers who do not itemize deductions on their federal returns may not itemize on their NYS returns.

Itemized deductions of higher-income taxpayers are subject to limitations. Itemized deductions are reduced by the sum of two percentages. The first percentage becomes effective at NYAGI levels which depend on the taxpayer's filing status, and the second becomes effective at NYAGI levels above $475,000.

1. In 1989 and later, the first percentage is 25 percent of a ratio which depends on the taxpayer's filing status:

Filing Status	Numerator = Lessor of $50,000 or the excess of NYAGI over:	Denominator
Married filing jointly	$200,000	$50,000
Single and married filing separately	$100,000	$50,000
Head of household	$150,000	$50,000

Example of first percentage (married, joint return): NYAGI = $225,000

$25,000 ÷ $50,000 = .5; .5 x 25% = 12.5%

2. In 1989 and later years, the second percentage is 25 percent of a ratio, the numerator of which is the lesser of $50,000 or the excess of NYAGI over $475,000 and the denominator of which is $50,000.

Example of second percentage: NYAGI = $550,000

$550,000 - $475,000 = $75,000; $50,000 is lesser.

$50,000 ÷ $50,000 = 1.0; 1.0 x 25% = 25%

This taxpayer would also be subject to the full 25 percent from the first calculation so the total reduction in itemized deductions would be 50 percent.

Rates

There are three separate rate tables for (1) married filing jointly and qualifying widow(er)s, (2) single, married 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 1990 law delayed the implementation of the 1990 rates that were in the 1987 law until 1994. Rates for that year are:

New York State Tax Rates, 1994

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

However, there is a gradual phase-in. The rate schedules for 1990 follow. These are the same schedules that were in effect for 1989.

Married Filing Jointly and Qualifying Widow(er)

If the 1990 New York taxable income is:

Over	Not Over	Tax
$ 0	$11,000	4% of the excess over $ 0
11,000	16,000	$ 440 plus 5% " " " " 11,000
16,000	22,000	690 plus 6% " " " " 16,000
22,000	26,000	1,050 plus 7% " " " " 22,000
26,000		1,330 plus 7.875% " " " 26,000

Single, Married Filing Separately and Estates and Trusts

If the 1990 New York taxable income is:

Over	Not Over	Tax
$ 0	$ 5,500	4% of the excess over $ 0
5,500	8,000	$220 plus 5% " " " " 5,500
8,000	11,000	345 plus 6% " " " " 8,000
11,000	13,000	525 plus 7% " " " " 11,000
13,000		665 plus 7.875% " " " 13,000

Head of Household

If the 1990 New York taxable income is:

Over	Not Over	Tax
$ 0	$ 7,500	4% of the excess over $ 0
7,500	11,000	$ 300 plus 5% " " " " 7,500
11,000	15,000	475 plus 6% " " " " 11,000
15,000	17,000	715 plus 7% " " " " 15,000
17,000		855 plus 7.875% " " " 17,000

Household Credit

The Tax Reform and Reduction Act of 1987 provided that only 50 percent of the New York State household credit would be allowed for taxable years beginning in 1990, and that no credit would be allowed for taxable years beginning after 1990.

The 1990 law provides that the full amount of credit will be allowed for taxable years beginning in 1990, 1991, and 1992, and 50 percent of the credit will be allowed for 1993. For taxable years beginning after 1993, the credit is eliminated.

Single taxpayers with household gross income up to $28,000 and all other taxpayers with income up to $32,000 qualify for a household credit 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 1990, 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 1990 as for 1989. 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, 1990

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

Spousal IRAs 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.

Other Credits

Other New York personal income tax credits 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

1. New York State will recognize (accept) ACRS or MACRS depreciation on assets placed in service on or after January 1, 1985.
2. The adjustment problems caused by NYS nonrecognition of ACRS depreciation during 1982 through 1984 are just about history. There may be some assets out there that still have a higher NYS basis. 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.

New York State Filing Requirements for Certain Small Partnerships

New York law does not contain a provision similar to the federal rule that allows certain small partnerships with 10 or fewer partners to not file a partnership return. Therefore, all partnerships having a New York resident partner or having any income derived from New York sources must file a partnership return. The penalty for not filing is $50 times the number of partners who were subject to the New York personal income tax for the year times the number of months (not to exceed five) that the failure to file continues.

Penalties will be waived for partnerships that failed to timely or completely file New York returns for prior years due to reliance on the federal ruling. Penalties will be waived only once.

Partnerships that filed late or incomplete returns for prior years and were billed for penalties should return a copy of the tax notice with a statement explaining that the partnership qualified for the federal automatic reasonable

cause provision and that the partnership relied on the provision in not filing New York returns. Partnerships that have not filed for prior years should do so immediately. When the partnership receives a bill for the penalty due, it should follow the procedure outlined above. If requested by the Department, any partnership that requests a waiver of penalty must be able to substantiate that all partners have fully reported their shares of the income, deductions, and credits from the partnership on their timely filed personal income tax returns.

Corporate Tax Surcharge

A temporary (36 months) corporate surcharge applies to the franchise tax, after credits (but not to New York S corporations except as noted in the next section and the MTB), starting with tax periods ending after June 30, 1990. The surcharge is 15 percent until June 30, 1992 and 10 percent between that date and June 30, 1993.

Franchise Tax on New York S Corporations

Effective with tax years beginning in 1990, S corporations become subject to tax under a rather complicated set of rules. The tax applies when the corporate franchise tax rate plus the surcharge exceeds the highest personal tax rate for the corresponding tax year. S corporations with "entire net income" less than $200,000 are taxed at a lower rate. "Entire net income" is calculated as it would be if the S corporation were a C corporation. Anyone involved in tax returns for New York S corporations needs to study the new rules.

New York State Investment Credit is Four Percent

The credit for individuals is 4 percent on qualified tangible personal property acquired, constructed, reconstructed or erected on or after January 1, 1987. For corporations, the rate for years beginning in 1990 is 5 percent on the first $425,000,000 of investment credit base and 4 percent on any excess. In 1991 and later, the 5 percent will apply only to the first $350 million.

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 4 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 taxpayer's tax liability in the year of disposition. However, there is no recapture once the property has been in qualified use for 12 consecutive years.

Use IT-212 to claim New York investment credit, 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 1 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 minimums ($325, $425, $800 and $1,500 depending on the size of the corporation).

New York State Minimum Tax

Federal items of tax preference after New York modifications and deductions are subject to the New York State minimum tax rate of 6 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 carryover 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

Income tax withholding is mandatory for agricultural employees subject to social security in 1990. An employer who expects to withhold $200 or more but less than $800 semiannually is required to file and deposit the tax on July 31 and January 31. Annual returns are required if the employer expects to withhold less than $200 semiannually. Monthly returns and deposits are required by employers withholding from $800 to $7,500 semiannually. Monthly returns are due on the fifteenth day of the following month, with the exception of the December return which is due January 31. More frequent deposits are required if withholding exceeds $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.

Gross Receipts Tax or Tax on Petroleum Businesses

New York State imposes a tax on every petroleum business owning or operating property in NYS. The tax rates beginning on September 1, 1990 are $.0633 per gallon on motor fuel, $.0575 per gallon on nonautomotive-type diesel motor fuel and $.0460 per gallon on residual petroleum fuels used for heating. These rates include a 15 percent surcharge in effect until June 1, 1992. The rates will be adjusted on April 1, 1991 and each successive January 1 to reflect changes in petroleum prices. During the first five months of 1990, the tax was 2.75 percent of petroleum business gross receipts. A rate of 7.2 percent plus a 15 percent surcharge was in effect June 1 through August 31, 1990.

The tax is passed on to fuel customers by oil distributors. There is no agricultural use exemption. Sales to consumers for residential heating and sales to NYS and its political subdivisions are exempt. Sales of kerosene, kero-jet fuel, bunker fuel for vessels, crude oil and liquified petroleum gases (butane, ethane and propane) are also exempt. Qualified utility companies are eligible for a credit. Aviation fuel businesses are subject to a different tax.

Tax on Lubricating Oil

A lubricating oils tax of $.10 per quart was imposed by NYS on the retail sales of all lubricating motor oils, gear oils, grease, transmission fluids and similar oils sold in NYS on and after September 1, 1990. There is no farm or nonhighway use exemption.

New York State Motor Fuel Tax

Farmers are still exempt from paying the NYS Diesel Motor Fuel tax of 10¢ per gallon and the gasoline tax of 8¢ per gallon on all fuel delivered in bulk to the farm and used in agricultural production. This tax should not be confused with the Petroleum Business tax.

Other Agricultural Economics Extension Publications

No.	Title	Author(s)
No. 90-17	Present Value, Future Value and Amortization Formulas and Tables	Eddy L. LaDue
No. 90-18	The Milkfat Issue: Production, Processing, and Marketing	Tom Cosgrove Andrew Novakovic
No. 90-19	Dairy Farm Business Summary, Eastern New York Renter Summary, 1989	Linda D. Putnam Stuart F. Smith
No. 90-20	Improving Communication About Risks Associated With Residues of Agricultural Chemicals on Produce	Nancy Ostiguy Enrique E. Figueroa Carole Bisogni
No. 90-21	Cornell Cooperative Extension Farm Business Management Program Guidelines, Suggestions, and Resources	Stuart F. Smith Wayne A. Knoblauch Gerald B. White
No. 90-22	Fruit Farm Business Summary, Lake Ontario Region, New York, 1989	Darwin P. Snyder Alison M. DeMarree
No. 90-23	Poultry Farm Business Summary, New York, 1989	Darwin P. Snyder Stewart Ackerman Kristen Park
No. 90-24	1989 New York Beef Cow-Calf Farm Business Summary	C. N. Rasmussen Stuart F. Smith Danny G. Fox
No. 90-25	Employee Recruitment and Selection Teaching Manual	Thomas Maloney Joann Gruttadaurio Walter Nelson Kristen Park Joan Petzen Alan White
No. 90-26	Employee Recruitment and Selection Participant Manual	Thomas Maloney Joann Gruttadaurio Walter Nelson Kristen Park Joan Petzen Alan White