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# INCOME TAX MANAGEMENT AND REPORTING FOR SMALL BUSINESSES AND FARMS

<p><b>SCHEDULE J (Form 1040)</b></p> <p>Department of the Treasury Internal Revenue Service</p>	<p><b>Farm Income Averaging</b></p> <p>▶ Attach to Form 1040.</p> <p>▶ See Instructions for Schedule J (Form 1040).</p>	<p>OMB No. 1545-0074</p> <p style="font-size: 2em; font-weight: bold;">1999</p> <p>Attachment Sequence No. <b>50</b></p>				
<p><b>SCHEDULE D (Form 1040)</b></p> <p>Department of the Treasury Internal Revenue Service (99)</p>	<p><b>Capital Gains and Losses</b></p> <p>▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).</p> <p>▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.</p>	<p>OMB No. 1545-0074</p> <p style="font-size: 2em; font-weight: bold;">1999</p> <p>Attachment Sequence No. <b>12</b></p>				
<p>Form <b>1040</b> Department of the Treasury—Internal Revenue Service <b>1999</b> (99) IRS Use Only—Do not write or staple in this space.</p> <p>U.S. Individual Income Tax Return</p> <p>For the year Jan. 1–Dec. 31, 1999, or other tax year beginning _____, 1999, ending _____</p>						
<p><b>Label</b> (See instructions on page 18.) Use the IRS</p>	<p><b>L A B E L</b></p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">Your first name and initial</td> <td style="width: 50%;">Last name</td> </tr> <tr> <td>If a joint return, spouse's first name and initial</td> <td>Last name</td> </tr> </table>	Your first name and initial	Last name	If a joint return, spouse's first name and initial	Last name	<p>OMB No. 1545-0074</p> <p>Your social security number</p> <hr/> <p>Spouse's social security number</p>
Your first name and initial	Last name					
If a joint return, spouse's first name and initial	Last name					

## 1999 Reference Manual for Regional Schools

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## 1999 TAX FORMS NEEDED BY MANY NEW YORK FARMERS

### Federal Forms

- 1040 - U.S. Individual Income Tax Return
  - Schedule A & B - Itemized Deductions and Interest and Dividend Income (no Capital Gains)
  - Schedule D - Capital Gains and Losses
  - Schedule E - Supplemental Income and Loss
  - Schedule EIC - Earned Income Credit
  - Schedule F - Profit and Loss from Farming
  - Schedule H - Household Employment Taxes
  - Schedule J - Farm Income Averaging
  - Schedule R - Credit for the Elderly or the Disabled
  - Schedule SE - Self-employment Tax, (short and long schedules)
- 1040A - Nonitemizers, under \$50,000 taxable income, other limitations
- 1040X - Amended U.S. Individual Income Tax Return
- 943 - Employer's Annual Tax Return for Agricultural Employees
- 1099's - 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 of Income (see rules for Sch. L, M-1 and M-2.)
- 3115 - Application for Change in Accounting Method
- 3800 - General Business Credit
- 4136 - Credit for Federal Tax on Fuels
- 4562 - Depreciation and Amortization: used to report depreciation, cost recovery, Section 179 expense election, and listed property.
- 4684 - Casualties and Thefts
- 4797 - Sales of Business Property
- 4835 - Farm Rental Income and Expense [Crop and Livestock Shares (not cash) Received by Landowner]
- 6251 - Alternative Minimum Tax Computation - Individuals
- 6252 - Installment Sale Income
- 8582 - Passive Activity Loss Limitations
- 8582-CR - Passive Activity Credit Limitations
- 8606 - nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions
- 8615 - Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,300
- 8801 - Credit for Prior Year Minimum Tax -- Individuals and Fiduciaries
- 8812 - Additional Child Tax Credit
- 8824 - Like-Kind Exchanges
- 8829 - Expenses for Business Use of Your Home
- 8863 - Education Credits

### New York State Forms

- IT-201 - Resident Income Tax Return (long form)
- IT-201-ATT - Summary of Other Credits and Taxes
- IT-201-X - Amended Resident Income Tax Return (only acceptable method)
- IT-204 - Partnership Return
- IT-212 - Investment Credit (recapture or early disposition schedule included)
- IT-215 - Earned Income Credit
- IT-217 - Claim for Farmers School Tax Credit (for individuals, estates and trusts)
- IT-220 - Minimum Income Tax
- IT-399 - New York State Depreciation Schedule (with instructions)
- CT-4-S - Short Form for S Corporations
- CT-47 - Claim for Farmers School Tax Credit (for corporations)
- NYS-45 - Quarterly Combined Withholding and Wage Reporting Return and Unemployment Ins.
- NYS-45-AT - Quarterly Combined Withholding and Wage Reporting Return and Unemployment Ins.

## **1999 TAX LEGISLATION AND FARM INCOME SITUATION\***

### **Federal Legislation**

As of the date this reference manual went to print, the Taxpayer Refund and Relief Act of 1999 had been vetoed by the President and prospects look slim for any major tax bill to be passed this year. Hopefully, some technical changes regarding tentative minimum tax and overdue regulation will be announced during the schools.

Highlights of happenings in the last 12 months are as follows:

- For the tax year 1998 only, Child Tax Credit and Education Credits were not limited by AMT. For 1999, IRS has prepared two versions of each form and worksheet, awaiting legislation as to which to issue.
- Income Averaging for farmers (Schedule J) was made permanent.
- Self-employed Health Insurance Premiums will be 60% deductible in 1999.
- For tax years beginning after 1997 NOL's from a farming business or a "farming loss" may be carried back 5 years and forward 20 years.
- IRS reversed its position of 1996, with regard to "disqualified income", and now excludes income from sale of assets used in a trade or business (cull cows), thus making many more farmers eligible for earned income credit if they otherwise qualified in 1996-1998.
- IRS computers, in error, rejected many or most all Schedule J calculations and Earned Income Credits from farmers.

### **1999 Farm Income Tax Situation**

New York farm gate milk prices will be down in 1999, compared to 1998. The cost of producing milk has declined on many farms because feed prices are down slightly. Sch. F net farm profits may be marginally higher in 1999, on well-managed dairy farms due to '98 tax management. The 1999 net farm incomes of cash crop, fruit and vegetable producers will vary widely. Feed, cash and vegetable crop production was down in many areas due to drought. Overall fruit income will be up from a year ago, but down from 1995-1997.

Tax management suggestions for farmers with high 1999 net farm profits:

- Purchase large quantities of feed and supplies before the year-ends. These prepaid expenses may be claimed if they do not exceed 50% of other expenses on Sch. F.
- Buy needed machinery now. Take advantage of the Sec. 179 deduction as well as rapid depreciation.
- Pay additional wages to family members who actually work on the farm. Consider paying Christmas bonuses to regular employees.
- Purchase IRAs or other tax deferred retirement plans.

\* This manual was written by Charles H. Cuykendall, Senior Extension Associate, Agricultural Finance and Management, Department of Agricultural, Resource, and Managerial Economics, Cornell University and Gregory J. Bouchard, Manager, Farm Credit of WNY Tax Service, Phelps, New York.

## FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

### Standard Deduction

The standard deduction is indexed to inflation and is adjusted annually. The 1999 standard deduction is about 1.4% higher than the 1998 standard deduction. Due to the inflationary adjustment the deduction for 2000 will be around 2.0% higher.

#### Basic Federal Standard Deduction for 1996, 1997, 1998, 1999 and 2000

Filing Status	1996	1997	1998	1999	2000 <sup>1</sup>
Married filing jointly; or qualifying widow(er)	\$6,700	\$6,900	\$7,100	\$7,200	\$7,350
Head of household	\$5,900	\$6,050	\$6,250	\$6,350	\$6,450
Single individuals	\$4,000	\$4,150	\$4,250	\$4,300	\$4,400
Married filing separately	\$3,350	\$3,450	\$3,550	\$3,600	\$3,675

<sup>1</sup> projected

A married taxpayer filing a separate return is not allowed to use the standard deduction if his or her spouse claims itemized deductions.

Each taxpayer over age 65 or blind receives the regular standard deduction plus an additional \$850 (same for 2000) deduction if married and filing a joint or separate return. The additional deduction is \$1,050 (\$1,100 for 2000) if single or head of household. The additional deductions are subject to the inflationary adjustment. A taxpayer that is both elderly and blind receives double the additional deduction. The additional deductions for age and blindness cannot be claimed for dependents.

### Personal Exemption

	1996	1997	1998	1999	2000
Personal Exemption Deduction	\$2,550	\$2,650	\$2,700	\$2,750	\$2,800 est.

Taxpayers are entitled to claim one exemption each for themselves, their spouses, and their dependents on their federal return. Taxpayers may not claim an exemption for themselves or any other person who can be claimed as a dependent on someone else's tax return.

The phaseout of the personal exemption for certain high-income individuals was made permanent by the RRA of 1993. For 1999, the benefit of the personal exemption is phased out for taxpayers with the following specific high levels of adjusted gross income (AGI). These threshold amounts are up 1.7% from 1998 and are adjusted for inflation annually:

- \$189,950 if married filing jointly or qualifying widow (er) with dependent child;  
(exemptions completely lost at \$312,450 AGI)
- \$158,300 if head of household; (exemptions completely lost at \$280,800 AGI)
- \$126,600 if single (exemptions completely lost at \$248,100 AGI)
- \$ 94,975 if married filing separately; (exemptions completely lost at \$156,225 AGI)

The 2000 threshold amounts are projected to be \$193,400, \$161,150, \$128,950, and \$96,700 respectively.

The phaseout in personal exemptions is 2% of the exemption amount for each \$2,500 increment (or any fraction thereof) by which AGI exceeds the appropriate threshold amount. A married taxpayer filing separately will lose 2% of his/her exemption for each \$1,250 increment above \$94,975.

The personal exemption phaseout or reduction is calculated on a nine-line worksheet called the **Deduction for Exemptions Worksheet** included in the 1040 instructions. If adjusted gross income exceeds the threshold, complete the worksheet before claiming the personal exemption deduction on line 38 of Form 1040.

Example: Mr. and Mrs. Dairy file jointly, have two children, and their 1999 AGI is \$250,000. They claim four personal exemptions. Their reduction and net exemption are calculated as follows:

AGI \$250,000 - \$189,950 threshold = \$60,050 excess.  $\$60,050 \text{ excess} \div \$2,500 = 24.02$  or 25 excess increments. Their reduction is  $25 \times .02 (2\%) = .50 \times \$11,000 (4 @ \$2,750) = \$5,500$ . Their net personal exemption is  $\$11,000 - 5,500 = \$5,500$ .

A way to evaluate the cost of the personal exemption phaseout to the taxpayer is to calculate the additional tax liability. In the example, Mr. and Mrs. Dairy are in the 36% taxable income bracket, where the \$5,500 of phased-out personal exemption will cost \$1,980.00 in additional taxes. In other words, their \$60,050 of excess AGI caused an additional tax liability of \$1,980.00 or added 2.9% to their tax liability and effectively increased their marginal rate to 38.5%.

### Dependents

Taxpayers must report the social security numbers of all dependents. The penalty for failure to report this information is \$50. Apply for a social security number by filing Form SS-5 with the Social Security Administration.

Taxpayers may not claim an exemption for a dependent that has gross income of \$2,750 or more unless it is for their child under age 19 or a full-time student child under age 24 at the end of the tax year. Nontaxable social security benefits and earnings from sheltered workshops are excluded. A full-time student must be enrolled in and attend a qualified school during some part of each of five calendar months. Individuals who can be claimed as dependents on another taxpayer's return may not claim a personal exemption on their own return.

For tax years after December 31, 1997 the qualified child, student, or other qualified dependent's basic standard deduction allowable is limited to the smaller of the basic standard deduction or (1) the larger of \$700 or (2) the individual's earned income plus \$250.

#### **Examples of TRA '97 Rule Single Taxpayers**

	Base Amount	Earned Income	Earned Income + \$250	Larger of the Two	Standard Deduction	Smaller of the Two
Case # 1	\$700	0	\$250	\$700	\$4300	\$700
Case # 2	\$700	\$4100	\$4350	\$4350	\$4300	\$4300

Investment or unearned income in excess of \$1,400 received by a dependent child under age 14 is taxed at the parent's marginal rate if greater than the income tax using the child rates. A three-step procedure is required to compute the tax on **Form 8615, Tax for Children Under Age 14 Who Have Investment Income of More than \$1,400**, where the excess over \$1,400 will be taxed at the parent's marginal rate and unearned income greater than \$700 but less than \$1,400 will be taxed at 15%.

The election to claim the child's unearned income on the parent's return with **Form 8814, Parent's Election to Report Child's Interest and Dividends**, is still available, and the adjusted \$1,400 base

amount and \$700 tax exemption are indexed for inflation on Form 8814. This election cannot be made if the child has income other than interest and dividends or if estimated tax payments were made in the child's name, or the child's income is more than \$6,999.

### 1999 Tax Rates

All the tax brackets have been adjusted for inflation this year. Each tax bracket has been moved up approximately 1.7% from 1998, which results in many taxpayers with constant taxable incomes paying somewhat less income taxes in 1999. Married taxpayers filing jointly with \$43,050 of taxable income in 1998 and 1999 will gain \$105.00 in tax savings from the adjustments in tax rates.

#### 1999 Tax Rate Schedules

Single Taxpayer		Married Filing Joint Return & Qualifying Widow(er)	
Taxable Income	Tax	Taxable Income	Tax
\$0-\$25,750	15%	\$0-\$43,050	15%
\$25,750-62,450	\$3,862.50 + 28% on excess*	\$43,050-104,050	\$6,457.50 + 28% on excess*
\$62,450-130,250	\$14,138.50 + 31% "	\$104,050-158,550	\$23,537.50 + 31% "
\$130,250-283,150	\$35,156.50 + 36% "	\$158,550-283,150	\$40,432.50 + 36% "
> \$283,150	\$90,200.50 + 39.6% "	> \$283,150	\$85,288.50 + 39.6% "

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Head of Household		Married Filing Separate Returns	
Taxable Income	Tax	Taxable Income	Tax
\$0-\$34,550	15%	\$0-\$21,525	15%
\$34,550-89,150	\$5,182.50 + 28% on excess*	\$21,525-52,025	\$3,228.75 + 28% on excess*
\$89,150-144,400	\$20,470.50 + 31% "	\$52,025-79,275	\$11,768.75 + 31% "
\$144,400-283,150	\$37,598.00 + 36% "	\$79,275-141,575	\$20,216.25 + 36% "
> \$283,150	\$87,548.00 + 39.6% "	> \$141,575	\$42,644.25 + 39.6% "

\* on excess over first number in bracket

The rates for head of household are most favorable. Single taxpayers that 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 head of household.

The tax rates for married taxpayers continue to be higher than for single taxpayers. Two married taxpayers each with \$61,000 of taxable income will pay \$1,637 more federal income taxes in 1999 than two singles with the same taxable income. As taxable income increases, the "marriage penalty tax" increases. A single taxpayer is not subject to the 36% rate until taxable income exceeds \$130,250, but a married taxpayer reaches the 36% tax rate when taxable income exceeds \$79,275 per person. Congress is discussing legislation that will change the marriage penalty tax.

For 2000, the beginning of the 28%, 31%, 36% and 39.6% projected rate brackets will respectively occur at the following incomes for:

Single taxpayer:	\$26,250	\$63,550	\$132,600	\$288,350
Married filing joint returns and qualifying widow(er):	\$43,850	\$105,950	\$161,450	\$288,350
Head of household:	\$35,150	\$90,800	\$147,050	\$288,350
Married filing separate returns:	\$21,925	\$52,975	\$80,725	\$144,175



## Itemized Deductions

A taxpayer should itemize if total itemized deductions are greater than his or her standard deduction. The election to itemize can be made or revoked on a timely filed, amended return. The limitation for high-income taxpayers must be considered when comparing itemized deductions with the standard deduction. The itemized deduction 3%/80% reduction rule for married filing separately in 1999 begins at \$63,300 (AGI) and the 1999 limit for all other taxpayers starts at \$126,600 (AGI).

Taxpayers with a 1999 AGI in excess of \$126,600 (\$63,300 if married and filing separately) must reduce all itemized deductions except medical expenses, investment interest, casualty losses, and wagering losses to the extent of wagering gains. The reduction equals the lesser of 3% of excess AGI or 80% of the applicable itemized deductions. Three percent of excess AGI will be the most common reduction and will not be a major additional tax burden unless AGI is very high and/or the applicable itemized deductions are relatively low. The 7.5% of AGI medical expense adjustment and 2% floor on miscellaneous itemized deductions must be applied before the high-income deduction. (The projected base for excess calculations for 2000 is \$128,950 and \$64,475.)

Example: Fred and Ann Veryrich's 1999 AGI is \$146,600. Their itemized deductions total \$17,000 including \$12,000 of deductible medical expenses (after the 7.5% AGI deduction) and investment interest. They claim no casualty or wagering losses. They must reduce their itemized deductions as follows:

$\$146,600 \text{ AGI} - \$126,600 \text{ maximum} = \$20,000 \text{ excess} \times .03 = \$600$ . \$600 is less than \$4,000 ( $.80 \times \$5,000$  of applicable itemized deductions). They reduce itemized deductions by \$600;  $\$17,000 - \$600 = \$16,400$  adjusted itemized deductions.

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. The \$100,000 restriction is for the total of all home equity loans.

Mortgage interest that exceeds these limits is nondeductible. Also there's a tax trap if you pay the mortgage on an ex-spouse's home, where only the ex-spouse resides after the divorce, there is no interest deductibility.

Investment interest expense is deductible on the 1999 return and is limited to the amount of net investment income. Investment interest expense is interest paid on debt incurred to buy investment property. It does not include investments in passive activities or activities in which the taxpayer actively participates, including the rental of real estate. Net investment income is gross investment income (including investment interest, interest received from the IRS, dividends, taxable portion of annuities, and certain royalties) less investment expenses (excluding interest). Gross investment income was redefined by the 1993 Act to exclude net capital gain on the disposition of investment property. A

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

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

Personal interest is not deductible.

Medical expenses that exceed 7.5% of AGI are itemized deductions not subject to the additional 2% AGI limit. "Medical expenses" are broadly defined to include payments made for nearly all medical and dental services, therapeutic devices and treatments, home modifications and additions made primarily for medical reasons, travel (auto mileage deduction for 1999 is \$.10 per mile) and lodging expenses associated with qualified medical care trips, legal fees required to obtain medical services, prescribed medicine and drugs, special schooling and institutional care, qualified health insurance premiums and the costs to acquire, train and maintain animals that assist individuals with physical disabilities. Most cosmetic surgery, general health maintenance, such as gym fees and weight loss programs, and well-baby care programs will not qualify. Remember that itemized medical expenses must be reduced by any reimbursement, including health insurance payments received.

Beginning in 1997, qualified long-term care insurance contracts are generally treated as an accident and health insurance contract. Contract benefits are generally excludable from taxation like money received for personal injury and sickness. The 1999 excludable limit is \$190 per day or \$69,350 annually. Benefits are reported to taxpayer on 1099-LTC and shown on Form 8853 Section B.

Long-term Health Care premiums are deductible for 1999, by itemizers when combined with other premiums and medical expenses that exceed 7.5% of adjusted gross income. However, there are annual limits on the deductible premiums tied to age. Filers over 70 years old can include long term health care premiums of up to \$2,660 per year per person subject to the 7.5% exclusion. Those between 61 and 70 years may include \$2,120 per person; 51 to 60 years \$800 per person; 41 to 50 years \$400 per person, 40 years and under only \$210 per person.

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

Charitable contributions made after 12/31/93 are subject to substantiation and disclosure rules. One set of rules applies to separate contributions of \$250 or more. For separate cash contributions exceeding \$250, a taxpayer cannot rely solely on a canceled check but needs substantiation from the charity showing the amount and date the contribution was made. For 1999 returns, acknowledgment must be obtained from the charity by the earlier of the filing date or the due date of the return, including extensions. For noncash contributions, the taxpayer must obtain from the charity a receipt that describes the donated property, a good-faith estimate of its value, and whether anything was given to the taxpayer in exchange. Taxpayers must use **Form 8283** to report total noncash charitable contributions over \$500.

For contributions exceeding \$75 where the taxpayer receives something in exchange (such as a dinner), the charity must provide a statement to the taxpayer that informs the donor that the value of the contribution that is deductible is the difference between the contribution and the value of the goods or services received by the taxpayer. Also, the charity must provide the donor with a good-faith estimate

of the value of whatever the charity gave to the donor. The standard mileage rate for passenger car use for charitable causes increased to \$.14 per mile for tax years beginning after December 31, 1997.

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

For expenses incurred after December 31, 1993, moving expenses are defined as the reasonable costs of (1) moving household goods and personal effects from the former residence to the new residence, and (2) travel, including lodging during the period of travel, from the former residence to the new place of residence. The standard mileage rate for passenger car use for moving is \$.10 per mile for 1999. Meal expenses are no longer included. The new place of work must be at least 50 (rather than the old 35) miles farther from the taxpayer's former residence than was the old place of work. The deduction will be subtracted from gross income in arriving at AGI.

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

Qualified moving expenses reimbursed by an employer are excludable from gross income to the extent they meet the requirements of qualified moving expense reimbursement (which appears to be the new definition of deductible moving expenses as described above).

Other itemized deductions not subject to the 2% AGI limit include state income and property taxes, and personal casualty losses (list not complete).

**Miscellaneous Deductions Subject To 2 Percent AGI Limit Include:**

1. Unreimbursed employee business expenses including employment-related educational expenses, travel, meals and entertainment expenses (subject to 50 percent rule), lodging, work clothes, dues, fees, and small tools and supplies. Employee business expenses reimbursed under a nonaccountable plan are also subject to the 2% AGI limit.
2. Investment expenses, including legal, accounting, and tax counsel fees, clerical help and office rental, and custodial fees.
3. Job hunting expenses may be deductible if one is looking for employment. Job hunters expenses are deductible if incurred in looking for a new job in their present occupation. The job searching expenses are not deductible if looking for a job in a new occupation or looking for a first job. Factors to determine if the employment is in the same occupation include: job classification, job responsibility, and nature of employment. The following are expenses that may be deductible: cost of typing, printing and mailing resumes; long distance phone calls and mailing; career counseling and agency fees; and travel or transportation expenses.
4. Other deductions: professional dues, books, journals and safe deposit box rental, hobby expenses not exceeding hobby income, office-in-the-home expenses, and indirect miscellaneous deductions passed through grants or trusts, partnerships and S corporations.

Meal expenses must be directly related to the active conduct of the taxpayer's trade or business (i.e. an organized business meeting or a meal at which business is discussed). A meal taken immediately preceding or following a business meeting will qualify if it is associated with the active conduct of the taxpayer's trade or business. The deductible portion of meal and entertainment expenses paid in connection with a trade or business is 50%. Effective for tax years beginning after December 31, 1997, the deductible percentage of the cost of meals consumed by employees subject to DOT will gradually increase from 50% to 80% over the next 10 years. DOT employees include FAA employees (pilots, crews, etc.) railroad employees, and interstate truck and bus drivers under DOT regulations.

### **Earned Income Credit (EIC)**

Basic earned income credit rates were gradually increased starting in 1994, the supplemental young child credit and the health insurance credit were eliminated, and some low-income workers without qualifying children became eligible for earned income credit. Earned income includes wages, salaries, tips and net self-employment earnings but does not include interest, dividends, alimony and social security benefits.

For taxpayers with one qualifying child, the 1999 EIC is 34.0% of the first \$6,800 of earned income. The maximum credit is \$2,312 and is reduced by 15.98% of modified AGI exceeding \$12,460. For taxpayers with two or more qualifying children, the EIC is 40% of the first \$9,540 of modified AGI. The maximum credit is \$3,816 and is reduced by 21.06% of modified AGI exceeding \$12,460.

The definition of modified AGI for the phase-out disregards certain losses, including: a) losses from the sale or exchange of capital assets in excess of gains b) net losses from trusts and estates and c) net losses from non-business rent and royalties. In TRA '97, the net losses from trades or businesses computed separately with respect to sole proprietorships, sole proprietorships in farming and other businesses that are disregarded in determining modified AGI, are increased from 50% to 75%. The TRA '97 also expands the list of included items in modified AGI to include interest that is received or accrued that is exempt from federal income tax and amounts received as pensions or annuities or IRAs to the extent not included in gross income. The latter two items are a technical correction to TRA '97.

### **Earned Income Credit Rates, Income Ranges, and Phaseouts \***

Qualifying Children	Credit rate	Earned income range		Phaseout rate	Maximum credit
		Maximum credit	Phaseout		
<u>For 1999</u>					
None	7.65%	\$4,530- 5,670	\$5,670-10,206	7.65%	\$347
One	34.00%	6,800-12,460	12,460-26,928	15.98%	2,312
Two or more	40.00%	9,540-12,460	12,460-30,580	21.06%	3,816
----- <u>For 2000</u>					
None	7.65%	\$4,610- 5,770	\$5,770-10,384	7.65%	\$353
One	34.00%	6,920-12,690	12,690-27,415	15.98%	2,353
Two or more	40.00%	9,720-12,690	12,690-31,152	21.06%	3,888

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

It is possible for some low-income taxpayers to be eligible for EIC even though that taxpayer doesn't have a qualifying child. To be eligible, such a taxpayer must be age 25 or more, but under 65 years of age. A married taxpayer that does not meet the minimum age requirement may be eligible if his or her spouse meets the minimum age requirement. Other eligibility rules for the low-income taxpayer are: he or she cannot be claimed as a dependent or a "qualified child" on another person's tax return; his

or her principal residence was in the USA for more than one-half of the tax year; the return must cover a 12-month period; the taxpayer cannot file a separate return if married, and cannot file Form 2555 or Form 2555-EZ. The credit percentage is much smaller (7.65%) for taxpayers with no qualifying children, and the credit is phased out over a lower income range.

To be eligible for the Earned Income Credit, any taxpayer must have all of the following: (1) earned income; (2) earned income and adjusted gross income, each below the maximum earned income allowed; (3) a return that covers 12 months (unless a short-year return is filed because of death); (4) a joint return if married (usually); (5) included income earned in foreign countries and not deducted or exclude a foreign housing amount; (6) not be used as a qualifying child making another person eligible for the earned income credit.

The 1996 Act expanded “disqualified income” to include (among other income items) “capital gain net income”. To disqualify more taxpayers, the law said gains from the sale of passive investments should be included as disqualified income. IRS originally said this included gain from sale of assets used in a trade or business. This interpretation included assets meeting the holding-period requirements of Sec. 1231 and are not subject to recapture rules of IRC Sec. 1245. In Rev. Rul. 98-56, IRS announced they were reversing their position retroactively in November 1998 as follows:

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

Therefore gain from the sale of equipment and livestock (sows, boars, beef cattle, horses, cull dairy cows) that are Sec. 1231 property are not disqualified income. With this late announcement by IRS it was too late to change Form 4797 instructions and program their computers for the 1998-filing season. Consequently, many taxpayers were denied the earned income tax credit (EITC) for 1998 and had to call or resubmit referencing Rev. Rul. 98-56, to get this credit if they had earned income below the maximum and did not have disqualified income exceeding \$2,300 for the tax year 1998.

IRS also reminded farmers who reported income from sale of culled cows (and other qualified gain) in 1996 or 1997 and were otherwise eligible to claim EITC they should file 1040X to claim a refund on all open years. The maximum amount of disqualified income for 1996 was \$2,200 and for 1997 was \$2,250. In 1999, the EITC is denied to all taxpayers with an excess of \$2,350 of taxable and nontaxable interest income, dividends and net income from rents and royalties not derived in the ordinary course of business. All gains from the sale of business assets including ordinary gains (Form 4797 Part II) and gains recaptured as ordinary income (Form 4797 Part III) are not included in disqualified income.

There are three tests for a qualifying child: relationship, residency, and age.

To meet the relationship test, the child must be (1) the taxpayer’s son or daughter or a descendant of the taxpayer’s son or daughter, (2) the taxpayer’s stepson or stepdaughter, or (3) the taxpayer’s eligible foster or adopted child.

To meet the residency test, the child must live with the taxpayer in his or her main home for more than half the year (all year if a foster child), and the home must be in the U.S. However, a child that was born, or died, anytime in 1999 and lived in the taxpayer's home will meet the residency test.

To meet the age test, the child must be (1) under 19 at year end, (2) a full-time student under 24 at year end, or (3) permanently or totally disabled at any time during the tax year, regardless of age.

Individuals with qualifying children will not be allowed EIC if they fail to identify those children by name age and TIN on their returns. TRA '97 imposes restrictions on the availability of EIC for taxpayers that improperly claimed credit in prior years. Where there is evidence that a taxpayer's claim of EIC was due to fraud, the disallowance period is 10 years after the most recent year for which the determination was made. Where the claim of EIC was due to reckless or intentional disregard of rules and regulations, the disallowance period is two years. In addition the taxpayer that is denied EIC may also be subject to accuracy-related penalty or the fraud penalty.

### **Earned Income Credit Reminders for Farmers**

If earned income is negative, there is no credit. Therefore, a farmer with a negative Schedule F net farm profit would not get a credit unless there were wage and Schedule C income more than enough to offset the loss on F, or the optional method of reporting self-employment income is used. A farmer with a negative 1999 net farm profit may use the optional method of reporting up to \$1,600 of self-employment income, to collect an EIC which would partially or wholly cover the self-employment tax and thus provide two quarters of social security coverage, providing disqualified income (such as interest and dividends) plus earned income are less than the maximum allowed.

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

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

The Earned Income Credit Advance Payment Certificate (Form W-5), 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. Advanced payments are limited to the credit amount for one qualifying child, regardless of the total number of children a taxpayer may have. An employer's failure to make required advanced EIC payments is subject to the same penalties as failure to pay FICA taxes. Employers of farm workers do not have to make advance EIC payments to farm workers paid on a daily basis (IRS Pub. 225).

### **Child Tax Credits**

For the taxable year 1999 a \$500 credit is allowed for each qualifying child under 17 years of age. For taxpayers with adjusted gross income in excess of the applicable threshold amount, the credit is phased out. The phaseout rate is \$50 for each \$1000 of modified adjusted gross income (for fraction thereof) in excess of the following threshold:

## 1999 AGI Phaseout Taxpayers With One Child

	Threshold Starting	Completely Gone
Married joint return	\$110,001	\$119,001
Single or head of household	\$75,001	\$84,001
Married separate return	\$55,001	\$64,001

Tentative minimum tax did not reduce the child tax credit for the tax year 1998. This was a one-year tax change. It is the authors opinion the same will be true for 1999.

Child tax credit is in addition to the credits for child and dependent care expenses and the earned income credit. The credit is nonrefundable for taxpayers with 1 or 2 qualifying child (1040 line 43) but may be refundable for those with 3 or more qualifying children (1040 line 60). Form 8812 for the Additional Child Tax Credit uses (1) social security and Medicare taxes withheld plus 1040 line 27 (1/2 self-employment tax) plus 1040 line 52 (social security and Medicare tax on tip income not reported) less (2) 1040 line 59a (EITC) and 1040 line 62 (excess SS withheld) to limit this refundable credit. Only if the amount in item (1) is greater than (2) then the difference is a refundable credit.

This year to protect against last minute tax changes regarding AMT, IRS has instructions and forms for the credit with and without the AMT limits. These two methods are labeled draft version A and version B with AMT. With legislative changes before year-end, allowing the use of version A then taxpayers will use the child credit worksheet for line 43, which includes:

- Question 1. If excluding income from Puerto Rico or filing 2555 or 2555-EZ or 4563 go to Pub 972, otherwise continue,
- Question 2. If exceeding income limits for your filing status go to Pub. 972,
- Question 3. If 1 or 2 qualifying children use worksheets,
- Question 4. If claiming adoption credit; Form 8839, mortgage interest credit; Form 8396, or DC credit; Form 8859 go to Pub. 972, otherwise go to worksheet,
- Question 5. If the worksheet indicates you have a tax liability and 3 or more qualifying children then go to Form 8812 to figure additional child tax credit using version A or B dependent upon AMT rules. Version B of the worksheet for line 43 includes the AMT limitation.

In addition to the above questions, the worksheet (version B) refers the taxpayer to Pub. 972 immediately, if they are filing Schedule C, C-EZ, D, E or F. If the answers to the questions on the form are such that you can get to the worksheet and AMT is in the 26% bracket, child tax credit maybe calculated right on the worksheet rather than going to Form 6251.

Many taxpayers with children will have to fill out the AMT Form 6251 for 1999. Some families (mostly with many children) with incomes in the \$50,000 to \$70,000 area will owe AMT for 1999 even though they do not have tax preference items. The child tax credit is required and will not reduce the liability for AMT.

### **Education Incentive Opportunities**

In the tables below the benefits restrictions and limitations on several tax incentives for participants in higher education are presented.

### Education Incentive Opportunities in the TRA '97

	<b>HOPE Credit</b>	<b>Lifetime Learning Credit</b>
Tax Incentive	Per Student; 100% of first \$1,000 and 50% of second \$1,000 used for tuition and fees for higher education for at least ½ time students incurring expenses the tax year	Per taxpayer; 20% of first \$5,000 (20% of first \$10,000 after 2002) for tuition and fees for any higher education including upgrading skills paid, on behalf of taxpayer, spouse, or dependent to whom taxpayer is allowed an exemption.
Restrictions	<ul style="list-style-type: none"> <li>• Only for first two post secondary years.</li> <li>• May not be claimed in same year as an education IRA distribution.</li> <li>• Maximum of two tax years.</li> <li>• Nonrefundable.</li> <li>• Not allowed for persons claimed as dependents on another taxpayer's return.</li> </ul>	<ul style="list-style-type: none"> <li>• Credit may not be claimed in the same tax year for the same person as claimed for the HOPE credit.</li> <li>• May not be claimed in same year as an education IRA distribution.</li> <li>• Nonrefundable.</li> </ul>
Modified Adjusted Gross Income Limits	Phaseout starts at \$40,000 and is gone at \$50,000 for singles; \$80,000 to \$100,000 for joint returns; the credit is not available to married filing separately.	Phaseout starts at \$40,000 and is gone at \$50,000 for singles; \$80,000 to \$100,000 for joint returns; the credit is not available to married filing separately.
	<b>Education IRA</b>	<b>Student Loan Interest Deduction</b>
Tax Incentive	Up to \$500 nondeductible contribution per beneficiary as a trust account for qualified higher education expenses for the withdrawal year. Caution any balance remaining after beneficiary reaches 30 or dies are deemed distributed within 30 days.	An above the line deduction, where no itemization required of <ul style="list-style-type: none"> <li>up to \$1500 for 1999</li> <li>up to \$2000 for 2000</li> <li>up to \$2500 after 2001</li> </ul> for interest paid on loans for higher education expenses while at least ½ time student.
Restrictions	<ul style="list-style-type: none"> <li>• Contributions must be made during calendar tax year.</li> <li>• 10% penalty plus tax on unqualified withdrawals.</li> <li>• Cash contributions only.</li> <li>• No contributions after account holder attains age 18.</li> </ul>	<ul style="list-style-type: none"> <li>• Deduction is allowed only with respect to interest paid during the first 60 months in which interest payments are required.</li> <li>• No deduction if student is allowed as dependent on another taxpayer's return.</li> <li>• No double benefits, as in home equity loans.</li> </ul>
Modified Adjusted Gross Income Limits	Phaseout starts at \$95,000 and is gone at \$110,000 for singles; \$150,000 to \$160,000 for joint returns; and the credit is not available to married filing separately.	Phaseout starts at \$40,000 and is gone at \$55,000 for singles; \$60,000 to \$75,000 for joint returns; and the deduction is not available to married filing separately.
	<b>Qualified State Tuition Plan Modification</b>	
Tax Incentive	The taxpayer makes after tax cash contributions to an account established solely for meeting qualified higher education expenses of the child. The earnings grow tax-deferred and distributions of earnings are taxable to distributee when withdrawn. Penalties apply on refund of unused earnings unless extenuating circumstances.	
Restrictions	Distribution use has expanded from post-secondary higher education expenses to include reasonable room and board costs incurred by an eligible student while attending an eligible educational institution.	
Modified Adjusted Gross Income Limits	None	



The following is a review of “constructive” payments by a cash basis taxpayer.

- a) Amounts paid with borrowed funds are deductible when paid, not when the loan is repaid.
- b) When a bank credit card is used to pay an expense, the payment is considered to have been made in the year the credit charge is made, regardless of when the cardholder pays the bank.
- c) A payment by check is considered payment at the time the check is delivered to the payee provided it later is paid by the bank. Although a US District Court held that the date of mailing the check is the date of payment, IRS ruled wages are not constructively paid for withholding and employment tax purposes when they are mailed to employees on the last day of the year and not received the same day.

### **Estimated Tax Rules**

TRA '97 may have provided relief in some areas but added confusing changing rules in others. The minimum threshold after subtracting income tax withholding and credits for estimated tax payments was increased from \$500 to \$1000 effective for tax years after 1998. To avoid underpayment of estimated tax, individuals with prior year AGI not exceeding \$150,000 (\$75,000 if married, filing separately), must make timely estimated payments at least equal to (1) 100% of last year's tax, or (2) 90% of the current year's tax liability. A change is for individuals who exceed the \$150,000 (\$75,000 if married filing separately) prior year's AGI amount as shown below:

#### **Estimated Tax Payment Due For**

<b><u>Tax Year</u></b>	<b><u>Safe Harbor Percentage</u></b>
1999	105% of 1998 tax liability
2000	106% of 1999 tax liability
2001	106% of 2000 tax liability
2002	112% of 2001 tax liability
2003 and later	110% of preceding year's tax liability

Similar rules apply to trusts and estates.

Farmers and fishermen who receive at least two-thirds of their total gross income from farming are exempt from estimated tax payments, providing they file and pay taxes by March 1. New York State officially follows the federal definition of gross income from farming for tax years after 1992.

### **Limitation on Compensation for Retirement Plan Calculations**

The maximum amount of compensation that can be taken into account under qualified retirement plans, SEPs, etc., was lowered to \$150,000 by the '93 tax act. This amount is adjusted annually for inflation, but only in increments of \$10,000. If the annual adjustment calculates to less than \$10,000, no adjustment will be made. The 1999 maximum amount is \$160,000. Transition rules apply to governmental plans and plans maintained under a collective bargaining agreement.

### **Employer-Provided Education Assistance**

The exclusion for up to \$5,250 of employer-provided educational assistance for undergraduates has been extended and is available for courses beginning before May 31, 2000 and is retroactive for tax years beginning after December 31, 1994. The exclusion date was not changed for graduate-level education expenses up to \$5,250 is for any course beginning before July 1, 1996. Consequently, withholding must be made on the cost of graduate courses.

## LONG TERM CAPITAL GAINS RATES CUT

The tax rates on net capital gains for individuals, estates and trusts were reduced and holding periods were generally increased by the TRA of '97. The RRA of '98 reduced the required holding period from 18 to 12 months for most assets sold after 1997 to qualify for the 20% maximum adjusted net capital gain rate. Some assets are excluded from adjusted net capital gains and are ineligible for the lowest long-term rates. Cattle and horses must be held 24 months to qualify for the lower capital gain rates. Short-term gains are still taxed as ordinary income.

The following table identifies the different maximum rates that apply to net capital gains occurring in 1997, 1998 and subsequent tax years.

### Capital Gains Holding Periods and Tax Rates

Date of sale or exchange <sup>1</sup>	Required holding period <sup>2</sup>	Maximum capital gain rate
Before 5/7/97	>12 months	28%
After 5/6/97 and before 7/29/97	>12 months	20% or 10% for taxpayers in 15% bracket <sup>3</sup>
After 7/28/97 and before 1/1/98	>12 but < 18 months	28% or 15% for lowest bracket taxpayers
	>18 months	20% or 10% as above <sup>3</sup>
After 12/31/97	>12 months	20% or 10% as above <sup>3</sup>
After 12/31/2000	>5 years	18% or 8% for taxpayers in 15% bracket <sup>4</sup>

<sup>1</sup> The date of sale or exchange also applies to the date installment sale payments are received.

<sup>2</sup> The required holding periods for livestock held for breeding, dairy, draft and sporting purposes remain at 24 months for cattle and horses and 12 months for other livestock.

<sup>3</sup> Gain from the sale of Sec. 1250 property (general purpose buildings and other depreciable real estate) that would be ordinary income under Sec. 1245 depreciation recapture rules and which has not already been taxed as ordinary gain under Sec 1250, has a maximum tax rate of 25%. The maximum rate on net capital gain from the sale of collectibles and certain small business stock remains at 28%.

<sup>4</sup> These rates apply only if the 5-year holding period begins after 2000. An asset sold before 2006 would not qualify for this rate unless the taxpayer elects to treat the asset as having been sold and reacquired for its fair market value on 1/1/2001. Gain must be recognized and losses disallowed under this option. Few taxpayers would benefit from this election.

### Adjusted Net Capital Gain Exclusions

Adjusted Net Capital Gain (ANCG) excludes unrecaptured gain from the sale of Sec. 1250 assets (general-purpose buildings), gain on collectibles and Sec. 1202 small business stock gain.

### Computing Net Capital Gain

Remember that some or all of capital gain income can be taxed below its maximum rate if the taxpayer is in the 15% taxable income bracket. Non corporate taxpayers will compute their 1999 net capital gains tax by applying capital gain income to the 15% taxable income bracket in the following order:

1. Unrecaptured Sec. 1250 gain (25% reduced to 15%).
2. Collectibles and other 28% rate gain assets (28% reduced to 15%).
3. Adjusted net capital gain (20% reduced to 10%).
4. Adjusted net capital gain in excess of the 15% taxable income bracket is taxed at 20%.

**Example:** Mr. and Mrs. F. P. Moor, file a joint return and their 1999 15% taxable income tax bracket goes to \$43,050. Their taxable income after personal exemptions and itemized deductions is \$48,200 exceeding the 15% bracket by \$5,150. Their taxable income includes \$6,000 unrecaptured Sec. 1250 gain from the sale of a farm building, \$3,500 of capital gain from the sale of antiques, and \$10,000 of adjusted net capital gain from the sale of dairy cattle. The \$6,000 unrecaptured Sec. 1250 gain and the \$3,500 capital gain on collectibles is all taxed at 15%. \$4,850 of their adjusted net capital gain (\$10,000 ANCG - \$5,150 15% bracket excess), is taxed at 10%. The remaining \$5,150 of ANCG is taxed at 20%.

5. Apply the 25% net capital gain tax to any unrecaptured Sec. 1250 gain exceeding the 15% bracket.
6. Apply the 28% net capital gain tax to any 28% rate gain assets exceeding the 15% bracket.

### **Netting Capital Gains and Losses**

The RRA of 1998 provides the following rules for capital gains and losses for tax years ending after May 6, 1997.

1. Short-term capital losses including carryovers are combined with short-term capital gains. Any net short-term capital loss is used to reduce long-term capital gains in the following order: 28% sale gain, unrecaptured Sec. 1250 gain (25%), and adjusted net capital gain (20%).
2. Gains and losses are netted within the three long-term capital gain groups to determine a net capital gain or loss for each group. There can be no net loss in the 25% group, which is limited to gain to the extent of straight-line depreciation.
3. A net loss from the 28% group (including long-term capital loss carryovers) is used to reduce gain in the 25% group, and then any net loss balance is carried to the 20% group.
4. A net loss from the 20% group is used to reduce gain from the 28% group and any remaining net loss is carried to the 25% group.

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

## **Inherited Property Rules**

TRA '97 and RRA '98 did not change the step-up in basis rule that gives decedent's property a new basis equal to its FMV on the date of death (or alternative valuation date). Only gain that occurs after that date will be subject to income tax. Inherited property will automatically be considered held the required holding period for long term capital gains treatment.

## **Other Provisions**

AGI will still include the entire net capital gain and will continue to influence the determination of the floor on certain itemized deductions, the phaseout of personal exemptions and itemized deductions.

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

On the sale or exchange of small business stock (Sec. 1202 stock), held for more than five years, 50% of the gain may be excluded from the taxpayer's gross income. The remaining capital gain is taxed at 28%. Any gain in excess of \$240,000 is subject to other rules. If such small business stock is sold before meeting the five year holding requirement, the gain will be taxed at the 20% maximum capital gains tax rate (if the required holding period has been met).

## **SALE OF TAXPAYERS PRINCIPAL RESIDENCE**

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

The new exclusion can be used by taxpayers of any age on each home they have owned and used as a principal residence for at least two years during the five-year period ending on the sale date. Use of the exclusion is limited to once every two years beginning May 7, 1997. Earlier sales do not count. Use of the old exclusion prior to May 7, 1997 does not affect the availability of the new exclusion. Married taxpayers filing joint returns get a \$500,000 exclusion if either spouse has owned the residence for at least two years, both spouses have lived in it for at least two years and neither spouse has used the new exclusion in the past two years.

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

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

Example: Mr. and Mrs. Move sold and moved out of their first home March 1, 1999. They began renting and living in that home on June 28, 1997 but did not buy it until August 4, 1997. They lived in the home for 611 days but owned it for only 574 days. Their partial exclusion is based on the portion of the two-year (730 days) ownership requirement that they lived in the house (574 days), the shorter of the two requirements. Their partial exclusion for 1999 is \$393,150 ( $574 \div 730 = .7863 \times \$500,000 = \$393,150$ ).

The length of ownership and use of the current principal residence may include the period of ownership and use of prior residences on which gain was rolled over to the current residence. For example, if the home sold by Mr. and Mrs. Move in the above example had been their second home, and the gain from the sale of the first home owned and used for more than one-year was used to reduce the basis of the second home, they would qualify for the full exemption.

The partial exclusion may be also claimed by taxpayers that have excluded the gain on the sale of another home sold after May 6, 1997 and within two-years of the current sale, if the current sale was due to a change in place of employment, health or unforeseen circumstances. Gains from insurance proceeds and other reimbursements for homes destroyed or condemned after May 6, 1997 qualify for the exclusion. The sale of a remainder interest in a home to a person related to or entity owned by the taxpayer does not qualify. Gain equal to any depreciation allowed or allowable for the business use of a home after May 6, 1997, can not be included in the exclusion.

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

Previously Form 2119 was used to report the sale of principal residences. That form has been discontinued. If any gain is to be recognized the sale is reported directly on Schedule D. On the line directly below that used to report the total gain, the exclusion amount (if any) is listed as a loss with a description of "Section 121 exclusion".

## INCOME AVERAGING FOR FARMERS

Individual farmers may elect to use a new three-year method of income averaging for tax years beginning on or after January 1, 1998. “Elected farm income” (EFI) is deducted from the current year’s taxable income and one-third of it is added to each of the three prior year’s taxable income. The election may not be used by C corporations, estates and trust.

“Elected farm income” is taxable income attributed to any farming business and designated to be included in the election. Gains from the sale of farm business property (excluding land) regularly used in farming for a substantial period, may be included in EFI. A “farming business” includes nursery production, sod farming, the production of ornamental trees and plants as well as the production of fruit, nuts, vegetables, livestock, livestock and horticultural products, and field crops. The terms “regularly used” and “substantial period” are not defined in IRC or committee reports.

The tax imposed when income averaging is elected will be the current year’s federal income tax liability without the EFI, plus the increase in the three prior years tax liability caused by the carryback of EFI. The election does not apply to self-employment tax or AMT. Current year’s EFI is subject to SE tax and AMT in the election year, not in carryback years. Note that this provision may result in tax savings from income averaging being offset by increases in AMT.

Farm taxpayers who elect income averaging will be able to spread taxable farm income over a four-year period and designate how much and what type of farm income to include in EFI. Schedule J is used to compute and report the tax from income averaging.

### Farm Income Averaging Example

Dairy farmers Mr. and Mrs. B & B Goodyear have a substantial increase in farm income in 1999. Milk receipts are up and feed costs are down. 1999 has been a “bigger and better goodyear”. Mrs. Goodyear works off-farm. They file a joint return, claim two exemptions and the standard deduction. Their taxable income for 1999 and the previous three years is determined as follows:

<u>Year</u>	<u>Sch. F Profit</u>	+	<u>Sec. 4797 cattle Sales(cap. gains)</u>	+	<u>other income</u>	-	<u>Pers. Exemp. Std. ded.</u>	=	<u>Taxable income</u>
1999	\$38,000		\$20,000		\$21,750		\$12,700		\$67,050
1998	4,000		18,000		18,400		12,500		27,900
1997	17,000		12,000		16,900		12,200		33,700
1996	6,000		16,000		15,000		11,800		25,200

The Goodyears elect to income average in 1999. Their maximum EFI is \$58,000 (taxable income attributed to farming). Their optimum EFI may be taxable income that exceeds their 15% tax bracket or \$24,000 (\$67,050 – \$43,050). They decide to use \$24,000 of their Sch. F profit as 1999 EFI and carryback \$8,000 to each of the last 3 years.

Will all of the EFI be taxed at 15%? In 1997 their 15% tax bracket ended at \$41,200, their taxable income was \$33,700 leaving \$7,500 available for EFI from the current year. Therefore \$500 (\$8,000-\$7,500) carried back to 1997 will be taxed at 28%.

Should the Goodyears reduce EFI to avoid the 28% tax bracket in 1997? For each \$1 of EFI subject to the 28% tax rate in 1997, \$2 is taxed at 15% in the other carryback years. The marginal tax rate for The Goodyears EFI is 19.33%  $(.15 + .15 + .28) \div 3$ . If they put less than \$24,000 in 1999 EFI their 1999 taxable income will exceed \$43,050 and their marginal tax rate will be 28%.

How much income tax will the Goodyears save by income averaging in 1999? They will save 13% (28-15) on the first \$22,500 (3 x \$7,500) or \$2,925, and 8.67% (28-19.33) on the remaining \$1,500 of EFI or \$130, for a total tax reduction of \$3,055.

### **Questions and Issues that Need Clarification**

#### **1. What taxpayers qualify for farm income tax averaging?**

Sec. 1301 says, “individuals engaged in a farming business” qualify and specifically excludes estates and trusts. IRS instructions indicate that partnerships, LLCs and S corporations qualify (presumably because they are not tax entities, farm income flows through the business and retains its character in the hands of the individual taxpayer). C corporations and their owners do not qualify for farm income averaging (although they are not specifically excluded by IRC Sec. 1301).

#### **2. Does EFI retain its character as it is carried back and may the taxpayer select the type of income to include in EFI?**

Taxpayers will be allowed to carryback ordinary farm income and keep capital gains in 1999 taxable income, or select the best combination of ordinary farm income and qualified capital gains to meet their tax management objectives. When a combination of ordinary farm income and capital gains is included in EFI, the IRS indicates that an equal portion of each type of income must be added to each prior year. The taxpayer cannot add all of the capital gains to a single prior year.

Any capital gain that is carried back to prior years will be treated at the capital gains tax rate in effect for that prior year. Therefore 1999 gains could be subject to a maximum 28% rate if taken back to 1996.

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

If the farm owner materially participates in the farming activity and properly reports the income on Sch. F, this income appears to qualify for income averaging. If the farm owner does not materially participate but receives share rental income this income is properly reported on Form 4835. 1998 IRS instructions did not include Form 4835 in its list of forms on which farm income and expense are typically reported. We believe that the forthcoming regulations are likely to say that non-materially participating landowner rental income is not eligible for averaging. Cash rental income reported on Sch. E is not income attributable to a farming business.

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

All sales reported on Sch. F and Form 4835 (assuming share-rent lessors qualify) are qualified. Sales of raised breeding and dairy livestock reported on Form 4797 qualify. Sales of farm property for which depreciation and for Sec. 179 deductions are claimed also qualify. Therefore it appears as if all sales of farm machinery, buildings, livestock and other eligible Sec. 1231 property qualify as “regularly used”.

**5. How long is the holding period required to meet the “substantial period” rule?**

It is likely that the only farm sales required to meet the “substantial period” are those reported on Form 4797. But “substantial period” has not been defined. The IRS instructions indicate that "substantial period" depends on all the facts and circumstances.

**6. If Sec. 1231 gain is part of EFI, is it subject to recapture due to unrecovered Sec 1231 losses in the carryback years?**

IRS instructions indicate that any net capital gains shifted to a prior year that had a capital loss do not offset that loss. The loss remains as a capital loss carryover. Presumably this same approach would be applied to Sec. 1231 gains which would then be taxed as long-term capital gains in the prior year.

**7. Can the election to income average be made on an amended return?**

IRS Publication 553 says that an election can be made, changed or revoked only if there is another change on the tax return, or by consent of the IRS.

**8. If a prior year return reflected an NOL carryover that was only partially applied, will additional NOL carryover be used in that prior year when one-third of this year's EFI is "carried back"?**

No, the amount of the NOL applied is not refigured to offset the EFI added to that prior year.

### **Planning Guidelines and Information**

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

Income averaging should be used to transfer as much as possible of high bracket income from the election year, to low bracket income in the carryback years. There will be cases where EFI carried back to one or more years is not taxed in the lowest bracket but income averaging will still saves taxes. A farm taxpayer needs the following information to determine if and how much 1999 farm income should be averaged:



1. Estimates of 1999 adjusted gross income, ordinary income and capital gain attributed to farming, personal exemptions and the standard (or itemized) deduction.

**1999 Personal Exemption and Standard Deductions\***

Personal exemption		\$2,750
Standard deduction:	Single	\$4,300
	Married filing jointly	\$7,200
	Head of household	\$6,350
	Married filing separately	\$3,600

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 \* Additional amounts for taxpayers over 65 and/or blind taxpayers are not included.

2. Taxable income from his or her 1996, 1997 and 1998 tax returns.
3. Taxable income tax brackets for 1999 and the 3 prior years.

**High End of Taxable Income Tax Brackets**

<b><u>Filing Status</u></b>	<b><u>Bracket</u></b>	<b><u>1999</u></b>	<b><u>1996</u></b>	<b><u>1997</u></b>	<b><u>1998</u></b>
<b>Single</b>	15%	\$25,750	\$24,000	\$24,650	\$25,350
	28%	\$62,450	\$58,150	\$59,750	\$61,400
	31%	\$130,250	\$121,300	\$124,650	\$128,100
	36%	\$28,300	\$263,750	\$271,050	\$278,450
<b>Married Filing Jointly</b>	15%	\$43,050	\$40,100	\$41,200	\$42,350
	28%	\$104,050	\$96,900	\$99,600	\$102,300
	31%	\$158,550	\$147,700	\$151,750	\$155,950
	36%	\$283,150	\$263,750	\$271,050	\$278,450
<b>Head of Household</b>	15%	\$34,550	\$32,150	\$33,050	\$33,950
	28%	\$89,150	\$83,050	\$85,350	\$87,700
	31%	\$144,400	\$134,500	\$138,200	\$142,000
	36%	\$283,150	\$263,750	\$271,050	\$278,450
<b>Married Filing Separately</b>	15%	\$21,525	\$20,050	\$20,600	\$21,175
	28%	\$52,025	\$48,450	\$49,800	\$51,150
	31%	\$79,275	\$73,850	\$75,875	\$77,975
	36%	\$141,575	\$131,875	\$135,525	\$139,225

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## CCC COMMODITY LOANS AND LOAN DEFICIENCY PAYMENTS

Low commodity prices are causing farm producers to use government programs that have not been used in the past few years. As market prices for commodities fall below the marketing assistance loan rates offered by the Commodity Credit Corporation (CCC), producers can realize more income by taking advantage of one or more of the government options. Those options and the income tax consequences are as follows:

### **CCC Nonrecourse Marketing Assistance Loan**

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

I.R.C. §77 provides for a binding election to treat these loans as income in the year received.

If the producer has not made the I.R.C. §77 election, the CCC loan is treated the same as any other loan.

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

The income tax consequences of the sale depend upon whether or not the I.R.C. §77 election has been made. In any event, the interest expense is deductible on Schedule F.

Typically, the I.R.C. §77 election has not been made so the producer has no basis in the commodity. Therefore, the full sale price must be reported as Schedule F income.

If the I.R.C. §77 election has been made, the producer has basis in the commodity equal to the amount of the loan. That basis is subtracted from the sale price to determine the gain on the sale (which is reported in the resale section of Schedule F).

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

A producer who redeems the commodity by paying the PCP will receive a Form CCC-1099-G from the CCC for the difference between the loan rate and the PCP. That amount must be reported as an Agricultural Program Payment on Schedule F.

However, if the producer made a §77 election, the difference between the loan rate and the PCP is not reported as taxable, since the full loan amount has already been reported on line 7a on Sch. F. The producer now has basis in the commodity only equal to the PCP.

### **Loan Deficiency Payment**

If market prices are below loan rates, producers can simply claim a loan deficiency payment (LDP) for their crops rather than borrowing from CCC. That payment is equal to the difference between the

loan rate and the PCP on the date the LDP is claimed. Producers get the same result as if they had taken the loan and paid the PCP rate on the date they claimed the LDP.

The LDP is reported as an Agricultural Program Payment.

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

1. CCC loan activity is not reported on the 1099. Borrowings and program payments may be commingled in taxpayer records.
2. Often, advance government payments are made. Then if market conditions are better than expected, these advances must be repaid. Sometimes these payments are simply netted from subsequent government payments. Sometimes they are paid by taxpayer check and can be confused with LDPs or repayments of CCC loans.
3. Interest paid to CCC on loans is not reported to the taxpayer on a 1099.

## **PROVISIONS APPLYING PRIMARILY TO BUSINESS ACTIVITY**

### **Business Use of Home**

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

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

Effective for tax years beginning after December 31, 1998 the home office rules are more relaxed. The definition of principal place of business has been expanded. It allows a deduction for administration and management even though the work is performed elsewhere. IRC 280A(c)(1) indicates that a home office will qualify as the principal place of business if: 1) the office in the home is used for the administrative or management activities of the taxpayer's trade or business, and 2) there is no other fixed location where the taxpayer conducts substantial administrative or management activities of the trade or business. All other rules continue to apply. The space must be used exclusively and regularly for business. IRS Pub. 587 provides great examples that describe 4 situations in which a taxpayer's home office will qualify for 1999 even if the use before 1999 did not qualify for the deduction.

**Form 8829, Expenses for Business Use of Your Home**, is not filed with Schedule F, but it may be used as a worksheet to help farmers determine the appropriate expenses to claim. Applicable expenses for business use of the home include a percentage of the interest, taxes, insurance, repairs, utilities and depreciation claimed.

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

Schedule C filers who claim expenses for business use of the home must file Form 8829. Form 4562 will be required if it is the first year the taxpayer claims such expenses. Limitations on use of home expenses as business deductions are calculated on Form 8829.

**Caution:** When a taxpayer sells a home on which expenses for business use have been claimed, tax consequences may occur.

**Transportation Expenses.** When a taxpayer has two established places of business, the cost of traveling between them is deductible as an ordinary and necessary business expense under Sec. 162, because the taxpayer generally travels between them for business reasons. However, when one business is located at or near the taxpayer's residence, the reason for travel can be questioned. In Rev. Rul. 94-47 IRS takes the position that transportation expenses incurred in travel from the residence are only deductible if the travel is undertaken in the same trade or business as the one that qualifies the taxpayer for a deductible home office.

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

### **Self-employed Health Insurance Premiums**

This tax provision allows self-employed taxpayers to deduct as an adjustment to income on 1040 a percentage of health insurance premiums paid. In 1999 to 2001 the deduction moves to 60%, with the balance subject to the 7.5% rule for those who itemize. The deduction will be 70% for the tax year 2002 and fully deductible beginning in the year 2003. Self-employed taxpayers include sole proprietors, partners and more than 2% S corporation shareholders.

Qualified health insurance premiums are limited to health insurance coverage of the taxpayer and/or the taxpayer's spouse and dependents. The deduction may not exceed earned income. It does not reduce income subject to self-employment tax and that part may not be included in medical expenses claimed as itemized deductions. A taxpayer eligible for coverage in an employer's subsidized health insurance plan may not deduct insurance premiums he or she pays even if it is the taxpayer's spouse that is the employee. Eligibility is tested monthly.

### **Employee Health and Accidental Insurance Plans**

An employer can claim premiums paid on employee health and accident insurance plans as a business expense on Schedules F or C. The payments are not included in employee income (I.R.C. Sec. 105 (b)). Plans purchased from a third party (an insured plan) as well as self-insured plans qualify but the latter are subject to nondiscrimination rules.

Health insurance purchased for an employee's family qualifies, even if a member of that family is the employer. A taxpayer operating a business as a sole proprietorship can employ his or her spouse,

provide health insurance that covers the spouse-employee and the family of the spouse-employee (including the employer), and deduct the cost as a business expense (Rev. Rul. 71-588).

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

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

1. The spouse must be a *bona fide* employee with specific duties and the salary and benefits received must be proportionate to the duties.
2. The employer must file all payroll reports, withhold income and FICA taxes and furnish a Form W-2 to the employee.

The advantages of paying the family health insurance premiums this way are a reduction of Schedule F or C net income, a reduction of combined taxable income, a potential reduction in self-employment income and a potential net tax savings. The disadvantages are additional bookkeeping, payroll tax deposits, a possible increase in social security taxes (if the employer's earnings are above the earnings base), and a potential reduction in social security benefits to the employer.

### **Business Use of Automobiles**

Automobile expenses are deductible if incurred in a trade or business or in the production of income. Actual costs or the standard mileage rate method may be used. Employers with 10 or more employees using their own cars for company business may use the Fixed and Variable Rate (FAVR) allowance or may devise their own consistent mileage allowance. The FAVR allowance is not available to self-employed individuals.

The 1999 standard mileage rate from January 1, 1999 to March 31, 1999 was 32.5 cents per mile for all business miles driven (leased as well as purchased vehicles). Then the first ever rate decrease occurred lowering to 31 cents per mile for the balance of the year. This rate could have further decreases in the year 2000. The standard mileage rate may not be used when the automobile has been depreciated using a method other than straight line, the car is used for hire or two or more cars are used at once. The use of Section 179, ACRS, or MACRS depreciation also causes disqualification from using the standard rate. When a taxpayer uses the standard rate on a vehicle in the first year it is used in the business, the taxpayer is making an election not to use MACRS depreciation or Section 179.

Effective for tax years beginning after December 31, 1997, a rural mail carrier that receives a qualified reimbursement for expenses incurred for use of their vehicle will be allowed a deduction for an amount equal to the reimbursement received ("a wash"). The special mileage rate equal to 150% of the basic standard mileage rate is no longer available for tax years beginning after December 31, 1997.

### **Deductibility of Borrowed Funds to Satisfy Interest Due**

Cash basis taxpayers are not entitled to interest deductions in cases where the funds used to pay the interest due are borrowed from the same lender to whom the interest is owed. Borrowing to satisfy the interest obligation has been ruled that the obligation was postponed rather than paid. If a taxpayer borrows to pay the interest from the same lender accurate records must be kept so when the note is paid the then deductible interest is not forgotten. Borrowing from a different lender or borrowing prior to payment due date and paying multi-obligations from the advance seems to meet the deductibility requirements.

## CORPORATE AND PARTNERSHIP PROVISIONS

### Corporations

C or regular corporations are subject to federal income tax rates ranging from 15 to 39%. Rates were not changed by the 1997 or 1998 tax legislation. Capital gains are taxed at the regular corporate rates. A personal service corporation is taxed at a flat rate of 35%.

#### 1999 Corporate Tax Rates For Small Businesses\*

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

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

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

A corporation is required to make estimated tax payments equal to 100% of the tax shown on its return for the current year or on 100% of last year's tax, if the estimated tax for the year is expected to be \$500 or more.

S corporations have elected not to be a tax paying entity but must file Form 1120S. S corporation shareholders will include their share of business income, deductions, losses and credits on their individual returns.

The alternative minimum tax has been repealed, effective January 1, 1998, for small corporations (less than \$15 million of total gross receipts from 1995 through 1997 and not more than \$22.5 million in any succeeding three-year period). The AMT rate remains at 20%, the exemption is \$40,000 and the exemption phase-out rules are unchanged.

Farm family corporations with annual gross receipts exceeding \$25 million in any year after 1985 must use accrual tax accounting. Non-family farm corporations with annual gross receipts exceeding \$1 million in any year after 1976 must use accrual tax accounting. When farm corporations become subject to the gross receipt rule and are required to change to accrual accounting, an adjustment (IRC Sec. 481) resulting from the change is included in gross income over a 10-year period beginning with the year of the change. TRA'97 replaced suspense accounts with the Sec. 481 adjustment for tax year's ending after June 8, 1997 and provided phase-out rules for suspense accounts established under prior law. The rules that require income from suspense accounts to be included in taxable income when gross receipts decline were retained.

## **Partnership Filing Rules and Issues**

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

**Schedules L, M-1 and M-2** on Form 1065 are to be completed on all partnership returns unless all three of the following apply; the partnership's total receipts are less than \$250,000, total partnership assets are less than \$600,000, and Schedules K-1 are filed and furnished to the partners on or before the due date of the partnership return, including extensions.

A number of partnership rules were modified by TRA '97 and some were adjusted in RRA '98. Most modifications affect electing large partnerships (generally partnerships with at least 100 partners) and will not affect farm and small business partnerships. Numerous changes made to the unified partnership audit procedures do not apply to small partnerships with 10 or fewer partners.

Premiums for health insurance paid by a partnership on behalf of a partner for services as a partner are treated as guaranteed payments. (Usually deductible on 1065 as a business expense, listed on Schedules K and K-1 and reported on Sch. E). For 1999-2001, a partner who qualifies can deduct 60% of the health insurance premiums paid by the partnership on his or her behalf as an adjustment to income on 1040.

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

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

### **Cost-Sharing Payments Under IRC Sec. 126**

Cost-sharing payments that qualify under Sec. 126 may be excluded from income reported by farmers. Several federal and state programs have been certified under Sec. 126. They include the NYS Agricultural Non-Point Pollution Grant Program, the NYC Watershed Agricultural Program and other watershed protection programs. WRP payments and EPA grants have not been certified. To be excluded, the payment must be for capital expenditures such as concrete pads, storage tanks, tile drains, diversion ditches and manure storage. Payments for items that can be expensed on Sch. F, including soil and water conservation expenses, may not be excluded. A portion of a payment that increases annual gross receipts from the improved property more than 10% or \$2.50 times the number of effected acres, may not be excludable.

All excluded Sec. 126 payments are subject to recapture as ordinary income to the extent that there is gain upon sale of the property within 10 years of receiving the payment (IRC Sec. 1255). If the property is sold in more than 10 and less than 20 years, a declining percentage of the excluded payment is recaptured.

## **Conservation Reserve Payments (CRP)**

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

- 1) If the taxpayer receiving CRP payments is materially participating in a farming business that includes the enrolled land, the CRP payments are Sch. F income.
- 2) If the taxpayer was a non-participating landlord before the land was put into the CRP and the taxpayer hires someone to manage the CRP acreage, the payments are Sch. E income.
- 3) If the taxpayer was materially participating in the farm business before entering the CRP, but is a non-participating landlord when CRP payments are received, the tax court has ruled the payments are Sch. E income (Wuebker, 110 TC No. 31 (1998)). IRS may still require the income to be reported on Sch. F.
- 4) If the taxpayer was and is a non-materially participating crop-share lessor, before and after entering the CRP, the payments are Form 4835 income.

## **The Wetlands Reserve Program (WRP)**

Farmers and other landowners may be receiving permanent and/or non-permanent easement payments for enrolling land in the WRP where its use is limited to hunting, fishing, periodic grazing, haying, and managed timber production. Permanent easements may be a lump sum payment or range from 5 to 30 annual payments. Non-permanent easement payments must be extended over 5 or more years. Landowners participating in the WRP are also eligible for cost-sharing payments to restore the land to a healthy wetland condition.

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

Example: True Wetland enrolls 100 acres under the WRP permanent easement option and receives \$500 per acre or \$50,000. The basis of the 100 acres, purchased in 1955, is \$20,000. True reduces the basis to \$0 and realizes a \$30,000 capital gain.

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

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



Cost-sharing payments under the WRP have not yet been qualified as excludible Sec. 126 income. These restoration payments are reported as Sch. F income where they are offset by the restoration costs. If the taxpayer continues to farm, some or all of the cost-sharing payments may be deducted as soil and water conservation expenses. Income and expenses associated with managing and maintaining the WRP land are reported on Sch. F or C.

## **INCOME FROM CANCELLATION OF DEBT AND RECAPTURE AGREEMENTS**

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

### **Bankrupt and insolvent debtor rules**

If canceled debt exceeds total tax attributes, the excess canceled debt is not reported as taxable income. If cancellation of debt outside of bankruptcy causes a taxpayer to become solvent, the solvent debtor rules must be applied to the DII equal to solvency.

### **Solvent farmer rules (debt discharged after 4-9-86)**

Discharged debt (DD) must be "qualified farm indebtedness" which is debt incurred directly in connection with the operation of the farm business. Additional "qualified farm indebtedness" rules are: (1) 50% or more of the aggregate gross receipts of the farmer for the three previous years must have been attributable to farming and (2) 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 will prevent some solvent farmers from using tax attributes to offset DII.

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

Solvent and insolvent farmers receive little relief from gain triggered on property transferred in settlement of debt. The difference between basis and FMV is gain regardless of the amount of DII. The FMV is ignored for non-recourse debt and the entire difference between the basis of property transferred and the debt canceled is gain or loss. Discharge of indebtedness is not includable in income if the transaction is a purchase price reduction (IRC Sec.108(c)(5)).

### **Farm Service Agency (FSA) Recapture of Previously Discharged Debt**

Some farm owners were required to give the FSA a shared appreciation agreement or a recapture agreement in exchange for the discharge of debt. The agreement allows FSA (formerly FmHA) to recapture part of the debt that was previously discharged if the farm is sold for more than the appraised value at time of discharge. If the taxpayer treated the debt reduction as DII debt for tax purposes at the time of the workout, then a FSA recapture will trigger a tax consequence. A typical appreciation agreement would obligate the farmer to pay FSA the lesser of the excess of the amount received when the farm is sold over the amount paid FSA under the agreement or, the difference between the FMV of the farm at buyout and the amount paid under the agreement. When discharged debt is recaptured the tax treatment of some DII, may need to be changed. The DII originally recognized as ordinary income now becomes a deduction against ordinary income. DD offset by a reduction in attributes is added back to the same attributes and DD not recognized under insolvency rules requires no adjustment.

## LIKE-KIND TAX FREE (Deferred) EXCHANGES

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

### **Rules and Requirements**

Generally, in order to have a deferred exchange, the transaction must be an exchange of qualifying property. A sale of property followed by a purchase of a like-kind does not qualify for non-recognition under Sec. 1031. Gain or loss is recognized if the taxpayer actually or constructively receives money or non-like-kind property before the taxpayer actually receives the like-kind replacement property. Property received by the taxpayer will be treated as property not of a like-kind if it is not "identified" before the end of the "identification period" **or** the identified replacement of property is not received before the end of the "exchange period".

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

### **Replacement Property**

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

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

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

## **Qualified Escrow Account and Intermediary**

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

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

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

## **Real Property**

For real property, "like-kind" is interpreted very broadly. Any real estate can be exchanged for any other real estate and qualify for I.R.C. Sec. 1031 so long as the relinquished property was, and the acquired property is, used in a trade or business or held for investment. Consequently, a farm can be exchanged for city real estate and improved real estate can be exchanged for unimproved real estate.

## **Farm Business Personal Property**

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

Most personal property used in a farm business is included in product class 3523 Farm Machinery and Equipment. Farmers will generally qualify for I.R.C. Sec. 1031 treatment when they exchange farm equipment for farm equipment. However, automobiles like general-purpose trucks, heavy general-purpose trucks, information systems and other office equipment are all assigned to separate general asset classes. Livestock of different sexes are not property of a like-kind but exchanges of same sex livestock have qualified as tax free exchanges.

## **Other Deferred Exchange Rules and Requirements**

**IRS Form 8824** is used as a supporting statement for like-kind exchanges reported on other forms, including Form 4797, Sale of Business Property, and Schedule D, Capital Gains and Losses. A separate Form 8824 should be attached to Form 1040 for each exchange. Form 8824 should be filed for the tax year in which the seller (exchanger) transferred property to the other party in the exchange.

If the relinquished property is subject to depreciation recapture under I.R.C. Sec. 1245, 1250, 1252, 1254, and or 1255; part or all of the recapture may have to be recognized in the year of the like-kind exchange.

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

## DEPRECIATION AND COST RECOVERY

The standard depreciation rules for regular income tax have not changed for 1999. AMT depreciation rules were modified in 1998 and will reduce the depreciation adjustment for 1999 and years following. This reference is for practitioners and taxpayers that want to apply depreciation rules to maximize after tax income. The modified accelerated cost recovery system (MACRS) provides for eight classes of recovery property, two of which may be depreciated only with straight line. MACRS applies to property placed in service after 1986. Pre-MACRS property continues to be depreciated under the ACRS or pre-ACRS rules. Most taxpayers will be using MACRS, ACRS, and the depreciation rules that apply to property acquired before 1981. This manual concentrates on the MACRS rules but some ACRS information is included. Additional information on ACRS and pre-ACRS rules can be found in the *Farmer's Tax Guide*.

### Depreciable Assets

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

Depreciation or cost recovery is not optional. It should be claimed each year on all depreciable property including temporarily idle assets. An owner who neglects to take depreciation when it is due now has two opportunities to recover the lost depreciation. It may be recovered by filing an amended return or by following a procedure for automatic change to a permissible accounting method for depreciable property, Rev. Proc. 97-37. A correction procedure is also available to taxpayers whose depreciation or amortization deduction claimed is more than the allowable amount (Rev. Proc. 97-27). Form 3115 (Application for Change in Accounting Method) must be filed with the IRS by the end of the tax year and a copy attached to the taxpayer's return for the tax year that the correction in depreciation is made. A fee is required when too much depreciation has been claimed. Procedures 99-27 & 98-60 carry detailed, line-by-line instructions on how to complete Form 3115.

### MACRS Classes

The MACRS class life depends on the asset depreciation range (ADR) midpoint life of the property.

MACRS Class	ADR Midpoint Life
3-year	4 years or less
5-year	More than 4 but less than 10 years
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 years or more
-----	
27.5-year	Residential rental property
39-year (31.5 if acquired before 5/13/93)	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:

1. Section 1245 property with an ADR class life of four years or less. This includes over-the-road tractors and hogs held for breeding purposes. It does not include cattle, goats or sheep held for dairy or breeding purposes because the ADR class life of these animals is greater than 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, typewriters, copiers and adding machines.
4. Logging machinery and equipment.

Seven-year property:

1. All farm machinery and equipment.
2. Silos, grain storage bins, fences, and paved barnyards.
3. Breeding or work horses (12 years old or less).

Ten-year property includes single purpose livestock and horticultural structures (seven-year property if placed in service before 1989) and orchards and vineyards (15-year property if placed in service before 1989).

Fifteen-year property:

1. Depreciable land improvements such as sidewalks, roads, bridges, water wells, drainage facilities and fences other than farm fences (which are in the 7-year class). Does not include land improvements that are explicitly included in any other class, or buildings or structural components.
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, machine sheds, and many storage buildings.

27.5-year property includes residential rental property.

39-year (31.5 if acquired before 5/13/93) property includes nonresidential real property.

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

Asset	Recovery Period (Years)		
	ACRS	MACRS	ADS
Airplane	5	5	6
Auto (farm share)	3	5	5
Calculators, copiers & typewriters	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*
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 (for farm labor housing)	19	20	25
Office equipment (other than calculators, copiers or typewriters) & furniture	5	7	10
Orchards	5	10***	20
Paved lots	5	15	20
Property with no class life	5	7	12
Rental property (nonresidential real estate)	19	39****	40
Rental property (residential)	19	27.5	40
Research property	5	5	12*
Sheep (breeding)	3	5	5
Silos	5	7	12*
Single purpose livestock structure(housing feeding, storage and milking facilities)	5	10**	15
Single purpose horticultural structure	5	10**	15
Solar property	5	5	12*
Storage (apple, onion, potato)	5	20	25
Tile (drainage)	5	15	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
Vineyard	5	10***	20
Water well	5	15	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.

\*\*\*\*31.5 if placed in service before 5/13/93.

## 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% declining balance (DB) rather than the 200 % available for nonfarm property. There are two straight line (SL) options for the classes eligible for rapid recovery. SL may be taken over the MACRS class life or the MACRS alternative depreciation system (ADS) life. A fourth option is 150 % DB over the ADR midpoint life. The changes in depreciation required for alternative minimum tax purposes are discussed in this section under Additional Rules and in the Alternative Minimum Tax section.

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

<u>Class</u>	<u>Most Rapid MACRS Method Available</u>
3, 5, 7 and 10-year	Farm assets: 150 % DB if placed in service after 1988.* 200 % if placed in service 1987 through 1988.* (See exception for orchards and vineyards above.)
	Nonfarm assets: 200 % DB with cross-over to SL
15 and 20-year	150 % DB with cross-over to SL
27.5 and 39(31.5)-year	Straight line <u>only</u>

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

### **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.)

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

<sup>1</sup> Rounded to two decimals, see Pub. 946 for more precise 20-yr. class rates.

<sup>2</sup> 5.90 in years 12 & 14, 5.91 in years 13 & 15.

## **Half-Year and Mid-Month Conventions**

MACRS provides for a half-year convention in the year placed in service regardless of the recovery option chosen. A half-year of recovery may be taken in the year of disposal. No depreciation is allowed on property acquired and disposed of in the same year. Property in the 27.5 and 39-year classes is subject to a mid-month convention in the year placed in service.

## **Mid-Quarter Convention**

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

**Example:** V. Sharp placed \$101,000 worth of 7-year MACRS property in service during 1999. He could expense \$19,000 and claim \$8,782 of depreciation in 1999 ( $\$101,000 - 19,000 = \$82,000 \times .1071 = \$8,782$ ) under the half-year convention. If \$51,000 of Sharp's property was placed in service in the last quarter and the \$19,000 Sec. 179 election is applied to this \$51,000, \$32,000 is left to be used in the 40% test. Thus,  $\$32,000 \div (\$101,000 - 19,000) = .39$ , which is less than 40%, so Sharp avoids the mid-quarter rules. However, if his 1999 items had totaled \$95,500 and \$51,000 was placed in service in the last quarter, he would be caught by the 40% rule, even if he applied the \$19,000 Sec. 179 to the items placed in service in the last quarter. That is,  $\$32,000 \div (\$95,500 - 19,000) = .42$ , and all the 1999 items would be subject to the mid-quarter convention.

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

## **MACRS Alternative Depreciation**

The MACRS alternative depreciation system (ADS) is required for some property and is an option for the rest. It is a straight line system based on the alternative MACRS recovery period (ADR midpoint lives). Farmers who are subject to capitalization of pre-productive expenses, discussed later, may elect to avoid capitalization, but if they do so, they must use the ADS life on all property.

## **Election to Expense Depreciable Property**

The Section 179 expense deduction is \$19,000 for property placed in service in 1999. It was \$18,500 for 1998. It increases to \$20,000 for 2000, \$24,000 in 2001 and \$25,000 in 2003. The expense deduction is phased out dollar for dollar for any taxpayer that places over \$200,000 of property in service in any year, with complete phaseout at \$219,000. Eligible property is defined as Sec. 1245 property to which Sec. 168 (accelerated cost recovery) applies. Property must be used more than 50% of the time in the business to qualify. General purpose buildings, property acquired from a related person, and certain property leased by non-corporate lessors do not qualify. Excluded is property used outside



the U.S., property used by tax exempt organizations, property used with furnished lodging, property used by governments and foreigners, and air conditioning and heating units. When property is acquired by trade, Sec. 179 deductions may not be claimed on the basis of the trade-in.

In the case of partnerships, the \$19,000 limit applies to the partnership and also to each partner as an individual taxpayer. A partner who has Sec. 179 allocations from several sources could be in a situation where only \$19,000 may be expensed because of the \$19,000 limitation. Any allocations in excess of \$19,000 are lost forever. The same concept applies to S corporations.

The amount of the Sec. 179 expense deduction is limited to the amount of taxable income of the taxpayer that is derived from the **active** conduct of all trades or businesses of the taxpayer during the year. Taxable income for the purpose of this rule is computed excluding the Sec. 179 deduction. Any disallowed Sec. 179 deductions are carried forward to succeeding years. The deduction of current plus carryover amounts is limited to \$19,000 in 1999.

Section 179 regulations provide that wage and salary income qualifies as income from a trade or business. Therefore, such income can be combined with income (or loss) from Schedules C or F in determining income from the "active conduct of a trade or business" when calculating the allowable deduction. Sec. 1231 gains and losses from a business actively conducted by the taxpayer are also included. Regulations issued Dec. 23, 1992 deal with the taxable income limitation, carryover of disallowed Sec. 179 amounts, and active conduct of a trade or business.

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

If post-1986 property is converted to personal use or if business use drops to 50% or less, Sec. 179 expense recapture is invoked no matter how long the property was held for business use. The amount recaptured is the excess of the Sec. 179 deduction over the amount that would have been deducted as depreciation. The recapture is reported on Part IV of Form 4797 and then on Schedule F.

Every business owner who has purchased MACRS property should consider the Sec. 179 expense deduction because only New York investment tax credit will be lost when it is used. It should not be used to reduce AGI below standard (or itemized) deductions plus exemptions, unless an additional reduction in self-employment tax is worth more than depreciation in a future tax year. Also, the taxpayer must be sure not to use more Sec. 179 deduction than the amount of taxable income from the "active conduct of a trade or business."

### **MACRS Property Class Rules**

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

**Example:** A farmer purchased a tractor, harvester and combine in 1999, all belongs in the 7-year property class. The farmer may not recover the tractor over seven years with rapid recovery (150% DB) and the other items over seven or ten years with SL. However, a taxpayer may choose a different recovery option for property in the same MACRS class acquired in a subsequent year. For example, a farmer could have chosen SL 10-year recovery for equipment purchased in 1997 (7-year property),

150% DB for seven years for equipment purchased in 1998, and could now select SL 7-year recovery for all machinery purchased in 1999.

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 15 years on most 10-year property.

### **Some Special Rules on Autos and Listed Property**

There are special rules for depreciation on vehicles and other "listed property". If used less than 100% in the business, the maximum allowance is reduced, and if used 50% or less, the Sec. 179 deduction is not allowed and depreciation is limited to SL. The maximum depreciation and Sec. 179 expense allowance for four-wheeled vehicles called "luxury cars" (6000 lbs. or less) placed in service in 1999 has been reduced to \$3,060 for the first year. The depreciation allowance is \$5,000 for the 2<sup>nd</sup> year, \$2,950 for the 3<sup>rd</sup> year and \$1,775 for each succeeding year. Cellular telephones acquired after 1989 are listed property. Computers are listed property unless they are used only for business.

### **Additional Rules**

For Sec. 1245 property placed in service after 1986 and before 1999, depreciation must be recalculated for AMT purposes using the following table:

Sec 1245 Property Placed in Service Prior to 1999	
Used for Regular Tax Purposes	Must Use for AMT Purposes
150 DB MACRS	150 DB, ADS life
200 DB MACRS	150 DB, ADS life
SL MACRS	SL, ADS life
ADS	ADS

The difference between regular depreciation and this re-determined amount is an income adjustment subject to inclusion in alternative minimum taxable income. The AMT depreciation adjustment for Sec. 1250 property is the difference between what was claimed for regular income tax and that allowed under MACRS ADS straight line depreciation. For Sec. 1250 property placed in service after 1998 (and also for any property depreciated under the SL method) the AMT depreciation adjustment is eliminated. For other property (Sec. 1245 property on which regular MACRS is used), the 150% DB MACRS method must be used over the normal recovery period (not ADS life). Therefore, farm property placed in service after 1998 is not subject to the AMT depreciation adjustment. An adjustment remains for property placed on a 200% DB depreciation schedule.

MACRS rules allow half a year's depreciation in the year of disposition if using the half-year convention. If the mid-quarter convention applies, depreciation is allowed for the quarters held in the year of disposition. Recovery may be claimed in the year of disposition (based on the months held in that year) on 27.5 and 39-year property.

When assets are sold, gain to the extent of all prior depreciation on all Sec. 1245; 3, 5, 7, 10 and 15-year MACRS property is ordinary income. There is no recapture of depreciation on property in the 20-year class if straight line recovery is used (see *A Review of Farm Business Property Sales* section).

Property placed in service during a short tax year is subject to special allocation rules that vary with the applicable convention used. Details are provided in Pub. 534.

## **Choosing Recovery Options**

Taxpayers will maximize after-tax income by using Sec. 179 and rapid recovery on 3, 5, 7, 10, and 15-year MACRS property, assuming the deductions can be used to reduce taxable income and do not create an AMT adjustment that results in AMT liability. The taxpayer that will not be able to use all the deductions in the early years may want to consider one of the straight line options.

Using straight line rather than 150% declining balance on 20-year property will preserve capital gain treatment (at a 25% maximum rate), at the time of disposal. However, the tax savings will be realized many years from now. For most taxpayers, the choice of the best recovery option for 20-year MACRS property should be based on the value of concentrating depreciation in early years versus spreading it out. The time value of money makes 1999 depreciation more valuable than that used in later years. However, depreciation claimed to reduce taxable income below zero is wasted.

## **Reporting Depreciation and Cost Recovery**

Form 4562 is used to report the Section 179 expense election, depreciation of recovery property, depreciation of non-recovery property, amortization, and specific information concerning automobiles and other listed property. Depreciation, cost recovery, and Sec. 179 expenses are combined on 4562 and entered on Schedule F. However, partnerships will transfer the Sec. 179 expense election to Sch. K, Form 1065 rather than combining it with other items on 4562. Since depreciation is excluded when calculating net earnings for self-employment on Sch. K and K-1, include it as an adjustment to net farm profit on Sch. SE.

## **Uniform Capitalization Rules for Fruit Growers and Nurserymen**

Plants subject to uniform capitalization rules include fruit trees, vines, ornamental trees and shrubs, and sod providing the pre-productive period is 24 months or more. The pre-productive period begins when the plant or seed is first planted or acquired by the taxpayer. It ends when the plant becomes productive in marketable quantities or when the plant is reasonably expected to be sold or otherwise disposed of. An evergreen tree, 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 non-depreciable costs of replacing trees and vines do not have to be capitalized.

**Treasury Decision 8729 (8-21-97) states:** “The IRS and Treasury Department are considering the publication of guidance with respect to the length of the preproductive period of certain plants that will have more than one crop or yield. At the present time, the IRS and Treasury Department anticipate that such guidance would provide that plants producing the following crops or yields have a nationwide weighted average preproductive period in excess of two years: apples, apricots, blueberries, blackberries, cherries, currants, grapes, nectarines, peaches, pears, plums, prunes and raspberries.” (only crops produced in N.Y. have been listed).

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

## **Accurate Records Needed**

Accurate and complete depreciation records are basic to reliable farm income tax reporting and good tax management. Depreciation and cost recovery must be reported on Form 4562. 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.

## GENERAL BUSINESS CREDIT

General business credit is a combination of investment tax credit, work opportunity credit, a new welfare-to-work credit, research credit, low-income housing credit, disabled access credit, plus others (see following page). Form 3800 is used to claim the credit for the current year, to apply carryforward from prior years, and claim carryback from later years. The credit allowable cannot reduce regular tax below tentative AMT. It is also limited to \$25,000 plus 75% of net regular tax liability above \$25,000. Special limits apply to married persons filing separate returns, controlled corporate groups, estates and trusts, and certain investment companies and institutions (Sec. 46(e)(i)). TRA '97 changed the carryback period to one-year and the carryforward period to 20 years beginning in 1998. The three-year carryback and 15-year carryforward rules remain for all credits earned before 1998.

### **Review of Federal Investment Credit**

Federal investment tax credit (IC) was repealed for most property placed in service after 12/31/85. IC may still be earned on rehabilitated buildings, qualified reforestation expenses, and certain business energy investments. IC (Sec. 45(a)(1)) is 10% of the amount of qualified investment with more liberal allowances for some rehabilitated historic buildings. IC is a direct reduction against income tax liability. If it cannot be used in the year it is earned, it can be carried back and carried forward to offset tax liability in other years. Unused investment credit from 1986 and earlier years, reduced by 35% may be carried forward 15 years. Reforestation IC does not require the 35% reduction.

If property is disposed of before IC claimed is fully earned, it must be re-computed to determine the amount to recapture. Recapture rules apply when there is early disposition of rehabilitated buildings, business energy property and/or reforested land for which investment credit has been claimed. The amount of recapture is 100% during the first year of service and declines to zero after five full years of service. Form 3468 is used for computing IC, Form 4255 is used to recapture IC.

Rehabilitated buildings (expenditures) credit is 10% for a qualified rehabilitated building and 20% for a certified historic structure. The building (other than a certified historic structure) must have been first placed in service before 1936. Expenditures for the interior or exterior renovation, restoration or reconstruction of the building qualify for the credit. Costs for acquiring or completing a building, or for the replacement or enlargement of a building, do not qualify. The credit is available for all types of buildings that are used in a business. Buildings that are used for residential purposes do not qualify unless they are certified historic structures that are used for residential purposes. The use of a building is determined based on its use when placed in service after rehabilitation. Thus, rehabilitation of an apartment building for use as an office building would render the expenditure eligible for credit. The basis for depreciation must be reduced by 100% of the investment credit claimed.

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

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

## **Other General Business Credits**

Work opportunity credit expired June 30, 1999\* but is available to employers on first year employee wages paid before July 1, 1999. First year wages paid targeted group employees with 120 to 400 hours of service earn 25% credit. The credit increases to 40% when an eligible employee reaches or exceeds 400 hours. There are eight targeted groups including qualified SSI recipients, recipients of aid to families with dependent children, (IV-A recipients), certain food stamp recipients, high risk youth living in empowerment zones, economically disadvantaged ex-felons, and certain disabled workers and veterans. Qualification rules were modified for IV-A recipients and veterans. The above rules include changes effective for workers employed after September 1997.

Welfare-to-Work Credit is available to employers on qualified wages paid to long-term family assistance recipients. The credit is 35% on qualified first year wages and 50% on qualified second year wages. The credit applies to the first \$10,000 of an eligible employees wage each year for a maximum credit of \$8,500 over two years. Wages include the value of benefits, health insurance benefits and employer contributions, educational assistance and dependent care expenses.

In general, to qualify as long-term family assistance recipients, members of a family must have been receiving family assistance for at least 18 months before the hiring date. The recipient must be certified by a designated local agency as being a member of a family receiving assistance under a IV-A program. Employers cannot get work opportunity credit and welfare-to-work credit on the same employee. The welfare-to-work credit expired June 30, 1999. \*

Research credit expired June 30, 1999. \* The old rules are in effect for the first half of 1999.

\*All 3 of these credits have been subject to annual expirations and annual, last minute, retroactive reinstatements.

Disabled access credit may be claimed by an eligible small business that incurs expenses for providing access to persons with disabilities. The maximum amount of the refundable credit is \$5,000 per year (50% of eligible expenses that exceed \$250 but do not exceed \$10,250). An eligible business is one that for the preceding year did not have more than 30 full-time employees or did not have more than \$1 million in gross receipts. An employee is considered full-time if employed at least 30 hours per week for 20 or more calendar weeks in the tax year.

Other general business credits: Low-income housing credit, alcohol fuels credit, enhanced oil recovery credit, renewable electricity production credit, empowerment zone credit, Indian employment credit and employer FICA tax credit on tips.

## A REVIEW OF FARM BUSINESS PROPERTY SALES

The major reduction in capital gains rates increases the spread between the regular marginal income tax rate and the capital gain rate for all individual taxpayers. Since farm taxpayers will be affected by the new capital gain rates and income averaging, tax planning and management of farm property sales has increased in importance. The first step in tax planning is making the distinction amongst gains from sales of property used in the farm business that are eligible for capital gain treatment, gains subject to recapture of depreciation, and Schedule F income.

The reporting of gains and losses on the disposition of property held for use in the farm business continues to be a complicated but an 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 meeting the new holding period requirements, cattle and horses held 24 months, other livestock held 12 months, casualty and theft losses and other involuntary conversions, qualified sales of timber, and un-harvested 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, 1252, and 1255. Also, see discussion below explaining that livestock must be held for dairy, breeding, sport or draft to qualify as Sec. 1231 property.

Under Sec. 1231, net gains are treated as long-term capital gains but net losses are fully deductible ordinary losses.

Note: Net Sec. 1231 gains are treated as ordinary income to the extent of un-recaptured net Sec. 1231 losses for the five most recent prior years. A taxpayer that claimed a net Sec. 1231 loss on the 1994, 1995, 1996, 1997 or 1998 return and has a net Sec. 1231 gain for 1999 must recapture the losses on the 1999 return. Losses are to be recaptured in the order in which they occurred. Any 1999 Sec. 1231 gains in excess of these prior year losses would still receive long-term capital gains treatment.

2. Section 1245 - One of the depreciation recapture sections. Farm machinery, purchased dairy, breeding, sport and draft livestock, held for the required period, and sold at a gain are reported under this section. Gain will be ordinary income to the extent of depreciation and Sec. 179 expense deductions. Gain to the extent of depreciation claimed on capitalized pre-production costs are also reported here.

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

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 Sec. 1245 property. If other than straight line depreciation was used, the gain to the extent of depreciation claimed after 1969 that exceeds what would have been allowed under straight line depreciation is recaptured as ordinary income. No recapture takes place when only straight line depreciation has been used. A taxpayer may shift such real property to straight line depreciation without special consent.

Gain to the extent of SL depreciation on Sec. 1250 assets sold after May 6, 1997 and before 2001, is called unrecaptured Sec. 1250 gain and is taxed at a maximum rate of 25%.

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

An illustration of taxation of gain on Sec. 1250 property. A general purpose farm building was purchased in 1997 for \$20,000. Regular MACRS was used until the building was sold for \$23,000 in 1999. Accumulated depreciation totaled \$2,861. Total gain was therefore \$5,861. SL depreciation would have been \$2,000 so excess depreciation of \$861 would be recaptured as ordinary income. The gain due to SL depreciation would be taxed at a maximum rate of 25%. The \$3,000 of gain resulting from the sale price exceeding the original cost would be subject to long term capital gains rates (10/20%).

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 conservation expenditures 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 expenses will be recaptured. The percentages of soil and water conservation expenses subject to recapture during this time period are: 6th year after acquisition of the land, 80%; 7th year, 60%; 8th year, 40%; and 9th year, 20%.

Here is an illustration:

Farmland acquired, April 1, 1993 cost	\$100,000
Soil and water expenses deducted on 1994 tax return	\$8,000
Land was sold May 15, 1999 for	\$130,000

During the time the land was owned, no capital improvements were made other than the soil and water expenses, so the adjusted tax basis at time of sale was \$100,000. The gain of \$30,000 would normally be all capital gain. The land was held for six years, so the gain is divided;  $\$8,000 \times .80 = \$6,400$  is ordinary gain and  $\$30,000 - \$6,400 = \$23,600$  qualifies as capital gain.

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

## **Livestock Sales**

The majority of livestock sales from Northeast farms are animals that have been held for dairy, breeding or sporting purposes. Income from such sales is always reported on Form 4797. Dairy cows culled from the herd and cows 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 Form 4797.

Income from livestock held primarily for sale is reported on Schedule F. Receipts from the sale of "bob" veal calves, feeder livestock, slaughter livestock, and dairy heifers raised for sale are entered on Schedule F, line 4. Sales of livestock purchased for resale are entered on line 1 of Schedule F, and for a cash basis farmer the purchase price is recovered in the year of sale on line 2. The intent of holding livestock is a key issue in determining if sales are reported on 4797 or Schedule F.

## **Dairy, Breeding, Sport or Draft Livestock**

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

1. Cattle and horses held two years or more, and other breeding livestock held one-year or more. Animals in this group are Sec. 1231 livestock and these holding periods were not changed by TRA '97 or RRA '98. Emus and ostriches are currently excluded from the IRS definition of Sec. 1231.
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 young stock 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 Sec. 1231 Livestock**

Sales of Sec. 1231 livestock are entered in Part I or Part III of Form 4797. Since Part III is for recapture, purchased Sec. 1231 livestock that produce a gain when sold are be entered in Part III where they become Sec. 1245 property. Sales of raised animals on which costs were capitalized are also reported in Part III as are animals on which pre-productive 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 Sec. 1231 livestock not subjected to the capitalization rules including all raised cattle and horses two years of age and older that are held for dairy, breeding, sport or draft purposes are entered in Part I. All purchased Sec. 1231 livestock that result in a loss when sold are also entered in Part I.

## **Reporting Sales of Livestock Not Meeting Holding Period Requirements**

Dairy, breeding, sport or draft livestock that are not held for the required period whether sold for a gain or loss will be entered in Part II of 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.



## Summary of Reporting Most Common Farm Business Property Sales

<u>Type of Farm Property</u>	<u>Tax Form and Section</u>
1. Cattle and horses held for dairy, breeding, sport or draft purposes & held for 2 years or more; plus other breeding or sporting livestock held for at least one-year.	
a) Raised, pre-productive 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 dairy, breeding, sport & draft, 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, other depreciable real property & farmland held for less than one-year	4797, Part II

### **Use of Form 4797 and Schedule D by Farmers**

All sales of farm business properties are reported on Form 4797 to separate Sec. 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 Form 4684 and transferred to Form 4797.

If the Sec. 1231 gains and losses reported on Form 4797 result in a net gain, net Sec. 1231 losses reported in the prior five years must be recaptured as ordinary income by transferring Sec. 1231 gain equal to the non-recaptured 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 Sec. 1231 items result in a net loss, the loss is combined with ordinary gains and losses on Form 4797 and then transferred to Form 1040.

## INSTALLMENT SALES

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

Taxable income from installment sales is computed by multiplying the amount 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 on installment sales.

### **Depreciation Recapture**

Recaptured depreciation does not qualify for the installment sale. That portion of the gain attributed to recaptured depreciation of Sec. 1245 and 1250 property must be excluded from installment sale reporting. Sec. 179 expenses and capitalized expenditures also are subject to Sec. 1245 recapture. The full amount of recaptured depreciation is reported as ordinary income in the year of sale regardless of when the payments are received.

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

When the sale of Sec. 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 to compute the correct gross profit ratio. This adjustment must be made to avoid double taxation of installment payments.

### **Related Party Rules (IRC Sec. 453)**

The installment sale/resale rules should be reviewed before farmers or other taxpayers agree to a sales contract. Gain will be triggered for the initial seller when there is a second disposition by the initial buyer, and the initial seller and buyer are closely related. (Closely related persons would include spouse, parent, children, and grandchildren, but not brothers and sisters.) The amount of gain accelerated is the excess of the amount realized on the resale over the payments made on the installment sale. Except for marketable securities, the resale recapture rule will not generally apply if the second sale occurs 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.

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) non-liquidating sales of stock to an issuing corporation.

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

### **Use of Escrow Accounts**

The installment method may be disallowed if the seller and buyer use an escrow account to hold all or part of the sale proceeds for payment in a future year. Deposits into an irrevocable escrow account are payment in full, unless a substantial restriction exists on the seller's ability to receive the funds (Rev. Rule's. 77-295 & 79-91). Tax courts have been more liberal and have allowed the use of escrow accounts where the arrangement is part of a *bona fide*, arms-length agreement between buyer and seller, no interest from escrowed funds is received by the seller and the escrow agent does not act under the exclusive authority of the seller.

### **Rule Changes from TRA'97**

Farmers may use the installment method of accounting for AMTI from the disposition of property used or produced in farming (see Alternative Minimum Tax). Manufacturers of tangible personal property will not be able to use the installment method to report income from sales to their dealers in tax years beginning after August 5, 1998.

### **General Rules Still in Effect**

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

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

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

A cancellation of all or part of an installment obligation is treated like a sale or other disposition of the obligation except gain or loss is calculated as the difference between the fair market value and the "basis" of the obligation if the parties are unrelated (IRC Sections 453B(f)(1) and 453B(a)(2)).

Grain and other farm inventory property, including livestock held for sale, may be included in a cash basis taxpayer's installment sale and it no longer requires an AMT adjustment in the year of sale (retroactive to 1987).

## **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 interest income by the seller and an interest deduction by the buyer. The amount of interest that must be recognized is called imputed interest. The imputed interest rule applies even if the seller elects out of the installment method or has a loss on the sale. When recharacterization of the loan is required, the seller's interest income increases and capital gain decreases.

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 where seller financing does not exceed \$3.8 million (indexed estimate) must have an interest rate of the lesser of 100% of the applicable federal rate (AFR) or 9% (compounded semiannually).
2. Sales exceeding \$8 million (indexed estimate) are subject to an imputed interest rate equal to 100% of the AFR. All sale-leaseback transactions are subject to rates equal to 110% of AFR.
3. The sale or exchange of the first \$500,000 of land between related persons, (brothers, sisters, spouse, ancestors or lineal descendants) in one calendar year, must have a test or stated rate of 6% compounded semiannually or the AFR.
4. The imputed interest rules do not apply to the sale of personal use property, annuities, patents, and any other sale that does not exceed \$3,000.
5. Imputed as well as stated interest may be accounted for on the cash accounting method on sales of farms not exceeding \$1 million and any other installment sale not exceeding \$250,000.

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

### **Recent Applicable Federal Rates (AFR)**

Term	Compounding Period	Sept. '99	Oct. '99	Nov. '99*
Short-term (<4 yrs.)	Annual	5.42%	5.54%	
	Monthly	5.29%	5.41%	
Mid-term (4-9 yrs.)	Annual	5.98%	6.02%	
	Monthly	5.82%	5.86%	
Long-term (>9 yrs.)	Annual	6.25%	6.31%	
	Monthly	6.08%	6.13%	

Source: [http://www.irs.ustreas.gov/prod/ind\\_info/index.html](http://www.irs.ustreas.gov/prod/ind_info/index.html)

\* Not available at press time

## LEASING OF LAND AND OTHER FARM ASSETS

### **Production Flexibility Contract (PFC) Payments on Leased Land**

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

### **Valid Tax Lease or Conditional Sales Contract**

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

- a) The agreement applies part of each payment toward equity interest.
- b) The lessee gets title to the property upon payment of a stated amount under the contract.
- c) The amount the lessee pays for a short period of time is nearly the amount that would have to be paid to buy the property.
- d) The lessee pays much more than the current fair rental value of the property.
- e) The lessee can purchase the property at a nominal price compared to the value of the property at the time of purchase.
- f) The lessee has the option to buy the property at a nominal price compared to the total amount the lessee has to pay under the lease.
- g) The lease designates part of the payments as interest or part of the payments is easy to recognize as interest.

The most common lease arrangement today is the leverage lease of newly purchased equipment where a large portion of the purchase price is financed with a loan that is fully amortized by lease payments from the lessee. These leases are used for automobiles, trucks, computers, equipment, etc. IRS will accept these transactions as a valid lease if all the following conditions are met.

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

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

### **ALTERNATIVE MINIMUM TAX (AMT)**

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

TRA '97 included some AMT relief as well as new concerns for taxpayers. The relief provisions reduced the capital gain rates and some major AMT exclusions (see explanation below). However more taxpayers may be subject to AMT as personal deductions and non-refundable credits increase.

#### **Four changes in AMT Affect Farmers**

1. Effective for tax years ending after May 6, 1997 the lower 10%, 20% and 25% capital gain rates used when computing regular taxes, are also used to compute AMT on net capital gains. Prior to TRA '97 net capital gains were taxed at the standard 26% or 28% AMT rate. A technical correction included in RRA '98 reordered the formula used to compute the AMT capital gain tax so that the lowest available rate is used first.
2. AMT depreciation for personal property will change to a maximum rate of 150% declining balance over the applicable MACRS recovery period for property placed in service after December 31, 1998. The ADS requirement has also been repealed for depreciable real property (Sec. 1250). Farmers will be able to use regular tax depreciation for AMT within the limits of the effective date. Non-farmers who use 200% decline balance depreciation for regular tax will still be required to make an AMT depreciation adjustment. Farmers will likely continue to have adjustments for property placed in service prior to 1999.
3. Cash basis farmers may use the installment method for reporting sales of inventory or property held primarily for sale to customers in the ordinary course of business in computing AMTI. This provision is retroactively effective for tax year's beginning after 1987. Therefore, qualified farmers are eligible to use the installment sale method for deferred payment contracts in computing AMT and regular income tax. Deferred payment contracts must avoid constructive receipts to defer income to the following year.
4. Corporations with a three-year average annual gross receipts of less than \$5 million will be exempt from AMT for tax year's beginning after December 31, 1997 (increasing to \$7.5 million for any later year).

## Other AMT Changes

The AMT exemption for children under age 14, has been increased to the child's earned income plus \$5,100 for 1999. This amount will be indexed for inflation. The annual exemption can not exceed \$33,750. The parent's AMTI or AMT exemption will no longer be used to determine the child's AMT exemption.

AMT depreciation for pollution control facilities placed in service after December 31, 1998 may be computed using MACRS class lives and the SL method. Prior to TRA '97 longer ADS lives were required.

## AMT Rate and Exemption Phaseout

The AMT has a two-tiered 26 and 28% rate system for non-corporate taxpayers. The 26% rate applies to the first \$175,000 of AMTI (\$87,500 for married filing separately) in excess of the exemption. The 28% rate begins at \$175,000 of AMTI. The exemptions are not indexed and are phased out at a rate of 25% 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**

<u>Filing Status</u>	<u>Maximum Exemption</u>	<u>AMTI Phaseout Range</u>	<u>Phaseout Percent</u>
Joint & qualifying widow(er)	\$45,000	\$150,000-330,000	25
Single & heads of household	33,750	112,500-247,500	25
Married filing separately	22,500	75,000-165,000	25

## Alternative Minimum Taxable Income (AMTI) for 1999

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

Adjustments and Preferences. The first category below contains adjustments treated as "exclusions". AMT due to exclusion items are 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% rule, state and local taxes, and interest adjustments. Interest adjustments include the difference between qualified housing interest and qualified residence interest, interest income on private activity bonds that are exempt from regular tax, and a net investment interest adjustment that could be either positive or negative. Preferences treated as exclusion items include; certain carryovers of charitable contributions, tax exempt interest from specified private activity bonds and excess tax depletion allowances.

2. The depreciation adjustment is the net difference between accelerated MACRS depreciation and that allowed for AMT. The Sec. 179 deduction is allowed in calculating AMTI. (See additional rules in Depreciation and Cost Recovery Section.) Exceptions include property depreciated under the unit-of-production method and property subject to transition rules for MACRS.
3. Adjusted gain or loss from dispositions reported in Forms 4797, Sch. D and 4684 that have a different basis for AMT than for regular tax (due to the accumulated depreciation adjustment).
4. Incentive stock option adjustments, passive activity adjustments, AMTI from estates and trusts, tax-exempt interest from private activity bonds
5. Accelerated depreciation on real and leased property and amortization of certified pollution control facilities placed in service before 1987.
6. Other adjustments may be required for intangible drilling costs, long-term contracts, certain loss limitations, mining costs, patron's distributions, pollution control facilities, research and experimental costs and tax shelter farm activities.

Related Adjustments. Any item of income or deduction for regular tax purposes that are based on income (e.g., earned income, AGI, modified AGI or taxable income from a business) must be recalculated based on alternative tax AGI.

### **Alternative Tax Net Operating Loss Deduction (ATNOLD)**

The deduction of ATNOLD is the last step in calculating alternative minimum taxable income. The alternate tax net operating loss is limited to 90% of AMTI and is calculated and deducted after all adjustments and preferences have been added in. The ATNOLD is calculated the same as the regular NOL except:

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

Form 1045 (Application for Tentative Refund) can be used to calculate the ATNOLD providing the above exceptions are included.

### **Tentative Minimum Tax**

The minimum tax exemption reduced by the 25% phaseout is subtracted from AMTI before the 26 and 28% rates are applied. Taxpayers with net capital gains from Sch. D apply regular rates by completing Part IV of Form 6251. Then the AMT foreign tax credit is subtracted to arrive at tentative minimum tax. A taxpayer who has regular foreign tax credit will compute AMT foreign tax credit in much the same manner, using a separate Form 1116 (Foreign Tax Credit).



## **Alternative Minimum Tax and Credits**

Tentative minimum tax less the regular income tax equals AMT. Regular income tax excludes several miscellaneous taxes, such as the tax on lump-sum distributions. Regular income tax is reduced by the foreign tax credit (but not business tax credits) before it is entered on Form 6251. The general business credit limitation is calculated on Form 3800, not on 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.

## **Who Must File Test**

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

## **The AMT Credit**

The AMT credit allows a taxpayer to reduce regular income tax to the extent that deferral adjustments and preferences created AMT liability in previous years. The AMT credit also includes any credit for producing fuel from a non-conventional 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 (Credit for Prior Year Minimum Tax) is used to compute the AMT that would have been paid in the previous year on the exclusion items if there had been no deferral items. This requires the computation of a minimum tax credit net operating loss deduction, which is calculated like the ATNOLD except that only the exclusion adjustments and preferences are included. It also requires computation of the minimum tax foreign tax credit on the exclusion items.

Part II of 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 non-conventional source, orphan drug, and electric vehicle credit.

## INFORMATIONAL RETURNS

### **Informational Forms** (often issued or received by farmers)

1099-MISC - Must be filed by any person engaged in a trade or business, on each non-employee paid \$600 or more for services performed during the year. Rental payments, royalties, prizes, awards, and fishing boat proceeds must also be reported when one individual receives \$600 or more. Payments made for non-business services and to corporations are excluded. When payments of \$600 or more are made to the same individual for independent services and merchandise, payments for the merchandise can be excluded only if the contract and bill show that a determinable amount was for the merchandise.

Farmers must include payments made to non-corporate independent contractors, attorneys, accountants, veterinarians, crop sprayers, and repair shops. Payments made to corporate and non-corporate attorneys of \$600 or more must be reported. Payments made for feed, seed, fuel, supplies, and other merchandise are excluded.

Health plan participants must report aggregated payments of \$600 or more to physicians and health care providers.

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

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 non-corporate recipient.

1099-PATR - Taxable Distributions Received from Cooperatives. Must be filed for each patron receiving \$10 or more.

1099-S - Report payments of timber royalties under "pay-as-cut" contracts and gross proceeds from the sale or exchange of most real estate transactions.

8300 - Recipient reports cash transactions of over \$10,000 received in the course of a trade or business, within one year in one lump sum or in separate payments, from the same buyer or agent, in a single or related transaction. Cash includes all currency and specific monetary instruments with a value of less than \$10,000 (cashier's checks, bank drafts, traveler's checks, and money orders). The report must be filed within 15 days after receiving \$10,000.

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

8809 - Request extension of time to file informational returns with IRS.

### **Filing Dates and Penalties**

The 1099's must be furnished to the person named on the return on or before January 31 and to the IRS with Form 1096 (Annual Summary and Transmittal) on or before February 28. There is a single \$50 per return penalty for failure to file correct and timely information returns. There is no penalty if failure is due to reasonable cause. The penalty is reduced when the failure is corrected on or before August 1. The penalty applies to each failure, and there is a \$25,000 penalty cap for small businesses. If failure to file or include correct information is due to intentional disregard of the regulations, the penalty is \$100 or 10% of the amount reported on the information return whichever is greater. The penalty for intentional disregard of reporting cash payments over \$10,000 received is now the greater of \$25,000 or the amount of the cash payment up to \$100,000.

## SOCIAL SECURITY TAX AND MANAGEMENT SITUATION, AND OTHER PAYROLL TAXES

Annual increases in the earnings subject to social security (FICA) and self-employment taxes continue to place a high priority on exploring opportunities to reduce the burden of these taxes through wise tax management. Additional payroll tax issues are included.

### **The Current Social Security Tax**

The social security earnings base increased to \$72,600 for 1999. There is no longer a cap on the amount of earnings subject to Medicare tax. FICA and self-employment tax rates remain the same as in 1998. The total rate is divided into two components representing the social security and Medicare tax. The maximum 1999 social security tax is \$4,501.20 (employer's share), up \$260.40 from 1998.

#### **Social Security Tax Table**

Year	<u>Earnings Base</u>		<u>FICA Rate %<sup>1</sup></u>		<u>Self-Employment Rate %</u>	
	Soc. Sec.	Medicare	Soc. Sec.	Medicare	Soc. Sec.	Medicare
1998	\$68,400	Unlimited	6.20	1.45	12.40	2.90
1999	\$72,600	Unlimited	6.20	1.45	12.40	2.90
2000	\$76,600 <sup>2</sup>	Unlimited	6.20	1.45	12.40	2.90

<sup>1</sup> Paid by both employer and employee.

<sup>2</sup> Projected

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

### **Two Deductions for Self-Employed**

1. Self-employed taxpayers deduct from taxable income, on line 27 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 deduct 7.65% from self-employment income when computing net earnings from self-employment. This is achieved by multiplying total profit (or loss) from Schedules C and/or F by 0.9235 on Schedule SE. This adjustment is made before applying the social security and Medicare tax earnings base. Taxpayers reporting less than \$72,600 of self-employment income will receive the greatest benefit from the deduction. This adjustment is allowed because employees do not pay social security tax on the value of their employer's share of FICA tax.

### **Farmer's Optional Method**

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 \$1,733. Self-employed non-farmers have a similar option. Self-employed workers should give serious consideration to using the optional method if they are not currently insured under the social security system. To be eligible for social security disability benefits, a worker must be fully insured and have 20 of the last 40 quarters of coverage. The earnings required to

receive one quarter of credit increased to \$740 in 1999. Thus, the optional method will yield only two quarters of coverage. Earning \$2,960 any time during 1999 will net four quarters of coverage.

### **Wages Paid to Spouse, Children and Farm Workers**

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

Wages earned by a person employed in a trade or business by his or her spouse and wages paid to individuals 18 years old and over working for their parent(s) in a trade or business are subject to FICA taxes and income tax withholding. Children under age 18 working for a parent's partnership, corporation, or estate also are covered by social security. Sole proprietors and husband-wife partnerships who hire their kids under 18 years old need't pay social security tax on them nor FUTA if under 21. Wages paid by a parent to a child for domestic service in the home are not covered until the child reaches 21.

### **Payment of Agricultural Wages with Commodities**

"In some instances" farmers and workers can reduce the amount of FICA taxes paid by paying wages in the form of grain, livestock or other commodities. It may not always be to the employee's advantage to reduce FICA taxes since social security benefits may also be reduced when disabled or retired.

In 1994, for the benefit of examiners, taxpayers and practitioners, IRS issued guidelines with a fairly narrow interpretation of I.R.C. Sec. 3121(a)(8)(A). The guidelines are just that, as there are many factors to determine a *bona fide* transfer of in-kind compensation. The guidelines may be followed, ignored or challenged and audits may result for those who do not follow them.

The two factors used to determine whether a *bona fide* transfer of in-kind compensation has occurred is Dominion and Control. The factors used by examiners to determine if the employer has parted with the control and the employee has exercised control over the commodity are:

- Documentation. This offers understanding of the arrangement and intent of the parties.
- Marketing of the commodity. After the commodity is transferred, the employee must market and dispose of the commodity, not in concert with the employer.
- Risk of gain or loss. The employee must assume the risk in quantity and quality.
- Employee's holding period. The length of time the commodity is held is indicative of the parties' intent.
- Cost of ownership. The employee should be responsible for the cost to maintain, store and market the commodity received.
- Identification of non-cash payment. The commodity should have evidence of a transfer of a specific identified commodity that is tagged, marked and separated to evidence recognition as a non-cash wage.

The second component of intent involves whether the in-kind payment is equivalent to cash. In addition to the six components of dominion and control as they effect cash equivalency the following factors must be considered:

- Cash advances. If received and satisfied upon sale of the commodity then the cash advance is considered wages.
- Immediate conversion. If employer knows the employee will immediately convert the in-kind payment to cash it will be considered wages.
- Sole source of income. When the transferred commodity is the workers only source of income, the transfer will be questioned since the employee will need cash to pay for family living expenses and would not be able to hold the commodity for a marketing period.

Remember even if the non-cash wages are ruled exempt from FICA, FUTA and income tax withholding, they are still subject to income taxes. When farm commodities are used to pay employees for services, the employer must report the fair market value of the commodity on the date of payment as Schedule F income. The same amount is claimed by the employer as a labor expense on Schedule F, but it is not reported as a social security wage on Form 943 or the employee's W-2. It is included as other compensation in box 1 of Form W-2 but not in box 3 and 5.

Employees who receive commodities in lieu of wages must report their initial market value as wage income. When the commodities are sold, the sale price is reported on Schedule D, less the basis, which is the initial market value plus storage and marketing expenses. If the employee is a farmer or dealer, then they would use Schedule F or C respectively to report the commodities sold.

### **Taxation of Social Security Benefits**

In 1994 and later, social security recipients are potentially subject to two sets of rules on taxation of social security benefits. Disability benefits are treated the same way as other social security benefits. The rules that tax 50% of social security benefits have been in effect for several years. The rules that tax up to 85% of social security benefits for higher-income taxpayers became effective in 1994. Under a U.S. and Canadian agreement signed in 1997 and retroactive to January 1, 1996, U.S. or Canadian SS benefits are taxed exclusively in the country where the recipient resides. This will result in a higher tax for some recipients and refunds for others.

**The 85 Percent rules** apply to single taxpayers with provisional incomes above \$34,000 and married taxpayers filing jointly with provisional incomes above \$44,000. Provisional income is modified AGI plus 50% of social security benefits. Modified AGI is AGI plus tax-exempt interest and certain foreign source income.

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

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

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

**Example 1:** His and Her Taxpayers have the following 1999 income:

Taxable interest and dividends	\$9,000
Tax-exempt interest	6,000
Taxable pensions	30,000
Social security benefits	16,000

Provisional income = \$9,000 + 6,000 + 30,000 + (1/2 x 16,000) = \$53,000. Taxable portion of social security benefits is the lesser of:

1. 85% of \$16,000 social security benefits = \$13,600; **or**
2. the sum of 85% of the excess of \$53,000 over \$44,000, which is \$9,000 x .85 = \$7,650 plus the smaller of:
  - a. 1/2 of \$16,000 = \$8,000 **or**
  - b. \$6,000.

So 2.a. = \$7,650 + 8,000 = \$15,650;  
 2.b. = \$7,650 + 6,000 = \$13,650.

Therefore, the social security benefit included in gross income = \$13,600, which is the smallest of 1, 2.a. or 2.b. In this example, 85% of social security benefits are included in income.

**Example 2:** Same as Example 1 except that the taxable pensions, taxable interest and dividends, and tax-exempt interest each is \$2,000 less.

Provisional income = \$7,000 + 4,000 + 28,000 + 8,000 = \$47,000. Taxable portion of social security benefits is the lesser of:

1. 85% of \$16,000 social security benefits = \$13,600, **or**
2. the sum of 85% of the excess of \$47,000 over 44,000, which is \$3,000 x .85 = \$2,550 plus the smaller of:
  - a. 1/2 of \$16,000 = \$8,000; **or**
  - b. \$6,000.

So 2.a. = \$2,550 + 8,000 = \$10,550;  
 2.b. = \$2,550 + 6,000 = \$8,550.

Therefore, the social security benefit included in gross income = \$8,550, which is the smallest of 1, 2.a. or 2.b. In this example, 53.4% of social security benefits are included in income.

**The 50 percent rules** apply to single taxpayers with provisional incomes between \$25,000 and \$34,000 and married persons filing jointly with provisional incomes between \$32,000 and \$44,000. For taxpayers in these ranges, the inclusion is still limited to the lessor of (1) one-half of the benefits received, or (2) one-half of the excess of the sum of the taxpayer's 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.) Medicare payments are excluded from gross income.

**Example:** Me and You Retiree received \$15,200 in 1999 social security benefits, \$3,000 of tax-exempt interest, and their AGI (joint return) was \$26,400 (excluding social security).

Calculation: a.  $\$26,400 + \$3,000 + \$7,600$  (one-half social security) = \$37,000

b.  $\$37,000 - \$32,000$  (base amount) = \$5,000  $\div 2 = \$2,500$ .

c. Me and You include \$2,500 since it is less than \$7,600.

### **Reduction of Benefits**

When a person's wage and self-employment earnings exceed the earnings limit, social security benefits of the working beneficiary and dependents are reduced by a percentage of the excess earnings. In 1999 the annual earnings limit for those less than age 65 is \$9,600, and for those age 65 to 70 it is \$15,500 (\$17,000 for 2000). For those aged 70 and older there are no reductions. The reduction of benefits is one-half of excess earnings when less than age 65 and one-third of excess earnings when age 65 to 70. The 1999 cost of living increase in benefits was 1.3%.

### **"Nanny Tax" Social Security Domestic Employment Act of 1994**

This act allows the payment of employment taxes for domestic workers (baby-sitters, yard workers, house cleaners) to be reported on the employer's tax returns. The wage threshold for reporting and paying social security taxes was raised to \$1,100 annually.

Household employers use Schedule H (Form 1040) to report and pay social security, Medicare, FUTA (threshold still \$1,000), and withheld income taxes. The quarterly return Form 942 is no longer used. Farmers may treat wages paid to domestic workers under the new \$1,100 annually threshold rules rather than the \$150 and \$2,500 agricultural wage thresholds, by filing Schedule H.

Household employers must include an employer identification number (EIN) on forms they file for their employees, like Forms W-2 and Sch. H. An EIN can be obtained by completing and filing Form SS-4, Application for Employer Identification Number. Order Form SS-4 by calling 800-TAX-FORM.

The 1995 law exempted household workers under the age of 18 from any social security and Medicare taxes unless household employment is the worker's principal occupation.

### **Schedule H (Form 1040)**

Taxpayers must file Schedule H if any of the following conditions apply:

(a) They paid any one household employee cash wages of \$1,100 or more in 1999.

(b) They withheld Federal Income Tax during 1999 at the request of any household employee.

### **Rental Income and Deductions (IRC Sec. 1402(a)(1))**

Generally, rental income from real estate and from personal property leased with the real estate (including crop share rents) is reported on Sch. E and not included in net earnings from self-employment. Crop and livestock share rents are reported on Form 4835 and flow through to Sch. E. There are two exceptions:

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

Income and expenses from the rental of personal property (not leased with real estate) is reported on Schedule C or C-EZ. Net profit from Schedule C is included in self-employment income. Material participation is not a factor in classifying income from the rental of personal property not leased with real estate.

### **Paying Rent to a Spouse**

It is common for husbands and wives to own farm real estate as joint tenants, for one to operate the farm as the sole proprietor and to pay self-employment tax on the entire farm "net profit." Paying rent to a spouse for use of the property he or she owns reduces self-employment tax.

Although Rev. Rul. 74-209, 1974-1 allows an operator to deduct rent paid to a spouse as a joint owner of business property equal to one-half its fair rental value, more recent IRS rulings and opinion have qualified that ruling. IRS indicated the deduction for spousal rent is allowable only if there is a *bona fide* landlord-tenant relationship and that substance rather than form governs. In Ltr. Rul. 9206008, the rental deduction on Schedule F was disallowed primarily for using inconsistent methods of deducting the ownership costs of the property. IRS is also utilizing Code Sections 482 and 162 to prevent tax avoidance via related-party transactions. They may argue that paying rent to a spouse is not an arms-length transaction, is not necessary and ordinary, and in some cases the lessee has an equity interest in the property.

If you deduct rental payments made to the spouse for use of his or her jointly owned property, follow these precautions:

- (1) have evidence that the spouse acquired equity in the property; and even a more desirable fact would be that the farm operator has no equity interest in the rented property;
- (2) make sure there is a formal, written, signed, rental agreement and a fair market value rental rate with at least annual payments;
- (3) deduct the taxes, interest, and insurance on the rented property on the spouse's Schedule E;
- (4) the spouse should deposit the rental income in a separate account and his or her tax and interest payments from the account;
- (5) the operator must file Form 1099 for all rent payments made;
- (6) the spouse should avoid material participation.

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



## **Preparers Election For Alternative Identification Numbers**

On July 22, 1998 IRS approved an alternative to preparers including their own social security number on prepared returns. Effective for the filing season beginning January 1, 2000 a preparer may apply for an alternative ID number (PTIN) on Form W-7P. The number, when issued will begin with a "P" followed by 8 digits with no dashes. A New York income tax representative indicated "on the telephone" that the State would be also honoring the PTIN.

## **Rules for Depositing FICA and Federal Income Taxes**

IRS has changed the de minimis threshold from \$500 to \$1,000 for filing of monthly employment tax returns. A new deposit threshold applies to quarterly Form 941 effective July 1, 1998 and January 1, 1999 for Form 943. However, under the new de minimis rule, if the total amount of accumulated employment taxes for a period is less than \$1,000 and it is deposited with a timely filed return for the period it will be considered a timely deposit.

IRS announced that small businesses would not be forced to invest in technology to make tax payments. They raised the threshold for mandatory use of Electronic Federal Tax Payment System (EFTPS) to \$200,000 in aggregate deposits beginning January 1, 2000. They also again waived penalties for not using EFTPS through December 31, 1999, while simultaneously raising the participation level to \$200,000 in aggregate 1998 deposits.

If required to comply a taxpayer should use Form 9779 to enroll in EFTPS and at least a 14-week lead-time is required.

## **Federal Unemployment Tax (FUTA)**

As farm businesses grow in size and employ more workers, more farm employers become subject to FUT. and New York unemployment insurance (UI). A farm employer must pay UI if (1) cash wages of \$20,000 or more were paid to farm employees in any calendar quarter during the current or preceding calendar year, or (2) employ ten or more farm workers on at least one day in each of 20 different weeks during that year or the preceding calendar year. IRS Pub. 51, Circular A and NYS-50, contain useful information on how FUTA applies to an individual farm employer.

The Federal Unemployment Tax Act exemption for alien agricultural workers has been made permanent for alien agricultural workers admitted to the U.S. to do agricultural work.

The employer must pay unemployment taxes; they may not be deducted or withheld from employee wages. The FUTA rate is 6.2% on the first \$7,000 of cash wages paid to each employee in 1999. The 1999 NYSUI rates range from 0 to 8.5% on the first \$8,500 (was \$7,000) of each employee's total earnings. The standard and maximum basic rate is 5.4%. The 1999 "new employer" rate is 4.4%. Employers may receive a credit of up to 5.4% for NYSUI taxes paid on their FUTA liability even when their NYS experience rate is less than 5.4%. A farmer subject to the NYSUI may pay a FUTA rate as low as 0.8% in 1999. Beginning, April 1, 1999 wage reporting will be used to determine unemployment benefit rates.

The FUTA tax deposit rule is different from those for other payroll taxes. When the amount subject to deposit reaches \$100, it must be deposited within one month following the close of the current calendar quarter. Form 940 (or 940-EZ) is the annual FUTA return to be filed by January 31. Exception: FUTA taxes (\$1,000 threshold) withheld from household employees are deposited with FICA and income taxes on Schedule H (Form 1040).

## NEW YORK STATE INCOME TAX

The 1999 New York State Budget Bill was passed on August 9, 1999. The tax highlights of this year's bill are the following:

- Corporate franchise (income) tax. The alternative minimum tax (AMT) was reduced from 3% to 2.5% for taxable years beginning after June 1, 2000.
- Personal income tax. Earned income tax credit (EITC) was increased from 20% of federal EITC, to 22.5% for taxable years beginning in 2000 (25% beginning in 2001).
- Sales and use tax. Sales of clothing and footwear priced at less than \$500 are tax exempt from the state sales tax January 15, 2000 through January 21, 2000 and local governments will have the opportunity to do the same. The "permanent" elimination of New York sales tax on clothing and footwear priced at less than \$110 is "scheduled" to be March 1, 2000. Again, local governments will have a choice to participate or not.
- STAR Program. Age requirements for enhanced exemption for 2000–2001 school year will be based upon age as of December 31, 2000.
- Estate and Gift Tax. New York conformed to federal law effective retroactively to January 1, 1998 in that the current unified credit exclusion from gross estate of family-owned business interests allowed under IRC Sec 2033A is now allowed to be converted to a deduction.

### **Farm Property School Tax Credit**

This very important tax relief program has been in effect since 1997 and is modified annually. For the 1999 tax year, NY taxpayers whose federal gross income from farming equals at least two-thirds of excess federal gross income, will be allowed a credit against personal income tax or corporation franchise tax equal to school property taxes paid on certain agricultural property (personal residence excluded). The allocation between personal residence plus other nonqualified property and agricultural property should be made based upon taxable value. Your local assessor may be willing to provide this information for you. Gross income from farming includes gross farm income from Sch. F, gross farm rents Form 4835 and gains from livestock Form 4797. It also includes gross income from farming from a partnership, S corporation, estate or trust. The NY tax credit limitation is based on school taxes paid on qualified agricultural property plus 50% above the base acreage. The 1999 base acreage is 250 acres. If a taxpayer's farmland acreage exceeds the base acreage, the school taxes paid credit is scaled back in proportion to the sum of the base acreage and 50% of the acreage in excess of the base.

The credit is claimed against NY State personal income tax, corporate franchise tax, S corp or LLC income tax liabilities. Refunds can be claimed or carried over. Qualified agricultural property is land located in New York State, which is used for agricultural production. The credit is not allowed for the lessee, as the operator must be the owner of the leased land. Lessors of farmland may or may not qualify dependent upon their qualifications as farm taxpayers. If agricultural property is converted to non-qualified use, no credit is allowed that year and recapture is triggered for the previous two taxable years.

The 1997 budget bill made some changes in definitions that will make more farmers eligible. Effective after the 1997 tax year, NY taxpayers whose federal gross income from farming equals at least two-thirds of excess federal gross income will be allowed the school property tax credit. Excess federal gross income is federal gross income from all sources for the taxable year in excess of a special \$30,000 subtraction. The special \$30,000 subtraction can be earned income (wages, salaries, tips and items of gross income included in computation of net earnings from self employment), pension payments (SS), interest and dividends. For 1998 and thereafter, the federal gross income of a corporation may, likewise,

be reduced by up to \$30,000 for the special subtraction. A special ruling, for this section of law, includes gross income from the production of maple syrup and cider, and from the sale of wine from a licensed farm winery, in the term federal gross income from farming.

If the modified New York adjusted gross income of the taxpayer exceeds \$100,000 the credit is phased out and completely lost at \$150,000. Modified NY adjusted gross income is the NY gross income for the taxable year reduced by the principal paid on farm indebtedness during the tax year. Farm indebtedness is the debt incurred or refinanced that is secured by farm property, where the proceeds of the debt are used for expenditures incurred in the business of farming.

Effective for taxable years on or after January 1, 1999, the Farmer's School tax credit has been expanded to farmers who pay school taxes under a "land sales contract". This now means an eligible farmer, under a land sales contract will be treated as the owner of the property if:

- The buyer is obligated under the contract to pay the school property taxes on the land, and
- The buyer is entitled to deduct these taxes as a tax expense for federal income tax purposes.

If the buyer is treated like the owner under these provisions, the seller may not claim the credit for the property. An arrangement for a "lease with an option to purchase" is not a land sales contract.

The Federal Tax Benefit Rule is "if you recover an amount that you deducted or took a credit for in an earlier year, include the recovery in your income only to the extent the deduction or credit reduced your tax in the earlier year" (Pub 525 Taxable and Nontaxable Income). Many questions arose in 1998 of what to do with the Farmers School Tax Credit when IT-201, line 21 additions, explanation A22, asked for taxpayers to include the amount of the credit claimed for 1997 and use it as an addition to income. Most taxpayers had already included it as other income on Schedule F and now were faced with the same amount being taxed twice on the state form. Research on the federal taxability of Farmers School Tax Credit indicated it was covered under the benefit rule. Letter Ruling 8435055 states under sect 111 of the code, gross income for Federal income tax purposes includes recoveries of previously deducted prior taxes to the extent that prior deductions resulted in an income benefit for the year of the deduction. The term "prior taxes" includes previously deducted state or local property and/or income taxes. Further rulings include Letter Ruling 8813029, Revenue Ruling 78-194, Letter Ruling 9853018, and memorandum dated 9/28/84.

What will the 1999 IT-201 be asking for as additional income on line 21 addition A22? The latest telephone source from New York State Department of Taxation and Finance indicated the same as last year, however, "do not make this modification if you were required to report the amount of the credit (farmers school tax) as income on your 1999 Federal Return".

### **New York State School Tax Relief (STAR)**

This program provides a partial exemption from school property taxes for owner-occupied primary residences. Senior citizen property owners must be 65 years of age or older, as of December 31, 2000 (advancing one-year annually) provide their latest available federal or state income tax return not to exceed \$60,000 adjusted gross income reduced by any distributions from an IRA or individual retirement annuity. The "enhanced" STAR senior citizen exemption phase in was amended to an immediate \$50,000 exemption from the full value of their property. The eligible senior citizen must apply with the local assessor for the "enhanced" STAR exemption by March 1, 1999 in most towns. This is the "taxable status date" but deadlines vary so most taxpayers should apply earlier.

Previously to qualify for the enhanced exemption all owners must have satisfied the age requirement except the spouse of a 65-year-old owner. For the 2000–2001 school year for residential property owned by siblings, only one of the owners must be 65 years of age. Likewise, in the case of property owned by a husband and wife, one of whom is at least 65, the exemption will not be rescinded solely on death of the older spouse if the surviving spouse is at least 62 years old.

The “basic” STAR program was available to all primary residence homeowners regardless of age starting with the school year 1999-2000. The full value assessment exemption will be phased in from \$10,000 to \$30,000 by the school year 2001-02. To be eligible an owner must own and live in a one, two or three-family residence, mobile home, condominium, cooperative apartment or farm house. Under recent legislation the exemption, for persons with disabilities and limited incomes, is subtracted from assessed value before subtracting the STAR exemption.

#### **STAR Property Tax Exemption Table**

School Year	1998-99	1999-00	2000-01	2001-02 and after
Eligible Senior Citizen Homeowners	\$50,000	\$50,000	\$50,000	\$50,000
All Primary Residence Homeowners	None	\$10,000	\$20,000	\$30,000

#### **NY Tuition Savings Program**

For tax years beginning after 1997, a taxpayer may contribute up to \$5,000 per year exempt from New York personal income tax to a family tuition account to be used for higher education expenses at qualified institutions. Married individuals can each contribute up to \$5,000 each year, but must each use a separate account. These contributions are subtracted from a taxpayers federal adjusted gross income in calculating the New York adjusted gross income. The interest earned receives tax-exempt treatment for NYS purposes and should receive deferred tax treatment for federal income tax purposes, thus taxed when used. The account must have been open for at least three calendar years before a qualified withdrawal can be made. Non-qualified withdrawals are subject to a NYS income tax and a 10% penalty. Investment income is subject to federal income tax on the investment income. Contributions to all accounts for any beneficiary on subject to a lifetime maximum of \$100,000.

#### **Standard Deductions and Exemptions**

<u>Standard Deduction</u>	<u>1997 and after</u>
Tax Status: Joint/(surviving spouse)	\$13,000
Head of household	\$10,500
Single	\$7,500
Married filing separately	\$6,500
Dependent filers	\$3,000
Exemption	\$1,000

Married persons filing separately each will receive one-half of the joint standard deduction. A New York State exemption is not counted for either the filer or the spouse.

## **Itemized Deductions**

Taxpayers, who file joint federal returns and separate N.Y. returns, must divide itemized deductions between them as if their federal taxable incomes had been determined separately. Taxpayers who do not itemize deductions on their federal returns may not itemize on their NYS returns.

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

1. The first percentage is 25% of a ratio, which depends on the taxpayer's filing status:

Numerator = Lesser of \$50,000 or the excess

<u>Filing Status</u>	<u>of NYAGI over:</u>	<u>Denominator</u>
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

$$\$25,000 \div \$50,000 = .5; .5 \times 25\% = 12.5\% \text{ reduction in itemized deductions.}$$

This taxpayer would not be subject to the second percentage because AGI is less than \$475,000.

2. The second percentage is 25% 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

$$\$550,000 - \$475,000 = \$75,000; \$50,000 \text{ is lesser.}$$

$$\$50,000 \div \$50,000 = 1.0; 1.0 \times 25\% = 25\% \text{ reduction}$$

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

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

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

Example: New and York Taxpayers have a NY taxable income of \$105,000 and a NYAGI of \$120,000. Tax on \$105,000 from the tax table is \$6,399.00, but at the top rate of 6.85% is \$7,192.50. The \$20,000 that exceeds the NYAGI level of \$100,000 is 40% of \$50,000. The difference between \$7,192.50 and \$6,399.00 is \$793.50; 40% of this is \$317.40, which is added to the tax computed from the table to make the total tax \$6,716.40.

**Spousal IRAs Allowed**

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

**Rates**

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

**NYS Personal Income tax if the 1999 New York taxable income and filing status is:****Married Filing Jointly and Qualifying Widow(er)**

<u>Over</u>	<u>Not Over</u>	<u>Tax</u>				
\$ 0	\$16,000	4.00% of the excess over				\$ 0
16,000	22,000	\$ 640 plus 4.50%	"	"	"	16,000
22,000	26,000	910 plus 5.25%	"	"	"	22,000
26,000	40,000	1,120 plus 5.90%	"	"	"	26,000
40,000		1,946 plus 6.85%	"	"	"	40,000

**Single, Married Filing Separately and Estates and Trusts**

<u>Over</u>	<u>Not Over</u>	<u>Tax</u>				
\$ 0	\$ 8,000	4.00% of the excess over				\$ 0
8,000	11,000	\$ 320 plus 4.50%	"	"	"	8,000
11,000	13,000	455 plus 5.25%	"	"	"	11,000
13,000	20,000	560 plus 5.90%	"	"	"	13,000
20,000		973 plus 6.85%	"	"	"	20,000

**Head of Household**

<u>Over</u>	<u>Not Over</u>	<u>Tax</u>				
\$ 0	\$ 11,000	4.00% of the excess over				\$ 0
11,000	15,000	\$ 440 plus 4.50%	"	"	"	11,000
15,000	17,000	620 plus 5.25%	"	"	"	15,000
17,000	30,000	725 plus 5.90%	"	"	"	17,000
30,000		1,492 plus 6.85%	"	"	"	30,000

**Household Credit**

Single taxpayers with household gross income (HGI) 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 filing separately).

In 1999, the amount of household credit for single taxpayers ranges from \$75 (taxpayers with 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, head of household, and surviving spouse, plus additional credit (\$5 to \$15) for additional exemptions. The maximum credit for a married couple (filing jointly) with less than \$5,000 of HGI is \$90 plus \$15 for each personal exemption less one.

### **Earned Income Tax Credit (NY EIC)**

An earned income credit is allowed against New York personal income tax. The NY EIC is 20% of the federal EIC for taxable years beginning in and after 1996 (increasing to 22.5% in tax year 2000 and 25% in tax year 2001). For taxable years beginning after 1995, the EIC must be reduced by the taxpayer's household credit. Therefore, a taxpayer will not receive the benefits of both the NY EIC and the household credit.

### **Credit for Child and Dependent Care (CDC)**

A refundable credit is allowed against New York State personal income tax for household and dependent care services necessary for gainful employment. After tax year 1998 the credit is 100% of the federal CDC credit for taxpayers with NY adjusted gross income (NYAGI) of \$35,000 or less. Federal CDC does not have to be claimed, but has to be allowed. The credit is phased down from 100% to 20% of the federal amount of CDC for taxpayers with NYAGI between \$35,000 and \$50,000. Taxpayers with a NYAGI over \$50,000 are allowed 20% of the federal CDC.

### **Real Property Tax Credit**

The tax credit computations and limits are shown below for 1999. 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 an average of \$450 a month, excluding utilities. The taxpayer must occupy the same residence for six months or more to claim rent paid to qualify for the 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% 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% 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. This tax credit is reduced by any other personal income tax credit to which the taxpayer is entitled.

#### **Partial Table for Computing Real Property Tax Credit, 1999**

Household Gross Income	Applicable Rate	Credit Allowed	
		Under 65	65 & Over
\$0 - \$ 3,000	0.035	\$75-71	\$375-341
3,001 - 5,000	0.040	69-67	324-307
5,001 - 7,000	0.045	65-63	290-273
7,001 - 9,000	0.050	61-59	256-239
9,001 - 11,000	0.055	57-55	222-205
11,001 - 14,000	0.060	53-49	188-154
14,001 - 18,000	0.065	47-41	137- 86

### **New York State Investment Credit (NYIC)**

The credit for individuals is 4% on qualified tangible personal property acquired, constructed, reconstructed or erected on or after January 1, 1987. For corporations, the rate is 5% on the first \$350,000,000 of investment credit base and 4% on any excess.

MACRS property placed in service after December 31, 1986 qualifies for NYIC. This means that farm property in the ACRS or MACRS 3-year class should qualify. There is no reduction in the amount of credit allowed for 3-year property, and if kept in use for three years it will earn 4% NYIC. Highway use motor vehicles are ineligible for NYIC.

All ACRS and MACRS property that qualifies for NYIC and is placed in a 5-year or longer life class earns full credit after 5 years even if a longer straight line option is elected. The same is true of 7, 10, 15, and 20-year MACRS property. Non-ACRS/MACRS properties that qualify for NYIC must still be held 12 years.

Excess or unused credit may be carried over to future tax years but the carryforward period is limited to 10 years. In no event may the credit claimed prior to 1989 be carried over to taxable years beginning on or after 1999. The 1997 bill expanded general business corporations carry forward period for unused investment tax credits from 10 to 15 years. There is no provision for carryback of NYIC. Unused NYIC claimed by a **new business** is refundable. The election to claim a refund of unused credit can be made only once in 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 (EITC) is available to regular corporations that qualify for NYIC and increase employees at least 1% during the year. The credit is 1.5% of the investment credit base if the employment increases less than 2%, 2% if the increase is between 2 and 3%, and 2.5% if the increase is 3% or more for each of the two years following the taxable year in which NYIC was allowed. The additional credit is available to newly formed as well as continuing corporations. The credit may not be used to reduce tax to less than the minimum taxable income base or the fixed dollar minimum, whichever is higher. Any remaining unused credit may be carried forward to the next seven taxable years.

Effective January 1, 1998 the employment incentive credit and economic development zone credit that applies to C corporations are expanded to sole proprietorship, partners of partnerships, shareholders of S corporations and beneficiaries of estates and trusts. The credits are available to those entities that make investments eligible for the investment tax credit and in the years following the investment increase their employee numbers.

### **Rehabilitation Credit for Historic Barns**

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



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

### **Other Credits**

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

### **New York State Minimum Tax**

Federal items of tax preference after New York modifications and deductions are subject to the New York State minimum tax rate of 6%. The specific deduction is \$5,000 (\$2,500 for a married taxpayer filing separately). A farmer who has over \$5,000 of preference items must complete Form IT-220 but may not be subject to minimum tax. New York personal income tax (less credits) and carry-over of net operating losses are used to reduce minimum taxable income. NYIC cannot be used to reduce the minimum income tax.

### **New York State SingleFile**

NYS Department of Taxation and Finance and Department of Labor have jointly developed a SingleFile program to simplify reporting requirements for employers. It combines: Quarterly Unemployment Insurance Report; Form IA-5, Quarterly Combined Withholding and Wage Return Reporting; Form NYS-4, enabling employers and their agents to report state withholding tax, wage reporting and unemployment information on a single form. This was effective for 1<sup>st</sup> quarter 1999 and due April 30, 1999.

The form is now NYS-45 and NYS-45-ATT in place of the current IA-5, NYS-4 and NYS-4-ATT. The withholding tax liability data for the fourth quarter, which was due on February 28, is now due January 31, effective with the 1999 fourth quarter.

The filing and payment rules for making withholding tax payment have not changed (NYS-1). For further details see NYS-50 (7/79) available on the New York website.

### **New Hire Reporting**

To facilitate the accurate and prompt determination of child support obligations, Chapter 81 of the law requires all employers to report to New York State Department of Taxation and Finance identifying information about each newly hired or rehired employee in New York State. Employers have 20 calendar days from the hiring date to provide the employee and employer name, address, and ID numbers.

## **Estimated Tax Rules**

For tax years beginning on and after January 1, 1999 New York residents with New York source income are required to make payments of estimated tax if they expect to owe, after withholding and credits, at least \$300 of New York tax (per jurisdiction) and withholding and credits are expected to be less than the smaller of (1) 90% of the tax for the year, or (2) 100% of the tax on the prior year's return (provided a return was filed and the taxable year consisted of 12 months).

For tax years beginning after 1993, individuals, estates and trusts (except farmers and fishermen) whose **New York** adjusted gross income in the prior year is more than \$150,000 (\$75,000 if married filing separately) must pay 110% of the prior year's state, and if applicable, city resident or nonresident tax, or 90% of the current year's tax, to avoid a penalty for underpayment of estimated tax.

Farmers and fishermen may use the preceding year's tax as a method of determining the required annual payment without regard to the above limitation.

The definition of farmers and fishermen for estimated tax purposes was changed so that Federal Gross Income rather than New York Adjusted Gross Income is used in determining whether at least two-thirds of the person's income is from farming.

## **State Taxation of Pensions of Non-Residents**

In January 1996, federal law banned the taxation by states of payouts from qualified pension, profit sharing, 401(k) or government plans and IRA's, if the taxpayer was a non-resident. Income from non-qualified deferred-payment plans can be taxed by states unless payouts are made as a life annuity, for a 10-year or greater span or the distributions are non-qualified excess-benefits plans.

## **Other Items of Importance From The 1999 New York State Budget Bill:**

- For tax years beginning after 2000 the farmer's school property tax credit is expanded to include land set aside or retired under federal programs.
- Effective March 1, 2001 building materials used to create structures for the production phase of farming will be sales tax exempt.
- The modification for different New York and federal basis in property that is acquired from a decedent dying on and after February 1, 2000 is repealed. The difference occurs if the estate was not required to file a federal estate tax return but was required to file a New York estate tax return, and used alternate or special valuation on the return. (Tax Law Sect. 612(r))

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