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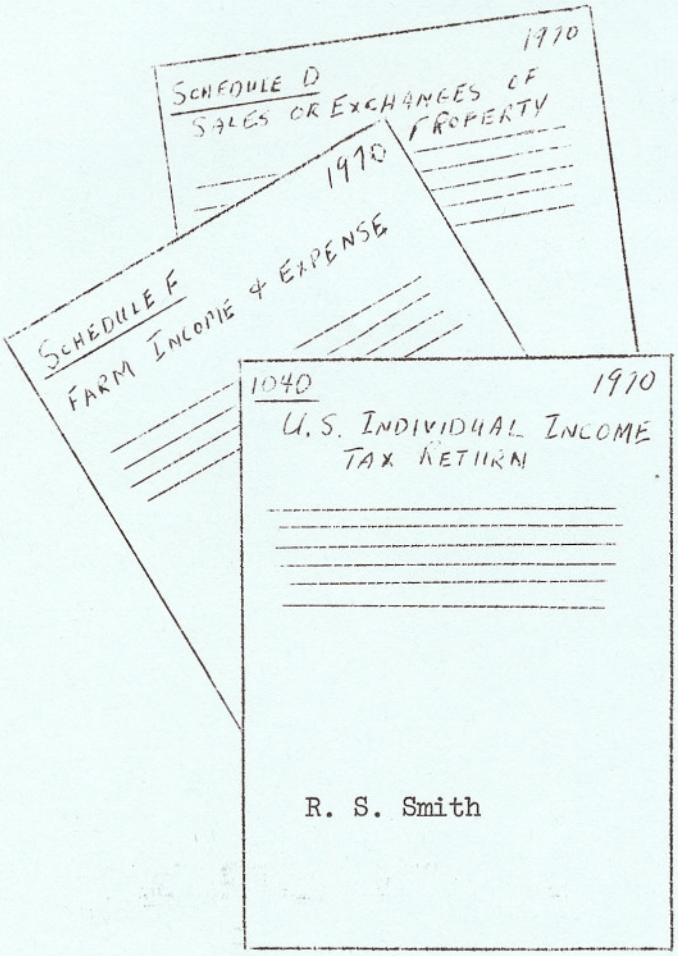
TEACHING MANUAL

FARM INCOME TAX MANAGEMENT
AND TAX REPORTING



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FARMER'S TAX CALENDAR FOR 1971*

Important dates for New York farmers to keep in mind in regard to income tax obligations for 1971 are as follows:

January 15 - Deadline for farmers who elect to file an estimate of Federal income tax due. Farmers may also elect to file an estimate of New York State income tax due on this date. When these estimates are used, the corresponding final Federal and/or State returns are due April 15.

January 31 - Deadline for a farmer to file Federal income tax Forms W-2 and W-3 if at least one individual was paid $600 or more.

- Deadline for filing Form 943. This year end Social Security report on hired help must be filed by any employer who paid an employee $150 or more cash wages during the year for agricultural labor, or who had an employee who performed agricultural labor on 20 or more days for cash wages on time basis. An employer who has made monthly deposits sufficient to cover his full tax liability is allowed 10 days additional for filing year end report.

March 1 - Deadline for filing Federal and State income tax returns and New York State unincorporated business tax, unless the farmer elected to file estimates on January 15. This deadline was changed in 1970 from February 15 to March 1, and continues at this later date.

February 29 (28th is Sunday) - Deadline for filing New York State Form IT2102.1 (or copy of Form W-2) and transmittal Form IT2102.4 if at least one individual was paid $600 or more.

- Also deadline for filing Federal Forms 1096 and 1099 when at least one individual was paid $600 or more in interest or rent.

April 15 - Deadline for filing final Federal and State income taxes and New York State unincorporated business tax for farmers who filed estimates by January 15.

Month-End Check - Any farm employer withholding Social Security taxes from hired men's wages must check at the end of each month to see if he has accumulated $100 in withholding and employer's contributions of all employees. If so, the total amount accumulated is to be deposited at any Federal Reserve Bank or authorized commercial bank by the 15th of the following month. Federal Reserve Form 511 is used for this purpose.

* When a tax filing date falls on a Saturday, Sunday, or legal holiday, the filing may take place on the next day which is not a Saturday, Sunday or holiday.

TAX FORMS NEEDED BY NEW YORK FARMERS

Federal Forms - Another revision of Form 1040 and supplemental schedules has been made for 1970. The computation form, 1040T, has been abolished and the tax computation now takes place on page 2 of 1040

1040 - U. S. Individual Income Tax Return, now a two page schedule

1040 A & B - A two page schedule for itemized deductions (A) and interest and divident income (B)

1040 C - Profit (or loss) from business or profession, unchanged

1040 D - Gains and losses from sales or exchanges of property, a major revision

1040 E & R - A two page schedule for supplemental income (E) and retirement income credit (R)

1040 F - Farm income and expenses, unchanged

1040 SE - Computation of self employment tax, attached to both C an

1040 X - Amended individual income tax return

1040 G - Income averaging, revised

943 - Employer's annual Social Security tax return for agricultural employees

1096 & 1099 - Information returns reporting payments of interest or rent

1065 - U. S. partnership return of income

W-2 - Wage and tax statement and transmittal form (W-3)

2950 SE - Payments as a self employed person to retirement plan (K

3468 - Investment credit (only rarely will be needed for 1970 retu

4255 - Investment credit recapture

4136 - Credit for federal tax on gasoline

New York State Income Tax Forms

IT-201 - Individual or joint return

IT-208 - Combined income tax return

IT-202 - Unincorporated business tax return

IT-204 - Partnership return (income and unincorporated business ta

IT-212 - New York investment credit schedule

IT-2102.1 - Information return (or use optional W-2)

IT-2102.2 - Transmittal form

INCOME TAX CHANGES OF MAJOR IMPORTANCE TO FARMERS

The tax reform act of 1969 contains many provisions of significance to all taxpayers, and a number of especial importance to farmers. Many of the changes will be effective for the first time on 1970 tax returns. Probably the most important provisions affecting all taxpayer groups including farmers are changes in exemptions and deductions which will increase the amount of income exempt from tax. These provisions are summarized briefly on this page. Other changes affecting many groups of taxpayers including farmers are too numerous and complex to explain in this bulletin, which will be devoted mainly to those changes of greatest importance to farmers. Six of the changes of greatest importance to farmers which will be treated in some detail in the pages that follow are:

- Recapture of depreciation on dairy and breeding livestock
- Extended holding period for livestock
- Limitation of farm losses
- Changes in Hobby Farming Rules
- Repeal of investment credit
- Liberalization of income averaging

Increase in Tax Exempt Income

A combination of an increase in personal exemptions, an increase in the standard deduction, and a new low income allowance will result in an increase in tax exempt income for all taxpayers.

Personal exemptions are increased to $625 for 1970, and increased in steps to $750 in 1973.

The ten percent standard deduction is unchanged for 1970, but is then increased in steps to thirteen percent in 1971, fourteen percent in 1972, and fifteen percent in 1973.

The minimum standard deduction is replaced by a low income allowance. This permits a maximum deduction of $1,100 for 1970, $1,050 in 1971, and $1,000 in following years.

The table summarizes the combined effect of exemptions and deductions.

Table 1. Maximum Incomes Not Subject to Tax

Exemptions	1970	1971	1972	1973 and after
Single Taxpayer	$1,725	$1,700	$1,700	$1,750
Married Couple	2,350	2,350	2,400	2,500
Family of Four	3,600	3,651	3,800	4,000

It is important to remember that if net farm income is too low to use this tax free income, it is gone.

Other Key Provisions For Farmers

- The new filing date of March 1st instead of February 15th, insti· tuted in 1970 for 1969 returns, is also in effect for 1970 returr and future years.

- A farm employer may now withhold from a farm employee's wages foı income tax purposes under voluntary agreements. This change is effective January 1, 1971. Prior to that date, farmers were for· bidden to withhold for income tax purposes. Instructions governi this change have not yet been released by I.R.S.

- Where soil and water conservation expenses have been deducted as operating expense rather than capitalized, subsequent sale of the land may result in some ordinary gain rather than all capital ga: Gain on sale of land will be ordinary gain to the extent of soil and water conservation expenses taken within five years of sale. Such expenses taken between five and ten years prior to sale wil be partially "recaptured". This rule change is effective for ta: years beginning after 1969.

- Income from crop insurance proceeds may now be reported in the year received or in the year the insured crop would have been sold. Previously, such insurance proceeds had to be reported in the year received.

- Installment sales rules have been changed slightly. Much attent: has been given to changes in the rules for installment sales. I appears that the changes will have little effect on selling fan on contract. Still most important is the rule stating that payments in year of sale do not exceed 30% of the selling price. T change specifies that if the seller receives "readily marketable securities or other evidence of debt this must be considered par of the down payment. This would seldom be the case in farm cont sales.

- Interest paid in advance for a period of more than 12 months bey the current tax year must be prorated. Cash basis farmers somet pay interest in advance as a tax management measure. This must limited to one year in advance.

- Gifts of property are no longer as attractive from a tax viewpoi Deductions for gifts of livestock or a commodity which would hav resulted in ordinary income if sold (like a steer or grain) are limited to the adjusted tax basis of the property. In the case a raised steer or grain, this is zero. Gifts of property which would have resulted in capital gain if sold (like a raised dairy cow) are treated differently. Generally, gift of a raised dairy cow to a church will result in an allowable deduction of 50 percent of the market value.

- The replacement period has been extended for involuntary conversions. A farmer who loses livestock, buildings, or other property in a fire and collects enough insurance to realize a tax gain often wants to postpone the tax on the gain by purchasing replacement property. He formerly had to replace the property lost within one year after the year in which the loss occurred. The new rule allows two years instead of one. Property taken in a condemnation proceeding is another example of an involuntary conversion where the new two year rule applies.

- Business property may be traded for other business property similar in use and nature in a tax free exchange. The exchange must be a direct one with no third party involved. A new interpretation states that when livestock is traded for livestock, the parties cannot trade heifers for steers or bulls for cows because they are not "of a like kind".

- Development costs for citrus groves must be capitalized. Expenditures attributable to the planting, cultivation, maintenance, or development of a citrus grove must be capitalized if they are incurred in the first four years. This applies to groves planted after 1969. Formerly, most of these costs could be either expensed or capitalized. This change now applies only to citrus groves, but the rule may well be extended to all types of orchards in the future.

- Real estate depreciation is more restricted on property acquired after July 24, 1969. Formerly, depreciable real estate could be subjected to the double declining balance method if it was acquired new, or to the 150 percent declining balance if acquired used. Under the new rule, depreciation on new real estate is limited to 150 percent declining balance, and on real estate acquired used to straight line depreciation. Residential property is not subject to the same restrictions.

- Rapid depreciation of real estate is more likely to result in ordinary rather than capital gain upon future sale. A 1964 change (section 1250) first caused recapture when rapid depreciation was used on buildings, then a sale was made at a gain. The new rule is more stringent in that to the extent of rapid depreciation taken after 1969, gain upon future sale will be ordinary gain no matter how long the property is held. Formerly, the penalty was gradually reduced if property was held 20 months or more, and eliminated if held 10 years.

- Limitations on individual capital losses are more stringent. Formerly an individual could deduct net long term capital losses from ordinary income to the extent these losses exceeded capital gains up to a $1,000 limit. Now the rule states that it takes two dollars of capital losses to offset one dollar of ordinary income up to the $1,000 limit. As formerly, the excess of capital losses can be carried over to future years and used first to offset capital gains and then ordinary income on the two to one basis up to the $1,000 limit. As farmers are much more likely to have long term capital gains than long term capital losses, the change will not affect many farmers.

DAIRY CATTLE PURCHASES AND SALES

Two major changes in the tax reform law of special interest to live stock owners have to do with taxation of gain on sales of livestock held for dairy, breeding, draft, or sporting purposes. These changes, made primarily to discourage nonfarmers from investing in breeding herds for tax advantages, will effect commercial dairymen, and in some cases will influence the way they obtain herd replacements and dispose of surplus or cull animals.

Sale of Purchased Dairy Animals Adversely Affected

Income from the sale of cattle that were purchased, added to the dairy herd, depreciation on the tax return, then sold, is treated differently under the new law. Here is an example: suppose a cow is purchased for $500, held for dairy purposes for four years during which $400 of depreciation is claimed. She is then sold for $300. As there remained $100 in cost to recover, the gain upon sale is $200. Under the old rule that gain normally was classified as capital gain, and only one-half was taxable. Under the new rule, the gain will be ordinary income and all taxable to the extent of depreciation taken after 1969. In effect, this means that within two or three years, practically all gain on sale of purchased dairy animals will be fully taxable.

A dairyman in the 30 percent tax bracket would pay $30 more income tax on the sale of the cow in this example as a result of the change. Internal Revenue calls this the depreciation recapture rule. It has be in effect on machinery and other depreciable personal property since 19

<u>A dairyman who purchases his herd replacements is disadvantaged by this new rule.</u> A dairyman who raises his replacements is not affected. The net effect of this depreciation recapture will vary from herd to he If the practice has been to set aside a large salvage value and depreci each purchased herd replacement over a six or seven year period, little gain has resulted so the cost of the new rule will be small. If the practice has been to ignore salvage value (an incorrect practice often overlooked by I.R.S.) and use a four year life for purchased animals, t loss in capital gains from the new rule will be substantial. A 100 cow herd where all replacements are purchased and moderate depreciation practices used may suffer a transfer of $3,000-$4,000 a year from capit gain to ordinary gain. The resulting increase in taxable income would $1,500 to $2,000.

The change does not appear of sufficient importance to influence dairymen who are on a program of purchasing replacements to move to a raised replacement program. It is likely to affect the nature of heif raising contracts. A dairyman who now sells heifer calves to another farmer with the contract right to repurchase the heifers at maturity w be encouraged to retain ownership of the calves and contract to have th raised for a fee. It is also possible that the tax change will encoura the purchase of replacements at a younger age, so that an increase in value will occur in the dairymen's herd, and make at least a part of the income upon sale eligible for capital gains treatment.

Dairy Animals Must be Held 24 Months to Receive Favorable Tax Treatment

A second major change relating to livestock moves the holding period on cattle and horses from 12 to 24 months. Other types of livestock still must be held only 12 months. Suppose, for example, a dairyman raises 10 heifer calves, expecting to add them to his herd. After they reach 18 months of age and are bred, he finds he will not need them as herd replacements, so sells them for $4,000. Under the old rule, the $4,000 was eligible for capital gains treatment, as his intent was to hold the animals for dairy purposes, and he had held them for more than 12 months. Under the new rule, the $4,000 will be ordinary income, as he failed to hold the animals for 24 months. In this case, the change would result in adding $2,000 to the dairyman's taxable income. If he was in the 30 percent tax bracket, the result is $600 in increased taxes.

This example also illustrates the confusion surrounding the taxpayers intent or reason for holding cattle. It is often unclear in a case such as this whether the dairymen really intended to hold the heifers for dairy purposes, or whether he knew all along they would be sold before becoming part of his milking herd. If his intent was to use them as replacements, and he held them 24 months, income upon sale will be capital gains. If his intent was to sell them, income upon sale is always ordinary income. The new law does nothing to clarify the "intent" rule.

Change in the holding period from 12 to 24 months will effect decisions relative to the sale of animals held for dairy purposes. A dairyman who would previously have sold animals at 18 months of age will now think twice before disposing of them before they reach two years of age. In herd disposals, it is likely that the new law will influence the owner to dispose of mature animals in one sale, then hold younger animals until a future date.

Changes Apply to Livestock Acquired and Depreciation Taken After 1969

Both the depreciation recapture rule and the increased holding period rule affect tax years starting after December 31, 1969. Although neither rule appears to have a severe impact on commercial dairymen, they will affect some decisions relative to the acquisition and disposition of dairy animals. Taxpayers most affected will be the relatively small group of nonfarmers who have found or sought a significant tax advantage in investing in breeding herds. And after all, the intended effect of the change was to discourage this practice.

In purchasing herd replacements, a dairyman should be aware of the new depreciation recapture rule, and recognize that the after tax or real cost of each herd replacement has been increased because of the change, probably by as much as five to ten percent of the purchase price. The new 24 month holding period will be important to keep in mind when disposing of raised animals held for dairy purposes.

FARM LOSSES UNDER THE TAX REFORM ACT OF 1969

Some of the changes in the Tax Reform Act are aimed at making the real or after tax cost of incurring tax losses in farming much higher. One change made to accomplish this objective is the revision of the Hobby Loss Rules to make it more difficult to offset nonfarm income with farm losses. Another more drastic change is the introduction of the Excess Deductions Account, with the objective of limiting the opportunity of running a farm business at a loss while creating large capital gains. The operation of this provision is very complicated. One saving factor is that only a small number of taxpayers will be effected, and most farmers will be able to ignore it completely.

The Excess Deductions Account

The new law requires that certain farmers keep a special account of farm net losses from year to year, called an excess deductions account (EDA). Sales of cattle and some other farm assets by a taxpayer with an EDA would change the classification of gain on such sales from capital to ordinary gain, to the extent of the balance in the EDA.

For example, if a taxpayer has a balance of $20,000 of accumulated farm losses in his EDA, and sells his herd of raised dairy cattle, realizing a gain of $50,000, the first $20,000 of gain on the sale would be ordinary gain, the remainder capital gain. Subsequently, the EDA balance would be reduced to zero.

Who Must Keep an EDA? Only farm taxpayers reporting on the cash basis are affected. Individuals, partnerships, and subchapter S corporations must keep an EDA only if their nonfarm income exceeds $50,000 per year and their farm losses exceed $25,000 per year. Only the losses in excess of $25,000 are added to the EDA account.

All farming corporations filing as regular 1120 corporations must keep an EDA. The dollar exemption rule does not apply to such corporations Any farm taxpayer, individual or corporation, can avoid keeping an EDA by reporting on the accrual basis.

How Are Farm Losses Calculated? Farm losses are the excess of farm deductions over farm gross income. They do not include capital gains or losses from disposition of breeding or dairy cattle or other property used in the farm business. It would appear that for EDA purposes, a farm loss will generally be the net loss figure which appears as the final entry on page 1 of Schedule 1040 F. This figure might have to be adjusted for gains or losses on sales of such items as cattle held for dairy purposes less than 24 months, reported on Schedule D. A taxpayer who has more than one farm business is directed to combine his net losses for EDA purposes.

The "Recapture" of Farm Losses - The balance in the EDA would be reduced by the amount of any net profit in a future year. At the end of each year, the EDA balance is compared with gains from sale or exchanges of "recapture" property. If the EDA balance is higher, all the gains on the recapture property are treated as ordinary gains. If the EDA balance is lower, gains on the recapture property are treated as ordinary gains to the extent of the EDA balance, and the remainder receives capital gains treatment. The EDA balance is then reduced by the amount of the recapture for carry over to the next year.

What is "Recapture" Property? Recapture property includes:

(1) Livestock held for two years or more for draft, dairy, breeding, or sporting purposes.
(2) Other depreciable personal property held more than six months.
(3) Unharvested crops sold with the land where the land has been held more than six months.
(4) Land held more than six months, to the extent of deductions taken in the sale year and the preceding four years for soil and water conservation expenses and land clearing expenses.

Depreciable improvements to real property, such as buildings, are not included.

Careful consideration of the property included as "farm recapture property" leads to the conclusion that the provision is aimed at reduction of the advantage of capital gain treatment on sale of livestock and reduction of the advantage of the special rules allowing soil and water and land clearing investments to be expensed rather than capitalized.

Probable Effect of Initiating EDA - The total number of farm taxpayers who will be required to establish an EDA will be very small. Few if any farmers will or should be influenced to change from the cash to the accrual basis of reporting. A few farm corporations may decide to seek status as subchapter S rather than regular corporations to avoid EDA. Even among the limited number of farm taxpayers forced to establish an EDA there will be a few instances where EDA will result in a much heavier tax burden.

Changes in the Hobby Loss Rule - The Tax Reform Act repeals the old rule which dissallowed losses from a business in excess of $50,000 for five consecutive years.

Under the new law, losses on an activity "not engaged in for profit" are deductable only to the extent of income from that "activity". But some expenses in such an activity, including taxes, interest, and casualty losses, are deductable anyway, even if they exceed income from this non-profit activity. The law does not use the word "hobby".

The new law says that if a taxpayer is engaged in an activity which shows a profit for two out of five consecutive years, it will be presumed that he was engaged in the activity for profit, and it will be up to I.R.S. to show that he was not. If the activity consists of breeding, training, showing, or racing horses, the taxpayer only needs to show a profit in two of seven consecutive years to have the presumption in his favor. Where profit does not result in two of five years (two of seven in horse farming) the burden will be upon the taxpayer to show that he is truly, even if unsuccessfully, engaged in the activity for profit. Tax years beginning after December 31, 1969, will be governed by the new hobby loss rules. It will be several years before the effectiveness of these changes will be truly tested.

INVESTMENT CREDIT CONSIDERATIONS FOR THE 1970 TAX RETURN

The investment credit against the Federal Income Tax is gone but must not be forgotten. A number of considerations remain in completing the 1970 tax returns.

Pretermination Property

The investment credit was repealed as of April 19, 1969, and generally, property acquired after that date is not eligible. However, property that has been acquired since then pursuant to a binding contract entered into before that date may be "pretermination property" and eligible for the credit. It is possible that in a few instances farmers constructed buildings or acquired machinery in 1970 under binding contracts entered into before the cutoff date of April 19, 1969. If so, they may thus have earned credit in 1970.

Carryover of Unused Credit

Investment credit earned before the cutoff date and unused prior to 1970 may be used to reduce tax in 1970. However, for 1970 and future tax years, only 20 percent of the carryover or carryback available in 1969 may be used in any one year. For example, if on the 1969 return there was $1,000 of carryover available, the law allowed the use of only $200. In 1970, another $200 may be used, and the rest carried forward. Unused credit must first be carried back three years and then may be carried ahead seven. Credit which cannot be used up in the regular seven year carry forward period because of the 20 percent limitation rule may be carried 10 instead of seven.

Recapture Rule and Replacement

If property on which the credit has been taken is disposed of before the expiration of the useful life on which the credit is computed, the taxpayer must recompute the amount of investment subject to the credit. If the recomputed credit is less than that used to reduce tax, the taxpayer must add to his tax liability in the year of disposition the difference between the credit taken and the credit earned.

When property on which credit was taken is replaced by property similar in use within six months, recapture of credit is reduced by the amount of credit which would have been allowed on the new property had the investment credit been continued. The recapture is never reduced below zero. The recapture rule also does not apply to property stolen or destroyed by casualty after April 18, 1969.

Because property on which investment credit was taken in the past is normally replaced by similar property, with similar or higher initial cost, the recapture rule will seldom be burdensome to a farmer except when he is selling his business, or when he is transferring property ownership to another family member. Gifts or contributions to a partnership do constitute dispositions, and the recapture rule is in effect.

INCOME AVERAGING RULES RELAXED

Some farmers have found income averaging beneficial in the past. Changes made in the averaging provisions in the 1969 law, effective for the first time on 1970 tax returns, will make averaging more attractive to farmers.

The changes are:

- Previously, averageable income was income in the current year in in excess of 4/3 (133 1/3%) of base period or "average" income. Under the new law, averageable income is income in the current year in excess of 6/5 (120%) of base period income. More income can now be averaged, providing greater relief in the current year.
- Formally, income from capital gains, wagering, and gifts was not eligible for averaging. Dairy farmers thus received no relief from averaging in a year when unusually large sales of dairy cattle occurred. Under the new law, capital gains, wagering, and gifts may be averaged. Thus averaging may now help dairy farmers in a year when part or all of the dairy herd is dispersed.

Income averaging is, in a sense, a last resort in tax management. It should not be considered a substitute for year end tax management. All reasonable efforts should be made to even out taxable income from year to year. After these efforts have been made, averaging is still available. It is well to remember that use of income averaging in the current year does not affect tax in previous years. Averaging can be used in the current year, ignored in the following year, and used again two years hence. The best way to gauge the possible benefit of averaging is to make the calculations - fill out a Schedule G. The exercise may show nothing will be gained, but it costs only a little time to find out.

The averaging procedure is more difficult to understand than to do. Schedule G, Form 1040, is used for computations where averaging is adopted, and the new form is not especially difficult to complete. Although dairy farmers will benefit most from the changes, many farmers who do not receive capital gains will also benefit. I.R.S. Publication 506, Computing Your Tax Under Income Averaging, gives detailed instructions.

In the following four farm cases averaging was computed using the new rules for each case. In each instance, it was assumed that the farmer was married filing a joint return for all years in the calculations. The surcharge was ignored in calculating the tax.

INCOME AVERAGING EXAMPLES

Farm	Taxable Income Base Period Pattern	Current Yr.	Tax No Averaging	Tax Averaging	Saving
		$	$	$	$
Grape Grower	8,000-2,000-4,000-16,000	25,000	6,020	5,150	870
Dairy Farmer	2,000-4,000-6,000-8,000	15,000	3,010	2,710	300
Dairy Farmer	6,000-5,000-6,000-8,000	10,000	1,820	Not Eligible *	
Vegetable Farmer	16,000-5,000-4,000-11,000	25,000	6,020	5,366	654

* Income in the current year does not exceed 120 percent of base period income by $3,000

Suppose a dairy farmer decides to disperse his milking herd but retain his youngstock with the intention of building up a replacement herd in the near future. Income from the sale of the dairy herd, all raised animals held for dairy purposes, is \$40,000, all qualifying for capital gain treatment. Assume that in the previous four years he had no capital gains income. Assume further that he is married and files a joint return in the current year and during the base period years.

His pattern of taxable income is as follows:

Previous four years - \$2,000 - \$4,000 - \$4,000 - \$6,000

Current Year - \$30,000 taxable income (\$20,000 of this is capital gain, excluded under the old rules)

The following calculations show how the new rules make averaging much more beneficial in such a case.

Steps	Calculations: Old Rule	Calculations: New Rule
1. Average base period income	\$16,000 ÷ 4 = \$4,000	\$16,000 ÷ 4 = \$4,000
2. Multiply base period average by factor This amount is "non-averageable" income	\$4,000 x $133\frac{1}{3}\%$ = \$5,332	\$4,000 x 120% = \$4,8
3. Compute averageable income by subtracting nonaverageable from total (Old rule excludes capital gain)	\$10,000 -5,332 = \$4,668	\$30,000 -4,800 = \$25,200
4. Add $\frac{1}{5}$ of averageable income to non-averageable	$\frac{\$4,668}{5}$ = 934 +5,332 = \$6,266	$\frac{\$25,200}{5}$ = 5,040 +4,800 = \$9,840
5. Compute tax		
A. Tax on total in step 4	\$1,051	\$1,785
Subtract tax on non-averageable income	873	772
	\$ 178	\$1,013
B. Multiply answer to 5A by 4	\$178 x 4 = \$712	\$1,013 x 4 = \$4,052
C. Calculate tax on all nonaverageable income plus 1/5 of averageable income (Old rule adds capital gain back in)	\$6,475 (tax on \$26,266)	\$1,785 (tax on \$9,
Add ans. to 5B	+712	+4,052
Total tax, current year	\$7,187	\$5,837

Tax on \$30,000, current year, without averaging - \$7,880
Tax in current year, averaging under old rules - \$7,187
Tax in current year, averaging under new rules - \$5,837

DEPRECIATION

Depreciation records are becoming more and more important in the preparation of accurate farm income tax reports. Copies of past returns do not provide sufficient information for complete and accurate reporting on most commercial farm operations. A separate more detailed depreciation record such as the one illustrated in the Farmers Tax Guide is suggested.

Item vs. Class Reporting

Entries on the depreciation schedule may be summarized into distinctly different classes of depreciable assets. However, the taxpayer must have his own records kept in enough detail to verify the accuracy of the summarized schedule.

In most cases, it is probably best for a farmer to continue to use item accounts rather than grouping machinery, buildings, or cattle. A separate continuation sheet of Part V - depreciation may be attached to Schedule F if more lines are needed.

Depreciation Guidelines

Internal Revenue Service Publication 456 includes guidelines for determining reasonable useful lines of depreciable farm business property. These include:

A. Machinery and Equipment - 10 years

B. Animals:
   Cattle, breeding or dairy - 7 years
   Hogs, breeding - 3 years
   Sheep and Goats, breeding - 5 years

C. Farm buildings - 25 years

For many classes of depreciable property, no specific useful lives are suggested, and statements are made that the facts in each case should determine the depreciable life. Depreciation rates should be set in line with experience on the farm of the taxpayer. I. R. S. Publication 456 says,

> "The determination of the useful economic life of an asset is a matter of judgement and estimate. For this reason, it is the policy of the Internal Revenue Service, generally, not to disturb depreciation deductions. Therefore, adjustments in the depreciation deduction should not be proposed unless there is a clear and convincing basis for a change."

It is important that the taxpayer keep a record of real estate purchases and of his allocation of the purchase price to land, buildings and other depreciable portions of the cost.

If an orchard or vineyard has been grown or a fence erected by the present owner and the costs deducted on previous income tax returns as annual operating expenses, then depreciation may not be taken because the costs have already been charged off.

Recovering Costs of New Orchards and Vineyards

Amounts spend in setting out new orchards and vineyards must be treated as capital investments rather than as current operating expenses.

The taxpayer may treat as either capital investment subject to depreciation or as current operating expense such expenditures during the development period of orchards and vineyards as those for cultivating, spraying, pruning, and taxes. Most farmers have found it convenient to treat these expenditures as current operating expenses.

The 1969 tax act singles out citrus groves for special treatment, and states that all expenditures incurred during the first four years of development must be capitalized rather than expensed. This new restriction does not currently apply to vineyards or to orchards other than citrus.

Economics of Rapid Depreciation

Farmers generally use straight line depreciation because of its simplicity. For farmers who do have sizeable taxable incomes, the savings through fast depreciation should not be overlooked. By combining the 20 percent first year special allowance with double declining balance, much of the tax reduction through depreciation can be crowded into the first years of ownership, which results in postponing tax. Even when a conservative value is placed on the use of those postponed tax dollars by the farmer, a significant saving results.

The use of the 20 percent special allowance is limited to $20,000 of eligible property on a joint return. It is especially useful because it is available on newly acquired items even though they were acquired at year end. It is thus helpful in evening out income from year to year.

Power equipment and harvesting equipment costing $10,000-$25,000 is no longer unusual. A farmer in the 32 percent tax bracket who purchases a harvesting machine for $20,000 with an expected life of eight years stands to save $500-$600 if he choses 20 percent special and double declining balance over straight line depreciation. A farmer who makes such an investment should carefully consider alternative tax strategies for cost recovery even before he makes the decision to invest, because the real cost of the machine is affected by the tax treatment selected.

Real Estate Depreciation

The 1969 law imposes new limits on depreciation on real estate. Depreciable real property, except for rented residential property, acquired after July 24, 1969, cannot be subjected to the double declining balance or sum of the years digits methods. Depreciation is limited to straight line, to 150 percent declining balance, or to any other consistent method which does not give greater allowances in the first two-thirds of useful life than does the 150 percent declining balance. Property bought or constructed prior to July 24, 1970, or property acquired through a binding contract to construct or finance entered into before that date is still subject to the old rules. The old rules allowed double declining balance or sum of the year's digits methods. Used real estate acquired after the July 24 date is allowed only straight line depreciation.

Suppose a dairy farmer constructs a new dairy barn complex at a cost of $50,000, and he assumes a 20 year life and a salvage value of $10,000. Table 2 illustrates recovery in the first five years using straight line depreciation, and maximum recovery permitted under the old rule and the new rule. Salvage value is ignored using declining balance. Thus double declining balance is 200 percent of straight line applied to total cost in this case, straight line equals five percent per year, so double declining balance equals ten percent per year taken on remaining or unrecovered cost. Under the new rules, rapid depreciation is limited to 150 percent of straight line, in this case 7.5 percent.

Table 2. $50,000 Dairy Buildings, Newly Constructed
20 Year Life - $10,000 Salvage Value

Year	Straight Line	Old Rule Maximum Double Declining Balance	New Rule Maximum 150% Declining Balance
1	$ 2,000	$ 5,000	$ 3,750
2	2,000	4,500	3,469
3	2,000	4,050	3,209
4	2,000	3,645	2,986
5	2,000	3,280	2,745
	$10,000	$20,475	$16,141

The example shows that the new rule significantly reduces the maximum depreciation allowed in the first five years of ownership. In this example, the change reduces the maximum depreciation allowed in the first five years more than $5,000. If the example had indicated purchase of used real estate, the reduction in maximum depreciation in the first five years would have been over $6,000, because the old rule allowed 150 percent declining balance on used real estate, and the new rule allows only straight line.

The new rules relative to depreciation of rented residential property are more liberal. Two hundred percent declining balance may still be used if the rented residential property is new, and 125 percent declining balance if it is used and has a useful life of 20 years or more.

Table 3. GUIDELINES FOR DEPRECIATION FOR FARM ASSETS

Description	Additional 1st. Yr. Dep.	Depreciation Methods	Suggested Life	Basis for Computing: St. Line Depreciation	Basis for Computing: Declining Balance Dep.	Basis for Computing: Sum of Digits Dep.	Basis for Computing: Add. 1st. Yr. Dep.
NEW MACHINERY PURCHASED	Yes - 6 yrs. or more life	St. Line - yes D. Bal. - 3 yrs. or more life Digits - 3 yrs. or more life	10 Yrs.	Boot paid plus undep. balance on trade less add 1st. yr. dep. less required salvage val.	Boot paid plus undep. bal. on trade less additional 1st. year dep.	Boot paid plus undep. bal on trade less add. 1st. year dep. less required salvage value	Boot only
USED MACHINERY PURCHASED	Same as above	St. Line - yes D. Bal. - 3 yrs. or more life and limited to $1\frac{1}{2}$ st line rate. Digits - no.	No Guide	Same as above	Same as above	Not eligible	Boot only
NEW BUILDINGS	Not eligible	St. Line - yes D. Bal. - 3 yrs. or more life. limited to 150% St. Line Digits - no	25 Yrs.	Cost less salvage value	Cost	Not eligible	Not eligible
USED BUILDINGS PURCHASED	Not eligible	St. Line only	No Guide	Same as above	Cost	Not eligible	Not eligible
FENCE, SILOS GRAIN STORAGES DRAIN TILE	Not eligible	St. Line - yes D. Bal. - 3 yrs Digits - yes	25 Yrs. Fence 10 yrs.	Same as above	Cost	Not eligible	Not eligible
BREEDING AND DAIRY ANIMALS PURCHASED	Yes - 6 yrs or more life	Same as above	3-7 Yrs.	Boot paid plus undep. balance on trade less 1st. yr. dep. less salvage value.	Poot paid plus undep. bal. on trade less 1st. year additional dep.	Boot paid plus undep. bal. on trade less 1st. yr. add. dep. less sal. val.	Boot only
FRUIT TREES AND VINES	not eligible	Same as above	No Guide	Cost	Cost	Cost	Not eligible

CAPITAL GAINS AND LOSSES*

For income tax purposes, property owned by farmers can normally be classified as capital assets, noncapital or ordinary assets, and hybrid assets that are sometimes treated as one and sometimes treated as the other, depending on the circumstances.

Capital assets includes almost all property owned for nonbusiness or personal use like stocks and bonds for investment, residence, car, etc.

Noncapital assets is property held for sale in the usual operation of the farm business. Apples, potatoes, feeder cattle, feeder lambs, bob calves, and poultry, are never capital assets.

Items that sometimes are, sometimes are not, treated as sales of capital assets can for convenience sake be called hybrid items. They include:

A. Sales, exchanges, involuntary conversions of:

(1) Livestock held for draft, dairy, or breeding purpose for one year or more, except that gain to the extent of depreciation taken after 1969 will be ordinary gain.*
(2) Farm land held for more than six months.
(3) Machinery held for more than six months except that gain on such items to the extent of depreciation occurring after 1961 will always be ordinary gain.
(4) Farm buildings held for more than six months, except that part or all of the gain which can be attributed to rapid depreciation may be ordinary assets.

B. Gains and losses arising from fire, theft, or condemnation of capital assets.

C. Casualty losses.

D. An unharvested crop sold with the land, when the land has been held for more than six months.

The farmer must compare gains and losses on all of these items in Part VII, 1040 D. If the comparison shows a net loss, none of them are treated as capital gains. All are then entered as ordinary gains and losses under "Property Other Than Capital Assets," on Schedule D, Part III except casualty losses on assets such as a boat, auto for personal use, etc. These are listed on Schedule A of Form 1040, if deductions are itemized. If the gains exceed the losses, all the gains and losses are listed in Part I, line 6 of Schedule D.

* Cattle and horses acquired after 1969 must be held two years to qualify.

Recapture of Real Estate Depreciation (1250 Property)

The sale of real property used in the business usually results in gain which receives capital gain treatment and is thus only 50 percent taxable. However, if rapid depreciation has been used, some or all of the gain will be classified as ordinary gain. This recapture of excess depreciation rule first went into effect in 1964. Changes in the 1969 law make it much more complicated. Attention to some basic facts may remove some of the confusion relative to this recapture rule.

- If only straight line depreciation has been used on depreciable real estate, and it has been held 12 months or more, no recapture takes place and no special calculations are necessary.

- The key is the amount of depreciation which has been taken in excess of that which would have been taken using only straight line. It is only this excess which may be classified as ordinary gain, and the amount of the excess must be determined as a first calculation.

- Rapid depreciation or excess depreciation taken after December 31, 1963 and before January 1, 1970 will receive a different treatment than that taken after January 1, 1970. Gain on sale of the property will be ordinary gain to the extent of excess depreciation taken after 1970 plus excess depreciation taken before 1970.

- One hundred percent of excess depreciation taken after January 1, 1970 will be used to convert gain to ordinary gain. One hundred percent of excess depreciation taken between 1963 and 1970 will be so used if the property was not held for more than 20 months. For each month held beyond 20, one percent of this pre-1970 excess depreciation will be forgiven.

- Residential depreciable real estate receives more favorable treatment on depreciation taken after 1970. If such property is held 100 months or longer, one percent of the excess depreciation will be forgiven for each additional month.

- Where the taxpayer has entered into a binding contract to dispose of the property prior to July 25, 1969, post 1970 depreciation will receive the same treatment as pre-1970 depreciation.

- A taxpayer may shift to straight line depreciation from <u>either</u> a declining balance or sum-of-digits method without special consent for real estate depreciation in any tax year commencing after July 24, 1969.

- Where the property is held less than 12 months, <u>all</u> depreciation - straight line or rapid - will be considered excess and recaptured.

Reorganization of Schedule D, 1040

The recapture rule on real estate depreciation has forced a reorganization of Schedule D, 1040, <u>Sales or Exchanges of Property</u>. The major changes are the addition of two sections, one (Part II) is for calculating the amount and type of gain on disposition of most depreciable real property, including buildings (Section 1250). Previously, 1250 and 1245 (machinery and equipment) transactions were combined. The other added section (Part VII) is for making a comparison of gains and losses on all items which sometimes are and sometimes are not afforded capital gain treatment (hybrid items). Although this comparison has always been necessary, no place was provided to make it on earlier forms. The following suggestions may help in making Schedule D entries of items commonly encountered on farm returns.

Gain or Loss From Sale of Capital Assets -

Income from the sale of capital assets (property not used in the business) like common stocks, can be directly entered in Part I as in the past.

Gain or Loss on Sale of Equipment -

Income from the sale (not trade) of farm machinery and equipment is entered first on Part V. If gain is realized from such a transaction, it is almost certain to be ordinary gain, and will next be moved to Part III.

Gain or Loss on Sale of Farm Real Estate -

Income from the sale of nondepreciable real estate used in the business - land - should first be entered in Part VII. Income from the sale of depreciable real estate - buildings - will first be entered in Part VI, where the calculations will be made to determine what part of any gain is ordinary, what part other. Even if only straight line depreciation has been used, the sale should first be entered in Part VI.

Gain or Loss on Sale of Livestock -

Income from the sale of livestock held for dairy or breeding purposes should be divided first into those which meet the holding period requirements and those which don't. Holding period requirements for livestock acquired prior to January 1, 1970, are 12 months. For livestock acquired after that date, they are 24 months for cattle and horses, 12 months for other livestock. Sales of all livestock held for dairy and breeding purposes which do not meet the holding period requirements are entered directly in Part III. Sales of raised livestock held for dairy or breeding purposes which meet the holding period requirements are entered first in Part VII. Sales of purchased livestock held for dairy or breeding which meet the holding period requirement are entered first in Part V along with any other 1245 property.

Casualty and Theft Losses -

Casualty and theft losses of animals held for dairy or breeding purposes for less than the required holding period and of farm buildings and equipment held for six months or less are listed in Part III, D.

A comparison of gains and losses on all other casualty and theft items must be made. Include in this comparison both personal and business casualty losses. Disregard the old distinction between insured and uninsured casualty losses, as they are now treated the same. Regardless of whether there is a net gain or a net loss when the comparison is completed, all casualty and theft losses must first be entered in Part VII, D. If there was a net loss in the comparison, they will next be entered in Part III of D, except that any personal casualty losses included must instead be entered on Schedule A when itemizing deductions.

If there was a net gain on the casualty comparison, these gains and losses will next be reported either in Part III of D or on Part I of D, depending on whether there is a net gain on all 1231 (Part VII) items, or a net loss on all 1231 items. Again the exception is that if there is a net loss on all 1231 items, the personal casualty losses included must be moved to 1040A and deductions itemized to get recognition of the loss. The first $100 of each personal casualty loss is excluded before it is placed in any comparison or entered on any return.

Even though the distinction between insured and uninsured casualty losses is eliminated, the effect of the new treatment of casualty losses is more confusion. The purpose of the changes is to give the taxpayer who has a net loss on casualties the full benefit of this loss, rather than requiring that the loss offset potential capital gain, as it did in certain circumstances under the old rules.

Summary -

After the initial entries of all transactions are made in the appropriate part of "D", calculations made there will determine where the different types of gains and losses will subsequently be moved for combination and summary.

TAX SAVINGS IN TRADING FARM PROPERTY

If farm business property is exchanged for farm or other business property, all or part of the gain can escape immediate taxation. The special tax treatment available in tax free exchanges is not commonly understood by farmers. As a result, farmers often make sales of property which they mistakenly believe qualifies as a trade or swap. On the other hand, farmers sometimes fail to take advantage of the opportunity to make a trade instead of making an outright sale, and thus incur heavy current taxes which could have been postponed.

A Simple Nontaxable Exchange Illustrated

Suppose a farmer decides to retire and liquidate his farm business. He has an offer of $100,000 for his farm real estate, which has an adjusted tax basis of $30,000. If he makes an outright sale for cash he incurs a gain of $70,000, of which $35,000 is taxable. He can, of course, ease his tax problem by selling on the installment basis. He might also be able to arrange a tax free exchange. Suppose he is selling to a real estate developer who owns an apartment house which he will sell for $100,000, or will trade even for the farm. If the farmer trades with the developer, he ends up owning an apartment house with an adjusted tax basis of $30,000, and has no gain to report in the year of the trade. He has postponed his tax problem, but has not eliminated it. However, he may be ahead with the trade. He may be able to dispose of the apartment house sometime in the future when other taxable income is less. Buying the apartment house may provide him with the kind of nonfarm investment which he wants.

Basic Rules to Qualify

- Both real estate and personal property will qualify for a nontaxable exchange.

- Property held must be "for productive use in a trade or business or for investment". Farm property qualifying would include farm land and buildings, livestock and equipment.

- The property exchanged must be of a "like kind". For real estate, the "like kind" rule is very flexible. Any income producing real estate may be exchanged for any other income producing real estate. Therefore, farm real estate may be exchanged for city real estate, such as an apartment, or for timberland, etc. The like kind rule for nonreal property is much more restrictive. Dairy cows can be swapped only for dairy cows, farm equipment only for farm equipment. Some livestock owners have assumed that it is permissable to trade heifers for steers. Although the law is unclear, it appears that this interpretation is too broad.

- The exchange must be a direct one. No third party can be involved in ownership at time of trade. Selling a herd of cows to one or several persons, then buying back a replacement herd is not a nontaxable exchange. A farmer who wishes to swap his farm real estate for an apartment house in town must find an apartment house owner who wants to own a farm. However, "arranging" such an exchange is permissable. A farmer located in an area being developed for industrial purposes can say to the developer who offers him $100,000 for his farm, "you go buy a farm 200 miles from here and we'll work out a swap".

- The property received in the trade must be acquired for use in a busine or for investment. A farmer who acquired an apartment in exchange for farm with the idea of immediate resale of the apartment would not quali

Some Gain May be Recognized in a Trade

If the trade is not even, if cash is received, or if the property traded received is mortgaged, part of the gain may be recognized and immediately taxa in an exchange - examples are:

A farmer who trades a farm for an apartment house and pays cash in additi adds the cash payment to the adjusted tax basis of his farm to determine the t basis of the apartment house, but has no gain to recognize.

If the farmer receives cash for his farm in addition to other investment property (the apartment house), the cash received must be reported as gain, up to the amount of gain which has occurred on the farm.

If a farmer trades his farm for an apartment house, with no cash involved but in the deal the farmer is relieved of a $10,000 mortgage on the farm, and assumes no mortgage on the newly acquired property, he is considered to have received $10,000 in money for tax purposes.

Installment Sale May be Combined With Nontaxable Exchange

A transaction which involves a swap of property plus some cash or "boot" may qualify as both a nontaxable exchange, and as an installment sale. A farmer might trade his $100,000 farm for a $30,000 rental property plus $70,0(in addition, to be paid in installments of $10,000 a year. If the farm had a basis of $20,000, he would realize a gain of $80,000, but only $70,000 is recognized. Because the contract price is $ 70,000 and the recognized gain i: $70,000, he would report 100% (70 ÷ 100) of his cash payments each year as tax gain. Each annual payment of $10,000 would thus result in taxable gain of $10 The rental property received in exchange would have a basis of $20,000.

Tax Free Exchange is a "Disposition" for Investment Credit Purposes

Property disposed of in a swap may result in investment credit recapture Investment credit previously taken on the traded-in property must be recaptur if the property was not held for the required length of time to "earn" the cr

Where Farmers May Benefit

There are probably few instances where farmers can materially benefit by arranging tax free exchanges of machinery or livestock. The usual method of trading used farm equipment for new farm equipment is a nontaxable exchange a way, and there are no obvious ways of capitalizing on equipment swaps. The swapping of livestock would not be beneficial for many dairy farmers. A cont practice of trading rather than selling would reduce the amount of income whi qualifies for capital gain treatment.

The most likely opportunities for tax benefits from nontaxable exchanges are associated with disposition of farm real estate. When the potential gain on the sale of a farm is great, and when the farmer is interested in finding a substitute investment in other real estate, then he should carefully examin the possibility of exchanging his farm for other real estate instead of selli it and then looking for a place to invest the proceeds of the sale.

TAX CONSIDERATIONS IN INCORPORATION OF THE FARM BUSINESS

Interest in the family or close-held corporation as a farm business arrangement has increased in the past few years. This interest is largely due to bigger businesses and more attention to income tax management.

Probably less than two percent of all commercial farms in New York are incorporated, but the number has been increasing. The corporate structure offers several possible advantages not related to tax management. Perhaps the most important is flexibility of property ownership represented by shares of stock, which can be easily transferred from one family member to another. However, many if not most farm corporations which have been formed recently have been created primarily as a way to save taxes.

There are several things to keep in mind in studying potential tax savings resulting from incorporation of farm business. First, only relatively large farm businesses with assets of $200,000 or more are likely to benefit. Secondly, only farm businesses with above average taxable incomes, stand to benefit. Thirdly, stockholders are usually only those family members who are actively engaged in the farm business. Fourthly, the type of corporation created can almost always qualify as a Subchapter S or 1120 S corporation. But if the choice is made to file as a Subchapter S corporation, some of the tax advantages sought by incorporating are lost. This is true because the 1120 S corporation is treated much like a partnership for Federal Income Tax purposes. Therefore, in citing tax considerations in incorporating, reference will be made to a regular 1120 corporation rather than to an 1120 S corporation.

Corporate Tax Rates Differ From Individual Tax Rates

Under current tax rate schedules, corporations are taxed at 22% on the first $25,000 of taxable income and 48% on all above. Individual tax rates start at 14%. For married taxpayers filing joint returns, the rate does not reach 22% until taxable income reaches $8,000. The rate is above 48% when taxable income exceeds $44,000.

Taxing of capital gains also differs between the individual and corporate taxpayer. The individual pays tax on only 50% of his capital gain, and that 50% is taxed at whatever rate the individual taxpayer is paying on total taxable income. Thus a taxpayer in the 25% tax bracket pays 12½¢ tax on each $1 of capital gain. The corporation is taxed on capital gain at the same rate as ordinary income or at 25%, whichever is lower. Thus a corporation with combined ordinary income and capital gains of $25,000 or less pays at the rate of 22¢ for each $1 of gain.

The Corporation is a Taxpayer

In forming a corporation, a new taxpayer is created. This presents some advantages. First, at the time the corporation is formed, a choice is available relative to fiscal or calendar year, and as to cash or accrual tax reporting. A more important advantage is the flexibility provided in shifting income between the corporation and family members.

Family members employed by the corporation normally draw salaries. Although salaries must represent reasonable compensation for services performed, and must be set at the beginning of the year, considerable flexibili is allowed in setting salaries, and in declaring bonuses during the year. Thus income can be shifted between corporation and individuals to take advantage of lowest tax rates.

Some Expenses May be Shifted From Personal to Business

Some expenses which cannot be charged as business deductions in a farm partnership or individual proprietorship may be charged in a corporation. Many of these are associated with the farm residences. If the houses occupie by family members employed by the corporation are owned by the corporation, depreciation and maintenance on these houses may be charged as corporate expenses. They are, in effect, "tenant houses", occupied by the employee at the direction of and for the convenience of the employer. Under this rule, value of house rent is not taxable income to the employee. However, it may be undesirable for other reasons to have the corporation own the houses occupied by the family members.

Salaries or Wages to Various Family Members More Readily Substantiated

The formal structure of a corporation apparently makes it easier to jus payment of salaries to different family members. For example, accounting du carried by a farm wife can justify a corporate salary. Even though the adva for Federal Income Tax may be small or nil, there may be an advantage on Sta Income Tax, and also this opportunity adds to the flexibility available in drawing off corporate income.

Transferring Farm Property to Corporation Seldom Results in Taxable Gain or

If a farm owner decides to form a corporation and transfer farm propert to the corporation, the transfer is usually a nontaxable exchange. Therefor no taxable gain or loss results at the time of transfer. This is true becau usually the person or persons who transfer property to the new corporation receive only stock in exchange and these individuals usually meet the requir ment of owning at least 80% of the stock immediately after the transfer.

In such a transfer, the property has the same adjusted tax basis in the hands of the corporation as it had in the hands of the previous owner or own A herd of raised dairy cattle would retain a basis of zero in such a transfe and a set of farm equipment would have the same basis in the hands of the co poration as last reported on the farmer's depreciation schedule.

Withdrawing Income From a Corporation Requires Management

Close held or family corporations usually do not pay dividends on corporate stock. If dividends are paid, double taxation results - first corpor tax on corporate profit, then tax to the stockholder when the dividend is pa Double taxation does not occur when corporate income is drained off as salar to family members. A family member may be a creditor of the corporation. This provides an opportunity to draw off corporate income as interest paymen

In some cases less total tax results if the corporation is allowed to show a profit and to pay income tax. In such cases, it is assumed that a way will be found in future years to transfer these undistributed profits to stockholders under favorable tax conditions. Close held corporations are generally not allowed to build up undistributed profits of over $100,000. In some very profitable farm businesses, this limitation has been one reason for forming two corporations - one to own the land, the second to operate the farm business, leasing the land from the first.

Family Members Employed by Corporation Have Different Tax Status

The farm family members who are employed by the family corporation have a new tax status somewhat comparable to any farm employee. The corporation as a "farmer" for tax purposes, is exempt from income tax withholding on employees, is responsible for social security withholding, is eligible for cash or accrual basis reporting, and is exempt from quarterly tax estimates if the February 15th date is used for the final return. The farmer himself, however, is no longer a "farmer" for tax purposes but is an employee of the corporation subject to the same rules on filing tax estimates and filing final returns as are other nonfarm taxpayers.

Deferred Taxation and Nontaxable Fringe Benefits of the Corporation

Farm family members may create an opportunity for deferred taxation fringe benefits by forming a corporation and becoming employees of that corporation. A corporation may establish a retirement plan for its employees, which can result in a reduction in tax to be paid on dollars placed in the retirement fund. Although it is true that a partnership or individual proprietorship can also do this, the rules governing corporate retirement plans allow more flexibility in method of funding the plan, in amounts which can be set aside, and in determining which employees are included.

The corporation also allows for the establishment of profit sharing plans and stock bonus plans which will provide deferred taxation for the employee.

In addition to these deferred taxation options, corporations can also provide important nontaxable fringe benefits to employees, including group health and accident insurance and group term life insurance.

Unfavorable Capital Gains Treatment Afforded Corporation May be a Problem

As has been pointed out, corporations do not receive a favorable treatment on taxable capital gains as to individuals, unless the individual is in the 50% tax bracket or above. A corporation therefore may be tax disadvantageous when the business at hand can expect significant income in the form of capital gains. For example, a dairy farmer in the 25% personal income tax bracket, operating as an individual proprietorship, selling $8,000 of raised animals held for dairy or breeding purposes each year, would normally pay $1,000 in Federal Income Tax as a result of these sales. If he switched to a corporation, he could expect to pay $2,000 in tax attributable to the same cattle sales. It should be pointed out that only dairymen with 150 cows or more, raising all replacements, would be likely to have sales of this magnitude. Also only livestock farms usually produce much income of this kind.

If farm land is transferred to a corporation, capital gains taxation takes on special significance. The market value of most farm land has increased considerably in recent years, and this results in a sizeable capital gain upon sale. For this reason, caution should be taken in transferring farm land with a low tax basis to a corporation where sale at much higher values is even a remote possibility in the near future.

Election to be Treated as a Subchapter S Corporation

If election is made to file for Federal Income Tax purposes as a Subchapter S corporation, the net income of the corporation is passed through to the stockholders proportionate to their shareholding. Capital gain of the corporation is also distributed in the same manner. The corporation files an information return, similar to the partnership return, but pays no tax itself.

Resort to the Subchapter S corporation removes the problem of higher capital gains taxation and the problem of distributing corporate earnings without double taxation. It also would appear that the possibility of shifting some expenses that are definitely "personal" in an individual proprietorship to "business" exists for the Subchapter S as well as the regular 1120 corporation. However, one potentially great tax advantage - that of shifting income between individuals and corporation - is lost when the 1120 S corporation is elected. It is the reluctance to give up this flexibility which causes many farm corporations to elect to file as regular 1120 corporations.

Permission to change from reporting as an 1120 S corporation to an 1120 corporation and back again is restricted. The election of 1120 S reporting must be made within one month of the beginning of the tax year to be effected. It must be in effect at least one year before permission will be granted to switch to reporting as an 1120 corporation. Permission would then not be granted to change again to an 1120 S corporation for five years.

Federal Income Tax Law Governing Both Corporations and Unincorporated Businesses Change Over Time

One of the imponderables in weighing the tax savings from incorporation is the certainty that tax law will not remain static. What currently is an advantage for the corporation might disappear in the next revision of the Federal Income Tax Law, and there could be several such revisions over the life of one farm business. For example, the important farm loss provision in the 1969 tax law to curb "Tax Dodge" farmers - people who enter farming expecting to use farm losses to offset nonfarm income - is much harsher on corporate farm taxpayers than on unincorporated farm taxpayers.

Although the relative tax treatment of corporate and unincorporated far businesses is sure to change, selection of the corporate organization now do not eliminate the possibility of dissolving the corporation at some future d

New York State Unincorporated Business Tax is a Consideration When Incorpora

When a New York farm business is incorporated, the effect is to exchang the New York State Unincorporated Business Tax for the New York Corporate Franchise Tax. This may result in a tax saving. This is best illustrated i is assumed that a very profitable unincorporated business is incorporated, then corporate taxable income is kept at or close to zero by drawing off income as salaries to family members. The result may be a small corporate tax in place of a sizeable unincorporated business tax.

Farm business partnerships are at a disadvantage under the unincorporated business tax. The unincorporated business tax provides an "allowance for taxpayer's services" of 20% of net income or $5,000, whichever is lower, and it allows an exemption of $5,000. A big farm business operated as a partnership to support three or more farm families must produce a significant amount of taxable income above these exemptions. Such a business gets no more exempt income under unincorporated business tax than a farm business owned and operated by one man. Thus a farm where two or more families are in partnership may gain by swapping the unincorporated business tax for the New York Corporate Franchise Tax. The calculation of the New York Corporate Franchise Tax is a complicated procedure. For planning purposes, it can be assumed that it will be $100 or 7% of corporate net income, whichever is higher.

Summary

The possibilities of saving income taxes by incorporating a farm business stem from these tax advantages:

- By forming a corporation, income may be shifted between individuals and the corporation to keep income in lower tax brackets.

- Some expenses which were previously nonbusiness may become business and deductable with a corporation.

- The corporation provides more opportunities for paying fringe benefits to employees which are nontaxable or on which taxation may be deferred.

- Tax saving may result from elimination of the New York State Unincorporated Business Tax.

In considering incorporation, these tax problems should be kept in mind:

- Taxation of capital gains is less favorable to a corporation than to an unincorporated business.

- Corporate earnings cannot be distributed to stockholders as dividends without double taxation of those earnings.

In weighing the tax advantages and disadvantages of a corporation, it should be recognized that a corporation offers nontax advantages as well as nontax disadvantages. The decision to incorporate should not be made solely on the basis of tax considerations.

The owner of any large and profitable farm business should examine the possibility of incorporating as a tax management measure. Substantial tax savings can be realized by a few good commercial farms.

This discussion of possible tax savings through incorporation of the farm business is very general. A farmer should obtain qualified professional assistance to determine how these points will affect his business and tax responsibilities.

FARM EMPLOYEES AND INCOME TAXES

Income Tax Withholding Not Required by Farm Employers

The law does not require farm employers to withhold federal income tax from wages paid to farm employees. Withholding was not permitted prior to 1970. The 1969 tax law permits withholding under voluntary agreements.

Increasing earnings levels by farm employees means that many have income tax to pay on April 15th, but few have the cash to meet their tax obligations. In many cases, farmers could provide a valuable service to their employees by withholding for income tax, and could at the same time avoid the necessity of helping the employee meet his tax problem through loans or advances, as is sometimes necessary.

Voluntary agreements for withholding must be in accordance with regulations established by Internal Revenue. The change to permit withholding is effective January 1, 1970 (Code Section 3402, G), but it will not be possible for farmers and their employees to enter into voluntary agreements for withholding until regulations are released by I. R. S.

Farm Employers Must Report Earnings

A farmer must report all amounts of $600 or more paid to any one employee. Form W-2 or Optional Form W-2 are used for reporting the amount paid. The federal form must be filed by January 31, and the state form by February 28.

Farm Employee Must File Returns

A hired man who meets the gross income test is required to file an income tax return. These must be filed by April 15. For federal income tax, a hired man may exclude from his gross income the value of any meals, lodging, or rental value of a house furnished to him by his employer for the convenience of the employer, but only if:

- The meals are furnished on the business premises of the employer and for the employer's convenience.
- Lodging or house rental where the employee is required to accept such lodging or housing on the business premises of the employer as a condition of his employment.

A farm employee is required to file a declaration of estimated income tax (Form 1040-ES) if his estimated tax is $40 or more. The tax may be paid in four equal installments which spreads the money needed for tax purposes throughout the year even though withholding is not permitted. Some employees have been penalized for not filing estimates.

Pay to Children

Farmers who pay their dependent children for work actually performed by them can save tax dollars by shifting income from themselves to their children. A child who earns $1725 or less in 1970 will not owe any federal or state income tax. If he is under 19 or a full time student, he may stil be a dependent if his parents provide more than half of his support. The wages paid to a child appear as a labor expense on the farmer's 1040 F.

RETIREMENT INCOME CREDIT AND FARMERS

Few farmers, even in older age brackets, think of themselves as retired. Consequently, it is likely that a significant number of farmers who are eligible do not take advantage of the retirement income credit when they file their income tax returns. Older farmers should be acquainted with this tax credit.

How is Credit Figured?

A summary of the rules will help to indicate the circumstances under which farmers can benefit from retirement income credit.

- To qualify, a taxpayer must meet the "prior earned income test," must have received over $600 of earned income in each of at least 10 prior calendar years.

- Fifteen percent of eligible retirement income is allowed as a credit directly against income tax due. The total allowed cannot be greater than the tax due.

- The maximum amount of retirement income eligible for the 15 percent credit is $1,524. Fifteen percent of $1,524 is $229, which represents the maximum reduction in income tax possible for a taxpayer.

- If both taxpayer and spouse are eligible and each has retirement income, each can claim the credit, even though filing a joint return. If both are 65 or over and file a joint return, they may use an optional calculation which grants $2,286 as maximum retirement income instead of the standard $1,524.

Eligible Retirement Income

- Eligible retirement income for taxpayers under 65 includes only pensions and annuities under public retirement systems. Eligible retirement income for taxpayers 65 and over includes all pensions and anuities, as well as interest, dividends, and gross rents.

- Eligible retirement income must be reduced by amounts received under Social Security and the Railroad Retirement Act regardless of age of taxpayer. Taxpayers 72 and over make no further reductions. Taxpayers 62 but under 72 must further reduce the eligible retirement income by a portion of earned income received over $1,200 (one-half of the amount between $1,200 and $1,700 and all of the rest). Taxpayers under 62 must further reduce eligible retirement income by all earned income received over $900.

- Earned income includes all wages, salaries, and professional fees received. For taxpayers engaged in a trade or business, such as farming, where both capital and the taxpayer's personal services are income producing factors, a reasonable amount (not over 30 percent) of net profit is considered earned income.

Who Will Likely Benefit?

Farmers most likely to benefit from the retirement income credit are those over 65 years of age in the following situations:

- Those who still own a farm but who have rented it to another operator.
- Those who have sold their farm and received significant sums in interest or dividends.
- Those who are still operating their farms, but who have slowed down to the point where net farm profits are low, and who receive significant sums in interest, dividends, or rents from other sources.

Few farmers receive income from retirement systems other than Social Security. For this reason, it is rare to find a farmer under age 65 who will benefit from the retirement income credit.

Farm wives who have worked off the farm often receive income from retirement systems. These should not be overlooked by the farm family when filing their tax returns.

Farmers over 65 who continue to operate large and profitable farm businesses are also unlikely to benefit because their income is derived largely from the farm itself, none of which qualifies for the credit and some of which will be classified as earned income and thus reduce or eliminate any eligible income from other sources.

Farmers 65 or over should have a general understanding of the retirement income credit provisions of the Federal Income Tax Law. Some will find that they have been failing to claim credit for which they are eligible. Others will be influenced in their plans to discontinue active farming or to change their farming activities.

When both spouses are 65 years of age or older and file a joint return, they should compute their Retirement Income Credit under the General Rule as well as under the Alternative Computation. They can then compare the results and choose the method which will result in the greater credit.

Retirement Income Credit

Example - Harry and Wilma Grant are both 66 years of age and file a joint return for 1970. Harry meets the 10 year prior earned income test but Wilma does not. Harry received in 1970 a taxable pension of $5,000 from his former employer, wages of $1,400 from part-time work, and a Social Security pension of $1,000. Wilma received Social Security benefits of $500 and wages of $1,300. The retirement income upon which the credit is based is determined as follows:

Total combined retirement income		$5,000
Maximum amount upon which the credit may be based		$2,286
Less:		
Harry's Social Security pension	$1,000	
Wilma's Social Security pension	500	
One-half of Harry's wages over $1,200 but not over $1,700	100	
One-half of Wilma's wages over $1,200 but not over $1,700	50	1,650
Retirement income upon which the credit is based		$ 636

Therefore, their joint retirement income credit for 1970 under the alternative computation is 15 percent of $636 or $95.40.

If the alternative computation were not elected, Harry's retirement income credit would be determined as follows:

Maximum amount upon which credit may be based		$1,524
Less:		
Harry's Social Security	$1,000	
One-half of Harry's wages over $1,200 but under $1,700	100	1,100
		$ 424

$424 x 15% = $63.60

Wilma would have no retirement income credit as she did not meet the 10 year prior earnings test. Therefore, by electing the special provision, the taxpayers will receive a tax saving of $31.80 ($95.40 minus $63.60).

Reporting Calculations

Calculations for the retirement income credit are made on form 1040R. (Page 2 of E & R)

RETIREMENT PLANS AND INCOME TAX MANAGEMENT

Starting in 1968, self-employed persons including farmers can shift part of their income to their retirement years by investing in qualified retirement programs. Liberalized provisions of the Self-Employed Individuals Tax Retirement Act of 1962 (Keough Act) make it possible and practical for farmers and other self-employed persons to set up a retirement program for themselves and their regular employees on a tax sheltered basis.

For a consistently profitable farm business, this kind of retirement planning can also be good tax management. A retirement plan can help to create a sound basis for income in later years for both the farmer and his regular employees. It can help to minimize income taxes by postponement of tax obligation to retirement years when total taxable income is likely to be less.

Contributions

Starting in 1968, owner-employees may contribute up to 10 percent of their earned income to a maximum of $2,500 to a qualified retirement plan. In 1967 and before, only half of these amounts were deductible.

All full-time employees with three or more years of consecutive service must be included in the retirement program. Employees with less than three years service may also be included. Deposits made by the owner-employee for his employee are tax deductible for the owner-employee but are not taxable to the employee until he gets the distribution during his retirement.

Owner-employees decide each year if they wish to contribute to the fund. They need not contribute each year. However, if the plan includes employees, the contribution must be made for them as required by the plan.

The owner-employee may deduct his contributions and those made on behalf of his employees and still itemize nonbusiness deductions, take the standard deduction, or the minimum standard deduction. Contributions for farm employees are entered as a farm expense on 1040F. Contributions for the self-employed farmer are shown on Form 2950 SE, and on page 2, 1040.

Initiating a Plan

Self-employed retirement plans are available from many life insurance brokers, from commercial banks, and from investment houses. It is suggested that a farmer who is considering investment in a retirement plan investigate at least two alternative sources before making a decision. He should also consult his tax advisor, as the retirement plan should be part of his overall strategy to minimize taxes. Retirement plans and other tax management fringe benefits are more flexible for corporate employees than for self-employed businessmen. Owners of the larger and more profitable farm businesses should investigate the possible tax advantages of incorporation before adopting a self-employed retirement plan.

Investment Alternatives

The funds may be held or invested in several ways. Many investment companies, banks, trust companies, and insurance companies have plans for investment of these retirement funds which are designed especially to meet the requirements of the Self-Employed Individuals Tax Retirement Act. These include:

a) Purchase of nontransferable annuity or endowment contracts

b) Purchase of special U.S. Retirement Bonds

c) Purchase of "face amount investment certificates" either nontransferable or held by a trust

d) Purchase of mutual fund or investment stock shares to be held by a bank as custodian

e) Contributions to a trust or custodial bank account

All qualified plans prohibit the payment of any benefits prior to age $59\frac{1}{2}$ years except in the case of death or disability. Distribution must have commenced by age $70\frac{1}{2}$ for owner-employees and for other employees at age $70\frac{1}{2}$ or at retirement, whichever is later.

A farmer can set up his own retirement system if he obtains approval from the Internal Revenue Service. However, in most cases, it is more practical to choose one of the plans provided by a well-established firm in the area.

It is possible to discontinue a retirement plan, but there are costs to the farmer if he drops the plan. For this reason, a farmer should give this question careful consideration before deciding to go into a plan.

A farmer who decides that he may be interested in entering into a self-employed retirement plan should seek competent counsel. Attorneys, bankers, tax consultants, investment counselors, and insurance representatives can be helpful in choosing a suitable plan which will satisfy requirements of the Internal Revenue Service.

SOCIAL SECURITY

Earnings Base

The maximum amount of earnings that can count for social security and on which you pay social security contributions was increased to $7,800 on January 1, 1968. This will continue through 1970 unless a new law is passed by Congress.

Table 4. SOCIAL SECURITY CONTRIBUTION RATES

	Rate for Employees and Employers			Rate for Self-Employed People		
	Percent of covered earnings			Percent of covered earnings		
Year	OASI*	Hospital insurance	Total	OASI*	Hospital insurance	Total
1969-70	4.2	.6	4.8	6.3	.6	6.9
1971-72	4.6	.6	5.2	6.9	.6	7.5
1973-75	5.0	.65	5.65	7.0	.65	7.65
1976-79	5.0	.7	5.7	7.0	.7	7.7
1980-86	5.0	.8	5.8	7.0	.8	7.8
1987 & after	5.0	.9	5.9	7.0	.9	7.9

* Federal Old-Age and Survivors Insurance Trust Fund and the Federal Disability Insurance Trust Fund

Farmer's Optional Method

Farm operators are the only self-employed group covered by social security that have the privilege of an optional method of reporting earnings for social security. If a farmer's gross farm income is over $2,400 but his net earnings are less than $1,600, he may choose to pay the social security tax either on his actual net earnings or on $1,600. If his gross income from farming is not more than $2,400, he may elect to pay social security tax on 2/3 of his gross income. This option has the effect of providing minimum covered earnings of $1,600 per year for any farmer who has a gross income of $2,400 or more.

Because retirement, survivor and other benefits are computed on the basis of average earnings, farmers will almost always benefit by using the optional method in years of low earnings.

Managing Self-Employment Income to Maximize Social Security Benefits

The importance of managing income to maximize social security benefits can be illustrated with the following case.

In this example, husband and wife reach age 65 in 1970. They have not taken advantage of the option in years of low income. A record of actual earnings reported as compared with what could have been reported under the optional method and with maximum covered earnings follows:

Table 5. Income Used as Basis for Social Security Benefits

Year	Actual	Optional	Maximum
1951 - 1954 - Farmers not eligible			
1955	$ 1,000	$ 1,600	$ 4,200
1956	(0)	(1,600) drop	(4,200) drop
1957	1,500	1,600	4,200
1958	0	1,600	4,200
1959	0	1,600	4,800
1960	2,100	2,100	4,800
1961	3,000	3,000	4,800
1962	3,500	3,500	4,800
1963	800	1,600	4,800
1964	4,000	4,000	4,800
1965	4,800	4,800	4,800
1966	5,000	5,000	6,600
1967	6,000	6,000	6,600
1968	7,200	7,200	7,800
1969	1,100	1,600	7,800
Total 14 years	$40,000	$45,200	$75,000

In estimating benefits, the steps are as follows:

1. Determine years to be figured in average earnings. In this case, the wage earner was born before 1930, so he counts each year starting with 1956 until but not including the year in which he reaches age 65 - answer 14 years. A wage earner born after 1929 starts with the year he reaches age 27.
2. List earnings beginning in 1951, as above.
3. Eliminate the years of lowest earnings until the remaining years equals the answer to step one. Farmers must eliminate 51-54 because they were not then eligible.
4. Figure the average on the remaining years. Following these steps we can show estimated benefits for the example, comparing actual earnings with optional earnings and maximum earnings are:

Situation	Average Yearly Earnings	Monthly Benefit Age 65 Husband & Wife	Widow (only)
Actual Earnings Reported	$2,857	$193	$106
Optional	3,229	207	114
Maximum	5,357	285	157

Use of the optional method would have increased the retirement benefits for husband and wife by about $14 per month. If this farmer could have managed income so as to have reported maximum earnings for the 14 years, retirement income would have been increased about $92 monthly.

It would require about $1,605 to purchase a $10/month jointly survivor annuity for a man and woman, both age 65.

FEDERAL INCOME TAX
SUGGESTIONS FOR PART-TIME FARMERS AND COUNTRY DWELLERS

People who work in town and live in the country sometimes derive income from their rural holdings. This income may be in the form of land or barn rent from a neighboring farmer, in the form of Government payments, from the sale of farm products, or other farm income. The manner in which such income and associated expenses should be reported to Internal Revenue depends on the kind and amounts involved. The following questions and answers may help to clarify the Federal income tax responsibilities of nonfarmers who have some farm income.

1. Who is a farmer? For tax purposes, if you receive at least two-thirds of your gross income from "farming" you are a farmer. Farmers use Federal Form 1040, Schedule F, to calculate their net earnings for tax purposes. Farmers must pay their tax by March 1st.

2. What is hobby farming? If a farm is operated for recreation or pleasure, and the expenses are in excess of receipts, the expenses are regarded as nondeductible personal expenses, and the receipts may be omitted from gross income. If receipts exceed expenses, however, the excess must always be included in income. If the taxpayer can show that he is attempting to show a profit, his farm operations will generally not be classified as a hobby farm. Generally, if the activity shows a profit in two years out of five, I. R. S. will not consider it a hobby (see page 9).

3. How do nonfarmers report income from farming? Any nonfarmer may use Federal Form 1040, Schedule F to report income and expenses related to farming, regardless of the amount. However, small amounts of both income and expense can be reported on 1040E as "other income." It is suggested (this is only a rule of thumb) that if farm income is from more than one source or exceeds $500, a farm Schedule 1040F be completed and filed with the Federal return Form 1040.

4. What about quarterly estimates? Farmers are not required to file quarterly estimates because they file their returns by March 1st instead of April 15. If your major source of income is wages or salary subject to withholding, but you receive some income in addition from farming, or other sources, you probably should file quarterly estimates. Generally, all taxpayers who receive enough outside income to require payment of $40 or more in tax in addition to tax withheld, must file the quarterly estimates.

5. Can a part-time farmer take depreciation? If you can show that you are attempting to make a profit on your farming, you can offset inco with all appropriate expenses, including depreciation. For example, if you are renting out your barn, you can take depreciation on your investment in the barn. If you are renting land, you can depreciate your investment in tile drains and fences. You cannot depreciate land.

6. What about income from wood, timber, or Christmas trees? Small amounts of income from these sources may be reported on the farm Schedule 1040F. You are allowed to recover your original investment in trees as a depletion allowance on Schedule F. For larger amounts of income from sale of wood, timber, and Christmas trees, it may be possible to use Schedule D and receive gains treatment on at least a portion of such income.

7. Can a part-time farmer earn Social Security benefits from farm income? If you had net earnings of $400 or more from farming and less than $7,800 in wages, you must pay Social Security tax on the farm earnings. If you had less than $400 net from farming, but at least $600 gross income from farming, you may get Social Security credit from farm income if you want. Use Form 1040SE to calculate and pay the self-employment tax.

8. Where should income from rural recreation facilities be reported? A farmer or a nonfarmer with minor income from renting campsites, boats, etc., may report this income on page 2, 1040 as "other income." If such income is substantial, Schedule C, Form 1040, should be filed and the recreation facilities thus reported as a separate business.

9. What Federal tax schedules should be used to report income to part-time farmers and country dwellers? The following table lists common items of income to part-time farmers, and forms which may be used to report this income.

Source	Form to Use
Rent of land or buildings	Schedule E, Form 1040
Rent of house	Schedule E
Interest and dividends	Schedule B, Form 1040
Sale of wood, lumber or Christmas trees	Schedule F, Form 1040, for small amounts. Schedule D for larger amounts.
Sale of fruit, berries, garden produce	Schedule F
Sale of honey or maple products	Schedule F
Sale of standing hay	Schedule F
Tractor or machine work for neighbors	Schedule F
Sale of eggs and chickens	Schedule F
Sale of livestock held for sale	Schedule F
Income from Government farm programs	Schedule F
Soil and gravel sales	Schedule F
Nursery stock, flowers and plants	Schedule F
Sale of livestock held for dairy or breeding purposes	Schedule D, Form 1040
Sale of house lot or other land	Schedule D, Form 1040
Wages from occasional farm work	Form 1040

Small amounts of income from almost any source may be reported on page 2, Form 1040. For a business other than a farm, use Schedule C, Form 1040. Income from all sources must be combined on Form 1040 to calculate the tax due.

INCOME TAX REPORTING FOR CHRISTMAS TREE GROWERS

The correct method of reporting receipts and expenses from a Christma tree business depends, in part, on the classification of the taxpayer.

Farmers--should use Federal Schedule F (Form 1040) for reporting ann expenses and ordinary income, and Schedule D (Form 1040) for calculating capital gain.

Nonfarmers--should use Schedule C (Form 1040) for reporting expenses and income, and Schedule D (Form 1040) for calculating capital gain; or, if the operation is small, report net income as "Miscellaneous income" on line 39, page 2 of Form 1040 with a full explanation attached.

It is especially important in keeping records for income tax reporti on a Christmas tree business to recognize that different types of expendi tures are handled in different ways and that in some cases the taxpayer has a choice.

Capital costs may be recovered as (1) depreciation, as (2) depletion or as (3) adjusted cost or basis, depending on what the cost was for, how the property was sold, and other circumstances.

So called current expenses are recoverable as (1) operating expenses or as (2) depletion. The method of recovery depends on what the expense was for and whether or not the operation is producing income.

Depreciation normally must be claimed each year or it is lost. Howe if the operation is not yet producing income, depreciation may be capital and recovered as depletion or as adjusted cost or basis when trees are so

Depletion differs from depreciation in that depletion can only be re covered as trees are cut or in the year that the taxpayer "Elects to Trea the Cutting as a Sale."

Adjusted cost or basis in trees is recovered as such when trees are sold standing. Adjusted cost or basis in land or nondepreciable improven is recovered when the land is sold.

Harvesting Christmas Trees Over Six Years Old

Christmas trees which are more than six years old when cut are considered the same as wood and timber for tax purposes. In this case, wher grower cuts trees from his own plantation and sells them, he may treat ir come as two separate deals. Here is an example where trees were raised, bundled, and sold at the roadside by a farmer:

Value of 1,000 trees, on stump	$800	
Capitalized costs of trees and planting	100	
Capital gain on growing operations	$700	
Proceeds from sale of trees at roadside		$1,100
Less fair market value of trees on stump	$800	
Less expenses for cutting, bundling and hauling	200	
		$1,000
Ordinary income from harvesting		$ 100

Table 6.

The table following lists various costs that might be incurred by a Christmas tree grower, and tells how they should be classified and how recovered:*

Cost Item	How Classify	How Recover Cost
Land	No choice--capitalize	Recover cost as "adjusted cost or basis" when land is sold.
Standing Trees	No choice--capitalize	Recover cost as "adjusted cost or basis" or as "depletion" when trees are sold.
Establishing Stand trees, planting basal pruning stump culture shearing	No choice--capitalize	Recover costs as "adjusted cost or basis" or as "depletion" when trees are sold.
Land Improvements road building or grading ditching fire breaks constructing tanks, reservoirs or dams	No choice--capitalize	If improvement has determinable useful life: Recover cost annually as "depreciation" unless property not yet producing income, in which case add depreciation year by year to cost of trees and recover as "adjusted cost or basis" or as "depletion" when trees are sold. If improvement has no determinable useful life: Add to cost basis of land and recover as "adjusted cost or basis" of land when sold.
Depreciable Assets tractors and equip., fences culverts bridges buildings	No choice--capitalize	Recover cost as "annual depreciation" unless property not yet producing income, in which case add depreciation year by year to cost of trees and recover as "adjusted cost or basis" or as "depletion" when trees are sold.
Carrying Charges property taxes interest payments protection costs other true carrying charges	Income Producing Property No choice--current expense Nonincome Producing Property Choice--current expense or capitalize; election made each year.	Recover cost annually as current expense Generally best to recover these costs as "current expense" if taxpayer has taxable income from some source to offset. Otherwise "capitalize" these costs and recover them as "adjusted basis" or as "depletion" when trees are sold.
Operating Expenses hired labor, equip. expenses maintenance of firebreaks, weeding cleaning, noncommercial thinning and other necessary maintenance expense items	Income Producing Property No choice--current expense Nonincome Producing Property Choice--current expense or capitalize; must follow consistent practice.	Recover cost annually as current expenses. Same as carrying charges with this exception. Once taxpayer elects to capitalize these costs he should continue to do so each year until property produces income.

* From Income Tax Reporting For Christmas Tree Growers, V. R. Houghaboom, University of Vermont, Burlington.

NEW YORK STATE INVESTMENT CREDIT

The 1969 session of the New York State Legislature passed an amendment to the State Tax Law, which provides for an investment credit for state tax purposes.

Qualified Investments

The credit is allowed for investments in tangible personal and other tangible property, including buildings and structural components of buildings, which are depreciable, have a useful life of four years or more, are acquired by purchase, have a situs in this state, and are principally used by the taxpayer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture, or commercial fishing.

A credit is not allowed for such property which the taxpayer leases to any other person or corporation.

Livestock purchases for dairy or breeding purposes having an expected useful life of four years or more falls within the definition of qualified investments.

Calculation and Use of the Credit

The amount of the credit is one percent (1%) of the cost or other basis for federal income tax purposes of the qualified investment. Form IT212 is used to calculate the credit.

The investment credit can be used by owners of unincorporated businesses to reduce the state personal income tax and the unincorporated business tax. It can be used by corporate businesses to reduce the franchise tax. If the amount of the credit allowable exceeds the taxpayer's tax for such year, the excess may be carried over and deducted from the taxpayer's tax of the following year or years.

Recapture of Credit

If property on which the state investment credit has been taken is disposed of "prior to the end of its useful life", part of the credit taken must be added back to the tax in the year of disposition. For this purpose, "useful life" is the life chosen for depreciation on the federal income tax return.

The amount of credit allowed for actual use is determined by multiplying the original credit by the ratio which the months of qualified use bear to months of actual use. For example, if the useful life chosen was 10 years (120 months) and the article was disposed of after five years (60 months) and the original credit was \$100 (1% x \$10,000). Then the credit allowed is $\$100 \times \frac{60}{120} = \$50$. In this case, \$50 must be added to the tax in the year of disposition.

It would appear that this recapture rule encourages the taxpayer to choose a useful life of four years or more but otherwise as short as will be acceptable in order to obtain credit but avoid recapture on as much property as possible.

Meaning of Disposition

Disposition includes sale of the property, gift of the property, contribution to a partnership or a corporation unless a substantial interest in the business is retained by the transfer or, sale by a partner of his interest in the business, conversion of the property to personal use or to nonqualified use, or moving the property to a location outside the state.

FARM TAX TIPS

1. Note the changes made in the tax forms for 1970. Form 1040 is once again two pages. Many farmers will be using the new combined Schedules A and B. Some farmers will use the new combined Schedule E and R.

2. Form 4255 should be used for computing the "Recapture Tax" from a prior year's investment credit.

3. Form 1040-X, which was new in 1968, may be used to correct an individual income tax return for any year.

4. The tax surcharge was dropped effective June 30, 1970. It was at a five percent rate for the first six months of 1970, so the effective annual rate for 1970 is two and one-half percent.

5. Net operating losses may be carried back three years and then ahead five years to offset income. This opportunity is especially important to crop farmers who may have had a losing year in 1970.

6. Operators of profitable farm businesses should investigate possible advantages of setting up a qualified retirement pension plan for themselves and their regular employees.

7. Some older farmers can reduce their income tax by using retirement income credit as computed on Schedule E & R (Form 1040).

8. Gasoline tax credit used to reduce income tax must also be reported as income. Such credit used by a cash basis taxpayer to reduce 1970 tax becomes income in 1971. Be sure to enter your 1969 credit on your 1970 return.

9. A farmer may deduct as a labor expense, reasonable cash wages paid his child for work actually performed by him. For 1970, each child may earn as much as $1725 without incurring a federal income tax liability.

10. Most farm business record books and electronic farm business accounting systems provide an acceptable classification of farm expenses for use in Part II of Schedule F. Under "Other (specify)" write in classes of expenses used in your records but not listed in Part II.

11. Many expenses are part personal and part business. These must be allocated for income tax purposes. Common examples of such expenses are real estate taxes, fire insurance, electricity, telephone, auto expenses, gas and oil, and travel expenses.

12. In computing net earnings from self-employment, you must claim all allowable deductions including depreciation.

13. Most farmers in years of low earnings will benefit by electing the <u>optional method</u> provided in Part II of Schedule SE for computation of net earnings from farm self-employment. This provides a better base for Social Security benefits upon retirement or in case of death.

14. New York State income tax, and except in the case of a partnership, the state unincorporated business tax, are not deductible on federal Schedule F as business expenses.

15. Depreciation allowances are lost if not taken in the year they are allowable. The special 20 percent first year depreciation is available only the first year depreciation is allowable.

16. Tax management should be aimed first at using all allowable exemptions and deductions each year.

17. Partnerships must use Form 1065 and Schedule D (Form 1065). Schedule F (Form 1040) is used to report farm partnership income and expenses. Only one Schedule F need be filed.

18. Money items on tax returns may be shown in whole dollars. To do this, eliminate amounts of less than 50 cents and increase amounts of 50 cents through 99 cents to the next highest dollar.

19. Agricultural employers must withhold Social Security tax from the wages of any employee who during the year earns $150 or more or who works 20 days or more for cash wages (except some family employees).

20. Farmers who employ help can save time in preparing reports by using optional Form W-2 for reporting wages paid farm employees.

21. Complete farm business records are essential for good income tax reporting. Incomplete records frequently result in paying more tax than is actually due.

22. The sale of a farm and other business assets frequently involves important tax considerations. A farmer needs competent professional advice in making arrangements for such a sale.

23. Investment credit is now available for New York State Income and Unincorporated Business Taxes. Do not overlook this tax credit.

24. If both husband and wife have incomes, it is usually advantageous to file separate state income tax returns even though a joint return is used for the federal tax.

25. The new depreciation rules on real estate limit depreciation on a new barn or silo to either straight line or 150 percent declining balance.

26. Farmers with unusually good incomes for 1969 may find tax averaging to their advantage. New averaging rules will be especially helpful to dairy farmers and others who regularly receive capital gains income.

27. Cattle acquired after December 31, 1969, and held for dairy, breeding, or draft purposes must be held two years to receive capital gain treatment on disposition.

28. Be sure to make a final check of all tax returns. Errors in arithmetic, missing Social Security numbers, and missing signatures are common errors.