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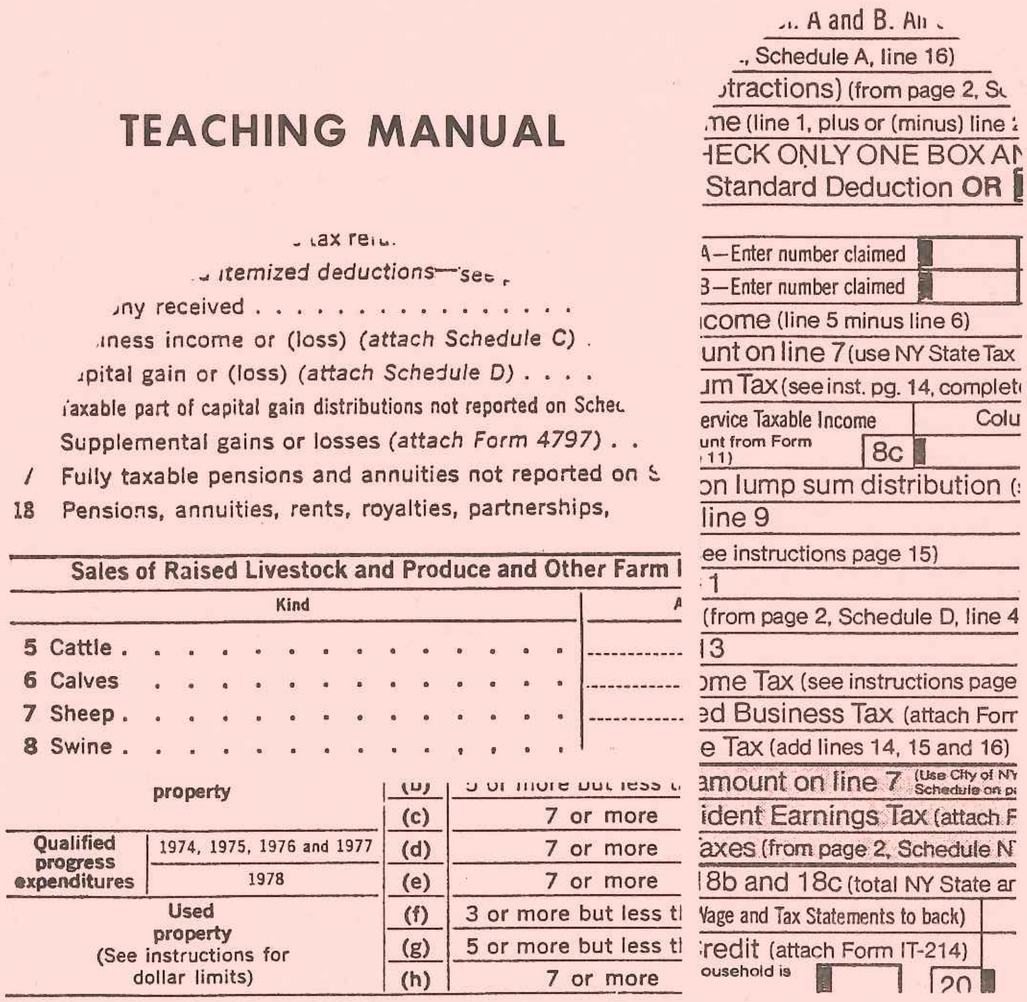
FARM INCOME TAX MANAGEMENT AND TAX REPORTING

TEACHING MANUAL



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FARMER'S TAX CALENDAR FOR 1980

New York State farm taxpayers filing on the calendar year basis must be aware of the following dates:*

January 15 - Deadline for filing 1040-ES, Estimated Tax Declaration, and for paying the estimated tax, if the farmer elects this option. Farmers may also elect to file an estimate of New York State income tax on or before January 15th.

January 31 - Deadline for farm employers to file Form 943, Employer's Annual Tax Return for Agricultural Employees and pay or deposit the taxes due. Farm employers must file 943 if they had at least one employee that met the "$150 a year" or "20 days a year" test. If the tax was deposited by using Form 511 prior to January 31, Form 943 is due on February 11.

Deadline for farm employers to give Copies B and C of Form W-2 to each employee that had FICA and/or federal income Taxes withheld, or was paid $600 or more.

February 11 - Deadline for employers who made timely deposits of withheld taxes to file 943.

February 29 - Deadline for farm employers to file Copy A of each Form W-2, along with transmittal Form W-3 to the Social Security Administration. Deadline for filing New York State Form IT-2102 (or state copy of optional W-2) and Reconciliation Form IT-2103 if at least one individual was paid $600 or more. New York State Form IT-2102.1 and IT-2102.4 must also be filed by this date.

Deadline for filing the federal Form 1099-INT and 1099-MISC with Form 1096.

March 3 - Deadline for individual farmers to file their federal and state income tax returns unless they elected to file an estimate on January 15.

March 17 - Calendar year corporations must file Form 1120 and deposit at least 50 percent of tax due or apply for an extension using Form 7004. Payment is made to a federal depository using Form 503. New York State Form CT-3 or CT-4 are also due.

April 15 - Deadline for filing final federal and state income tax returns for farmers who filed estimates by January 15. Individuals not qualifying as farmers must file federal and state returns or apply for a two month extension.

Deadline for filing Form 1065, U.S. Partnership Return.

August 1 - Employers who have adopted HR-10 pension plans and are on the calendar year file Forms 5500, 5500-C, 5500-K, plus required attachments, as applicable.

Month End Check - Any employer withholding FICA and federal income taxes must watch the accumulated balance of withholdings and employer's contributions to all employees. If the accmulated balance is more than $2,000 at the end of any quarter-month, it must be deposited within three banking days. Deposits are made with Form 511. If the accumulated month end balance is $200 or more it must be deposited at an authorized bank by the 15th of the following month.

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* When a tax filing deadline falls on a Saturday, Sunday or legal holiday, the deadline is extended to the next business day.

1979 TAX FORMS NEEDED BY NEW YORK FARMERS

Here is a list of the most important 1979 income tax forms needed by farmers and an indication of those that have changed.

Federal Forms

1040 - U.S. Individual Income Tax Return, some improvements in readability, some changes, notably lines 20b, 29, 49b, and 53.

Schedule A & B - Itemized Deductions and Dividend and Interest Income. No significant changes. Interest or dividend income exceeding $400 is entered on B.

Schedule D - Capital Gains and Losses. Major changes.

Schedule E - Supplemental Income Schedule, change in the format.

Schedule F - Farm Income and Expenses, the additions of line 59 (for cash) and line 92 (for accrual) for "at risk" rules.

Schedule G - Income Averaging.

Schedule R and RP - Tax Credit for Elderly.

Schedule SE - Computation of Social Security Self-Employment Tax. Attach to both C and F. Earnings base is increased.

Schedule TC - Tax Computation Schedule.

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

1045 - Application for Tentative Refund. For carry back of net operating loss, unused investment credit and unused jobs credit for three years.

943 - Employer's Annual Tax Return for Agricultural Employees.

1099-INT, 1099-MISC and 1096 - Information Returns and Transmittal Form. Farmers paying at least one individual $600 or more in interest use 1099-INT. Report rent on 1099-MISC.

1065 - U.S. Partnership Return of Income.

W-2 - Wage and Tax Statement and Transmittal of Income and Tax Statement (W-3).

3468 - Computation of Investment Credit, business energy property (Schedule B, 3468).

4136 - Computation of Credit for Fed. Tax on Gasoline, Spec. Fuels & Lub. Oil.

4255 - Investment Credit Recapture (undated).

6251 - Alternative Minimum Tax Computation.

4797 - Supplemental Schedule of Gains and Losses.

5695 - Residential Energy Credit.

5884 - Computation of targeted Jobs Tax Credit.

New York State Income State Forms

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

IT-201-Att - attachment for computing tax credits.

IT-204 - Partnership Return (income and unincorporated business tax).

IT-212 - Investment Credit Schedule.

IT-220 - Minimum Income Tax Computation Schedule.

IT-2102 & IT-2103 - Wage and Tax Statement, and reconcilation form.

1979 FARM TAX AND INCOME SITUATION

Although it now appears that there will be no major new federal income tax legislation passed before 1980, much of the 1978 legislation became effective for the first time in 1979. These as well as other important tax provisions affecting farmers and other taxpayers are reviewed in this manual.

Highlights of Tax Changes for 1979

- Personal exemption is $1,000
- Zero bracket amount is $3,400 for joint return, $2,300 for single taxpayers
- Personal tax rates are lower and the brackets are wider
- The general tax credit is out
- Alternative Minimum Tax is in
- Earned income credit has increased
- Job credit programs have changed

Review of New Tax Proposals

Several new tax bills have been introduced in Congress. All have an uncertain future. The provisions that are expected to pass during the 1979 session include:

1) Repeal of carryover basis rule affecting inherited property

2) Windfall profits tax

Proposals that would institute major changes in current taxation policy are the Capital Cost Recovery Act of 1979 and the Tax Restructuring Act of 1979. The first would liberalize and simplify depreciation rules, the second would reduce current tax rates and raise additional revenue with a value added tax. These and other proposals are discussed later.

Farm Income Situation

New York dairy farm incomes have increased substantially in 1979. A study of dairy farms enrolled in the Cornell Agricultural Management Information System shows average net operating income up 39 percent, through the first nine months of 1979 compared with the same period of 1978. Income from the sale of dairy cattle is running about 40 percent higher than in 1978. Larger depreciation deductions and investment credits associated with higher farm equipment and facility costs will help reduce taxes on some farms. Time spent on year-end tax management will benefit many farmers.

The 1979 income picture on New York fruit and vegetable farms is variable. Most grape producers are not having a banner year. Apple prices are also down. Cash grain producers realized higher prices but potato growers have had a disasterous harvest.

REVIEW OF IMPORTANT TAX CHANGES

Many new and important tax provisions were included in The Revenue Act of 1978 and earlier legislation. Some of the newer provisions will affect taxpayers for the first time when 1979 returns are filed. Other important provisions carried over from 1977 and 1976 legislation are still worthy of review. Most of the major changes affecting farmers are covered in more detail in other parts of this manual.

Individual Exemptions, Deductions and Tax Rate Changes

Each personal exemption, including those additional exemptions for age and blindness, are $1,000 for 1979.

The zero bracket amount (standard deduction) is $3,400 for joint return taxpayers, $2,300 for single taxpayers and $1,700 for married taxpayers filing separate returns.

Taxpayers can still benefit from itemizing deductions if qualified itemized deductions exceed the zero bracket amount. Gasoline taxes and expenses for yachts, hunting lodges and fishing camps no longer qualify.

The increases in personal exemptions and ZBA transform into the following 1979 filing requirements:

Married couple, joint return	$5,400
Married, joint return, one spouse 65	6,400
Married, joint return, both 65	7,400
Married couple, separate return	1,000
Surviving spouse	4,400
Single taxpayer, (including head of household)	3,300
Single taxpayer, age 65	4,300

Most farmers must continue to file to report self employment income if their farm income (Schedule F) is greater than $400.

The adjustments in the 1979 tax rates will save most taxpayers more taxes than the increase in exemptions and deductions. The 1979 tax brackets are wider and more income is taxed at lower rates than before. Married couples filing 1979 joint returns will save approximately $300 if taxable income is $20,000, and more than $500 if taxable income is $35,000. Joint return filers with $50,000 of taxable income stand to save $700 from the lower 1979 rates.

Capital Gains and Losses for Individuals

The amount of capital gains excluded from an individual taxpayer's ordinary income is 60 percent on transactions occurring after October 1978. All 1979 sales of farm business property and capital assets meeting holding period requirements, qualify for the 60 percent capital gains deduction. Installment payments received after October 31, 1978 also qualify even though the sale producing the payments may have occurred before that date.

The holding period necessary to qualify for long term capital gain treatment on 1979 sales of assets such as the personal auto, stock and bonds, household goods, real estate and farm machinery, continues to be one year. It was six months in 1976, and nine months for assets sold in 1977. There is no change in the required holding period for livestock. The holding period for commodity futures contracts purchased as an investment remains at six months.

The limit on the amount of net capital losses that can be deducted against ordinary income continues at $3,000 for 1979. Only 50 percent of net long term capital losses in excess of net short term capital gains may be deducted from ordinary income.

Alternative Minimum Tax

The 60 percent capital gains deduction is one of the two tax preference income items subject to the new alternative minimum tax. A complete explanation of Alternative Minimum Tax is included in this manual.

Sale of Residence

The one-time exclusion of gain from the sale of a principal residence by a taxpayer 55 or over is $100,000 ($50,000 if married filing separately) for sales occurring after July 26, 1978. To qualify, the taxpayer must have owned and lived in the home (principal residence) for three out of the last five years. The new election replaces the old $35,000 of sales exemption for taxpayers 65 or older. But, a taxpayer 65 or older may use the old five out of eight year rule to qualify for sales occurring before July 26, 1981.

The sale of a jointly owned residence will qualify for the $100,000 one-time exclusion if at least one spouse is age 55 or over at the time of sale, and a joint return is filed.

Other home sellers may now rollover gains more often than 18 months if the sale resulted from an employment related move. Self-employed qualify if they move to a new principal place of work.

Maximum Tax on Personal Service Income

The 50 percent maximum tax on personal service income continues for 1979, but a change in what constitutes personal service income could be important for some farmers. Personal service taxable income includes wages, salary, professional fees, and net earnings from the sale or property. Prior to 1979 personal service income from farming and other businesses, where capital was a material income producing factor, could not exceed 30 percent of the net business profits.

Starting in 1979 the 30 percent limitation is gone but income qualifying for the maximum tax benefits is still limited to reasonable compensation for services actually rendered. Capital gains deductions on sales after October 1978, no longer reduce personal service income eligible for the maximum tax. Other tax preference items continue to reduce personal service income.

Earned Income Credit

The earned income credit has been increased and made permanent. For tax years beginning after 1978 the credit is 10 percent of the first $5,000 of earned income and is reduced as earned income or adjusted gross income (whichever is larger) rises above $6,000. The reduction is 12.5 percent of the amount which earned income or AGI exceeds $6,000. Taxpayers with $5,000 of earned income and not more than $6,000 of earned or Adjusted Gross Income will earn $500 of credit. Taxpayers with incomes exceeding $6,000 will lose $125 of credit for each $1,000 above $6,000.

To qualify for earned income credit a taxpayer must maintain a household and have at least one qualifying child. A qualifying child is any child under 19, a student, or a disabled son or daughter that earns less than $1,000 in that year. A foster child living with the taxpayer for the entire year qualifies.

Married taxpayers must file a joint return to be entitled to the credit. It is not allowed for taxable years that represent less than 12 full months.

Earned income credit is refundable to the extent that it exceeds total tax liability on Form 1040. Taxpayers who have gross incomes below the minimum filing requirements should be advised to file for the earned income credit.

Investment Tax Credit

Single purpose livestock and horticultural structures as well as certain rehabilitated buildings now qualify for investment credit. The 1978 law also made the 10 percent investment credit rate and the $100,000 limit on used property permanent. The maximum amount of credit that may be used for 1979 is $25,000 plus 60 percent of the excess. These changes as well as other important aspects of investment credit are reviewed in this manual.

Targeted Jobs Tax Credit

The Targeted Job Tax Credit replaces the old jobs tax credit for wages paid in 1979 and later years. The targeted jobs credit is much more restrictive in that fewer employees qualify but the potential amount of credit is greater. More on the targeted jobs tax credit is included in this manual.

Work Incentive (WIN) Program Credit

Starting in 1979, the WIN credit is 50 percent of the first $6,000 of first-year WIN program expenses plus 25 percent of the first $6,000 of second-year WIN program expenses for each eligible employee.

An eligible employee is one certified by the appropriate federal, state or local agency, employed for more than 30 consecutive days on full-time work, has not displaced any other employee of the taxpayer, and is not a migrant worker. The employer's deduction for wages paid is affected by the amount of the WIN credit claimed.

Child and Dependent Care Tax Credit

The child and dependent care tax credit is now available on wages paid to a relative regardless of whether the qualifying relatives services constitute employment for social security purposes.

The credit continues to be 20 percent of the employment related child care expenses not exceeding $2,000 ($400 of credit) for the care of one individual or $4,000 ($800 of credit) for two or more individuals. The amount on which the credit is based may not exceed the taxpayer's earned income, which in the case of a married couple, is the earned income of the spouse with the smallest income. There is no refund for credits in excess of tax. Except for care of dependents under 15 years, the expenses have to be incurred in the taxpayer's home.

Tax Credit for the Elderly

Many senior taxpayers including farmers age 65 and over could be eligible for this tax credit. The rules that apply to farmers are unchanged since 1976. The tax credit is 15 percent of a base called the "section 37 amount". This base amount starts at $3,750 for married taxpayers filing jointly, both over 65, and is reduced by social security benefits and by 50 percent of earnings exceeding $10,000.

Corporate Tax Rates Reduced

There are two new tax brackets and lower rates for corporations in 1979. Taxable income from $50,000 to $75,000 will be taxed at 30 percent, taxable income from $75,000 to $100,000 will be taxed at 40 percent, and taxable income over $100,000 will be taxed at 46 percent. Formerly all income over $50,000 was taxed at 48 percent. In 1979 the first $25,000 of taxable income will be taxed at 17 percent rather than 20 and the second $25,000 will be taxed at 20 percent rather than 22.

Fiscal year corporations with tax years beginning in 1978 and ending in 1979 must prorate their tax computations using both old and new rates and the percentage of days in each year.

New 1979 corporate tax rates at a glance:

Taxable Income	Tax Rate	Maximum Tax Per Bracket
$1 to 25,000	17%	$ 4,250
$25,001 to 50,000	20%	5,000
$50,001 to 75,000	30%	7,500
$75,001 to 100,000	40%	10,000
$100,001 and over	46%	460/thou.

A corporation with $50,000 of 1979 taxable income will be subject to a tax of $9,250 (before credits), $1,250 less than the tax on $50,000 in 1978.

Corporate Capital Gains

The alternative capital gains tax has been reduced to 28 percent from 30 percent, effective in 1979. Corporate gains are still subject to the 15 percent minimum tax, but not the new alternative minimum tax.

Accrual Accounting Rules Relaxed

The postponement of accrual accounting requirements that were to apply to all corporations making over $1 million was made permanent in the Revenue Act of 1978.

Accrual accounting will not be required for farm corporations if: a) members of two families or less have owned at least 65 percent of stock and shares or b) members of three families have owned at least 50 percent, and c) remaining stock is owned by employees, their families or by a trust set up to benefit same. The rule applies to tax years beginning after December 31, 1977.

Farmers, Nurserymen and Florists currently on Accrual Accounting that are not required to capitalize preproduction period expenses, have two new accounting options. They:

1) may not be required to inventory growing crops, or
2) may change to the cash method for any business in which growing crops is the principal activity without permission. Growing crops do not include trees for lumber, pulp and other non-life purposes.

The new options are good for taxable years after December 31, 1977. The taxpayer must make the election before January 1, 1981.

Sod farms are also exempt from accrual accounting for taxable years beginning after 1976.

Subchapter S Shareholders and Election Periods

Subchapter S Corporations will be allowed 15 shareholders for tax years beginning in 1979. Husband and wife count as one shareholder. The election to file as a Subchapter S corporation may be made any time during the preceding taxable year and the first 75 days of the taxable year in question. A corporation will qualify as Sub S if money and property received for stock does not exceed $1 million. The maximum amount that may be treated as ordinary loss doubled to $50,000.

Business Mileage Allowance Raised

The standard mileage allowance for business use of an automobile has been raised to 18.5 cents per mile for the first 15,000 miles per year. The rate for mileage in excess of 15,000 miles remains at 10 cents per mile.

IRS Interest Rate Increased

The rate of interest charged on tax deficiencies have been raised from six percent to 12 percent, effective February 1, 1980. The new rate will remain in effect until February 1982.

POTENTIAL TAX CHANGES OF THE FUTURE

Several important tax changes have been proposed in 1979 but none have been passed and signed into law at this time. Some of the proposals that may have a significant affect on farmers are examined here.

Change in the Installment Sale Provision

Senate and House bills S.1063 and H.R. 3899 were introduced last summer to institute major changes in the installment sale provision. The changes would, 1) eliminate the less than 30 percent payment requirement, 2) eliminate the requirement to make payments in two or more years, 3) increase the $1,000 selling price limitation on casual dispositions of personal property to $3,000, and 4) eliminate installment sale reporting for sales between related parties.

The provision that would prevent sales between related persons from qualifying raised the ire of taxpayers and tax experts. Even the Treasury Department testified against it at committee hearings. Plans are to amend the bills to remove this unpopular provision and replace it with some measure that would discourage resales of property which has been sold to a related party using the installment sale.

Repeal of Carryover Basis

Senator Dole's amendment to repeal the estate tax carryover basis provision has lots of support but is bogged down with the windfall profits tax bill. The future of carryover basis repeal will depend on how long it takes to get the bill out of committee, and how long the windfall profits tax is debated after it gets to the Senate floor.

The Technical Corrections Act of 1979

The House passed the Technical Corrections Act of 1979 in July and the Senate Finance Committee has given its approval to the parts of the bill that affect 1979 forms and instructions, (e.g., the zero bracket deduction will be allowed when computing alternative minimum taxable income).

Technical corrections that must still be approved by the Senate include: 1) changes to the "at risk" rules, 2) technical corrections pertaining to special use valuation and 3) minor corrections pertaining to investment tax credit on pollution control facilities.

Senate Committee Expands Energy Credits

Residential energy tax credits would be available on more energy conservation expenditures if approved by Congress and President Carter. The proposal includes; air tight wood stoves, heat pumps, replacement oil and gas furnaces that meet certain efficiency standards, and qualifying expenditures in more than one home and rental units.

Jones - Conable Capital Recovery Act

Congressmen Barber Conable and Jim Jones have introduced legislation that would revolutionize depreciation rules and provide a much faster recovery of capital invested in productive farm and business assets. The "Cost Recovery

Act of 1979" would place depreciable property into three categories and all assets in each category would be subject to the same years of life and depreciation rates. Buildings would be depreciated in ten years, automobiles and light trucks would be written off in three years. All other depreciable tangible property, such as farm machinery, would be depreciated over five years. Accelerated depreciation rates that peak in the second year would be used.

The Capital Recovery Act would also eliminate salvage value from tax calculations, allow full investment tax credit for qualified assets with at least five years of life and six percent credit for assets with three years of life.

The future of this legislation depends upon how serious Congress gets about major tax cuts for individuals and businessmen in 1980.

Investment Credit and Statute of Limitations

A little known bill, H.R.2644, has been introduced by Mr. Evans of Delaware with the express intent to open up some past tax years for claiming investment credit. More specifically, it would allow taxpayers to claim investment credit on qualifying single purpose agricultural or horticultural structures, back to August 15, 1971 without regard to the statute of limitations.

Although H.R. 2644 has been introduced to the Ways and Means Committee, no hearings have been held to date.

Proposed Estate and Gift Tax Amendments

A bill is developing under Senator Wallop's leadership that would make several significant and beneficial changes in the present estate and gift tax law. The proposals include: 1) An unlimited (100 percent) marital deduction for lifetime gifts and transfers at death to a spouse; 2) increase the annual gift tax exclusion from $3,000 to $5,000; 3) several changes in special valuation rules for farms and businesses including elimination of the material participation test and the $500,000 reduction in value limitation.

Value Added Tax

The Tax Restructuring Act (HR 5665) introduced by Representative Ullman is more revolutionary than the Capital Recovery Act. This legislation would impose a ten percent value added tax (VAT) on sales of goods and services at each stage of the production and distribution process. Everyone throughout the production and distribution chain would receive VAT credit except the final consumer. Some items and services would be fully or partially exempt.

The $80 billion annual revenue from VAT would allow reductions in individual and business taxes including social security taxes. Individual income tax rates would be cut nearly 30 percent and the higher corporate rates would be cut 25 to 30 percent. Scheduled social security tax hikes would be rolled back. Committee hearings on HR 5665 are being held in November. Most experts feel that there is little chance that VAT will pass in this Congress.

FEDERAL INVESTMENT CREDIT

Federal investment tax credit is one of the most important features of farm tax reporting and tax management. The Revenue Act of 1978 made the 10 percent investment credit rate permanent.

The credit is a direct reduction against income tax liability. If the credit cannot be used in the year it is earned, it can be carried back and carried forward to offset tax liability in another year. If property is disposed of before credit claimed is fully earned, the credit must be recomputed to determine what amount to recapture.

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

- Farm machinery and equipment with a useful life of at least three years.
- Livestock (other than horses) with a useful life of three years or more.
- Fences, paved barnyards, roadways, unloading areas, water wells, drain tiles, irrigation systems, and depreciable reserviors and dams.
- Orchards and vineyards in the year production starts.
- Storage facilities used principally for the bulk storage of fungible (interchangeable) commodities such as silos, grain bins, corn cribs or manure storages.
- Single purpose livestock and horticultural structures.
- Expenditures for rehabilitating buildings more than 20 years old if 75 percent of the exterior walls are retained.
- The cost of certified pollution control facilities that are rapidly amortized (60 months) and have actual useful lives of at least five years is now 100 percent eligible. Pollution control facilities that have useful lives of three to four years will only be allowed one-third of the full credit.
- Used as well as new property counts. When used property is acquired to replace used property only the boot qualifies unless investment credit is recomputed on the disposed used property.
- Maximum qualifying investment in used property is <u>$100,000 (joint return) in any one year</u>.

Amount of Credit

Maximum credit allowed in one year is the tax liability on line 37, Form 1040 or $25,000 plus 60 percent of tax liability in excess of $25,000, whichever is less. The percent limitation will increase to 70 percent for 1980, 80 percent for 1981 and 90 percent for 1982.

Qualified Investment

The extent to which eligible property becomes qualified investment depends upon its estimated useful life: Three or four years, one-third qualifies, five or six years, two-thirds qualifies; seven or more years, 100 percent qualifies.

Buildings

The Revenue Act of 1978 specifically extended investment credit to cover "single purpose livestock and horticultural structures" effective for taxable years that end after August 15, 1971.

- Definitions:

  "Single purpose livestock structure means any enclosure or structure specifically designed, constructed and used for housing, raising and feeding a particular type of livestock and their produce, and for housing the equipment (including any replacements) necessary for the housing, raising and feeding."

  "Single purpose horticultural structure means a greenhouse specifically designed, constructed and used for the commercial production of plants and a structure specifically designed, constructed and used for the commercial production of mushrooms."

- The structure may include workspace only if used for:

  (a) stocking, caring for, or collecting livestock or plants or their produce; (b) the maintenance of the structure; and (c) maintenance of equipment and stock.

This means that many livestock buildings such as dairy barns, hog confinement buildings, and chicken houses as well as greenhouses that IRS has previously disqualified are now eligible for investment credit. Although the eligibility extends back to August 15, 1971 the I.R.S. will not accept amended returns for closed tax years. Tax years ending in 1975 and earlier are closed for most farmers.

It must be remembered that the 1978 Act does not qualify all buildings for investment credit. For example, a machinery shed does not qualify nor does a general purpose structure that can be used to house various types of livestock. Also, if part of the space in a greenhouse is used for selling plants, the greenhouse does not qualify.

Rehabilitated Buildings

Rehabilitation expenditures incurred after October 31, 1978, on a building that has been in service for at least 20 years before rehabilitation, qualify for the investment credit. The physical rehabilitation work must begin at least 20 years after the date the building was first placed in service. In the future, such expenditures can qualify on the same building only once every 20 years.

Expenditures for the interior or exterior renovation, restoration or reconstruction of the building qualify for the credit if the rehabilitation improvements have a five-year-or-more useful life. Furthermore, the credit is available for all types of buildings that are used in business or productive activities except buildings that are used for residential purposes. The use of a building is determined on the basis of its use when placed in service after rehabilitation. Thus, rehabilitation of an apartment building for use as an office building would render the expenditure eligible for the credit.

Costs for acquiring or completing a building or for the replacement or enlargement of a building do not qualify. If more than 25 percent of the exterior walls are replaced, the rehabilitation does not qualify for the credit.

Special Rules on Livestock Investments and Replacements

Determining the qualified investment in eligible livestock is complicated. If purchased livestock replaces "substantially identical" livestock within six months, the price paid must be reduced by the price received when no recapture of I.C. is required. The used property substitution rule also affects livestock. When used property is purchased to replace used property sold, qualified investment is price paid less unrecovered cost. It is important to note that both the "substantially identical replacement" (S.I.R.) rule and the "used property substitution rule" do not apply if the I.C. is recomputed.

The following guidelines will help in determining the qualified investment.

- The age, and the use to which animals are suited will help determine whether livestock purchased are "substantially identical" to those sold. A mature dairy cow is not substantially identical to a two year old heifer. A cull dairy cow sold because she no longer is suitable for milk production is not substantially identical to a cow bought to replace her in the herd. Purchased dairy cows are substantially identical to cows sold for dairy or breeding purposes.
- The substantially identical replacement period rule (S.I.R.) covers replacements bought within a period of six months before or six months after a disposition.
- The S.I.R. livestock rule is not applicable if purchased cattle replace those lost in involuntary conversion.
- A used dairy cow is generally one which has been milked. A used beef cow is one which has calved, and a used bull is one which has bred a cow.

Unused Investment Credit

It continues to be important to maintain an accounting of investment credit. If allowable credit for the tax year exceeds the limitation based on tax liability, the unused credit should be carried back to offset tax paid in the three previous years, then carried forward to offset tax in seven future years. Unused credit from 1969 and earlier years may be carried forward 10 rather than seven years.

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

Recapture of Credit

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

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

Following is an illustration:

> A tractor was purchased 9/75 for $7,000, estimated life seven years. $700 of I.C. was claimed on the 1975 return, $200 was used in 1975 and $500 was used in 1976. The 1975 tractor was traded for a new tractor 9/79. The cost basis of the new tractor is $20,000, estimated life seven years, investment credit $2,000. The old tractor was held four years and earned only one-third of $700 or $233 of I.C. The earned credit is first applied to 1975 and the balance, $33, is applied to 1976. That used in 1976 but not earned, $467, does not need to be paid back because that amount of the 1979 credit can be carried back to the 1976 return in the taxpayer's recomputation.

The recapture rule causes confusion in the case of farm property transferred between father and son, or other related parties. Generally, when a father disposes of property on which he has taken investment credit by selling it to his son (or giving it to his son) the father must compute the credit and the amount not earned will be recaptured. Since property purchased or received from lineal descendents does not qualify for investment credit, the son who purchases otherwise eligible property from his father will not receive the investment credit.

Additional examples of how to recompute investment credit to determine how much credit must be recaptured, can be found in the 1980 edition of the Farmer's Tax Guide.

Investment Credit for Cooperatives

Most limitations on the use of investment credit by cooperatives have been eliminated and cooperatives are permitted to use investment credit in the year property is placed into service to the same extent as corporations, except that unused amounts cannot be carried back or forward. If a cooperative cannot use investment credit because of dollar limitations, any unused amount can be allocated to patrons on the same basis as allocation of patronage dividends. If the cooperative must recapture investment credit because of early disposition of property the recapture will apply at the cooperative level even if credit had originally been allocated to the patrons. This provision applies for taxable years ending after October 31, 1978.

BUSINESS ENERGY TAX CREDITS

The Energy Act of 1978 provides a new 10 percent business energy investment credit. This credit is in addition to the regular investment credit. Some property may qualify for both credits. The computation of the business energy credit is made on a separate Schedule B, Form 3468, Computation of Business Energy Investment Credit.

Qualifying Energy Property

Energy property is: 1) Alternative energy property which includes specific types of equipment that use an alternative substance other than oil and natural gas or their products as a primary fuel; 2) Solar or wind property which is equipment that uses solar or wind energy to heat or cool, or provide hot water for use in a structure, or to generate electricity; 3) Specially defined energy property which means property for which the principal purpose is to reduce the amount of energy consumed in an existing process and installed in connection with an existing facility; 4) Recycling equipment; 5) Shale oil equipment; and 6) Equipment for producing natural gas from geopressured brine.

Since IRS regulations on business energy credits have not yet been presented it is difficult to know exactly what property qualifies for the credit. Property used to generate methane gas from manure would be considered alternate energy property. Solar devices for either space heating or water heating and wind devices for water heating would qualify under the solar and wind category. Heat exchangers for heating water with heat taken from milk in the cooling process should qualify under the specially defined category.

Other property that would qualify as specially defined energy property includes a recuperator, a heat wheel, a regenerator, a waste heat boiler, a heat pipe, an automatic energy control system, a turbulator, a preheater, a combustible gas recovery system, an economizer, and other property yet to be specified by regulations.

The property must be new depreciable property that has a useful life of at least three years and placed in service after September 1978, and before 1983. The credit is taken the year the property is placed in service. If the property is disposed of before the end of three years the credit is recaptured.

Amount of Credit

The business energy credit is limited to 100 percent of tax liability. However, the credit for solar and wind energy property is refundable and may exceed 100 percent of tax liability. If both regular investment credit and the business energy credit are being claimed (on the same or separate property), first the regular investment credit is applied, subject to the limitation for that credit. Then, the business energy credit, other than for solar or wind energy property, is applied against 100 percent of any remaining tax liability. Finally, any solar or wind energy credit is applied to any remaining tax liability. If this last credit exceeds the tax liability, the excess is refunded. Any unused business credit not from solar or wind property is treated as unused credit carryback orrcarryover.

RESIDENTIAL ENERGY CREDITS

Residential Insulation and Other Energy-Saving Components

The Energy Tax Act of 1978 provides a tax credit for insulation and other energy-conserving expenditures on the principal domestic residence of a taxpayer. The credit is 15% of the first $2,000 of qualifying expenditures (maximum credit of $300). Construction of the residence on which the expenditures are made must have been substantially complete before April 20, 1977.

The credit applies to qualifying insulation and other energy-conserving components. Insulation is defined as any item specifically and primarily designed to reduce the heat loss or gain of a dwelling or water heater. Other energy-conserving components include: (1) a furnace replacement burner which is more energy efficient, (2) a device for modifying flue openings designed to increase efficiency of the heating system, (3) an electrical or mechanical furnace ignition system that replaces a gas pilot light, (4) a storm or thermal window or door, (5) an automatic energy-saving setback thermostat, (6) caulking or weatherstripping of an exterior door or window, (7) a meter which displays the cost of energy usage, and (8) other items which are specified by regulations as increasing the energy efficiency of a dwelling. To be eligible the original use must begin with the taxpayer, the insulation or component must reasonably be expected to remain in operation for at least three years, and must meet the performance and quality standards (if any) stated by regulations.

Residential Renewable Energy Source Equipment Credit

The Energy Tax Act also provides an income tax credit for qualifying solar and wind energy equipment expenditures on the principal domestic residence of a taxpayer. The credit amounts to 30 percent of the first $2,000 and 20 percent of the next $8,000 of qualifying expenditures, for a maximum credit of $2,200. Original use of the property must commence with the taxpayer and the property must reasonably be expected to remain in operation for at least five years. The credit applies to solar systems, to equipment using geothermal energy, and to other equipment items which rely upon renewable energy resources for the purpose of heating or cooling the residence or providing hot water.

Claiming the Credits

The credits may be claimed for items installed on or after April 20, 1977 and before January 1, 1986. The maximum credit amounts discussed above ($300 and $2,200) apply to the maximum total credits that a taxpayer can take on the same residence. The tax basis for the property must be reduced by the amount of the credit. A credit carryover is provided to the extent that the credit exceeds the taxpayer's tax liability. Unused credit can be carried until used through taxable years ending before January 1, 1988. Among those eligible for the credit are owners, renters who pay for the expenditure, individuals owning stock in a cooperative housing association and members of a condominium management association. The taxpayer must complete Form 5695. Residential energy credits are then claimed on line 45 of Form 1040. To be claimed, the total of the two credits must be at least $10.

TARGETED JOBS TAX CREDIT

The Revenue Act of 1978 replaces the former new jobs tax credit with a targeted jobs tax credit that is more restrictive in terms of the types of employees that qualify. The targeted jobs credit will be based on wages paid by employers to workers from certain targeted groups in tax years ending after 1978. The first year credit is equal to 50 percent of the first $6,000 of first-year wages paid to a qualified individual. The second year credit is equal to 25 percent of the first $6,000 of second-year wages paid to the qualified individual.

The first-year wages that qualify may not exceed 30 percent of the total unemployment insurance wages (FUTA wages) paid by the employer during the calendar year to all employees. Since very few agricultural employers are affected by FUTA, (an estimated 4.3 percent of farm employers in New York State), agricultural employers are allowed to use their records under the social security tax (FICA). Since FUTA coverage is on the first $6,000 of wages for each employee, agricultural employers are restricted to the first $6,000 of FICA wages paid to each employee to determine the 30 percent restriction.

The targeted jobs credit is limited to 90 percent of the employer's tax liability after reduction by many of the nonrefundable tax credits (such as investment credit). There is no dollar limitation to the credit. Any unused jobs credit because of the 90 percent limitation may be carried back three years and forward seven years. Total wage expenses must be reduced by the amount of credit claimed. This reduction includes any unused carry back or carry forward credit. Because the deduction for wages is reduced by the amount of the credit, the actual reduction in an employer's taxes for hiring a member of a target group who earns $6,000 ranges from $900 for an employer in the 70 percent tax bracket, to $2,850 for an employer in the 14 percent tax bracket.

There is no limitation on passing targeted jobs credit earned by a partnership or Subchapter S corporation on to individual partners or shareholders. The WIN credit is an alternative to the targeted jobs credit and may not be claimed in addition to the targeted jobs credit.

The target group of potential employees include: 1) A handicapped individual undergoing vocational rehabilitation; 2) A member of an economic disadvantaged family, 18 to 24 years old; 3) A Vietnam veteran member of an economic disadvantaged family, less than 35 years old; 4) An individual receiving qualifying social services benefits; 5) A qualified cooperative education program participant, age 16 to 18; and 6) An ex-convict from an economically disadvantaged family, out less than six years.

In New York State to become certified an individual (or employer) should contact a local New York Job Service division of the New York Department of Labor. The individual will receive a voucher. The employer should complete the declaration on the voucher and return it to the New York Job Service. The employer will receive a certification for that employee. The certification process can be completed after the individual is hired. The certification is proof of qualification and relieves the employer of proving qualification.

Congress stressed the importance of various agencies keeping employers informed of the availability of the credit. The targeted jobs credit is to terminate for wages paid or incurred up to and including December 31, 1981.

ALTERNATIVE MINIMUM TAX

The new alternative minimum tax is one of the most important changes coming out of the Revenue Act of 1978. Yet it has received little publicity and practically no explanation to date.

The term alternative minimum tax may be misleading. Taxpayers cannot choose between two or more methods for computing minimum tax. The alternative minimum tax is not a substitute for the 15 percent add-on minimum tax. Some taxpayers will have to compute both the old and the new minimum tax but most farmers will only need to compute the alternative minimum tax.

Tax Preference Income

With tax years starting in 1979 and later, the old 15 percent minimum tax no longer applies to the 60 percent capital gains deduction or to adjusted itemized deductions. The new Alternative Minimum Tax, (AMT), will apply to those two tax preference items. The 60 percent capital gains deduction is the most common and most important tax preference item on farms. Adjusted or excess itemized deductions are generally the amount of itemized deductions in excess of 60 percent of adjusted gross income. Few farmers have this type of tax preference income.

Alternative Minimum Taxable Income

The first step in computing AMT is to determine alternative minimum taxable income (AMTI). AMTI is not limited to the two tax preference items previously defined. AMTI is adjusted gross income less itemized deductions (or the zero bracket amount, whichever is greater), less all personal exemptions, plus the two required tax preference income items. Here is an example:

H.I. Farmer's 1979 adjusted gross income is $39,000, he files a joint return, his itemized deductions are $100 more than the $3,400 zero bracket amount, he has five exemptions and his 60 percent capital gains deduction is $20,000. His AMTI is computed as follows:

Adjusted gross income	$39,000
Itemized deductions (or ZBA)	- 3,500
Personal exemptions, 5 @ $1,000	- 5,000
Capital gains tax preference income	+20,000
Alternative Minimum Taxable Income	$50,500

Individual taxpayers are subject to the AMT only when the AMT computation comes out higher than the regular income tax liability. Form 6251 will be used to compute the tax. Corporations are not subject to AMT.

Alternative Minimum Tax Rates

The alternative minimum tax rates are lower than the minimum tax rates for low and moderate incomes but higher for big incomes. AMT rates are:

AMTI	Tax Rates
$0 to $20,000	0%
$20,001 to $60,000	10%
$60,001 to $100,000	20%
more than $100,000	25%

The first $20,000 of AMTI is exempt from the tax. A married individual filing a separate return would receive a $10,000 exemption and the dollar amounts in the AMTI tax rate table would be cut in half.

AMT Computation and Liability

The appropriate rate times the alternative minimum taxable income produce a computed AMT. Only the amount of computed AMT that exceeds the individual's regular income tax becomes the AMT liability. Regular income tax is net of investment credit and other credits deducted on line 46 of 1040. But, these credits cannot be used to reduce computed AMT. Here are some examples:

1. H.I. Farmer's AMTI is $50,500. His computed AMT is $3,050 ($50,500 AMTI - $20,000 exemption = $30,500 x .10 = $3,050). His regular income before credits is $8,291. He has $4,000 of investment credit available for 1979. Regular tax net of IC is $4,291 ($8,291 - $4,000). H.I. pays no AMT in 1979 since regular tax ($4,291) exceeds computed AMT ($3,050).

2. H.O. Farmer's AMTI is $110,000 ($58,500 AGI + $60,000 capital gains exclusion - $8,500 exemptions and deductions). Her computed AMT is $14,500 ($20,000 x 0 + $40,000 x .10 + $40,000 x .20 + $10,000 x .25). Her regular 1979 income tax before credits on $53,400 ($58,500 AGI - $5,000 personal exemptions - $100 excess itemized deductions) taxable income (joint return) is $16,444. H.O. has $4,000 of investment credit so her after credit regular tax liability is $12,444. Her AMT liability is $2,056 which is the amount the computed AMT exceeds her regular income tax. She pays $12,444 regular tax, $2,056 AMT, $1,855 self-employment tax, less any gasoline tax credit.

3. H.M. Farmer's AMTI is $27,000 ($8,500 AGI + $27,000 capital gains exclusion - $8,500 exemptions and deductions). His computed AMT is $700, ($20,000 x 0 + $7,000 x .10). His regular income tax is $0. He pays $700 AMT.

Unused Investment Credit

Taxpayers subject to the AMT may not be able to receive full benefit from investment credit claimed for the year and/or carried over from previous years. Example 2 illustrates this situation. H.O. Farmer has $4,000 of investment credit but only $1,944 ($4,000 credit available - $2,056 AMT paid) is used to actually reduce total tax liability. H.O. cannot benefit from $2,056 of her investment credit, the amount equal to the AMT liability.

Any investment credit benefit that is lost due to AMT liability becomes eligible for carryback and carryover. In other words, the available investment credit that cannot be used to reduce current year's AMT is handled like any other unused investment credit, it is added to the balance of unused credits.

Impact of AMT on Farmers

Farmers in two different income situations will most likely be subject to the AMT.

1) Farmers with relatively small regular income tax liabilities and substantial amounts of capital gains preference income.

2) Farmers with relatively large taxable incomes and large amounts of investment credit.

Most farmers in the first category that have not more than $80,000 of capital gains preference income will pay less minimum tax than they would have under old minimum tax rules. However, farmers selling entire dairy herds and/or substantial amounts on real property could pay much more tax under AMT.

Some farmers in the second category will pay more under AMT because AMTI includes regular income. Farmers and other taxpayers with little or no capital gains income can be caught in this trap.

REGULAR MINIMUM TAX

The regular minimum tax or 15 percent add-on tax has not been completely replaced by the new alternative minimum tax. Following is a list of tax preference income items that are still subject to the 15 percent minimum tax:

Tax preference income subject to regular minimum tax:

- Accelerated depreciation (in excess of straight line) on real estate.

- Accelerated depreciation on personal property subject to a lease.

- Amortization in excess of depreciation of pollution control facilities.

- Percentage depletion less adjusted basis of property at year-end.

- Stock options to the extent market value exceeds option price.

- Intangible drilling costs on oil and gas wells in excess of amount amortizable.

The minimum tax rate is 15 percent. The exemption is $10,000 ($5,000 if married filing separately) or one-half the taxpayer's regular income tax, whichever is greater. The amount of the minimum tax is added to the regular tax. Individuals file form 4625 (corporations use 4626) if qualified tax preference income exceeds $10,000. Investment credit cannot be used to reduce minimum tax.

A REVIEW OF FARM BUSINESS PROPERTY SALES

For income tax purposes, property owned by farmers can normally be classified as capital assets, noncapital or ordinary assets. Business assets are sometimes treated as capital assets and sometimes or always treated as ordinary assets, 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. Fruit, vegetables, slaughter cattle, feeder livestock, bob calves and poultry, are never capital assets.

Items that on disposition sometimes are and sometimes are not treated as capital assets, can for the sake of convenience be called hybrid items. They include most property held for use in the business. For a farmer they include farm real estate, equipment, livestock and unharvested crops sold with land.

The reporting of gains and losses on the disposition of property held for use in the farm business (hybrid items) is the most complicated phase of farm tax reporting. Form 4797 must be used to report gains and losses on hybrid items. This form must be completed before completing Schedule D.

The treatment of gains and losses on disposition of property used in the farm business can be better understood after a review of IRS classifications for such property. Note the special discussion on livestock on pages 24 and 25.

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

Section 1245 - Farm machinery held for the required period and sold at a gain is reported under this section. So is purchased livestock held for dairy and breeding purposes, held for the required holding period, and sold at a gain. Other depreciable farm property may also be classified as 1245 property. Gain will be ordinary gain to the extent of depreciation taken after specified cut off dates - December 31, 1961 for equipment and December 31, 1969 for cattle.

Section 1250 - Farm buildings held over 12 months and sold at a gain are reported in this section. If other than straight line depreciation was used on such property, a portion of any gain will be ordinary rather than capital.

Section 1251 - A "farmer" who had $50,000 or more in nonfarm income and $25,000 or more in farm losses in any year from 1969 to 1975 inclusive must use 1251 when disposing of farm property at a gain. Regular corporations are not exempted from Section 1251 on the basis of the $50,000 - $25,000 test.

Section 1252 - When soil and water conservation costs have been expensed rather than capitalized, and the land so improved is sold at a gain after having been held less than 10 years, Section 1252 is applicable. Part of the gain will be ordinary gain.

Farmer's Use of 4797 and Schedule D

All of the above transactions are reported first on Form 4797 to separate 1231 gain and loss and recapture of depreciation. If the individual gains and losses result in a net gain the gain is transferred to Schedule D, where it is combined with capital gain or loss, if any, from disposition of capital assets. If the 1231 items instead result in a net loss the loss is combined with ordinary gains and losses on 4797, and then transferred to Form 1040.

Recapture of Real Estate Depreciation (1250 Property)

The sale of depreciable real property used in the business may result in a gain. This gain usually receives at least partial capital gain treatment. However, if rapid depreciation has been used, some or all of the gain will be classified as ordinary gain. 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 of depreciation takes place and all the gain is treated as 1231 gain.

- 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.

- 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 converted to 1231 gain.

- A taxpayer may shift to straight line depreciation from either 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, all depreciation - straight line or rapid - will be considered excess and recaptured.

Farm Losses and the $50,000 - $25,000 Rule (1251 Property)

Changes in the 1969 Reform Act were aimed at making the real or after tax cost of incurring tax losses in farming much higher. One change made to accomplish this objective was the introduction of the Excess Deductions Account and the $50,000 - $25,000 rule.

The law required 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. The 1976 law substituted other tax shelter provisions for the EDA or $50,000 - $25,000 rule. Therefore, no taxpayers are to make any additions to EDA's for farm losses occurring in tax years commencing after December 31, 1975. Taxpayers who had to set up such accounts for losses incurred between 1969 and 1975 must continue to maintain the account until or unless profits in subsequent years wipe out the loss balance which built up in the 1969-1975 period.

Soil and Water Conservation and Land Clearing Expenditures (1252 Property)

A special rule allows farmers to elect to deduct as current expenses certain soil and water conservation and land clearing outlays which would otherwise be capitalized. The following specifics relative to the rule have been in effect since 1954.

- Deductible as operating expenses under the rule are: Cost of moving earth to construct ditches, ponds, etc.; construction costs relative to diversion ditches, grading, dams, etc.; brush eradication, wind break planting.
- Not deductible are depreciable items such as concrete dams, drainage tiles, and water wells.
- Deductions for soil and water expenditures are limited to 25 percent of gross income from farming during the year.
- Deductions for land clearing expenditures are limited to $5,000 or 25 percent of taxable income from farming, whichever is less.
- Once the election has been made to deduct soil and water or land clearing expenditures or to capitalize them, the method cannot be changed without the consent of the Director. The election is made when the taxpayer first incurs such expenditures. No other notification is necessary. Thus, if such expenditures were incurred in a prior year and were not taken as an expense, the failure to do so constituted an election to capitalize them.

Gain on sale of land held less than 10 years will be part ordinary and part capital gain when soil and water and land clearing expenses have been taken after December 31, 1969. If the land was held five years or less, all soil and water or land clearing expenses taken will be "recaptured" as ordinary gain. If the land was held more than five and less than 10 years, part of the soil and water and land clearing expenses will be recaptured. The percent of soil and water conservation or land clearing expenses subject to recapture during this time period are; sixth year after acquisition of the land 80 percent, seventh year 60 percent, eighth year 40 percent, and ninth year 20 percent.

Here is an illustration:

Farm land acquired, 1975 cost	$12,000
Soil and water expenses deducted on 1976 tax return	$ 1,000
Land was sold, 1979, for	$20,000

During the time the land was owned, no capital improvements were made other than the soil and water expenses, so the adjusted tax basis at time of sale was $12,000. The gain of $8,000 would normally be all capital gain. But the land was not held for more than five years, so the gain is divided, $7,000 qualifies as capital gain, $1,000 is ordinary gain.

LIVESTOCK SALES AND PURCHASES

The majority of livestock sales in New York State are animals that have been held for dairy, breeding or sporting purposes. Income from such sales are always reported on Form 4797. Dairy cows culled from the herd and cows sold for dairy and breeding purposes are the most common of these sales. Sales of horses and other livestock held for breeding, draft or sporting purposes also go on 4797.

Only income from livestock held primarily for sale is reported on Schedule F. The most common is the sale of "bob" veal calves from the dairy herd. Receipts from the sale of feeder livestock, slaughter livestock and dairy heifers raised for sale are entered on Schedule F, lines 5 through 8. Livestock purchases for resale produce income which is entered on line 1 of Schedule F and for a cash basis farmer the purchase price is recovered in the year of sale.

Breeding, Dairy, Draft or Sporting Livestock

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

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

2. Cattle and horses held less than two years, and other breeding livestock held less than one year.

Most dairy animals will meet the two year holding period requirement. Major exceptions are raised youngstock sold with a herd dispersal and the sale of cull cows that were purchased less than two years prior to sale. The age of raised animals sold will determine the length of the holding period. The date of purchase is needed to determine how long purchased animals are held. The holding period begins the day after the animal is born or purchased and ends on the date of disposition.

Reporting Sales of 1231 Livestock

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

Reporting Sales of Livestock Not Meeting Holding Period Requirements

Breeding, dairy, draft or sporting livestock that are not held for the required period whether sold for a gain or loss will be entered in Part II of 4797. This will include raised cattle that are held for dairy or breeding but sold before they reach two years of age and purchased cattle held for dairy or breeding but held for less than two years.

Tax Management Considerations

The extended holding period on livestock, and depreciation recapture on purchased 1231 livestock, have a direct effect on the amount of tax liability produced by many farm businesses. Dairymen and other livestock producers should consider various alternative methods of acquiring and disposing of livestock in order to decrease their tax liabilities. Following are some tax management suggestions that may be recommended if consistent with successful farm management practices used on the farm.

1. Farmers planning to disperse their herds should consider holding raised yearlings until they become two years old.
2. If purchased dairy, breeding and sporting livestock are to be sold sometime near the 24 month holding period, the tax consequences of the sale should be estimated before the sale decision is made. The goal should be to make transactions that result in a loss before the animals are held 24 months (ordinary loss) and delay sales that are going to produce substantial gains (capital gain) until after holding the animals 24 months. Exception: If the total loss from animals held more than 24 months and other business assets held at least 12 months will exceed the total gain from animals held more than 24 months and other business assets held at least 12 months then the net loss is an ordinary loss.
3. Dairymen who now buy all their replacements might consider hiring replacements raised on contract. Such animals qualify as raised animals and when sold the entire sale price will be capital gain.
4. If buying replacements is the best management alternative, the farmer should consider buying new rather than used livestock because new livestock may be depreciated with DDB while used livestock are limited to 1.5 DB.

Records of livestock purchases and sales must be adequate to substantiate tax return entries relative to depreciation and holding periods as well as gains and losses. When depreciating livestock the 10 percent reduction of salvage value cannot be used.

SUMMARY OF REPORTING LIVESTOCK SALES

Type of Livestock	Tax Form and Section
1. Cattle and horses held for breeding, dairy, draft or sporting purposes and held for two years or more; plus other breeding or sporting livestock held for at least one year.	
a) Raised	4797, Part IB
b) Purchased, sale results in gain	4797, Part III
c) Purchased, sale results in loss	4797, Part IB
2. Livestock held for breeding, dairy, draft and sporting purposes but not held for the required period.	4797, Part II
3. Livestock held for sale.	Schedule F, Part I

DEPRECIATION

Recognizing depreciable assets, determining the basis for depreciation, selecting depreciation rates and methods, and understanding the tax consequences of various depreciation alternatives are important ingredients for accurate tax reporting and successful business management.

Depreciable Assets

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

Depreciation is not optional. It should be claimed each year on all depreciable property. If a buyer neglects to take depreciation when it is due, he is not allowed to recover the lost depreciation by claiming it in a later year. He may recover lost depreciation by filing an amended return. Depreciation begins when an asset is placed in service. A building is depreciable when construction is completed. Purchased machinery and livestock are depreciable when placed in service or ready for service.

Better Records Needed

Accurate and complete depreciation records are basic to reliable farm income tax reporting and good tax management. A separate depreciation record such as illustrated in the Farmer's Tax Guide or the Cornell Farm Inventory and Depreciation Book is needed to supplement Part III of Schedule F. Depreciable farm assets may be grouped as buildings, machinery, and livestock in Part III of Schedule F since it is not necessary to submit the complete list of items.

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

Useful Life

Although IRS continues to publish very conservative guideline lives for depreciable farm business property, they also allow much flexibility in selecting useful lives based on the farmer's experience. IRS Publication 225 contains the following:

"There is no average useful life that is recognized as applicable to all farms. The useful life of an item depends upon the period you plan to use the item, and may be affected by such factors as the amount of use, age when acquired, policy as to repairs and upkeep, climate, and other conditions."

"If your experience for a particular item of property is inadequate you may use the general experience of farming operations in your locale until your own experience forms an adequate basis for determination."

Here are some observations that should qualify as general experience of farming operations in New York State.

- Dairymen replace approximately 25 percent of their milking herd annually. Therefore, the average life of purchased two year olds is four years. Older purchased cows would have useful lives of three years or less.
- Silo unloaders, feeding equipment, waste disposal equipment and similar machinery that is used intensively and wear out fast, are usually replaced within five years.
- Power machinery and seasonal equipment such as tractors and hay balers have variable lives depending upon use and upkeep. The usual practice is to depreciate this equipment over five to 10 years.
- The life of buildings depends more upon obsolesence than on wear. Some milking parlors and milk houses have been replaced in less than 10 years. Some silos have been torn down or abandoned in less than 10 years. Most farm buildings and structures remain functional for 15 to 20 years.

Depreciation Methods

The table on the next page shows what depreciation methods are available and how to compute the amount available for depreciation. The most common and simplest form of depreciation is the straight line method but other methods allow faster depreciation. Double declining balance provides the greatest amount of depreciation in early years. "New" dairy heifers qualify for the double declining balance method. A taxpayer may change from the declining balance to the straight line method without permission. Consent of the commissioner must be obtained to make other changes.

Additional First Year Depreciation

Additional first year depreciation (AFYD) applies to farm machinery, equipment, dairy and breeding animals with useful lives of six years or more. The basis for computing AFYD is not reduced by salvage value and includes only the boot paid when property is acquired in a tax free exchange. It is limited to $20,000 worth of property on a joint return or $4,000 of AFYD. The maximum allowance for an individual return or a partnership is $2,000 of AFYD.

Reduction of Salvage Value

In the case of personal property (other than livestock) with a life of three years or more, salvage value may be reduced by an amount up to 10 percent of the tax basis of the property when acquired.

Review of ADRS

The Asset Depreciation Range System (ADRS) is an optional system of depreciation. The taxpayer has an annual election regarding the use of ADRS and if he elects to use it, it applies to all assets acquired during the year. It also requires that a vintage depreciation account be established for each class of asset acquired for each year he uses ADRS. It will allow taxpayers to select useful lives within a range of 20 percent above or 20 percent below the IRS guidelines. Use of ARDS will allow the adoption of a modified first year convention or a half year convention. The ADRS appears to offer few advantages over procedures used by most farm taxpayers.

GUIDELINES FOR DEPRECIATION FOR FARM ASSETS

Acquired After 7-24-69

Description	Additional 1st Yr. Dep.	Depreciation Methods	IRS Suggested Life	Basis for Computing: St. Line Depreciation	Basis for Computing: Declining Balance Dep.	Basis for Computing: Sum of Digits Dep.	Basis for Computing: Addl. 1st. Yr. Dep.
(1) NEW MACHINERY PURCHASED	Yes - 6 years 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 salvage value.	Boot paid plus undep. bal. on trade less additional 1st year dep.	Boot paid plus undep. bal. on trade less add. 1st yr. dep. less sal. value	Boot only
(2) USED MACHINERY PURCHASED	Same as (1)	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 (1)	Same as (1)	Not eligible	Boot only
(3) NEW BUILDINGS PURCHASED	Not eligible	St. Line - yes D. Bal. - 3 yrs. or more life and limited to $1\frac{1}{2}$ st. line rate. Digits - no.	25 Yrs.	Cost less salvage value	Cost	Not eligible	Not eligible
(4) USED BUILDINGS PURCHASED	Not eligible	St. Line - yes D. Bal. - no Digits - no.	No Guide	Same as (3)	Not eligible	Not eligible	Not eligible
(5) FENCE, SILOS GRAIN STORAGES DRAIN TILE	Not eligible	New - same as (1) Used - same as (2)	25 Yrs. Fence 10 yrs.	Same as (3)	Cost	Cost less sal. value	Not eligible
(6) BREEDING AND DAIRY ANIMALS PURCHASED	Yes - 6 years or more life	New-same as (1) Used-same as (2)	3-7 Yrs.	Boot paid plus undep. balance on trade less 1st. yr. dep. less salvage value.	Boot paid plus undep. bal. on trade less 1st. yr. additional dep	Boot paid plus undep. bal. on trade less 1st. yr. add. dep. less sal. value	Boot only
(7) FRUIT TREES AND VINES	Not eligible	New-same as (3) Used-same as (4)	No Guide	Cost less salvage value	Cost	Cost less Salage value	Not eligible

NEW YORK STATE INCOME TAX

New York State Personal Income Tax - Exemptions, Deductions and Adjustments

Farmers residing in New York State must file Form IT-201 if required to file a federal return, or if "total New York income" exceeds number of exemptions x $700, or if items of tax preference exceed $5,000 on joint return. No New York tax is payable when total New York income is $2,500 or less for single taxpayers, and $5,000 or less for married taxpayers. The personal exemption is scheduled to increase to $750 in 1980.

The New York standard deduction is 16 percent of total New York income or $2,400, whichever is less. The minimum standard deduction is $1,900 for a joint return surviving spouse and for head of a household, and $1,400 for single taxpayers. If the taxpayer does not itemize deductions on the federal return, he or she cannot itemize on the New York State return. A husband and wife may determine their incomes separately and divide the 16 percent or $2,400 standard deduction as they elect.

"New York income", with some exceptions, is the same as federal adjusted gross income. One major exception affects income from the sale of farm property and capital assets. Income which qualifies for the federal capital gains deduction is 60 percent taxable for New York State personal income tax. The adjustment for 1979 should be an addition of one-third of the federal capital gains exclusion. However, the old 20 percent addition rule is still in effect because new legislation has not been passed. A second major adjustment must be made by taxpayers claiming the federal targeted jobs credit which cannot be used to reduce New York taxes. Since the credit reduces the allowable wage expense on Schedule F it should be added back in as a farm expense or deducted from New York income.

If a farmer's spouse has income greater than personal exemptions, it will usually pay them to file separately.

The 15 percent tax rate bracket has been eliminated for 1979 and the 14 percent bracket has been expanded to apply to taxable incomes over $23,000. (See later discussion on 12 percent Maximum Tax.)

Household Credit

All New York taxpayers with a household gross income of less than $25,000, except those who can be claimed as a dependent on another taxpayer's return, will qualify for the New York State Household Credit. The credit is taken as a direct tax reduction on the personal tax and is computed on IT-201. Household gross income is total New York State adjusted gross income for husband and wife plus minimum taxable income. The amount of household credit is as follows:

Household Gross Income	Household Credit
less than $5,000	$65
$5,000 - $5,999	$50
$6,000 - $6,999	$40
$7,000 - $24,999	$35

Child and Dependent Care Credit

Twenty percent of the federal child care credit may be used to offset New York State personal tax liability. The amount of credit used may not exceed the tax liability for the year. The credit is not allowed against the minimum tax. When a couple filing a joint federal return elect to file separate New York State returns, the child care credit may only be used by the spouse with the lower taxable income.

Real Property Tax Credit

A new real property tax circuit breaker credit is available to New York taxpayers with $12,000 or less of household gross income. Household gross income for computing this credit is New York income plus social security, unemployment compensation, welfare payments and other non-taxable income. Full year New York State residents may qualify if they lived in the same residence, that they owned or rented, for six months or more during 1979.

The credit is based on residential real estate taxes or 25 percent of adjusted rent paid, less a deduction that varies from four to seven percent of household gross income depending upon five income levels and two age classifications. IT-214 (2 pages and 37 lines) must be filed to claim the credit. The credit is refundable.

Only taxpayers representing a household with at least one member age 65 or over and a Household Gross Income of $7,200 or less can earn the $200 maximum credit allowed. If the oldest qualifying member of the taxpayer's household was less than age 65, the tax credit will not exceed $20. Instructions to IT-214 must be read to determine who is included in the taxpayer's household and how household gross income is computed.

Owners of real estate valued at more than $65,000 are ineligible for the credit. Persons claimed as a dependent by another taxpayer, and taxpayers claiming the real property tax circuit breaker deduction are excluded.

Credit for Special Additional Mortgage Recording Tax

Starting in 1979 farmers who pay the new special additional mortgage recording tax of 25¢ for each $100 of debt principal can claim it as a tax credit.

New York State Investment Credit

New York State investment credit has increased to four percent for 1979. The credit is applied to both personal and unincorporated business tax. Corporations that increase their number of employees at least one percent over the previous year are eligible for an additional one percent investment credit for three years following the year for which the original credit was allowed. The additional credit applies to eligible property acquired after January 1, 1976.

Qualifying property is "tangible personal property and other tangible property, including buildings and structural components of buildings which":

a) are acquired, constructed, reconstructed or erected by the taxpayer after December 31, 1968;

b) are depreciated pursuant to Section 167 of the Internal Revenue Code;

c) have a useful life of four years or more;

d) are acquired by the taxpayer by purchase pursuant to Section 179(d) of the Internal Revenue Code;

e) have a situs in New York State; and

f) 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.

Property used in the production of goods includes machinery, equipment or other tangible property which is principally used in the repair and service of other machinery and equipment or other tangible property used directly in the production of goods.

How To Claim The Credit - An individual must file Form IT-212 to claim the New York State Investment Tax Credit. Corporations file Form CT-46. The investment credit can be used by owners of unincorporated businesses to reduce personal income tax, and by corporate businesses to reduce the franchise tax. The credit may not be used to offset minimum 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. There is no carry back provision in the New York law.

Recapture - 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 recaptured in the year of disposition. For this purpose, "useful life" is the life chosen for depreciation on the federal tax return. Recapture is not required if the property has been in qualified use for more than 12 years. The amount of credit to be added back is computed as follows:

a) The total number of months in qualified use of the property divided by the total number of months of useful life.

b) Multiply the amount computed in (a) by the amount of the credit claimed on the property to ascertain the credit allowed for actual use.

c) Subtract the credit allowed for actual use from the amount taken to determine credit to be added back in the year of disposition.

Parents and Students Savings Plan and Tuition Expenses

New York State resident taxpayers may use certain educational expenses and/or savings plans to reduce federal AGI in computing total New York income for tax years starting in 1978. Parents of present and/or future college students may have two kinds of qualifying deductions.

1) A deduction for a portion of college tuition expenses paid for a taxpayer's dependents. The dependent must be a full-time student in New York State and there are additional limitations.

2) A deduction for contributions to a qualified higher education fund established by the taxpayer. Contributions are limited to $750 per each eligible dependent beneficiary. A dependent who was a college student during the previous taxable year will not be eligible.

A qualified higher education fund is a fund established under a written plan solely for defraying costs of attendance at an institution of higher education for one or more beneficiaries. The fund must be in the form of a trust or custodial account held by a bank, insurance company or other person approved by the tax commission.

The beneficiary or student that receives payments must include them in his or her taxable income over a five year period beginning after the last payment is received.

If the fund terminates because of disqualification, 110 percent of the value of assets in the fund must be added to New York income.

Real Property Tax Deduction

Some taxpayers under age 65 may be able to benefit more from the Real Property Tax Circuit Breaker Deduction than from the credit mentioned previously. To qualify household gross income must exceed $5,400 and not exceed $12,000. The maximum deduction allowed ranges from $250 to $450, depending upon the household gross income. Owners of more than $65,000 of real estate plus other categories of taxpayers, do not qualify.

Twelve Percent Maximum Tax

New York State taxpayers with more than $21,000 of 1979 personal service taxable income may benefit from the 12 percent maximum tax. New York State personal service income includes all earned income and pensions or annuities resulting from past personal services. Personal service income less adjustments such as employee business expenses, moving expenses and IRA payments equals personal service net income. Personal service net income divided by New York adjusted gross income, times New York taxable income, less tax preference items equals New York personal service taxable income.

Form IT-250 must be completed and submitted to claim the maximum tax. The tax is determined by first computing the regular personal income tax and then deducting a tax credit or benefit based on personal service taxable incomes that exceed $21,000. The net effect is a 12 percent maximum tax on personal service income.

New York State Minimum Tax

The 40 percent of capital gain which is not taxable on the New York State personal income tax is treated as a tax preference item subject to the New York State minimum tax. Items of tax preference are similar to the federal items of tax preference, and include the portion of capital gain not taxed. The exemption is $5,000 ($2,500 for a married taxpayer filing separately).

A farmer who has over $5,000 of preference items must complete Form IT-220 but may not be subject to minimum tax. New York personal income tax (less credits) and carryover of net operating losses are used to reduce minimum taxable income.

The New York State minimum tax rate is six percent. Investment tax credit cannot be used to reduce the minimum income tax.

Corporation Franchise Tax

Regular farm corporations organized under the laws of New York must file a New York Corporation Franchise Tax Report CT-3 or CT-4. CT-3 is the long form and is supposed to be used when tax is over $1,000, optional depreciation is used, or investment tax credit is claimed. Form CT-4 is a simplified form.

A declaration of estimated tax must be made by every corporation if New York State tax liability can be expected to exceed $1,000. Form CT-400 must be filed on or before the 15th day of the 7th month of the fiscal year along with a payment of one-third of the estimated tax liability.

Three or four tentative tax calculations are required depending upon the form used. The minimum tax is $250. The maximum for successful farm corporations is usually 10 percent of taxable income.

Investment credit is claimed on CT-46. Claims for refunds resulting from NOL and Capital loss carry backs are made on CT-8.

Phase Out of Unincorporated Business Tax

Farm businesses are not subject to the New York State unincorporated business tax for taxable years starting in 1979.

The UBT paid by non-farm businesses in New York State will be phased out starting in 1979. Here is the schedule:

For taxable years beginning in	The UBT rate
1979	4.5%
1980	4%
1981	3%
1982	0%

SOCIAL SECURITY, FEDERAL AND STATE INCOME TAX ON EMPLOYEES

Social Security (FICA) Tax Rate and Earnings Base

The 1979 FICA tax rate on wages paid to employees is 6.13 percent. The employer and the employee each pay 6.13 percent for a total of 12.26 percent. The social security tax rate for the self-employed is 8.1 percent on income earned in 1979.

The maximum amount of 1979 earnings subject to social security taxes and future benefits is $22,900. Changes in the social security law made in 1977 provide for increases in the rate and base as indicated in the table below. Tax rates for years after 1981 have been established but the maximum earnings base will be raised as cash benefits are increased.

SOCIAL SECURITY RATES AND TAX ON MAXIMUM EARNINGS

	Employees & Employers			Self-Employed	
Year	Max. Earnings Base	Tax Rate*	Tax on Max. Earnings*	Tax Rate	Tax on Max. Earnings
1979	$22,900	6.13	$1,404	8.1	$1,855
1980	25,900	6.13	1,588	8.1	2,098
1981	29,700	6.65	1,975	9.3	2,762

* Tax rate and tax on maximum earnings shown apply to both employees and employers share. Double this for total contribution.

Self-Employment Income

Self-employment income for the farmer is income from regular farm operations. It excludes gains and losses from the disposition of assets, income from dividends and interest, rentals from real estate and personal property leased with real estate, and wages received as an employee. A landowner who leases or rents his land to a tenant is not subject to self-employment taxes on this income unless he materially participates in the business. If net earnings from self-employment are less than $400, the self-employed is not subject to the tax but may choose the optional method described below.

Farmer's Optional Method

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 two-thirds of his gross income. This option has the effect of providing some minimum coverage earnings for any farmer.

Social Security Tax Withholding on Employees

Farm employees who are paid by an employer $150 or more in cash wages during a calendar year, or who have worked for an employer on 20 or more days during a calendar year for cash pay on a time basis are covered by social security. These rules do not apply to the farmer's spouse. However, employed parents and children over 21 are included. The year-end social security report on hired help must be filed by the employer on federal Form 943 by January 31st. It is important that the employer has an "Employer's Identification Number" to properly complete and identify the Form 943. Every farm employee should possess a social security number which must be available to the employer.

Depositing Taxes Withheld - If withheld and the employer's share of social security tax plus Federal Income taxes withheld total $200 at the end of a month, they must be deposited in a Federal Depository by the 15th of the following month. Farmers use Form 511 for this purpose. Undeposited taxes totaling less than $200 at the end of the year may be paid with the 943 return. For very large farm businesses undeposited taxes could exceed $2,000 in one month. If so, deposits must be made within three banking days of the end of the week within which the $2,000 level is reached.

Penalties - The employer cannot escape his liability to file returns and to pay FICA taxes on employees. Penalties range from 5 percent for one month overdue timely deposits up to 25 percent for skipping an entire payment period.

Federal Income Tax on Employees

Withholding - The Internal Revenue permits income tax withholding on all taxable renumeration of agricultural workers if both employer and employee agree to withholding. Withholding is not required. An employee who wants income tax withheld can so request by giving his employer a completed W-4, Employee's Withholding Allowance Certificate. The employer agrees to withholding by beginning to withhold the correct amount of tax. Either may terminate the agreement by giving a written notice to the other.

Information Returns - It is the responsibility of the farm employer to file an annual information return for payments made to farm employees during the year for salaries, fees and other compensation for personal services totaling $600 or more to any individual. The employer must file Form 943 with the IRS. Copy A of W-2 and Form W-3 will be filed with the Social Security Administration.

Exemption from Withholding on Income Normally Subject to Withholding. An individual is not subject to withholding of federal income tax if: (1) He paid no tax last year, and (2) he does not anticipate any federal income tax liability this year. Such a person should check the box on line 3 of Form W-4 and give it to his employer. The exemption applies only to income tax and not to social security tax.

Family Help - It may be to your advantage to pay wages to your children who are working on the farm. For Federal purposes, your child can earn up to $3,300, working for you or anyone else, and pay no tax (ZBA of $2,300 plus $1,000 personal exemption). You may still claim him as an exemption if you provide more than half his support, he is under 19 or a student and does not file a joint return. A person who can be claimed as a dependent on his/her parent's return and has unearned income of $1,000 or more must file a return.

Employee Tax Responsibility - Farm employees should be aware that every single citizen or resident of the U.S., whether an adult or minor, who had $3,300 or more income in the taxable year must file a return. In the case of married couples filing joint returns, the amount is $5,400. These figures are increased by $1,000 if the individual or his spouse is over 65 years of age and by $2,000 if both are over 65.

A farm employee is required to file a declaration of estimated income tax (Form 1040-ES) if he has income of $500 or more from sources not subject to withholding and expects to have a total tax of $100 or more. The tax may be paid in four equal installments. Some employees who do not request withholding have been penalized for not filing estimates.

State Tax Withholding and Informational Returns on Employees

Withholding state income taxes from farm employees is optional. If the employee wishes his employer to withhold for state income tax, he should furnish the employer with a completed Form IT-2104. Withheld taxes should be sent to New York State Income Tax Division with Form IT-2101-BNS. An employer who reasonably expects to withhold at least $300 but less than $3,000 semi-annually must file returns monthly and remit by the 15th of the following month. An employer who expects to withhold less than $300 semi-annually files and remits on a semi-annual basis, by July 31 and January 31.

Information returns must be filed with the State Tax Department indicating payments made for salaries to all farm employees receiving $600 or more during the calendar year. A copy of federal Form W-2 (or State Form IT-2102) and IT-2103, Reconciliation of Tax Withheld, are used.

Tax Statement to Workers

The employer must provide each employee with a statement by January 31, indicating wages reported to IRS and the State Tax Bureau as well as FICA and any federal or state tax withheld. Copies B, and C of W-2 are used.

TAX SHELTERED RETIREMENT PLANS

Farmers have two tax-sheltered plans available to them. They are the self-employed retirement plan, commonly referred to as the Keogh or HR-10 plan, and the individual retirement account plan (IRA). As the title indicates, a self-employed retirement plan applies to self-employed individuals such as farmers. An individual is self-employed if he is subject to the self-employment tax (social security). In contrast, an individual retirement account plan is available to any individual who is not an active participant in any other qualified retirement plan (social security is not a qualified plan). A self-employed individual would generally be eligible for an individual retirement plan in lieu of a self-employed retirement plan.

These tax-sheltered retirement plans permit a farmer to place a portion of his current earnings into a restricted fund for retirement. The amount deposited is deducted from gross income the year the deposit is made and is not subject to income taxes that year. However, when the retirement fund is liquidated the entire amount of the fund would normally be subject to taxation - both the original principal and any accumulated earnings from the principal. The purpose of the plans are to have individuals set up specific retirement plans. To induce the establishment of a plan, tax is deferred on the contributions and fund earnings to a later date and often to a period (retirement) where the fund would be taxed at a lower rate. There are a number of restrictions concerning the yearly contributions and use of the plan.

The Self-employed Retirement Plan

Some of the important features and considerations of a self-employed retirement plan for farmers are as follows. The maximum annual contribution is the lesser of $7,500 or 15 percent of earned income. However, an annual contribution of at least $750 can be made if the contribution does not exceed the annual earned income. Earned income is net earnings from self-employment as defined for Social Security purposes. No minimum annual contribution is required. A self-employed individual can be covered under a tax-sheltered plan provided through an employer and still have his own plan based on his self-employment earnings. Taxpayers are allowed to make contributions for a given tax year until the due date (and extensions) of the tax return. The plan, however, must be in existence before the end of the tax year.

A partner may not set up a plan independent of the partnership since a plan must be the plan of the employer and the partnership is regarded as the employer. If a partner owns more than a 10 percent interest in the partnership he may contribute on his own behalf subject to the $7,500 and 15 percent limitations. A partner who owns 10 percent or less of the business may also participate in the retirement plan set up by the partnership. He is not considered an owner-employee but a self-employed individual.

Self-employed individuals who are not owner-employees may contribute more than the $7,500 and 15 percent limitation but may only deduct from income the $7,500 or 15 percent. The advantage of excess contributions is that the return on the excess contributions is not taxed until the plan is distributed. Sole proprietory farmers are owner-employees. An owner-employee who is the only Keogh Plan participant (current and previous years) is now not required to file Form 5500-K.

Any full-time employees with three or more years of service must be covered by the plan. Any employee with 1,000 hours or more a year is considered full-time. All employees must be covered at the same rate as the employer-owner. What is set aside for employees is theirs or their beneficiaries (fully vested) even if they terminate employment, die, or the plan is terminated.

Individual Retirement Plan

A farmer may establish an IRA for himself or any IRA for himself and spouse without covering employees. The maximum annual contribution for an individual is the lesser of $1,500 or 15 percent of earned income. If the arrangement also covers a nonworking spouse, deductions are limited to the lesser of:

(1) 15 percent of the working spouses' earned income
(2) $1,750 ($875 for each spouse)
(3) twice the lowest amount contributed for either spouse.

Deductions to a joint IRA will not be allowed if the taxpayer's spouse has earned income during the year. In that case each self-employed taxpayer may have an IRA with annual contributions limited to the lesser of $1,500 or 15 percent of earnings. Contribution for a tax year can be made until the due date (and extensions) of the tax return. The IRA may be established on the date that the contribution is made.

If an employee is covered either the employee or the employer may contribute. The limitation to total annual contribution is the lesser of 15 percent of the employee's compensation or $7,500.

An IRA participant may use part of his current year limitation to correct an excess contribution for a previous year. Example: Smith was entitled in 1978 and 1979 to deduct $1,000 for contributions to an IRA. In 1978 he erroneously contributed $1,400 but deducted only the entitled $1,000. He can correct the 1978 excess contribution by contributing $600 in 1979 and then taking $1,000 deduction to which he is entitled.

Even if the time of filing his return has passed, an individual can withdraw an excess contribution for the year without being subject to the 10 percent penalty tax on premature distributions or to being required to include the withdrawn excess contribution in his gross income for the year of withdrawal. However, the 10 percent penalty will still apply if: (1) a deduction was allowed for the excess contribution or (2) total contributions (including the excess contributions) for the year exceeded $1,750.

Rules permit an individual retirement plan to switch the investment types of the plan. This rollover is permitted only once in a three-year period.

An individual retirement annuity must now provide for the flexible payment of premiums. Under a transitional rule fixed premium contracts can be exchanged for flexible premium contracts before 1981 without tax consequences.

A taxpayer will not have to file Form 5329 unless he owes excess contribution taxes, premature distribution taxes or taxes on certain accumulations in IRA accounts or annuities.

Restrictions on Both Self-employed and IRA Retirement Plans

Although differences do exist between self-employed and IRA retirement investment plans, in general, money can be invested in one of three basic ways -

(1) individual account usually with a bank, savings and loan, or credit union as trustee
(2) individual retirement income policy or annuity with a life insurance company
(3) investment in U.S. retirement plan bonds.

There is a six percent penalty tax imposed on excess contributions until the excess contribution is eliminated. Retirement benefit payments can begin after age 59 1/2 and must begin by age 70 1/2. At age 70 1/2 payments must not be distributed for a period longer than the life expectancy of the participant or spouse. Any premature distribution before age 59 1/2 is subject to a 10 percent penalty tax. However, this restriction does not apply in the event of death or disability.

Lump sum payment at death is included in a taxable estate unless, the beneficiary waives the 10 year averaging method for income tax purposes and waives the treatment of the distribution as capital gain. Annuity payments are not included in a taxable estate. The funds in the plan may not be used to secure a loan without the 10 percent premature distribution tax applying.

The Use of Tax-Sheltered Retirement Plans

Items to consider before establishing a tax-sheltered investment plan are:

(1) if the taxpayer will be in a lower tax bracket when he retires a shelter may be beneficial
(2) if the funds can be reinvested in the business and earn a higher return than a tax retirement shelter, even on an after tax basis, then a plan is not profitable
(3) although a plan may be less profitable than reinvesting in the farm business, it may diversify the source of retirement income and thus provide income stability. However, a retirement plan is not liquid since an individual cannot use those funds until age 59 1/2 without a substantial penalty
(4) a retirement plan can provide a source of income for dependents should a taxpayer die.

AGRICULTURAL TAX SHELTERS

The tax shelter provisions under Title II of the 1976 Tax Reform Act were aimed at reducing the incentives for investment in activities primarily for tax advantages.

Farming Syndicates

The restrictions in the 1976 Act apply to "Farming Syndicates". The law defines "syndicates" to include investment schemes where stock is registered with SEC as well as private unregistered syndicates where at least 35 percent of the deductions go to "passive" partners. Anyone who helps manage the farm, lives on the farm, belongs to the family that owns it, or who feeds his own cattle in a feedlot is an active partner, not affected.

Those taxpayers who are affected, may not deduct expenses for feed, seed, fertilizer or other supplies until they are used. They must also capitalize costs of poultry, groves, orchards and vineyards incurred before the year when the property begins producing a "crop".

The net effect of these requirements for syndicates is to eliminate much of the opportunity for tax postponement previously available to investors in such schemes.

Losses Limited to Capital at Risk

The amount of any loss which may be deducted in connection with farming and certain other tax shelter activities is limited to the amount of capital which the taxpayer has "at risk". Capital at risk generally means the sum of the following items contributed to the activity: (1) cash; (2) basis of contributed property; (3) borrowed funds for which he is personally liable; and (4) market value of the taxpayer's personal assets used to secure nonrecourse borrowings for the activity.

New Provisions

The 1978 Revenue Act extended "at risk" rules to all activities other than real estate, and to most closely held corporations. Here are the specifics of these changes:

- The "at-risk" rules will cover all activities that are part of a trade or business or that are engaged in for the production of income rather than only the four categories of activities covered in the 1976 Act. The only excluded activities are (1) closely held corporations engaged in leasing equipment that is Sec. 1245 property and (2) some types of real estate activities. Real estate used in farming continues to be part of the farming activity subject to the "at-risk" rules.

- The categories of taxpayers covered by the at-risk rules are broadened to include closely held corporations in addition to individuals, tax-option (Sub-S) corporations, personal holding companies and any other taxpayers previously covered. The special at-risk rules for partnerships have been repealed because they are also covered under Section 465(c). A closely held corporation is one in which five or fewer individuals own 50 percent or more of the stock.

- Under certain conditions, all of a taxpayer's activities that constitute a trade or business may be aggregated and treated as one activity. This apparently will prevent the at-risk rules from applying in some cases where they would if activities were not aggregated. Aggregation is not automatic and will not be allowed unless "active participation" in each of the separate activities can be demonstrated.

The impact of the new provisions on farmers is difficult to predict but a few observations can be made. Most full time farmers are not likely to be affected. Farming was included in the 1976 list of activities. The aggregation provision may exclude some farming operations now subject to the at-risk rules. Broadening the categories of taxpayers covered may mean that some closely held farm corporations previously not subject to the rules will be after 1978.

Proposed Regulations

Proposed Regulations under Section 465 concerning limitation of losses to the amount at risk were issued on June 5, 1979 in 44 Fed. Reg. 32235. These proposed regulations describe the rules which apply in limiting losses incurred in farming to the amount the taxpayer is at risk.

Excess Deductions Account

The old excess deductions account is still in a hold position. The old law penalized taxpayers who received $50,000 or more in nonfarm income and deducted $25,000 or more in farm losses. They were required to keep an excess deductions account, and when selling certain farm property at a gain, were forced to report what otherwise would have been capital gain as ordinary gain to the extent of their balance in the EDA. No additions have been made to the EDAs by such taxpayers for tax years beginning after December 31, 1975.

The old EDA rule may still result in recapture of capital gain as ordinary gain for those taxpayers who were required to keep an EDA and had a balance in the account at the end of 1975. Those taxpayers may still reduce or eliminate their EDA balance and thus avoid recapture of capital gain by showing net farm profit for years after 1975.

In effect, the 1976 law substitutes over-time the at risk provisions and farming syndicate provisions for the old EDA or $50,000 - $25,000 rule.

IRS Watches Syndicated Tax Shelters

Syndicated tax shelters continue to receive considerable attention from IRS. Revenue Rul. 79-229 reemphasizes the material distortion of income test in relation to "prepaid" feed purchases and is aimed primarily at syndicates. IRS will take a close look at the purpose behind syndicated feed purchases and apply the material distortion test independent of the business purpose test. Rev. Rul.79-229 includes the following factors that are to be considered in determining if material distortion exists: 1) The useful life of resulting assets during and beyond the taxable year paid; 2) the materiality of the expenditure in relation to the taxpayer's income for the year; 3) the purpose for paying in advance; 4) the customary, legitimate business practice of the taxpayer in conducting livestock operations; 5) the time of year the expenditure was made; 6) the amount of the expenditure in relationship to past purchases and 7) the effect the deduction has on taxes.

HOBBY FARMING

Many taxpayers who have nonfarm income and farming activities will escape the capital at risk and farming syndicate provisions of the 1976 law. If these taxpayers sustain losses in farming which they wish to use to offset nonfarm income, they still must contend with the hobby farming rules, which were changed very little by the 1976 law.

A taxpayer whose farming activity is being subsidized by nonfarm income must have a <u>profit motive</u> in order to fully deduct farm losses against other income. The most convincing way to demonstrate the profit motive is to show a profit. A two out of five year rule was initiated in 1969 and revised in 1976. This rule allows a taxpayer to elect a five year period within which to show he can make a profit. After making this election, if he shows a profit for two out of five consecutive years, it will be <u>presumed</u> that he was engaged in the activity for profit, and it will be up to IRS 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.

In making the election to have a period of years to show the profit motive, the taxpayer agrees to extend the statute of limitations for each year in the period to two years after the due date of the last year in the period. However, the 1976 law provides that these returns must remain "open" for this extended period only on items related to the "activity" in question.

In many cases, affected taxpayers will be able to manage income and expense over time in such a way as to show two profit years within the specified period. The two years do not need to occur consecutively. Receipts from sale of livestock are considered as full income in order to determine a profit year.

If the taxpayer does not elect the five year presumption, or if he cannot show enough profit from his farming activity to have the presumption in his favor, he may still produce evidence to prove the profit motive. Factors that IRS normally consider include the following:

1. The businesslike manner in which the taxpayer carries on his farming activity.
2. The expertise of the taxpayer or his advisors.
3. Hiring of a professional farm manager.
4. The time and effort expended by the taxpayer in carrying on the activity.
5. The taxpayer's pursuit of knowledge concerning the activity.
6. Expectation that assets used may appreciate in value (land).
7. The existence and use of recreational facilities on the farm.
8. Residence of the taxpayer on or near the farm.
9. The amount of profits in relationship to losses and the amount of income from nonfarm sources.

Tax court cases indicate that the taxpayer need only be able to prove that he had a genuine - not a reasonable - intention of making a profit. The distinction is indeed important, as many taxpayers without farm experience do invest in farm enterprises under the mistaken impression that they have a reasonable chance of profiting from the investment.

INCOME AVERAGING

For New York dairy farmers 1979 is again expected to be a year of high incomes. Hence, income averaging might be useful to many farmers this year. However, income averaging must not be considered a substitute for year end planning. Reasonable efforts should be made near the end of the year to even out taxable income from year to year. If this objective can not be accomplished, or if the farmer reports income on an accrual basis, income averaging is still available at tax reporting time.

To be eligible for income averaging a taxpayer (and spouse if they file a joint return) must have been either a U.S. citizen or resident, and have furnished at least half of his or her support during each of the four previous years. There are a number of exceptions to the support test. Income averaging may still be used if more than half of the taxable income of the computation year (1979) was the result of work performed during two or more of the four previous years (base period years). Or, if the taxpayer is at least 25 years old and has not been a full-time student for at least four years since age 21. The support test will not apply to the spouse if 25 percent or less of the combined adjusted gross income of both in the computation year is attributed to the spouse.

To use income averaging, taxable income for the current year must exceed 120 percent of the average taxable income for the four year base period by at least $3,000. The computation is done on Schedule G. Although that schedule computes the tax by a different mathematical procedure, the gist of the procedure is to divide that portion of the income ("averageable income") that is greater than 120 percent of the base period income into five equal parts. Tax is computed on the 120 percent of base income, and then on the 120 percent of base plus one-fifth of averageable income. The tax difference of these two computations is multiplied by five and added to the tax on the 120 percent of base income to arrive at total tax liability. In essence, the top 4/5 of the "averageable income" is taxed at the same rate as the bottom 1/5 of the "averageable income". Since income tax rates are progressive, total tax is reduced.

Example:

Taxable income for 1979	$22,200
Note: Tax on $22,200 without income averaging would be $4,925)	
Less 120 percent of average base period income of $14,200	17,040
Averageable Income	$ 5,160
(Note: Averageable income is greater than $3,000)	
Tax on $17,040 plus 1/5 of $5,160	$ 3,527
Less tax on $17,040	3,217
Tax on 1/5 of averageable income	$ 310
Tax on $17,040	$ 3,217
Plus 5 X $310	1,550
Tax using income averaging	$ 4,767

Tax saved by income averaging is $4,925 - $4,767 or $158

REVIEW OF TAX MANAGEMENT TECHNIQUES

Before the End of the Year

Estimate 1979 taxable income to determine the probable amount of income tax. Before a decision is reached to legally shift some taxable income into 1980 or later years, determine the potential effect on 1980 or later years taxable incomes. Although tax may be deferred the result may be even greater tax in a later year. If the later tax is greater than the tax saved in the current year, plus the return (or interest) earned on the savings, then it does not pay to defer the tax. However, since the width of tax brackets have been increased for tax years beginning after 1978, there is now less danger of placing a farmer into high tax brackets by legally deferring income. This is especially the case at the higher income brackets where income is often more variable, but the tax brackets are much wider.

(1) Sales of some commodities and many sales of capital items can be scheduled, with very few tax restrictions, to provide substantial tax savings. Year end purchases for next years feed and supplies must be used with caution.

(2) Consider the impact of making major capital purchases this year versus next year. Analyze first year depreciation, regular depreciation, and investment tax credit.

(3) Plan personal deductions. Many medical expenses and contributions that are normally spread out over two years can be paid in one year and itemized as deductions. In the next year, the standard deduction (zero bracket) may be taken if greater than itemized deductions. There is a limited opportunity to arrange for exemptions.

(4) Pay reasonable wages to children and spouse for farm work. Social security tax does not have to be paid on wages to a spouse or to children under 21.

(5) Installment sales of property can be used to spread income over a period of years.

After the End of the Year

(1) Select depreciation methods and rates that will save the most tax dollars over the life of the asset. Remember that a switch from an accelerated method to the straight line method can be made during the useful life of the asset but not vise versa.

(2) Be sure to take investment credit on all eligible property. Do not overlook unused investment credit balances or net operating losses from previous years. If this is the first year you are completing a taxpayer's return, ask to see previous years returns.

(3) Tax management is a year-round consideration whenever business transactions and decisions are made. Be especially cognizant of long range decisions such as setting up depreciation schedules, etc.

(4) Note deficiencies in the farm record system that prevent or hinder effective tax management. Suggest changes.