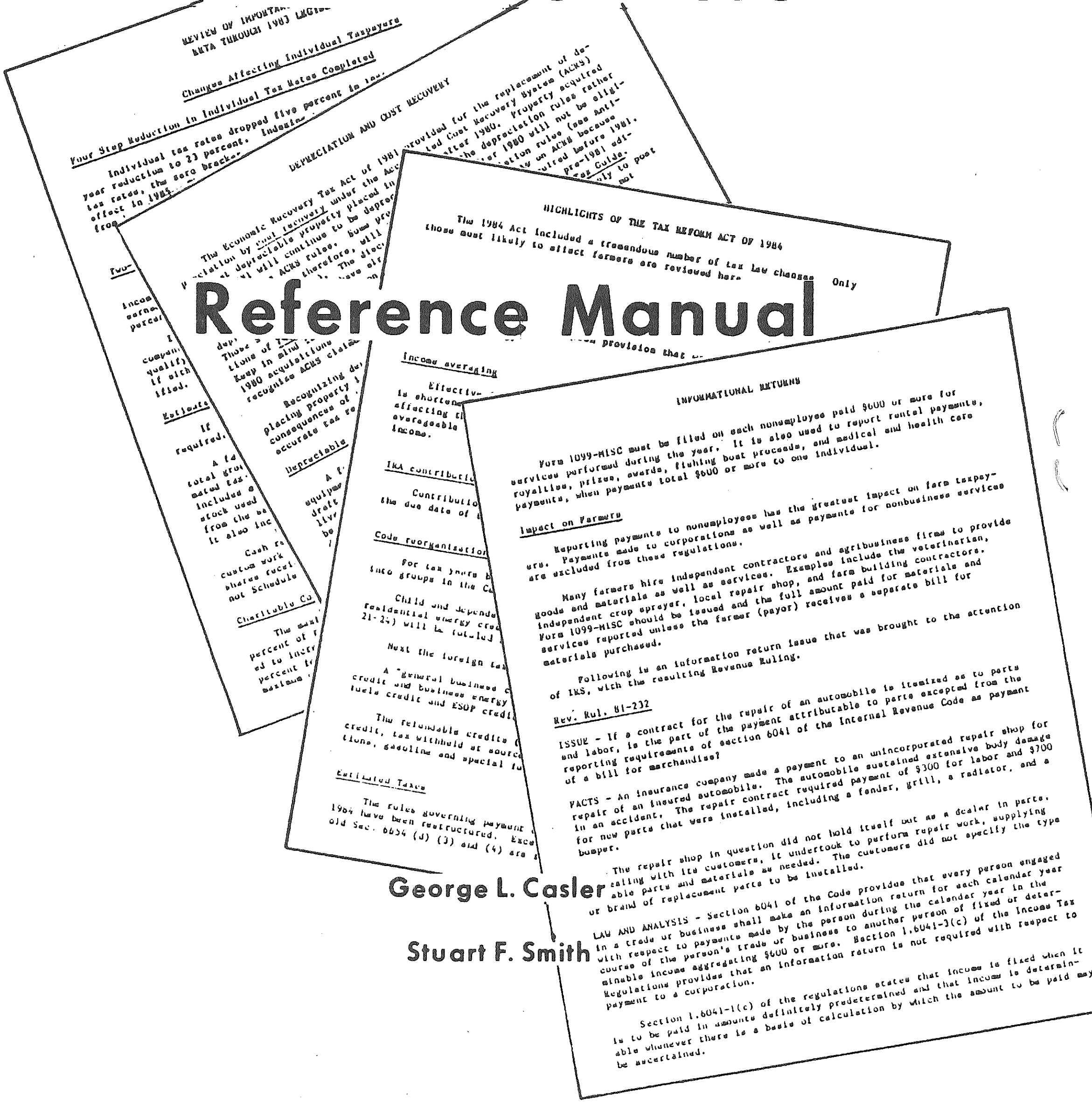
November 1984

A.E. Ext. 84-29

FARM INCOME TAX MANAGEMENT AND REPORTING



Reference Manual

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Page

3 <u>Below Market Interest Loans</u>. For term loans, the "federal" rate will be the short term (3 years or less), intermediate term (more than 3 years but not more than 9 years), or long term (more than 9 years) rate on government obligations at the time the loan was made, depending on the term of the loan.

For demand loans, the applicable federal rate will be the short term rate for the period for which the amount of foregone interest is being determined.

Rates will change each six months.

39 Three-line paragraph in the middle of page. Delete ACRS so that it reads "Corporate despositions of real property . . ."

45 End of second paragraph, add: A glitch in the 1984 Act prevents the lost credits from being carried forward or back. (Hopefully, this will be corrected.)

45 C.G.'s AMTI and AMT are computed as follows:

Adjusted gross income	$38,000	AMTI	$91,250
less deductions	-750	base deduction	40,000
plus tax preferences income from		Taxable AMTI	$51,250
sale of cows, $90,000 x .60 =	$54,000	Gross AMT	
TOTAL AMTI	$91,250	(AMTI x .20)	$10,250

C.G.'s 1984 federal income tax liability is $10,250. He must pay $5,338 of regular income tax plus $4,912 of AMT, the amount that computed AMT exceeds regular income tax.

49 <u>Keogh Plans</u>, second paragraph. The 1984 law states that the limit is 25 percent of earned income from self-employment, <u>without</u> reduction for any contribution to a Keogh plan. Also, some people argue that the limit is less than 25%.

50 The limit on employer contributions to SEP's is 15%, not 25% of compensation.

50 Last paragraph. "Appealed" should be "repealed"

1984 TAX FORMS NEEDED BY NEW YORK FARMERS

Here is a list of the more important 1984 income tax forms needed by farmers and some indication of those that have changed.

Federal Forms

1040 - U.S. Individual Income Tax Return. Line added for Social Security benefits. Credit lines on page 2 have been reorganized.
  Schedule A & B - Itemized Deductions and Dividend and Interest Income.
  Schedule D - Capital Gains and Losses. Page 2 is revised.
  Schedule E - Supplemental Income Schedule.
  Schedule F - Farm Income and Expenses.
  Schedule G - Income Averaging. Revised.
  Schedule R - Credit for Elderly and Permanently and Totally Disabled. Revised.
  Schedule SE - Computation of Social Security Self-Employment Tax.
  Schedule W - Deduction for Married Couple when both work.
1040A - Can now be used to report IRA deductions and the child care credit.
1040EZ- For single filers with no dependents, income under $50,000, wage income only, interest under $400 and no dividends.
1040X - Amended U.S. Individual Income Tax Return.
943 - Employer's Annual Tax Return for Agricultural Employees.
1099 - Information returns to be filed by person who makes certain payments of $600 or more: 1099-INT interest payments; 1099-MISC to report rents, royalties, prizes, awards, payments to fishing boat crews, medical and health care payments, and nonemployee compensation; 1099-G statement for recipients of certain government payments (new in 1983).
1096 - Summary and transmittal form for 1099's and 1087's.
W-2 - Wage and Tax Statement. W-3 - Transmittal of Income and Tax Statement.
1065 - U.S. Partnership Return.
3468 - Computation of Investment Credit and Business Energy Credit (Schedule B)
4136 - Computation of Credit for Federal Tax on Gasoline, Special Fuels, and Lubricating Oil.
4255 - Investment Credit Recapture (updated).
4562 - Depreciation: Use to report depreciation, cost recovery, and Section 179 expense election. Revised for 1984.
4684 - Casualties and Thefts. Revised.
4797 - Supplemental Schedule of Gains and Losses. Revised.
5695 - Residential Energy Credit.
6251 - Alternative Minimum Tax Computation.

New York State Forms

IT-201 - Income Tax Resident Return (individual, joint, or separate).
IT-201ATT - Summary of Other Credits and Taxes.
IT-201X - Amended Resident Income Tax Return (only acceptable method).
IT-204 - Partnership Return
IT-212 - Investment Credit and Recapture Schedule.
IT-220 - Minimum Income Tax Computation Schedule.
IT-250 - Maximum Tax on Personal Service Income.
IT-2102 & IT-2103 - Wage and Tax Statement, and Reconcilation form.
IT-2102.1 & IT-2102.4 - Informational Return and Transmittal form.
IT-399 - Depreciation Schedule (to compute and compare New York depreciation with ACRS)

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1984 FARM TAX AND INCOME SITUATION

Recent Legislation

The Tax Reform Act of 1984 contains hundreds of provisions, some of which will affect farm taxpayers in 1984 and future years. The last tax reduction from ERTA of 1981 becomes effective in 1984. Indexing will affect tax liability beginning in 1985.

The 1984 Act requires the Secretary of the Treasury to conduct a study of replacing the individual income tax and the corporate income tax with an alternative tax system. The alternative tax systems to be studied are a simplified income tax based on gross income, a consumption tax, a consumption based tax, and broadening of the base and lowering of the rates. The study shall also include tax shelters and how they impact on the equity of the tax system. A report on the study is to be made by December 31, 1984.

Future Legislation

Our crystal ball is no better than yours. However, the prospect of continuing large federal deficits and perceived inequities in the tax system suggest that a combination of spending cuts and tax changes will be made. The indexing of brackets scheduled to take place in 1985 would seem to be an easy target.

1984 Farm Incomes

Dairy farm incomes in 1984 generally will be lower than in 1983. January through August operating receipts less operating expenses on 62 CAMIS dairy farms were down 10 percent per farm and 13 percent per cow from year earlier levels. During the last four months of 1984, lower feed prices compared to year earlier levels and some strength in milk prices compared to the first eight months of the year will moderate the drop in net incomes compared to 1983.

Grain prices were high early in 1984 due to the effects of PIK and dry weather in 1983. Prices for the 1984 corn crop will be well below those for the 1983 crop. Incomes of grain farmers in 1984 will depend to a large extent on timing of sales of their 1983 crops and PIK corn and 1984 crops.

Many grape farmers will have lower incomes in 1984 than in 1983 due to lower prices. For some, 1984 incomes will be drastically lower because of loss of contracts for their 1984 crops. Prices for the 1983 apple crop, some of which was sold in 1984, were above year earlier levels. Revenues for the 1984 crop are likely to be about the same as for the 1983 crop.

Egg prices in the first half of 1984 were well above year earlier levels but will be below year earlier levels in the last half. In general, 1984 net incomes of egg producers will be above 1983 levels. Net incomes of hog and beef producers in 1984 will not differ much from 1983.

There is likely to be potential for tax savings by either carryover or carryback of net operating losses, depending on the specific situation.

HIGHLIGHTS OF THE TAX REFORM ACT OF 1984

The 1984 Act included a tremendous number of tax law changes. Only those most likely to affect farmers are reviewed here.

Changes Affecting Individuals

Net Interest Exclusion

The net interest exclusion provision that would have become effective in 1985 was repealed.

Income Averaging

Effective for years beginning after 1983, the base period for averaging is shortened from four years to three years so that the number of years affecting the averaging formula is reduced from five to four. The averageable income is increased to that above 140 percent rather than 120 percent of average base period income.

IRA Contribution

Contributions to IRA's after December 31, 1984 must be made on or before the due date of the return without extension. For contributions made after December 31, 1984, trustees are required to report to the IRS the tax year to which the contribution applies. See Tax Deferred Retirement Plans section for other changes.

Code Reorganization of the Tax Credits

For tax years beginning after 1983, tax credits have been reorganized into groups in the Code.

Child and dependent care credit, credit for the elderly and disabled, residential energy credit, and political contributions credit (Code Secs. 21-24) will be totaled and claimed as a group on 1040.

Next the foreign tax credit (Sec. 27) will be claimed.

A "general business credit" (Code Sec. 38) will include investment credit and business energy investment credit, targeted jobs credit, alcohol fuels credit, and ESOP credit. These will be claimed as a group on 1040 after claiming the credits above.

Some personal credits, which previous to 1984 were claimed after investment credit, now will be claimed before the general business credit. This will be an advantage to some farmers because they will be able to use some personal credits (the excess of which cannot be carried forward or back) and preserve any excess business credit for carryover or carryback purposes.

The refundable credits (credit for withholding on wages, earned income credit, tax withheld at source on nonresident aliens and foreign corporations, gasoline, and special fuels credits) are now Code Secs. 31-34.

Earned Income Credit

For tax years beginning after 1984, the earned income credit will be 11 percent of earned income up to $5,000 so that the maximum allowable credit will be $550. As income increases from $6,500 to $11,000 the credit is phased down to zero. After 1984, the earned income credit will be reduced by alternative minimum tax liability.

Estimated Taxes

The rules governing payment of estimated taxes for years beginning after 1984 have been restructured. Exceptions 4 and 2 on Form 2210 described in old Sec. 6654(d) (3) and (4) are repealed.

The underpayment penalty with respect to any installment will apply if payments do not equal at least one of the following:

a) 80 percent of the installment due based on the tax shown on the current year's return,
b) 100 percent of the preceding year's tax, and
c) 80 percent of the tax that would be due if each installment period were annualized.

Alternative minimum tax must be included in the estimated tax calculation beginning in 1985.

The requirement for estimated tax declarations was repealed.

For tax years beginning in 1984, IRS has more discretion in waiving penalties.

Below Market Interest Loans (New Code Sec. 7872)

Effective for loans made after June 6, 1984, loans made at a rate below the applicable federal rate (10 percent for 1984) are subject to a new set of rules too complicated to cover completely here.

The new rules apply to gift loans, compensation-related loans, corporate-shareholder loans, tax avoidance loans, and other loans where interest is charged below the federal rate.

"Gift" loans usually will be between family members. In the case of demand loans, the difference between the interest at the market rate and the rate charged will be interest income to the lender and interest expense to the borrower. If the total loans between lender and borrower are less than $10,000 the rules will not apply (unless the loan is attributable to the purchase or carrying of income producing assets). If gift loans between the lender and borrower do not total over $100,000, the income transfer will be limited to the borrower's "net investment income" for the year (defined in Code Sec. 163(d)(3)) unless the primary purpose of the loan is tax avoidance. If net investment income is under $1,000 it is considered to be zero.

A compensation-related loan is any loan from an employer to an employee or independent contractor at below market rates. The $10,000 exception also applies in this case, assuming that tax avoidance is not one of the principal purposes of the loan. Corporation-shareholder below-market loans have a similar set of rules.

In the case of term loans, the excess of the original amount of the loan over the present value of the loan payments computed at the federal rate will be treated as having been transferred from the lender to the borrower on the date the loan was made. Then there are some complicated rules as to the tax treatment of this amount.

Keep in mind that the rules are much more complicated than the simple versions included here.

Personal Casualty and Theft Gains and Losses

Beginning in 1984, gains and losses from personal casualty and theft are not combined with 1231 gains and losses. If personal gains exceed personal losses, the net gain will be a long term capital gain, not a 1231 gain. If personal losses exceed personal gains, the net loss will be allowed as an itemized deduction to the extent it exceeds 10 percent of adjusted gross income.

Alternative Minimum Tax

Effective for tax years beginning after 1982, the definition of regular tax for AMT purposes has been amended to eliminate any investment credit recapture tax. Other changes not likely to affect farmers were also made in AMT.

1984 Payment-in-Kind For Wheat

Income from the 1984 spring wheat PIK program generally will be treated as though the wheat had been grown by the farmer. If the PIK contracts are sold or exchanged, the income will not be treated as income from the trade or business of farming.

Farm Loss Recapture Rule

Section 1251, dealing with farm losses of high income taxpayers, was repealed for taxable years beginning after 1983. It is deadwood due to the Tax Reform Act of 1976.

Holding Period For Long Term Gain

For property acquired after June 22, 1984 and before January 1, 1988, the holding period for long term capital gain treatment is reduced from one year to six months. The change does not affect livestock but does affect machinery, land, buildings, and other improvements.

Interest Rates For Installment Sales

Code Sec. 1274 has been added and interacts with Sec. 483. If a property transaction is excepted out of Sec. 1274, then 483 applies. In general, there will be imputed interest on an installment sale contract if the stated rate is below 110 percent of the "federal rate". Interest will be imputed at 120 percent of the federal rate which is set for six month periods beginning January 1 and July 1 of each year. Sec. 1274 is effective for sales or exchanges after June 30, 1985. (See Installment Sales for exceptions and details.)

Tax Provisions Affecting Businesses

Real Property

For real property placed in service after March 15, 1984, the recovery period is 18 years rather than 15 years (except for low income housing which remains at 15 years). There are exceptions to the March 15 date for binding contracts entered into before that date. The excess of depreciation over straight line is added to the list of tax preferences in Code Section 57. Qualified rehabilitation expenditures also includes 18 year property improvements.

There is a mid-month convention that applies to acquisitions and dispositions of 18 year property acquired after June 22, 1984.

Investment Credit Limitation on Used Property

The scheduled increase from $125,000 to $150,000 has been delayed from 1985 to 1988.

Election of ITC Basis Reduction

If a partnership or S corporation elects the ITC basis reduction, each partner's or shareholder's share of the reduction and recapture adjustments are to be taken into account in determining his/her share in the entity. The rules apply to property placed in service after 1982.

Section 179 Expense Election

The increase from $5,000 to $7,500 is delayed from 1984 to 1988. The increase from $7,500 to $10,000 is delayed from 1986 to 1990.

Section 1231 Gains and Losses

For tax years beginning after December 31, 1984, net gain from 1231 transactions will be treated as ordinary income (rather than capital gain) to the extent of unrecaptured 1231 losses in the prior five years beginning after 1981. This will reduce the benefits of capital gain treatment of 1231 assets of farmers who have had 1231 losses in years after 1981.

Recapture of Depreciation on Installment Sales

For installment sales of real or personal property made after June 6, 1984, depreciation recapture under Secs. 1245 and 1250 is to be included in income in the year of disposition regardless of payments actually received. The balance of the gain will be reported as payments are received. The recapture that is included as income is treated as if it increases the basis for purposes of determining the gross profit ratio and calculating how much of each installment payment is included in income. More later.

Rehabilitation Investment Credit

There is now an alternative test for the "75 percent of external wall" provision which applies to expenditures made after December 31, 1983. See Investment Credit section.

Depreciation and ITC For Luxury Automobiles

For vehicles weighing 6,000 pounds or less placed in service after June 18, 1984 and used over 50 percent for business, the ACRS deductions and ITC are limited. IC is limited to $1,000 unless the taxpayer elects the reduced IC, in which case IC is limited to 2/3 of what it would otherwise be. The ACRS deduction is limited to $4,000 the first year (Sec. 179 election would also be limited to $4,000) and $6,000 for succeeding years. There is an inflation adjustment for years after 1984. The limits apply before the percentage allocation to business versus personal is made.

Property Not Predominately Used in a Business (Code Section 280F)

Automobiles, computers, and other "listed property" placed in service after June 18, 1984 not used more than 50 percent for business will not qualify for investment credit (not even on the business portion) and depreciation must be taken by the straight line method using a five year life for three year property, 12 year life for five year property, 25 year life for 10 year property, and 40 year life for 18 year property. There are also several other new rules.

If the more than 50 percent test is met, ITC and ACRS depreciation will be allowed on the income producing portion of the property. Use of the property for the production of income (not from a trade or business) can be counted in determining the amount eligible for ITC and ACRS, but not for meeting the more than 50 percent test.

If the more than 50 percent test is met in the year the property is placed in service, but not met in a subsequent year, there will be recapture of the investment credit and of depreciation and Sec. 179 expense election in excess of that which would be allowable under the applicable straight line method.

Substantiation of Business Expenses

Effective in 1985, taxpayers are required to keep contemporaneous records to substantiate:

1) travel expenses that are trade or business expenses or expenses for the production of income,
2) entertainment expenses,
3) business gifts,
4) investment tax credit or ACRS deductions claimed for business use of listed properties (Sec. 280 F (d)(4)).

Taxpayers no longer will be allowed to substantiate deductions by adequate records or by sufficient evidence corroborating their own statements.

The records must reflect the business use of property, including the business purpose. For auto expenses, the log must record the date of the trip and the mileage driven for business purposes.

Targeted Jobs Credit

This credit is extended one year so that targeted group members who start work before December 31, 1985 are eligible.

Corporations

Graduated Tax Rates

For years beginning after 1983, the benefit of graduated rates is eliminated for corporations with taxable income exceeding $1,000,000.

Minimum Tax and Tax Preferences

The TRA of 1984 increases the 15 percent cutback in tax benefits from certain corporate tax preference items to 20 percent for taxable years beginning after 1984.

Modification of Corporate Tax Preferences

Several changes have been made in corporate tax preferences. The one most likely to affect farmers is gains from dispositions of Sec. 1250 property after 1982. The additional amount taxed as ordinary income is generally equal to 20 percent (rather than 15 percent) of the gain that would have been recaptured as ordinary income under the Sec. 1245 rules.

S Corporations

The changes affecting S corporations are too numerous to cover here. Most appear not to affect most farm S corporations substantially.

Partnerships

Much of the legislation affecting partnerships was directed at tax shelters. The new provision most likely to affect farm partnerships follows.

Allocations With Respect to Contributed Property

For property contributed to a partnership after March 31, 1984, income, gain, loss, and deductions are to be shared among partners to take account of the variation between the partnership's adjusted basis of the property and the fair market value of the property at the time of contribution. Similar rules will apply to contributions of accounts payable and other accrued but unpaid items by partners who use cash accounting. This will mean an increase in the "specially allocated" items on partnership returns.

Return Preparers

Effective for tax years beginning in 1985, return preparers are required to advise taxpayers that adequate contemporaneous records must be kept to substantiate travel expenses, entertainment expense, business gifts, and investment credit and depreciation allowances on certain listed property. In addition, return preparers are required (1) to obtain a written confirmation from the taxpayer that such requirements were met with respect to any such deduction or credit claimed on a return or claim for refund, and (2) to sign the return or claim for refund. If written confirmation is not obtained, the preparer is not to sign the return or refund claim. The preparer is subject to a $25 penalty for each failure to comply.

REVIEW OF IMPORTANT CHANGES FROM ERTA THROUGH 1983 LEGISLATION

Changes Affecting Individual Taxpayers

Four Step Reduction in Individual Tax Rates Completed

Individual tax rates dropped five percent in 1984 bringing the total four year reduction to 23 percent. Indexing provisions that will adjust individual tax rates, the zero bracket amount, and personal exemptions for inflation take effect in 1985. The scheduled tax adjustments are intended to prevent taxpayers from being pushed into high tax brackets by inflation.

The zero bracket amount (standard deduction) and personal exemption are unchanged for 1984.

Two-Earner Married Couple Deduction Continues

Married couples earning separate incomes may still qualify for a gross income deduction based on a percentage of the lower earning spouse's "qualified earned income". The deduction for 1984 continues at the lesser of $3,000 or 10 percent of earned income. The maximum tax savings would be $1,500.

Income from pensions, annuities, individual retirement plans, deferred compensation payments, and wages received from working for one's spouse do not qualify as "qualified earned income". Non-itemizers can claim the deduction but if either spouse claims an exclusion for income earned abroad they are disqualified.

Estimated Tax Threshold and Farmers Exemption

If the 1984 estimated tax was $400 or more, estimated tax payments were required. In 1985, the estimated tax threshold increases to $500.

A farm taxpayer whose gross income from farming is at least two-thirds of total gross income for the current or the prior tax year is exempt from estimated tax payments (IRC Section 6073). Estimated gross income from farming includes all gains from the sale of dairy, breeding, draft and sporting livestock used in the business (Rev. Rul. 63-26). Total gross income includes gains from the sale of all business property, land, and all other taxable income. It also includes the spouse's taxable income on a joint return.

Cash rental income received by a farm landlord and services provided by a custom work operator are not gross income from farming. Crop and livestock shares received by nonparticipating landlords should be reported on Form 4835, not Schedule E.

Charitable Contribution Deduction for Non-Itemizers

The maximum deduction for non-itemized charitable deductions is $75 or 25 percent of the first $300 of qualified contributions. The deduction is scheduled to increase to 50 percent for taxable years beginning in 1985 and to 100 percent for 1986, the final year of the deduction. There is no ceiling or maximum deduction for 1985 or 1986.

Medical Expense Deduction

For tax years beginning in 1984 and after, the separate deduction for drug expenditures in excess of one percent of adjusted gross income is eliminated. Prescription drugs and insulin may be included as part of the medical and dental expense deduction subject to a floor of five percent of adjusted gross income. The separate deduction for one-half of health insurance premiums up to $150 was also eliminated by TEFRA at the end of 1982.

Highlights of Social Security Changes

1984: Specified FICA tax rate is seven percent but employee's credit makes the employers share seven percent and the employees share 6.7 percent. The effective self-employment tax rate is 11.3 percent on a maximum earnings base of $37,800 for a tax of $4,271. Some social security benefits received by some taxpayers become taxable.

1985: FICA tax rate increases to 7.05 percent for both the employer and the employee's share. Self-employment tax rates increase to 11.8 percent. The maximum earnings base increases to $39,600.

1986 and 1987: FICA rates go to 7.15 percent, self-employment rates to 12.3 percent.

Backup Income Tax Withholding

Temporary regulations became effective on January 1, 1984 providing general rules with respect to backup withholding on interest paid, dividend payments, and payments to nonemployees requiring a 1099-MISC. Twenty percent backup withholding is required when:

1) the payee fails to furnish a taxpayer identification number, or

2) the IRS notifies the payor that the number furnished by the payee was incorrect, and if

3) the payor must file a 1099 on the payee for the current year, or was required to file same for the preceding year, or the payor was required to impose backup withholding on this payee during the preceding calendar year.

A payee will not be subject to the 20 percent backup withholding for a period of 60 days, if the payee is waiting for a taxpayer's identification number and provides the payor with a signed certification that application has been made. Here is a suggested "awaiting TIN certification" statement: "I certify, under penalties of perjury, that a taxpayer identification number has not been issued to me, and that I mailed or delivered an application to receive a taxpayer identification number to the appropriate Internal Revenue Service Center or Social Security Administration Office (or I intend to mail or deliver an application in the near future). I understand that if I do not provide a taxpayer identification number to the payor within 60 days, the payor is required to withhold 20 percent of all reportable payments thereafter made to me until I provide a number." Form W-9, Payer's Request for Taxpayer Identification Number, should be used by taxpayers to inform IRS that the waiting period is in effect.

Business Tax Changes

Major changes covered in more detail in other sections include:

1) ACRS and investment tax credit
2) Section 179 expensing deduction
3) Alternative Minimum Tax
4) Information returns
5) Tax deferred retirement plans

Corporate Tax Rates and Provisions

Corporate tax rates have not been changed for 1984. The progressive rates vary from 15 percent of taxable income not exceeding $25,000, to 46 percent of taxable income exceeding $100,000.

The 15 percent reduction in corporate tax preference items that started in 1983 continues in effect for 1984. The provision relating to depletion allowances applies to tax years beginning after 1983. The cutback in certain tax preference items does not apply to S corporations.

Targeted Jobs Tax Credit

The TRA of 1984 extended Targeted Jobs Credit through 1985. Here are some of the major features of the credit:

1) The regular credit is 50 percent of the first $6,000 of wages paid in the first year of employment, and 25 percent of the first $6,000 of wages paid in the second year of employment to a target group individual.

2) There are nine regular target groups.

3) A special targeted group includes economically disadvantaged youths who are 16 to 17 years of age on the hiring date and have not worked for the employer before. The credit for this targeted group is 85 percent of up to $3,000 of wages paid for services attributable to any 90 day period between May 1 and September 15. A qualified summer youth can be certified as a member of another targeted group without recertification if employment continues with the same employer after the 90 day period ends.

FUTA Rates Increase

Federal unemployment tax rates increased from 3.5 percent to 6.2 percent on remuneration paid after December 31, 1984. The wage base remains at $7,000. The maximum allowed for state credit doubles to 5.4 percent.

INFORMATIONAL RETURNS

Form 1099-MISC must be filed on each nonemployee paid $600 or more for services performed during the year. It is also used to report rental payments, royalties, prizes, awards, fishing boat proceeds, and medical and health care payments, when payments total $600 or more to one individual.

Impact on Farmers

Reporting payments to nonemployees has the greatest impact on farm taxpayers. Payments made to corporations as well as payments for nonbusiness services are excluded from these regulations.

Many farmers hire independent contractors and agribusiness firms to provide goods and materials as well as services. Examples include the veterinarian, independent crop sprayer, local repair shop, and farm building contractors. Form 1099-MISC should be issued and the full amount paid for materials and services reported unless the farmer (payor) receives a separate bill for materials purchased.

Following is an information return issue that was brought to the attention of IRS, with the resulting Revenue Ruling.

Rev. Rul. 81-232

ISSUE - If a contract for the repair of an automobile is itemized as to parts and labor, is the part of the payment attributable to parts excepted from the reporting requirements of section 6041 of the Internal Revenue Code as payment of a bill for merchandise?

FACTS - An insurance company made a payment to an unincorporated repair shop for repair of an insured automobile. The automobile sustained extensive body damage in an accident. The repair contract required payment of $300 for labor and $700 for new parts that were installed, including a fender, grill, a radiator, and a bumper.

The repair shop in question did not hold itself out as a dealer in parts. In dealing with its customers, it undertook to perform repair work, supplying suitable parts and materials as needed. The customers did not specify the type or brand of replacement parts to be installed.

LAW AND ANALYSIS - Section 6041 of the Code provides that every person engaged in a trade or business shall make an information return for each calendar year with respect to payments made by the person during the calendar year in the course of the person's trade or business to another person of fixed or determinable income aggregating $600 or more. Section 1.6041-3(c) of the Income Tax Regulations provides that an information return is not required with respect to payment to a corporation.

Section 1.6041-1(c) of the regulations states that income is fixed when it is to be paid in amounts definitely predetermined and that income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained.

Section 1.6041-3(d) of the regulations provides that returns of information are not required under section 6041 of the Code with respect to payments of bills for merchandise, telegrams, telephone, freight, storage, and similar charges.

The payment here is made in the course of the payor's trade or business, the amount is fixed and determinable, and the recipient is not a corporation. Therefore the entire payment is reportable, unless that part attributable to replacement parts can be considered the payment of a bill for merchandise.

Although the contract required the furnishing of certain parts, the repair shop did not hold itself out as a dealer in parts, and the customer did not specify the kind of parts to be installed. The obligation to furnish certain parts was incidental to the obligation to repair the car. Therefore payment under the contract was not in any part a payment of a bill for merchandise within the meaning of section 1.6041-3(d) of the regulations.

HOLDING - No part of the payment is excepted from the reporting requirements of section 6041 of the Code as a payment of a bill for merchandise.

Filing Dates and Penalties

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

Failure to file a required information return is subject to a $50 fine for each failure without reasonable cause. Failure due to intentional disregard of the law subjects the taxpayer to a minimum penalty of 10 percent of the amount not reported.

Returns Required for Certain Payments Received

1) A person who receives $10,000 or more in cash (not including checks) in the course of a trade or business must file a 1099. Applies to amounts received after December 31, 1984 (Code Sec. 60501).

2) Payments of $600 or more of mortgage interest received from one individual, in connection with the taxpayer's trade or business, must be reported.

Magnetic Media

Any taxpayer who is required to file information forms 1099 DIV, 1099 PATR, 1099 OID or 1099 INT for more than 50 payees must file on magnetic media, starting with tax year 1984. IRS encourages other taxpayers to use tapes or disks for information returns. Magnetic tape, disk pack, and diskette reporting are applicable for filing information documents. IRS Pub. 1220 contains the specifications for using magnetic media. Different types of payments may be reported on the same tape or disk submission. Form 4419, Application for Magnetic Media Reporting of Information Returns, must be filed prior to submitting returns on magnetic media.

Taxpayers can get relief from the above requirement if they establish that filing on magnetic media would cause undue hardship. Requests must be sent to the regional service center (Andover, Massachusetts for upstate New York).

SUBCHAPTER S CORPORATIONS

The provisions of the Subchapter S Revision Act of 1982 generally are effective for tax years beginning after 1982. The Tax Reform Act of 1984 includes additional provisions effective on the same date.

An S corporation may have no more than 35 shareholders. There can be only one class of stock, but there can be differences in voting rights within the class. A partnership may not be a stockholder in an S Corporation. The shareholders must unanimously consent to the S election.

Taxation

In general, an S corporation is exempt from income tax and the income is taxed to the shareholders. Under some conditions, the corporation is taxed on net capital gains income and/or excess net passive income. Pre-election investment credit is recaptured at the corporate level. Transferors of property to the S corporation are responsible for recapture of investment credit from which they originally benefited.

An S corporation may be taxed on net capital gains but only if: (1) the net capital gains for the taxable year exceed $25,000, (2) the net capital gains exceed 50 percent of the corporation's taxable income, and (3) the corporation's total taxable income exceeds $25,000. However, the tax is not imposed if the S corporation was either (a) an S corporation for the three taxable years immediately before the year in which the net capital gains were realized, or (b) an S corporation for the entire period of its existence and was in existence for less than four taxable years, including the taxable year the gains were realized. However, there is an exception to the exceptions in (a) and (b) under certain conditions.

New S corporations must file on a calendar year basis unless a business purpose for a noncalendar year can be justified to the IRS. Existing S corporations using a noncalendar year are not required to change to a calendar year unless there is a 50 percent shift in ownership due to reasons other than death or family transactions.

The passive income rules may lead to tax on or the termination of an S corporation. This is true only for an S corporation that was once a C corporation. If, after the S election, a corporation has for three consecutive taxable years, accumulated earnings and profits from a C corporation at the close of each year and passive investment income in each of the three years exceeds 25 percent of gross receipts, termination will occur. Also, there may be a tax on the passive income even if termination does not occur.

For S corporations established after 1982, shareholders with more than two percent of the stock will be treated the same as partners in a partnership with respect to the fringe benefits of meals and lodging for the convenience of the employer, death benefit of $5,000, premiums for accident and health plans, employer payments to accident and health plans, and group term life insurance of $50,000. These items are not deductible by the S corporation. S corporations existing before 1983 will be able to deduct these fringes until 1988.

The IRS has the power to reallocate income to shareholders if one or more shareholders provides services or capital without receiving reasonable compensation. This could cause a problem for a farmer who wishes to work for nominal wages and shift income toward other shareholders (family members).

The credit for tax on gasoline, special fuels, and lubricating oil is not passed through to shareholders. The credit is taken against tax due at the corporation level on capital gain and passive income.

Soil and water conservation expenses are passed through to the shareholders.

Distributions from an S corporation apparently are not treated as self-employment income (they were not under prior law and the 1982 Sub-S Act did not address the issue). Therefore, earnings on S stock should not result in self-employment income which could reduce social security benefits. However, there could be problems in cases where an employee-stockholder did not receive adequate compensation for labor.

New York State Recognizes S Corporations

An S corporation can become exempt from the New York franchise tax if all the shareholders make the election under Sec. 606(a) of the laws of 1984. The election to be treated as a New York S corporation must be made on Form CT-6. The form must be filed on or before the 15th day of the third month of the 1985 tax year to be effective for 1985. Once the election is made and accepted, it becomes effective for the taxable year for which it is made and all succeeding taxable years of the corporation until it is terminated. A transitional rule was in effect until October 25, 1984, allowing S corporations to make a retroactive election for 1983 and 1984 taxable years.

New York S corporations must file an information return, Form CT-3S, on or before the 15th day of the third month following the close of each taxable year.

Farm and other businesses that become electing S corporations will continue to be subject to tax liabilities caused by the recapture of tax credits claimed in prior years when the business was not an electing S corporation. The mere change to an electing S corporation will not trigger IC recapture by itself. Early disposition or nonqualified use will result in recomputation and potential recapture.

FARM FAMILY AND SMALL PARTNERSHIPS FILING REQUIREMENTS

In general, partnerships are required to file a complete partnership return (Form 1065). A partnership is two or more persons who join together to carry on a trade or business, with each person contributing capital, labor or management, and each sharing in the profits and losses of the business.

Exclusions

The following organizations that have the characteristics of a partnership may be excluded from Form 1065 filing requirements under IRC section 761(a):

1) An investing unincorporated business not formed to conduct business.

2) An organization formed for joint production, extraction or use of property but not to sell products or services.

3) An organization that deals in securities for a short period for the purpose of underwriting, selling or distributing a particular issue.

Small (less than 10 partners) family partnerships are not specifically excluded from 1065 filing requirements but they are provided relief from penalties under Rev. Proc. 81-11 (see below).

Penalties

If a required partnership return is late or incomplete, penalties are assessed at $50 per month up to a maximum of five months. This amount is multiplied by the total number of partners in the partnership during the tax year. If the partnership can show reasonable cause for not filing a complete return or filing late, no penalty will be imposed.

Rev. Proc. 81-11

A partnership composed of 10 or fewer partners of a type that has not historically filed a partnership return, such as a family farm partnership, a family-owned retail store partnership, or, in some cases, co-ownership of property, will be considered to have met the reasonable cause test and will not be subject to the penalty imposed by section 6698 of the Code for failure to file a partnership return, provided that the partnership or any partner establishes, if so requested by the Service, that all partners have fully reported their shares of income, deductions, and credits of the partnership on their timely filed tax returns.

Schedules L and M Exemption Opportunity

A family partnership is not required to complete Schedule L (the partnership balance sheet) and Schedule M (Reconciliation of Partners' Capital Accounts), if the following requirements are met:

1) The partnership's only income-producing activity is from one or more of the following:

a) family farm partnership
b) family owned wholesale or retail store partnership
c) co-ownership of investment property.

2) There are 10 or fewer partners.

3) It is a domestic partnership made up entirely of noncorporate general partners.

4) The partnership is not in partnership with any other partnership.

5) Each partner's interest in the capital is the same as his or her interest in the profits.

6) All of the income, deductions, and credits are allocated to each partner in proportion to that partner's pro rata interest.

7) Schedules K-1 are filed as required.

Item M must be checked on the front of Form 1065 to elect not to complete Schedules L and M. This election also exempts the partnership from completing items F on the 1065 and Schedule K-1 dealing with capital accounts and assets.

While many farm partnerships could avoid completing Schedules L and M, in the long run the partners and tax preparer may be better off to complete these schedules and also to complete each year a partnership balance sheet based on fair market values.

Exchange of Partnership Interests Must be Reported

A transfer of partnership interest involving unrealized receivables or appreciated inventory items will require an information return for exchanges after 1984.

Allocation of Partnership Gain and Loss

For contributions after March 31, 1984, depreciation, depletion, and gain or loss with respect to contributed property must be shared among partners so as to take account of the difference between the partnership's basis for the property and the fair market value of the property at the time of contribution. When the regulations are written for this provision, it is likely that the effect will be the same as under present regulations when a partnership elects to allocate the above items to take account of the difference between basis and fair market value.

Character of Gain or Loss on Disposition of Property Contributed to a Partnership

When a partnership disposes of property which was inventory property in the hands of a partner immediately before contribution, any gain or loss to the partnership within five years of the contribution will be ordinary income or loss.

DEPRECIATION AND COST RECOVERY

The Economic Recovery Tax Act of 1981 provided for the replacement of depreciation by cost recovery under the Accelerated Cost Recovery System (ACRS) for most depreciable property placed in service after 1980. Property acquired before 1981 will continue to be depreciated under the depreciation rules rather than under the ACRS rules. Some property acquired after 1980 will not be eligible for ACRS and, therefore, will fall under the depreciation rules (see Anti-Churning Rules below). The discussion here will concentrate on ACRS because depreciation decisions have already been made on property acquired before 1981. Those who need information on depreciation rules should consult pre-1981 editions of Farm Income Tax Management and Reporting or the Farmers Tax Guide. Keep in mind that some parts of the old depreciation rules do not apply to post 1980 acquisitions that are not eligible for ACRS. New York State will not recognize ACRS claimed for federal purposes in 1982 through 1984.

Recognizing depreciable assets, determining the basis for cost recovery, placing property in the correct cost recovery class and understanding the tax consequences of various cost recovery elections are important ingredients for accurate tax reporting and successful business management.

Depreciable Assets

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

Depreciation or cost recovery is not optional. It should be claimed each year on all depreciable property. An owner who neglects to take depreciation when it is due is not allowed to recover the lost depreciation by claiming it in a later year. Lost depreciation may be recovered by filing an amended return.

Accurate Records Needed

Accurate and complete depreciation records are basic to reliable farm income tax reporting and good tax management. Depreciation and cost recovery must be reported on Form 4562. A complete depreciation and cost recovery record is needed to supplement Form 4562. It is not necessary to submit the complete list of items included in the taxpayer's depreciation and cost recovery schedules.

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

Cost Recovery Period

Depreciable assets purchased after December 31, 1980 that qualify for ACRS must be placed in one of five cost recovery classes regardless of the expected useful life of the asset in the farm business. (There is a sixth class, 15 year public utility property that will not be applicable to farm property.) The Accelerated Cost Recovery System (ACRS) introduced as part of the Economic Recovery Tax Act of 1981 provides for placing depreciable assets in one of the five ACRS classes depending primarily on the Asset Depreciation Range (ADR) class lives as of January 1, 1981. The ACRS classes are also defined in terms of Section 1245 and Section 1250 property.

Three year property. The 3-year class includes:

1) Section 1245 property with an ADR class life of four years or less. This includes automobiles, light duty trucks (less than 13,000 pounds), and over-the-road tractors. It also includes hogs for breeding purposes but not cattle or goats held for dairy or breeding purposes or sheep held for breeding purposes because the ADR class life of these animals is greater than four years.

2) Section 1245 property used in connection with research and experimentation. Few farmers will have this type of property.

3) Race horses more than two years old when placed in service and any other horses more than 12 years old when placed in service.

Five year property. Section 1245 property that is not 3-year property, 10-year property, or 15-year public utility property, is considered 5-year ACRS property. For farm businesses the 5-year class includes almost all 1245 property that is not 3-year property because farm businesses will have little or no 10-year property and 15-year public utility property.

The 5-year class includes the following farm property:

1) All farm machinery and equipment except light trucks.

2) All purchased breeding, dairy and sporting livestock (except hogs and any horses which are included in the 3-year class).

3) Silos, grain storage bins, fences, paved barnyards, water wells, and drain tiles.

4) Orchards, groves, and vineyards when they reach the production stage.

5) Single purpose livestock and horticultural structures. These structures were classified Section 1245 property by the Economic Recovery Tax Act of 1981.

Ten-year property. The only farm property included in the 10-year class appears to be mobile homes (residential manufactured homes).

Fifteen year property. The 15-year class includes Section 1250 property with an ADR class life of more than 12.5 years. This class will include all depreciable farm real estate (if purchased prior to March 16, 1984) that is not 1245 property included in the 5-year class. Examples are general purpose buildings such as tool sheds, machine shops, and multipurpose barns. Tenant houses will also be included in the 15-year class. If fast recovery is used on 15 year property it will become 1245 property when sold.

Eighteen year property. The 18-year class includes Section 1250 property (other than low income housing) placed in service after March 15, 1984. This class will include the same items that would have been in the 15-year class if purchased prior to March 16, 1984. If acquired after June 22, 1984, a mid-month convention applies.

Cost Recovery Options

The taxpayer must choose one of four cost recovery options for each of the five classes of depreciable farm property which qualify for ACRS. If fast recovery (the regular ACRS option) is chosen, the percentage recovered each year will be the amount shown in the table below. For 3, 5, and 10-year property, these rates approximate 150 percent declining balance with switchover to straight line and a half-year convention applied in the year of acquisition (see section below). The rates for 15-year and 18-year property are based on 175 percent declining balance with switchover to straight line and will not use the half-year convention.

FAST (REGULAR) RECOVERY PERCENTAGES UNDER ACRS

Recovery Year	Type of Property				
	3-Year	5-Year	10-Year	15-Year[1]	18-Year[2]
	Percentage				
1	25	15	8	12	9
2	38	22	14	10	9
3	37	21	12	9	8
4	--	21	10	8	7
5	--	21	10	7	7
6	--	--	10	6	6
7	--	--	9	6	*
8	--	--	9	6	
9	--	--	9	6	
10	--	--	9	5	
11-15 (per year)	--	--	--	5	

[1] Percentage deductions in this column apply only to 15-year property placed in service during the first month of the tax year. Fifteen-year property placed in service later in the tax year will earn one percent per month in the first year. See table on next page for percentage recovery for acquisitions in months other than the first.

[2] For property placed in service after June 22, 1984. For property placed in service between March 15 and June 22, 1984, see Publication 534.

*See Publication 534 for remainder of percentages for 18-year property.

ACRS FAST RECOVERY TABLE FOR 15-YEAR PROPERTY EXCEPT LOW-INCOME HOUSING

If the Recovery Year is:	Month in First Year the Property is Placed in Service											
	1	2	3	4	5	6	7	8	9	10	11	12
	The applicable percentage is:											
1	12	11	10	9	8	7	6	5	4	3	2	1
2	10	10	11	11	11	11	11	11	11	11	11	12
3	9	9	9	9	10	10	10	10	10	10	10	10
4	8	8	8	8	8	8	9	9	9	9	9	9
5	7	7	7	7	7	7	8	8	8	8	8	8
6	6	6	6	6	7	7	7	7	7	7	7	7
7	6	6	6	6	6	6	6	6	6	6	6	6
8	6	6	6	6	6	6	5	6	6	6	6	6
9	6	6	6	6	5	6	5	5	5	6	6	6
10	5	6	5	6	5	5	5	5	5	5	6	5
11	5	5	5	5	5	5	5	5	5	5	5	5
12	5	5	5	5	5	5	5	5	5	5	5	5
13	5	5	5	5	5	5	5	5	5	5	5	5
14	5	5	5	5	5	5	5	5	5	5	5	5
15	5	5	5	5	5	5	5	5	5	5	5	5
16	0	0	1	1	2	2	3	3	4	4	4	5

The entire range of straight line options is shown below:

Straight line Option	1st Year	Intermediate Years	Last Year
3-year class options			
3 years	1/6	1/3 in each of next 2 years	1/6
5 years	1/10	1/5 in each of next 4 years	1/10
12 years	1/24	1/12 in each of next 11 years	1/24
5-year class options			
5 years	1/10	1/5 in each of next 4 years	1/10
12 years	1/24	1/12 in each of next 11 years	1/24
25 years	1/50	1/25 in each of next 24 years	1/50
10-year class options			
10 years	1/20	1/10 in each of next 9 years	1/20
25 years	1/50	1/25 in each of next 24 years	1/50
35 years	1/70	1/35 in each of next 34 years	1/70
15-year class options			
15 years	1/180 per mo.	1/15 in each of next 14 years	balance
35 years	1/420 per mo.	1/35 in each of next 34 years	balance
45 years	1/540 per mo.	1/45 in each of next 44 years	balance
18-year class options			
18 years	1/216 per mo.*	1/18 in each of next 17 years	balance
35 years	1/420 per mo.*	1/35 in each of next 34 years	balance
45 years	1/540 per mo.*	1/45 in each of next 44 years	balance

*If acquired after June 22, 1984, use half this amount for month of acquisition.

Half-Year Convention

The 3-year, 5-year, and 10-year ACRS classes have a built-in half year convention for the first year of depreciation. In other words, a farmer will receive six months of depreciation on all depreciable assets placed in the three, five, and 10-year classes regardless of the actual month of purchase. The month of purchase cannot be ignored, however, for it will affect investment tax credit recapture. Recapture is discussed under Investment Credit. First year depreciation on 15-year and 18-year real property is based on the month of acquisition.

ACRS Property Class Rules

For three, five, and 10-year ACRS property, the same recovery option must be used for all the property acquired in a given year that belongs in the same ACRS class. Taxpayers do not have the option to establish subdivisions of a property class. For example, if a farmer purchased dairy cows, a new tractor, a silo, and built a dairy barn in 1984, all belong in the 5-year property class. The farmer may not recover the cows over five years and the single purpose agricultural structure over 12 or 25 years. However, the taxpayer may choose a different recovery option for property in the same ACRS class acquired in a subsequent year. For example, a farmer could choose fast recovery for a farm auto purchased in 1983 (3-year property) but choose straight line for three or five years for a pickup truck purchased in 1984. Keep in mind that fast recovery would be used on any other 3-year property purchased in 1983 and the same straight line option used on the pickup would be required on all 3-year property purchased in 1984.

A taxpayer may select different recovery options for different ACRS classes established for the same year. For example, he could select fast recovery on 3-year property, straight line over 12 years on 5-year property, and straight line for 10 years on 10-year property.

In the case of 15-year and 18-year property, the recovery options may be chosen on a property-by-property basis; that is, different options may be chosen on items in this class purchased in the same year. If a substantial improvement is made to 15-year or 18-year property, the taxpayer may choose a recovery option different from the option chosen on the original building. An improvement is substantial if it is made at least three years after the building was placed in service and the amount of the improvement over a two year period is at least 25 percent of the adjusted basis of the building as of the first day of that period.

Reduction in Basis Due to Investment Credit

The basis of property on which the 15 or 20 percent credits for rehabilitation were taken must be reduced by the full amount of such credits. If investment credit is recaptured on such property, the basis will be adjusted upward for 100 percent of the recapture amount.

For property placed in service after 1982, the basis for cost recovery must be reduced by 50 percent of the regular investment tax credit, 50 percent of the allowable energy investment credit, and 50 percent of the 25 percent credit for rehabilitating certified historic structures. The taxpayer will have the alternative of reducing the regular investment credit by two percentage points rather than reducing the basis. This applies only to the regular credit. The basis would need to be reduced by 50 percent of allowable energy investment credit and 50 percent of the 25 percent credit for rehabilitating certified historic structures even if the election to take a reduction in regular investment credit was made.

If the taxpayer elects to reduce the regular investment credit rather than reduce the basis, the IC will be four percent for 3-year property and eight percent for other recovery property that is eligible. The election will be made on a property-by-property basis.

If investment credit is recaptured on an asset on which the basis reduction was taken, the basis will be adjusted upward by 50 percent of the recapture amount.

The basis reduction will be treated as a deduction for depreciation for purposes of calculating the amount of depreciation to be recaptured as ordinary income.

Election to Expense Depreciable Property

An expense deduction is provided for taxpayers (other than trusts, estates, or certain noncorporate lessors) who elect to treat the cost of qualifying property, called Section 179 property, as an expense rather than a capital expenditure. To qualify for Section 179, property must be both ACRS recovery property and Section 38 property. The old 20 percent additional first year depreciation option was eliminated beginning January 1, 1981. Section 179 formerly applied to AFYD but now applies to the expense election.

The Section 179 election is $5,000 for 1982 through 1987, will increase to $7,500 in 1988, and to $10,000 in 1990. Although it is intended to replace the old additional first-year depreciation, Section 179 property is not treated exactly like depreciable property. No investment credit is allowed on the portion of any item of property placed under the Section 179 election. There are also restrictions on the use of Section 179 for property acquired from relatives and other businesses controlled by the taxpayer.

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

When ACRS property is converted to personal use before the end of its second taxable year, most of the Section 179 expense deduction claimed must be recaptured. The amount subject to recapture is the Section 179 expense claimed less that proportion of the deduction that would have been allowable depreciation if Section 179 was not used. The amount of Section 179 expense subject to recapture under this rule is reported in Part II of Form 4797.

The major disadvantage of using the election is loss of investment credit, New York as well as federal. While the Section 179 election usually will be to the taxpayer's advantage in the first year, many will be better off in the long run by claiming the investment credit and ACRS deductions. The only depreciable assets that most farmers should consider for the Section 179 election are those that will be held for short periods of time. Farmers in high tax brackets and with high opportunity cost of capital might want to consider expensing rather than depreciating dairy cattle, particularly if they are likely to be held only three or four years.

Anti-Churning Rules

A set of anti-churning rules are designed to prevent a taxpayer from taking advantage of ACRS on property acquired before 1981. These rules are complex and will not be completely covered here.

The rules prevent a taxpayer from using ACRS on property previously used in his or in a related (as defined by IRS) person's business prior to 1981. A young farmer buying personal and real property from his or her parents in 1981 or later that was originally non-ACRS property cannot use the ACRS system but must use the depreciation rules that apply to used property. Tax free exchanges between a taxpayer's business organizations (e.g., incorporation transfers), and leasebacks do not qualify for ACRS depreciation unless the property was originally ACRS property. ACRS property that is sold or transferred from one member of a family to another is not eligible for a new recovery option.

Some Special Rules

For acquisitions after June 18, 1984, there are special rules for depreciation on luxury automobiles used in business and for automobiles, computers, and other "listed property" used not more than 50 percent for business. See page 6.

Additional Rules

Salvage value is disregarded when computing ACRS recovery. No recovery deduction is allowed in the year 1245 property (all 3-year and 5-year class property) is disposed of. Recovery may be claimed in the year of disposition (based on the months held in that year) on ACRS buildings (1250 property).

Gain (or loss) will be calculated and recognized when a depreciable asset is sold much as it is on non-ACRS property. Gain to the extent of ACRS deductions on all Section 1245 three and 5-year ACRS property is ordinary income. ERTA leaves no doubt about how single purpose livestock structures, horticultural structures, silos and grain storages will be handled. When these post 1980 depreciable 1245 assets are sold, all ACRS deductions previously claimed will be recaptured as ordinary income. General purpose buildings and tenant houses in the 15 or 18-year real property classes are still eligible for capital gains treatment if straight line recovery is used. (There is a special rule for corporations for disposals in 1983 and later.) If ACRS fast recovery is used on nonresidential buildings, <u>all</u> gain to the extent of recovery deductions claimed is ordinary income. In effect, the asset becomes 1245 property. If fast recovery has been chosen on either a building or a substantial improvement to it, any gain from disposition of the entire building will be recaptured as ordinary income to the extent of the fast recovery taken on either part of the building. Any remaining gain will be treated as capital gain.

Choosing Recovery Options

Taxpayers will always be better off using rapid recovery on three, five, and 10-year property, assuming the recovery deductions can be used to reduce taxable income. The taxpayer who will not be able to use all the deductions in the early years may want to consider one of the straight line options.

The choice of recovery option is much more difficult for 15 and 18-year nonresidential property for two reasons: (1) The excess of rapid recovery over straight line is subject to the alternative minimum tax. (2) All gain due to fast ACRS recovery is subject to recapture as ordinary income when the real estate is sold at a gain while none of the straight line recovery is recaptured (except for corporations). In other words straight line recovery will result in capital gain (if there is a gain) while fast recovery will result in ordinary gain.

An analysis published in the Journal of Taxation suggests that 15-year straight line recovery is the preferred option on nonresidential 15-year property that is likely to be sold in the future for at least its original cost unless the taxpayer's opportunity cost of capital is extremely high or the holding period will be very long (more than 20-25 years). Most farmers, even those who will not be subject to minimum tax on the excess recovery, probably should select 15-year SL rather than fast recovery if there is a potential for substantial capital gain from sale of the real estate in the next 15 years or so.

Reporting Depreciation and Cost Recovery

Form 4562 will be used to report the Section 179 expense election (Part IA), depreciation of recovery property (Part IB), depreciation of nonrecovery property (Part IC), and amortization (Part II). The only recovery property that may be excluded from ACRS (Part IC, line 4) is property on which depreciation can properly be computed under the unit-of-production method or any method not expressed in terms of years. Depreciation, cost recovery, and Section 179 expenses are combined on 4562 and entered on line 53 of Schedule F. However, partnerships will transfer the 179 expense election to Form 1065 rather than combining it with other items on 4562.

GENERAL BUSINESS CREDIT

Effective for tax years beginning after December 31, 1983, investment credit, business energy investment credit, targeted jobs credit, alcohol fuels credit, and ESOP credit are all part of Sec. 38, General Business Credit. The credit allowable is limited to tax liability up to $25,000 plus 85 percent of the taxpayer's net tax liability exceeding $25,000. Special rules apply to married individuals filing separate returns, controlled groups, certain persons (Sec. 46(e)(1)) and estates and trusts.

FEDERAL INVESTMENT CREDIT

Federal investment tax credit is one of the most important features of farm tax reporting and tax management. The credit is 10 percent of the amount of qualified investment but there are more liberal allowances for rehabilitated buildings. The credit is a direct reduction against income tax liability. If the credit cannot be used in the year it is earned, it can be carried back and carried forward to offset tax liability in other years. If property is disposed of before credit claimed is fully earned, the credit must be recomputed to determine the amount to recapture.

Form 3468 is used for computing the credit, but records showing credit claimed on individual property should be a part of the depreciation record. 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.

- Livestock (other than horses).

- Fences, paved barnyards, roadways, unloading areas, water wells, drain tiles, irrigation systems, and depreciable reservoirs and dams.

- Orchards and vineyards in the year production starts.

- Storage facilities such as silos, grain bins, corn cribs or manure storages used principally for the bulk storage of fungible (interchangeable) commodities.

- Single purpose livestock and horticultural structures.

- Expenditures for rehabilitating buildings 30 or more years old if 75 percent of the exterior walls are retained (see special rules).

- The cost of certified pollution control facilities that are rapidly amortized (60 months) and have actual useful lives of at least five years is 100 percent eligible.

- 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 property.

- Maximum qualifying investment in used property is $125,000 (joint return) in any one year for 1981-87 and will be $150,000 after 1987.

Qualified Investment

For Accelerated Cost Recovery (ACRS) Property acquired after 1980, the extent to which eligible property becomes qualified investment depends upon its ACRS class. Five year property is 100 percent qualified and 3-year property is 60 percent qualified. Ten, 15 and 18-year property that is eligible is 100 percent qualified. For eligible property acquired before 1981 and for non-ACRS property acquired in 1981 and later, the qualified investment depends on useful life: Three or four years, one-third qualifies; five or six years, two-thirds qualifies; seven or more years, 100 percent qualifies. Capital purchases expensed under Section 179 are not eligible for investment credit.

Luxury automobiles acquired after June 18, 1984 are limited to $1,000 of investment credit. Automobiles, computers, and other "listed property" not used more than 50 percent for business will not qualify for investment credit.

Reduction in Credit

For assets acquired after 1982, the taxpayer has the option of reducing the regular investment credit by two percentage points rather than reducing the basis by one-half the investment credit. Thus the qualified investment is 40 percent for three year and 80 percent for other property. This option does not apply to the credit for rehabilitated buildings nor to the business energy credit.

If the investment credit for which the downward basis adjustment was made remains unused at the end of the 15 year carry over period, the taxpayer will be allowed a 50 percent deduction for the unused credit. In the case of rehabilitated buildings, a 100 percent deduction will be allowed.

In the case of leased property where the lessor passes the investment credit to the lessee, the lessee must include in income ratably over the ACRS recovery period an amount equal to 50 percent of the investment credit allowable. As an alternative, the lessee may elect the two point reduction in the regular investment credit.

Buildings

Buildings are not eligible for investment credit. However, 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. The IRS will not accept amended returns for closed tax years. Tax years ending in 1980 and earlier are closed for most farmers.

The 1978 Act did not make all buildings eligible for investment credit. For example, a machinery shed is not eligible nor is a general purpose structure that can be used to house various types of livestock.

Single Purpose Livestock and Horticultural Structures

Regulation 1.48-10, adopted July 18, 1983 contains the rules for single purpose agricultural (livestock) structures and single purpose horticultural structures. Some excerpts from Reg. 1.48-10 follow:

A single purpose agricultural structure may be used only for: "Housing, raising and feeding a particular type of livesock, and, at the taxpayer's option, its produce. ...The structure may also be used for storing feed or machinery, but more than strictly incidential use for these purposes will disqualify the structure". If more than one-third of a structure's volume is devoted to feed storage, the structure will be disqualified but "this presumption may be rebutted with clear and convincing evidence".

If the taxpayer changes the type of livestock (say from dairy cows to hogs) housed in the structure, it no longer qualifies for investment credit.

"A single purpose agricultural structure must also house equipment necessary to house, raise and feed livestock... Required equipment must be an integral part of the structure, and includes, but is not limited to, equipment necessary to contain the livestock, to provide them with water or feed, and to control the temperature, lighting and humidity of the interior of the structure. For purposes of this section, equipment is an integral part of the structure if it is physically attached to or part of the structure. The useful life of the structure, however, need not be contemporaneous with the life of the equipment it houses. A structure without required equipment is not a single purpose agricultural structure."

A single purpose horticultural structure must be used for "the commercial production of plants (including plant products such as flowers, vegetables or fruit) in a greenhouse, the commercial production of mushrooms ... and may, but is not required to, house equipment necessary to carry out these permissible purposes".

"... a single purpose agricultural or horticultural structure may contain workspace only if it is used for:

(i) stocking, caring for, or collecting livestock, plants, or mushrooms,
(ii) maintenance of the structure, or
(iii) maintenance or replacement of the equipment or stock enclosed by or contained in the structure.

Thus, for example, an eligible structure may not contain space devoted to processing or marketing or other nonpermissible purposes."

Those with questions about single purpose agricultural and horticultural structures should read the entire five-page Reg. 1.48-10.

Rehabilitated Buildings

Changes in 1982 eliminated the investment credit for rehabilitating buildings less than 30 years old. Rehabilitation expenditures after December 31, 1981 will earn 15 percent investment credit if the building is at least 30 years old, 20 percent if the building is at least 40 years old, and 25 percent if the building is a certified historic structure.

The rehabilitation must be "substantial", that is, qualified rehabilitation expenditures during the 24-month period ending on the last day of the taxable year must exceed the greater of the adjusted basis of the property or $5,000. The expenditures must have been incurred after 1981. The physical rehabilitation work must begin at least 30 years after the date the building was first placed in service. A transitional rule allows credit for expenditures after 1981 on buildings 20 to 30 years old if the rehabilitation began before 1982.

Expenditures for the interior or exterior renovation, restoration or reconstruction of the building qualify for the credit only if the rehabilitation improvements have a recovery period of 15 years (18 years for expenditures after March 15, 1984). Furthermore, the credit is available for all types of buildings that are used in business or productive activities except buildings that are used for residential purposes. However, the credit may be earned on a certified historic structure that is used for residential purposes. The use of a building is determined based on its use when placed in service after rehabilitation. Thus, rehabilitation of an apartment building for use as an office building would render the expenditure eligible for credit.

Costs for acquiring or completing a building or for the replacement or enlargement of a building do not qualify. To qualify for the credit, at least 75 percent of the existing exterior walls must be retained in place as external walls.

Effective for rehabilitations after December 31, 1983, there is an alternative test for definition of qualified rehabilitated buildings. A building will qualify for purposes of meeting Sec 48(g)(1)(A)(iii) (the 75 percent rule) if:

(i) 50 percent or more of the existing exterior walls of the building are retained as exterior walls,

(ii) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls, and

(iii) 75 percent or more of the existing internal structural framework of such building is retained in place.

The credits are available only if the taxpayer elects ACRS straight line recovery. The basis for recovery must be reduced by the amount of the credit except in the case of certified historic structures where the basis must be reduced by 50 percent of the 25 percent credit.

Special Rules on Livestock Investments and Replacements

Determining the qualified investment in eligible livestock sometimes 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 of the replaced property. 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 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 which were of approximately the same age.

- 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 is important to maintain an accurate 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 15 future years.

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

Recapture of Credit

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

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

The recapture provisions for ACRS property acquired after 1980 are different from those for qualified property acquired before 1981 and for post 1980 non-ACRS property. Disposition of non-ACRS property requires recomputation of investment credit if the property was held for a period which placed it in a life-category shorter than the category used in the original computation of investment credit.

The recapture for ACRS property depends on year-by-year calculations rather than on life-categories as used in non-ACRS property. The investment credit holding period for ACRS property depends on the date actually placed in service, not July 1 as assumed by the half-year convention for depreciation purposes.

Disposition of ACRS property requires recapture according to the percentages in the following table:

If the recovery property ceases to section 38 property within the period:	The recapture percentage is: For 15-year, 10-year and 5-year property	For 3-year property
One full year after placed in service	100	100
More than one but less than two full years after placed in service	80	66
More than two but less than three full years after placed in service	60	33
More than three but less than four full years after placed in service	40	0
More than four but less than five full years after placed in service	20	0

The following is a recomputation illustration based on non-ACRS property:

A tractor was purchased 9/80 for $20,000, estimated life seven years. $2,000 of I.C. was claimed on the 1980 return, $600 was used in 1980, and $1,400 was used in 1981. The 1980 tractor was traded for a new tractor 9/84. The cost basis of the new tractor is $30,000, it is 5-year property, and investment credit is $3,000. The old tractor was held four years and earned only one-third of $2,000 or $667 of I.C. The earned credit is first applied to 1980 and the balance, $67, is applied to 1981. That used in 1981 but not earned, $1,333, does not need to be paid back because that amount of the 1984 credit can be carried back to the 1981 return in the taxpayer's recomputation (assuming there is excess credit in 1984).

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

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

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 in 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.

Reforestation Expenditures

Effective January 1, 1980, a taxpayer may elect seven year amortization on up to $10,000 of qualifying reforestation expenditures each year. Under previous law, such expenditures were capitalized and recovered through a depletion allowance when the timber was harvested 15 or more years later. Under the new law, the taxpayer may also claim 10 percent investment credit on qualifying reforestation expenditures that could be amortized, even if the taxpayer does not amortize the expenditures. The credit does not apply to Christmas trees.

Investment Credit on Leased Property

Farmers often are involved in leases of the type of property that normally would be eligible for investment credit. A common situation would be one where a farmer who owns property on which investment credit has been taken decides to rent or lease the property to a son or other person who will use the property. In most cases, IRS will claim that the property is no longer eligible for investment credit and will require recapture.

In another (probably less common) situation, a farmer or other person acquires property with the intention of leasing it to a farmer. Usually the lessor will be a noncorporate lessor and, therefore, ineligible to claim investment credit (unless he can jump some hurdles which usually are too high). There is a possibility that the lessor could pass the investment through to the lessee even though he could not claim it himself.

Purchase of Leased Property

Tax court decisions have clearly stated that if a taxpayer purchases property otherwise eligible for investment credit that he was formerly leasing, that property will be ineligible for investment credit. The reason is that the same person is using the property after the purchase who was using the property previously. These decisions suggest, for example, that if a farmer purchased a farm with a single purpose livestock structure that he had previously been leasing, the structure would not be eligible for investment credit. Similarly, if a farmer had leased a silo or tractor and subsequently purchased it, the item would not be eligible for investment credit. This would be true whether or not the taxpayer had, as the lessee, received a pass-through of investment credit.

FEDERAL BUSINESS ENERGY INVESTMENT CREDIT

The computation of the business energy credit is made on Schedule B, Form 3468, Business Energy Investment Credit. The eligibility of several types of energy property expired for property purchased after December 31, 1982. Expired property includes: a) alternative energy property, b) specially defined energy property, c) recycling equipment, d) equipment for producing natural gas from geopressured brine, and e) cogeneration equipment.

Qualifying Energy Property

Qualifying energy property includes three groups based on the amount of credit:

- The 10 percent group includes: a) biomass property, and b) qualified intercity buses.

- The 11 percent group includes qualified hydroelectric generating equipment.

- The 15 percent group includes solar and wind equipment, ocean thermal equipment, and geothermal equipment.

In general, eligibility for the business energy credit applies to property described above and purchased through 1985.

Few farmers will be able to collect BEIC on property acquired after 1982. Active solar devices for either space heating or water heating and wind devices for water heating would qualify under the solar and wind category.

Property eligible for the business energy investment credit that is also ACRS property will have the same rules for qualified investment and recapture that apply to regular investment credit on ACRS property. There are some special recapture rules for the business energy credit related to failure to make adequate repayments of loan principal.

Previous to 1981 the extent to which eligible property became qualified investment for the business energy tax credit followed the same rules as for the regular investment credit (3-4 years: 33 1/3 percent, 5-6 years: 66 2/3 percent, seven years or more: 100 percent). Recapture rules for property acquired prior to 1981 also are the same as for regular investment credit.

Amount of Credit

Before 1984, the business energy credit was limited to 100 percent of tax liability and the regular investment credit was applied first, subject to the limitation for that credit. The business energy credit then was applied against 100 percent of any remaining tax liability.

Beginning in 1984, the energy credit from 3468B is combined with the regular credit on 3468 and the total is subject to the limitations described on page 25 of this manual. If a taxpayer has one of the other credits in the general business credit group, new From 3800 will be required.

RESIDENTIAL ENERGY CREDITS

Residential Insulation and Other Energy-Saving Expenditures

The Energy Tax Act of 1978 provided a tax credit for insulation and other energy-conserving expenditures on the principal domestic residence of a taxpayer. The credit is 15 percent 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 energy-conserving components: (1) insulation specifically and primarily designed to reduce the heat loss or gain of a dwelling or water heater, (2) a storm or thermal exterior window or door, (3) caulking or weatherstripping of an exterior door or window, (4) a furnace replacement burner which is more energy efficient, (5) a device for modifying flue openings designed to increase efficiency of the heating system, (6) an electrical or mechanical furnace ignition system that replaced a gas pilot light, (7) an automatic energy-saving setback thermostat, (8) a meter which displays the cost of energy usage, and (9) an item of the kind which the Secretary specifies 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 of quality standards (if any) stated by regulations.

Residential Renewable Energy Source Expenditures

The Energy Tax Act and the Crude Oil Windfall Profits Tax Act (COWPTA) also provided an income tax credit for qualifying solar, geothermal, and wind energy property expenditures on the principal domestic residence of a taxpayer. The credit is 40 percent of the first $10,000 of eligible property for a maximum credit of $4,000. 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. Credit may be claimed for those expenditures installed on a new residence. No credit will be allowed for a swimming pool used as a storage medium or for any other energy storage medium which has a primary function other than the function of such storage. Solar panels will not be disqualified solely because they are structural components of a roof.

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 $4,000) 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 carry over is provided to the extent that the credit exceeds the taxpayer's tax liability. Unused credit can be carried forward 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 43 of Form 1040. To be claimed the total of the two credits must be at least $10.

CASES AND RULINGS

Investment Credit Recapture on Transfer of Assets to New Corporation

In the Loewen case (76 TC90, CCH Dec. 37,619), the taxpayers transferred all their farm assets (market value $1,200,000) except the real estate (market value $1,000,000) to a newly formed corporation. The real estate was leased to the corporation under a year-to-year oral lease. IRS argued that substantially all of the assets necessary to operate the business had not been transferred to the corporation and, therefore, investment credit should be recaptured on the assets transferred. The Tax Court disagreed and held that the lease of the land along with the transfer of other assets necessary to operate the business was sufficient to satisfy Sec. 1.47-3(f)(1)(ii)(c) of the regulations.

Subsequent to this decision, IRS revoked Rev. Rul. 76-514 which dealt with our old friend, the dentist, who was required to recapture IC on his dental equipment transferred to his corporation when he didn't transfer his building to the corporation.

Investment Credit and Leasing

1) A taxpayer was not entitled, either as a manufacturer or as a producer, to an investment tax credit for the costs incurred in developing an almond orchard since he was not in the business of farming. It was the taxpayer's wholly owned corporation, which leased land and the orchard from the taxpayer, that was in the trade of farming. The fact that the taxpayer was involved in the corporate farming activity as president and manager was irrelevant because the corporation's business was not considered a business carried on by the taxpayer individually (IRS Letter Ruling 8220004, January 29, 1982).

   The taxpayer in question was an individual. Individuals are not entitled to investment credit as lessors unless the individual is the manufacturer or producer of the Sec. 38 property [Sec. 46(e)(3)(A)].

2) In L.M. Carlson versus Com., August 8, 1983, Carlson was denied investment credit on apple bins he leased to Welch Apples, Inc. on the grounds that he failed to qualify as the manufacturer of the bins. The bins were bought and paid for by Carlson but ordered and assembled by Welch Apples. IRS claimed (1) assembling was not manufacturing, and (2) Carlson did not carry out the manufacturing function. The tax court agreed with the second point and ruled in favor of IRS.

3) An individual who leased real and tangible personal property and who used the leased property in his farming operations could not claim an investment tax credit for the used personal property in the year he purchased the farm from the lessor because the use he made of the property before and after the sale was substantially identical. Although the leasing agreement assigned no fixed rental to the personal property, there is no requirement that rent be separately stated for a transaction to qualify as a lease (Carl A. Kleuskens and Helen R. Kleuskens vs. Commissioner, T.C. Memo 1982-216).

Hay Lofts and Sawdust Storage

LR 8323011 ruled that a dairy structure with hayloft qualifies for investment credit under 48(p)(2). Because the milking operations structure was specifically designed for the housing, raising, and feeding of dairy cows and their produce, and for housing necessary equipment, it clearly qualified as a single purpose livestock structure. The memorandum also found that the equipment was an integral part of the structure. The loft occupied less than 11 percent of the structure.

LR 8324009 held that a hay storage room and a sawdust storage section meet the 48(p)(2) usage test because they occupy only 29 and three percent of the total volume of the structure and the storage is incidental to the primary use as a dairy facility. A vacant room in the milking equipment wing will not disqualify the structure.

Embryo Transplants

LR 8304020 held that fees for embryo transplants are a deductible expense and do not have to be capitalized. A reproduction center makes separate charges for the embryo, transplanting the embryo, preparing the cow for transplant, and either the fair market value of the cow or a rental charge for the cow. The charges become the obligations of the taxpayer if the cow is pregnant 90 days after the transplant. There is no guarantee of a healthy calf. IRS distinguished this from Rev. Rul. 79-176 which applied to a case where a calf is guaranteed and, therefore, the cost of the calf is a capital expenditure. In the 1983 letter ruling, IRS did not express an opinion on the lease fee. It seems obvious that the purchase of the recipient cow would be a capital expenditure.

Optional Method of Computing Deductible Meal Expenses (Rev. Proc. 83-71)

Taxpayers may elect to deduct a specified amount per day for meals while travelling on business instead of substantiating the actual cost of each meal. IRS refers to the election as the standard meal allowance.

The standard meal allowance is $14 per day for travel that requires a stay of less than 30 days in one general area, and $9 per day if the time spent in one general locality exceeds 30 days. One-fourth the applicable allowance may be claimed for each six-hour portion of a part day the taxpayer spends on the road at the beginning and end of a business trip.

Energy Credit Denied on Wood Stove

The Tax Court has upheld Reg. 1.44C-6(c)(2)(i) that excludes wood and wood byproducts from the list of renewable energy sources. Taxpayers were not entitled to a residential energy credit for costs incurred in connection with the installation of a wood burning stove.

A REVIEW OF FARM BUSINESS PROPERTY SALES

The reporting of gains and losses on the disposition of property held for use in the farm business is a complicated phase of farm tax reporting. Form 4797 must be used to report gains and losses on farm property 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.

1) 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, buildings, and other improvements is treated specifically under Section 1245, 1250, 1251, 1252, and 1255. Note: For real estate and equipment acquired after June 22, 1984 and before January 1, 1988, the holding period is six months.

2) Section 1245 - The purpose of this section is to recapture depreciation, cost recovery, Section 179 expense election, and basis reduction as ordinary income. Farm machinery, dairy and breeding cattle held for the required period and sold at a gain are reported under this section.

   Tangible real property (except some buildings and their structural components) used as an integral part of farming is 1245 property. Single purpose livestock and horticultural structures are 1245 property if placed in service after 1980. Nonresidential 15-year and 18-year ACRS property becomes 1245 property if fast recovery has been used. Other tangible real property includes silos, storage structures, fences, paved barnyards, orchards and vineyards.

   Gain will be ordinary income to the extent of depreciation or cost recovery taken after December 31, 1961 for equipment and December 31, 1969 for cattle. Gain will also be ordinary income to the extent of Section 179 expense deductions and the basis reduction required after 1982.

3) Section 1250 - Farm buildings and other depreciable real property held over 12 months (six months if acquired between June 22, 1984 and January 1, 1988) and sold at a gain are reported in this section unless the assets are 1245 property. If other than straight line depreciation was used on non-ACRS property, a portion of any gain may be recaptured as ordinary income. If regular (fast) recovery has been used on ACRS 15-year and 18-year real property other than residential property, all gain due to depreciation or cost recovery will be ordinary. In effect, this property becomes 1245 property.

4) Section 1251 - Has been eliminated.

5) 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 or all of the gain will be ordinary gain.

6) Section 1255 - When government soil and water conservation payments are not required to be reported as income and the land so improved is sold at a gain after being held less than 20 years, Section 1255 is applicable. Part of all of the gain will be ordinary gain.

Livestock Sales

The majority of livestock sales in New York State are animals that have been held for dairy, breeding or sporting purposes. Income from such sales is always reported on Form 4797. Dairy cows culled from the herd and cows sold for dairy 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 4 through 8. Sales of livestock purchased 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 of 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 and Part III of Form 4797. Since Part III is for recapture, only purchased 1231 livestock that produce a gain upon sale will be entered in Part III where they become 1245 property. Sales of raised 1231 livestock will be entered in Part I. This will include all raised cattle and horses two years of age and older that are held for breeding, dairy, draft or sporting purposes. All purchased 1231 livestock that result in a loss when sold are also entered in Part I.

Reporting Sales of Livestock Not Meeting Holding Period Requirements

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

Tax Management Considerations

The holding period on livestock, and depreciation and cost recovery recapture on purchased 1231 livestock, have a direct effect on the amount of tax liability produced by many farm businesses. Dairy farmers 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 meeting holding period requirements will exceed the total gain from animals held more than 24 months and other business assets meeting holding period requirements then the net loss becomes an ordinary loss.

3) Dairy farmers 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.

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.

Recapture of Real Estate Depreciation and Cost Recovery (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. If rapid depreciation has been used on non-ACRS 1250 property, 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 as it applies to non-ACRS property.

1) If only straight line depreciation has been used on depreciable real estate, and it has been held more than 12 months (six months if acquired after June 22, 1984), no recapture of depreciation takes place and all the gain is treated as 1231 gain.

2) 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.

3) One-hundred percent of excess depreciation taken after December 31, 1969 will be used to convert gain to ordinary gain.

4) 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.

5) Where the property is held less than 12 months (six months if acquired after June 22, 1984), all depreciation - straight line or rapid - will be considered excess and recaptured.

In the case of ACRS property if fast (regular) recovery has been used, the asset becomes 1245 property and all gain due to recovery deductions will be recaptured as ordinary income regardless of holding period. If one of the ACRS straight line options is chosen, all gain will be capital. However, the law allows a different ACRS option to be used on a substantial improvement than on the original building. If fast recovery has been used on either the building or a substantial improvement to it, gain will be ordinary on the entire building to the extent of fast recovery and any remaining gain will be capital gain. For residential real estate, gain will be ordinary only to the extent that fast recovery deductions exceed 15 year straight line on 15-year property and 18 year straight line on 18-year property.

Corporate dispositions of ACRS real property after 1982 are subject to a recapture as ordinary income of 15 percent (20 percent after 1984) of straight line depreciation claimed.

Recapture of Soil and Water Conservation or Land Clearing Expenditures (1252 Property)

Gain on the sale of land held less than 10 years will be part ordinary and part capital gain when soil and water or land clearing expendiures after December 31, 1969 have been expensed. If the land was held five years or less, all soil and water or land clearing expenses taken will be "recaptured" as ordinary gain. If the land was held more than five and less than 10 years, part of the soil and water and land clearing expenses will be recaptured. The percentages of soil and water conservation or land clearing expenses subject to recapture during this time period are: 6th year after acquisition of the land 80 percent, 7th year 60 percent, 8th year 40 percent, and 9th year 20 percent.

Here is an illustration:

Farmland acquired, 1981 cost	$30,000
Soil and water expenses deducted on 1982 tax return	$2,000
Land was sold, 1984 for	$37,000

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 $30,000. The gain of $7,000 would normally be all capital gain. But, the land was not held for more than five years, so the gain is divided; $5,000 qualifies as capital gain, $2,000 is ordinary gain.

Excluded Cost-Sharing Payments (Section 1255)

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

Use of 4797 and Schedule D by Farmers

All sales of farm business properties (except casualties and thefts) are reported on Form 4797 to separate 1231 gain and loss from recapture of depreciation, cost recovery, and Section 179 expense deduction and basis reduction. Casualty and theft gains and losses are reported on 4684 and transferred to 4797. If the 1231 gains and losses reported on 4797 result in a net gain, 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 result in a net loss, the loss is combined with ordinary gains and losses on 4797 and then transferred to Form 1040.

SUMMARY OF REPORTING MOST COMMON FARM BUSINESS PROPERTY

Type of Farm Property	Tax Form and Section
1. Cattle and horses held for breeding, dairy, draft or sporting purposes and held for two years or more; plus other breeding or sporting livestock held for at least one year.	
a) Raised (1231 Property)	4797, Part I
b) Purchased, sale results in gain (1245 Property)	4797, Part III
c) Purchased, sale results in loss (1231 Property)	4797, Part I
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
4. Machinery held for one year or more*	
a) Sale results in gain	4797, Part III
b) Sale results in loss	4797, Part I
5. Buildings, structures and other depreciable real property held for one year or more*	
a) Sale results in gain	4797, Part III
b) Sale results in loss	4797, Part I
6. Farmland, held for one year or more, sold at a gain*	
a) Soil and water expenses were deducted or cost sharing payments excluded	4797, Part III
b) If 6.a. does not apply	4797, Part I
7. Machinery, buildings and farmland held for less than one year*	4797, Part II

*For real estate and equipment acquired between June 22, 1984 and January 1, 1988, substitute six months for one year.

INSTALLMENT SALES

The installment sale method of transferring ownership of farm and other business property continues to be an important and useful business and tax management strategy. The modifications included in ISRA of 1980 broadened the use and application of installment sale reporting. The most significant changes affecting farm taxpayers were: 1) elimination of the 30 percent limit on payment in year of sale, 2) inclusion of casual sales of crops and supplies by farmers on cash basis reporting, and 3) new rules that can affect sales between family members. Elimination of the old rule requiring two or more payments spread over at least two taxable years may be advantageous to some taxpayers.

Installment Sales Between Family Members

Every farm and business family should understand the installment sale resale rules before agreeing to a sales contract. Gain will be triggered for the initial seller when there is a second disposition by the initial buyer, and the initial seller and buyer are closely related. The amount of gain accelerated is the excess of the amount realized on the resale over the payments made on the installment sale. Except for marketable securities, the resale recapture rule will not generally apply if the second sale occurs two or more years after the first sale and it can be shown that the transaction was not done for the avoidance of federal income taxes. The two year period will be extended if the original purchaser's risk of loss was lessened by holding an option of another person to buy the property, or by any short sale.

In no instance will the resale rule apply if the second sale is also an installment sale where payments extend to or beyond the original installment sale payments. Also exempt from the resale rule are dispositions (1) after the death of either the installment seller or buyer, (2) resulting from involuntary conversions of the property (if initial sale occurred before threat or imminence), (3) nonliquidating sales of stock to an issuing corporation. Closely related person would include spouses, parent, children, and grandchildren, but not brothers and sisters.

If tax deferral or avoidance results, then installment sale treatment is not available for sales of depreciable property between a taxpayer and (a) his or her spouse, or (b) a trust owned by the taxpayer or the spouse, or (c) a business which is 80 percent owned by the taxpayer and/or the spouse. An installment sale is allowed in the above cases if no significant tax deferral or avoidance benefits will be derived from the sale. An installment sale between a taxpayer and his or her spouse would be allowed if the sale is incident to a divorce or separation.

Interest Rules

Interest received on the installment sale contract is ordinary income. Regulation 1.483-1 requires that for installment sales exceeding $3,000 entered into after June 30, 1981 that qualify for capital gain, nine percent simple interest must be charged or the IRS will impute interest at 10 percent compounded semi-annually.

The Economic Recovery Tax Act of 1981, however, placed a maximum imputed seven percent interest rate (computed semi-annually) on sales of land between related persons. This implies that the required minimum stated interest rate on these transactions may be six percent simple interest when regulations are released. Up to $500,000 a year in land installment sales to a spouse, sibling, ancestor, or lineal descendant, is eligible for the reduced interest rate. The law specifically states land, not real estate, and it appears the IRS will restrict the eligibility for the lower interest rate to land only.

New Original Issue Discount Rules

The TRA of 1984 changed and extended some OID rules. One new OID rule will determine IRS imputed interest rates on large installment sale transactions occurring after June 30, 1985 (delayed six months by late legislation). The new rule (Code Sec. 1274) says that stated interest on an installment sale must be 110 percent of the federal market rate or interest will be imputed at 120 percent of the federal rate and must be reported annually even if no principal payments are received. The federal rates will be based on average yields for marketable U.S. obligations and will be redetermined every six months.

There are major exceptions from this new 120 percent imputed interest and reporting rule which limit its application. The following sales are covered under other code sections and are subject to other interest rules:

1) Farmland sales not exceeding $500,000 between related parties (see rule discussed above).

2) Sales of farms and small businesses for less than $1 million by individuals, partnership, S corporation, estate or trust. This rule will probably be limited to real property (nine percent stated interest rule applies).

3) Sale of principal residence (nine percent stated interest applies to sale price of $250,000 or less).

4) Sales of business property where total payments, including interest, will not exceed $250,000. This would appear to apply to the sale of dairy and breeding livestock, machinery, partnership interests, closely held corporations, and land trust interests. The 120 percent imputed interest rule applies but it is reported only as principal payments are made.

Reporting Gains

The seller's primary income tax benefit from installment reporting is the ability to spread recognized gain over the period that installment payments are actually received. However, certain kinds of gain have to be recognized first. When both ordinary income (depreciation recapture) and long term capital gain are generated from the sale of assets in the same class, the ordinary income must be reported first. Recaptured depreciation under Section 1245 and 1250 and recaptured Section 179 deductions are ordinary income.

Under TRA of 1984 ordinary income resulting from recapture must be recognized in the year the sale contract is made, even if no principal payments are received in that year. The new law applies to installment sales occurring after June 6, 1984 unless the contract was binding on March 22, 1984. This new law has the potential of wiping out the beneficial tax management effects of some installment sales.

ALTERNATIVE MINIMUM TAX

The alternative minimum tax (AMT) is the only federal minimum income tax paid by individuals. TEFRA combined the old add on minimum tax and the original alternative minimum tax into what we have now. The list of tax preference items was expanded and some deductions were excluded in 1983. The purpose of AMT is to prevent taxpayers with large capital gains exclusions, high levels of investment credit, and large amounts of accelerated depreciation from reducing their income taxes to zero.

Technically the term alternative minimum tax refers to the "net" amount of AMT that exceeds the regular tax. Many farmers and other taxpayers will need to compute alternative minimum taxable income (AMTI). If AMTI exceeds $40,000 on the joint return ($20,000 if married filing separately, $30,000 if single), Form 6251 must be completed to determine AMT liability. IRS is now requesting that Form 6251 be filed showing the AMT computations, even if there is no AMT liability.

Tax Preference Income

The 60 percent capital gains exclusion continues to be the most important tax preference income item for farmers. There are now 11 tax preference items that must be added to AGI to determine AMTI. The most common items are:

1. The 60 percent capital gain exclusion (except gain on principal residence).

2 & 3. Accelerated depreciation on real property and on leased personal property.

4. The $100 ($200 joint return) dividend exclusions.

Other farm business tax preference items include: excess amortization of certified pollution control facilities, excess mining development costs, excess depletion deduction, and excess oil and gas drilling costs. Adjusted itemized deductions are no longer a tax preference item.

Determining Alternative Minimum Taxable Income (AMTI)

The first step in computing AMT is to determine AMTI. AMTI is adjusted gross income less AMT deductions plus tax preference items. The tax preference items are identified above. The allowable AMT deductions are:

1) AMT Net Operating Loss Deduction. Starting in 1984 the AMT net operating loss deduction is calculated by modifying the regular NOL as follows:

   a. AMT itemized deductions are used rather than regular itemized deductions.

   b. Tax preference items used to compute the NOL must be added back in and will reduce the AMT NOL.

   These modifications were not required on 1983 returns.

2) AMT Itemized Deductions. The AMT itemized deductions are limited to:

a. Casualty and theft losses and the wagering loss deduction.

b. Charitable deductions.

c. Medical expenses to the extent they exceed 10 percent of AGI.

d. Qualified interest. (Interest paid on principal residence mortgage and other interest to extent of investment income).

e. Estate tax deduction.

A taxpayer does not have to itemize deductions on Schedule A, 1040 to claim AMT itemized deductions.

3) Accumulation Distributions From Trusts. A beneficiary's share of an accumulation distribution from a trust is an allowed deduction from AGI even though it is never added to AGI.

Here is an AMTI determination example:

A.B. Farmer's 1984 AGI is $40,000. He files a joint return, has no AMT NOL deduction, itemized deductions are $3,500 but only $1,800 qualifies as AMT itemized deductions ($1,700 was State income and sales taxes). His only tax preference income is $24,000 of capital gains deduction. AMTI is computed as follows:

Adjusted gross income	$40,000
AMT itemized deductions	- 1,800
Tax preference income	+24,000
Alternative Minimum Taxable Income	$62,200

Alternative Minimum Tax Rates

The old progressive AMT rate schedule is gone. Now all AMTI above a base exemption is taxed at 20 percent. The base exemption varies according to taxpayer classifications as follows:

Married; joint return & surviving spouse	$40,000
Single taxpayer	30,000
Married, separate return & estate or trust	20,000

AMT Computation and Liability

The 20 percent rate times AMTI that exceeds the base deduction results in a computed or gross alternative minimum tax. Only the amount of gross AMT that exceeds the individual's regular income tax becomes the net AMT or AMT liability. Regular income tax must be net of investment credit and other nonrefundable credits deducted on Form 1040 and does not include ITC recapture.

A.B. Farmer's 1984 net AMT is computed as follows:

Alternative Minimum Taxable Income	$62,200
Less base deduction (joint return)	-40,000
AMTI exceeding base	$22,200
Gross AMT @ 20 percent	$ 4,440
Regular income tax net of $3,000 investment credit (line 50 of 1040)	- 3,142
Net AMT	$ 1,298

A.B. Farmer pays $3,142 of regular income tax plus $1,298 of alternative minimum tax in 1984. The investment tax credit used to reduce regular income tax cannot be used to reduce A.B.'s AMT (see treatment of credits).

Treatment of Credits

Investment credit and other nonrefundable credits can no longer be used to offset AMT attributable to ordinary income. The foreign tax credit is the only credit allowed against AMT. It is possible for a taxpayer to have an AMT liability without having tax preference income. For example; a taxpayer with $60,000 of AGI, $15,000 of investment credit, no tax preference income, filing a joint return, would pay no regular federal income tax but could pay as much as $4,000 of AMT.

If the tax benefit of investment credit and other nonrefundable credits is lost because of the AMT, the credit can be carried to another tax year to the extent of the lost benefit. The previous A.B. Farmer example can be used to illustrate this rule. A.B. Farmer would have had $0 net AMT in 1984 if he had not been able to reduce regular tax with investment credit. The use of IC reduced A.B. Farmer's regular income tax liability to a point $1,298 below his gross AMT causing the $1,298 net AMT. A.B. has lost $1,298 of IC tax benefit that should be added to the balance of unused IC for carryback or carryforward.

When more than one tax credit is cancelled out by AMT, the lost benefit is allocated first to general business credits, then to research credits, to other credits, and last to residential energy credits.

Impact of AMT on Farmers

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

1) Farmers with large amounts of capital gains preference income in relation to Schedule F income.

   Example: C.G. Farmer sold all his raised dairy cows in 1984 for $90,000. No other business assets were sold. Regular farm and other income was $2,000. Adjusted gross income, including $36,000 from the cow sales, was $38,000. Assume regular income tax liability with four exemptions and the standard ZBA equals $5,338. AMT itemized deductions equal $750.

   C.G.'s AMTI and AMT are computed as follows:

Adjusted gross income	$38,000	AMTI	$92,750
less deductions	750	base deduction	40,000
plus tax preference income from		Taxable AMTI	$52,750
sale of cows, $90,000 x .60 =	54,000	Gross AMT	
Total AMTI	$92,750	(AMTI x .20)	$10,550

   C.G.'s 1984 federal income tax liability is $10,550. He must pay $5,338 of regular income tax plus $5,212 of AMT, the amount that computed AMT exceeds regular income tax.

   A very similar alternative minimum tax situation can occur in the year a taxpayer sells farm real estate or the entire business. Fortunately, the capital gain deduction attributable to the sale of a principal residence is excluded from tax preference income.

2) Farmers with more than $40,000 of AMTI and large reservoirs of unused business credits.

NET OPERATING LOSSES

Many New York farmers will sustain a net operating loss in 1984 which may be carried back to recover taxes paid in former years, or carried forward to reduce taxes to be paid in future years. The net operating loss is the taxpayer's loss for the year modified to remove some of the other tax benefits. The calculation of a net operating loss, and its application to recover taxes in another year, is a complex process governed by strict rules of procedure.

How to Report a Net Operating Loss

A farmer who has a net business loss - that is, a minus figure on at the bottom of 1040F - should enter the loss on line 19 of page 1, 1040, as a minus figure. If, as a result, deductions exceed all ordinary income for the year this taxable loss, after adjustments, may be used to offset taxes paid in other tax years. The amount of the loss which may be carried forward or back is called a net operating loss. The net operating loss is not to be considered when calculating net earnings from self-employment for the year to which the NOL is carried.

A NOL is usually carried back before it is carried forward. If it is carried back it must be carried back three years, then to each succeeding year, if necessary, to use it up. A 1984 NOL would be first carried back to 1981, then to 1982, 1983, and then forward to 1985 and in order to 1999 if necessary. The carry forward provision is now 15 years. A taxpayer may now elect to forego the entire carry back period. The election must be made by the due date for the return of the NOL year for which the election is made by attaching a statement to the return. If there is more than one operating loss to be carried to the same tax year, the loss from the earliest year is applied first.

In making a claim for a NOL, a concise statement showing the amount of the deduction and how it was computed must be filed with the return for the year the NOL is used. For a carry back year the statement can be filed with a Form 1045 or 1040X. Form 1045 must be filed within one year after the close of the NOL year. Form 1040X may be filed within three years of due date for the NOL year return. Schedule A (Form 1045) serves as a convenient NOL computation form.

A partnership (or small business corporation) is not allowed to claim a NOL, but each partner may use his or her share of the partnership's NOL to determine his individual loss. A regular corporation's NOL is handled similar to an individual's but the modifications and adjustments are calculated differently.

Step One - How to Calculate a Net Operating Loss

To determine NOL for the year, adjustments must be made by adding the following items to the taxable loss reported on Form 1040. This is the first step and must be done before you know how much loss can be applied to another year's return. Schedule A (Form 1045) is provided to compute net operating losses.

1) Personal exemptions.

2) Nonbusiness deductions (ZBA or itemized deductions) that exceed nonbusiness income.

3) The long-term capital gain exclusion.

4) Capital losses in excess of capital gains.

5) NOL carry overs or carry backs from other taxable years.

D.T. Farmer shows an $18,900 loss on Schedule F. The farm loss is combined with other income and deductions on Form 1040 to show a taxable income on line 37 of ($20,200).

Income:		
Part-time salary		$ 1,000
Interest income		600
Dividends (net of exclusion)		300
Capital gain from Schedule D (1040)		2,400
Supplemental gains (Form 4797)		900
Farm loss		(18,900)
Total Income		$(13,700)
Deductions:		
Itemized deductions	$3,500	
Personal exemptions (3)	3,000	
Total Deductions		- 6,500
Taxable Income		$(20,200)

No net operating loss was carried over to 1984 from a prior year.

The following adjustments are made to compute the current year's NOL:

Taxable Income		($20,200)
Personal exemptions	$3,000	
Capital gain exclusion	3,600	
Excess of nonbusiness deductions over nonbusiness income ($3,500 - 900 = $2,600)	2,600	
Total adjustments		$ 9,200
Net Operating Loss, 1984		$11,000

The above example does not illustrate the adjustment required when capital losses exceed capital gains. Also note that because of the required adjustments the $18,900 Schedule F loss was trimmed to a $11,000 NOL.

Step Two - How to Use the NOL

The full NOL must be carried to the earliest eligible year. If the NOL is equal to or less than the AGI less the ZBA (or itemized deductions) for that year, deduct the full NOL as in Step 3. However, if the NOL is greater than the AGI less the ZBA (or itemized deduction), the NOL must be compared to modified taxable income to determine how much of the available NOL may be used.

Modified taxable income is taxable income for that eligible year adjusted as follows:

1) The capital loss deduction is limited to the amount of capital gains included in gross income. If excess capital losses were claimed, add them back in.

2) The long-term capital gain exclusion must be included in income.

3) Personal exemption deductions are not allowed.

4) Modified taxable income must be computed before any NOL deduction from the loss year and all later years.

5) Itemized deductions based on or limited by a percentage of income (e.g., medical deductions) must be recomputed based on the AGI after modifications 2, 3 and 4 above. Charitable deductions are excluded from this rule.

6) The charitable deduction must be recomputed using a limit based on a AGI modified by rules 2, 3, and 4 and by removing NOL carrybacks.

If D.T. Farmer carries his 1984 NOL of $11,000 back to 1981 where he had a taxable income of $18,780, the full NOL will be used. If 1981 taxable income had been less than $11,000 the adjustments listed above would have been applied to determine the modified taxable income. If 1981 modified taxable income was $8,000, D.T. would deduct only $8,000 of his 1984 NOL on the 1981 return.

Step Three - Determining Amount of Refund

In determining the amount of refund due when a carry back is made to a prior year, the taxable income for that year must be recomputed. After the NOL is deducted, itemized deductions based on a percentage of AGI must be recomputed. The income tax liability for that year, minimum tax, alternative minimum tax, and tax credits claimed must be refigured.

D.T. Farmer determines his 1981 refund as follows:

Adjusted gross income on 1981 return	$18,780
Less 1984 NOL	-11,000
Adjusted gross after carry back	$ 7,780
Minus zero bracket amount	- 3,400
Tax table income after carry back	$ 4,380
Tax liability on $4,380 after carry back	0
Tax liability on 1981 return	1,504
Tax paid on 1981 return (net of IC)	$ 504
Less tax liability after carry back	0
Refund on 1981 return	$ 504

D.T. Farmer paid no minimum tax or AMT in 1981 but $1,000 of investment credit was used to reduce the 1981 tax liability. If there had been no investment credit used in 1981, the tax paid would have been $1,504 and D.T. would be eligible for a $1,504 refund. Since only $504 of income tax was actually paid in 1981, that is the extent of the 1981 NOL refund. However, the $1,000 investment credit originally used is freed by the NOL and is now an unused investment credit balance of $1,000 that may be carried back to 1978.

Step Four - Carry Over Unused NOL to Subsequent Year

Under the alternative assumption, D.T. Farmer's 1981 modified taxable income was $8,000 which limited 1984 NOL used in 1981 to $8,000. The amount of unused NOL, $3,000, is carried over to the 1982 return.

TAX DEFERRED RETIREMENT PLANS

Noncorporate farmers have two tax-deferred retirement plans available to them: the Keogh or HR-10 plan and the individual retirement account plan (IRA). An individual may take an income tax deduction for an IRA even if that taxpayer is an active participant in another qualified retirement plan, including a Keogh. Thus, a farmer may have an IRA in addition to a Keogh plan. To encourage the establishment of a retirement plan, tax is deferred on the contributions and fund earnings until retirement. 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.

Keogh Plans

TEFRA combined the provisions of Keogh and Corporate plans so that they will be, for the most part, indistinguishable beginning in 1984. The purpose was to eliminate the incentive to incorporate a business or practice solely because of the more lucrative corporate pension plan provisions.

For 1984, the maximum annual contribution to a Keogh plan is the lesser of $30,000 or 25 percent of earned income from self-employment. Earned income is equal to net earnings less the plan contribution. The minimum $750 deduction has been eliminated beginning in 1984. The maximum annual retirement benefit under a defined benefit plan will be $90,000. Cost-of-living adjustments for defined benefit plans have been frozen by TRA until 1988.

Beginning in 1984, full-time employees who are at least 25 years old or have one year of service must be included in the Keogh Plan. A self-employed person with a Keogh who changes the business form to a partnership cannot continue to contribute to the old Keogh. The partnership must have its own plan if contributions are to made.

Various restrictions apply to top-heavy plans to prevent discrimination in favor of owner-employees. A defined contribution plan is top-heavy if the sum of the account balances of participants who are key employees for the plan year exceeds 60 percent of the sum of the account balances of all employees under the plan. Multiple plans of a single employer are aggregated to determine top-heaviness. Most farm plans would probably be classified as top-heavy.

Most of the old Keogh plan restrictions apply to top-heavy plans (i.e., distribution by age 70 1/2, 10 percent tax on premature distribution). Some of these restrictions are relaxed for non-top-heavy plans. Employee vesting under top-heavy plans can be either (a) 100 percent for employees at least 25 years old who have completed at least three years of service, or (b) a six-year graduated vesting schedule (20 percent a year after one year).

Also, Keogh plans now qualify for the "perks" that previously only corporate plans qualified for--items such as loans, nonfinancial trustees, integration with social security, more flexible profit sharing, and $5,000 income exclusion for death benefits to beneficiary.

Farmers who have Keogh plans, especially if they have covered workers, should study the changes to see what adjustments or modifications are necessary to keep the plan legal.

Individual Retirement Accounts

A farmer may establish an IRA for himself/herself and a nonworking spouse if desired without covering employees. The maximum annual contribution to an IRA is $2,000 and there is no percentage of earnings limitation. If a taxpayer has $2,000 or less in earnings, the entire earnings can be deposited in an IRA. If the IRA also covers a nonworking spouse, total deductions are limited to the lesser of: 1) $2,250 or 2) 100 percent of the working spouse's earnings. Although the contribution between the two IRA's (working and nonworking spouse) can be unequal, no more than $2,000 can be contributed to either IRA.

The last day a taxpayer may set up a new IRA or make a payment is the due date for filing his or her tax return (not including extensions for contributions made after December 31, 1984). 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. The TRA of 1984 allows the life expectancy to be recalculated each year after the payouts begin. Any premature distribution before age 59 1/2 is subject to a 10 percent penalty tax. However, the restriction does not apply in the event of death or disability. The funds in the plan may not be used to secure a loan without the 10 percent premature distribution tax applying.

Money received from an IRA is included in gross income as ordinary income in the year received. A taxpayer can use income averaging but not the special 10-year averaging rate that applies to lump-sum distributions from qualified employer plans.

The law permits a divorced taxpayer to continue a spousal IRA that had been established at least five years before a divorce, if contributions were made for three of those five years. The annual deduction for the divorced taxpayer is limited to the lesser of $1,125, or the divorced taxpayer's compensation and alimony received during a year. For taxable years beginning after December 31, 1984, alimony up to $2,000 is eligible as an IRA contribution.

If an employee is covered under a Simplified Employee Pension (SEP)-IRA, either the employee or employer may contribute. Beginning in 1984, the maximum employer contribution is 25 percent of compensation or $30,000, whichever is less. The employer's payments to the taxpayer's SEP-IRA are not subject to income tax withholding and are not taxed under the Federal Insurance Contributions Act (FICA) or Federal Unemployment Tax Act (FUTA) if it is reasonable to believe that the taxpayer will be able to deduct the payments. The employee enters the deductible amount on Form 1040. The employee may also contribute $2,000 to an IRA which is part of a SEP or the employee may establish a separate IRA.

Many taxpayers do not understand that they are allowed to move their IRA fund from one trustee to another (i.e., from one bank to another bank) as often as they want without any limitations, restrictions, or tax implication. However, if they receive the money themselves, various restrictions apply to their rollover of the funds to another eligible retirement plan.

Estate Tax on Retirement Plans

The provision that allowed the first $100,000 value of an annuity left to heirs to be excluded from a decedent's estate was appealed by TRA for deaths after 1984. However, there is a transitional rule that will apply in some cases.

NEW YORK STATE INCOME TAX

Review of New York State Tax Laws Affecting Individual Taxpayers

1) New York personal income tax rates have not changed since 1978. They are progressive and range from two percent of New York taxable income not exceeding $1,000 to 14 percent of New York taxable income exceeding $23,000 (see maximum tax on personal service income).

2) The New York standard deduction (for taxpayers who do not itemize deductions) continues at 17 percent of New York adjusted gross income, with a maximum of $2,500. The minimum standard deduction is $1,500 for a single individual and $2,000 for married filing jointly, unmarried head of household or qualifying widows and widowers.

3) The New York personal exemption stays at $800 for 1984.

4) Itemized Deductions and Separate Returns

   If the taxpayer does not itemize deductions on the federal return, he or she cannot itemize on the New York State return.

   A husband and wife may determine their incomes separately and divide the itemized or standard deduction as they elect on separate returns. Each must claim at least one personal exemption. If a farmer's spouse has income greater than personal exemptions, it will usually pay them to file separately. Working, married couples will lose their Schedule W (1040) deduction for state purposes if they file a separate New York State return.

5) Household credit is available to New York taxpayers whose household gross income is less than $25,000 providing they cannot be claimed as a dependent on another taxpayer's return. Household gross income is total NYAGI for both spouses plus additional minimum taxable income for other members of the household. Household credit continues as a direct tax reduction on IT-201.

New York Household Tax Credit, 1982 and After

Household Gross Income	Household Credit 1982 and After
less than $ 5,000	$70
$5,000 - 5,999	55
6,000 - 6,999	45
7,000 - 24,999	40

6) 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.

7) New York State solar and wind energy credit amounting to 55 percent of qualified costs up to $2,750 of credit, is available to homeowners through 1986. The credit is a direct reduction of tax liability and may be carried forward if it exceeds tax liability in any year. The maximum credit limitations apply to each principal residence owned by a taxpayer during this eight year period.

The credit is earned on the costs of purchasing and installing qualified active and passive solar and wind energy systems first used in the taxpayer's principal residence. The energy credit is not allowed on equipment and insulation that is part of the conventional heating, cooling, insulating or electrical systems of a home. It may be prorated between two or more owners of a home or condominium providing the home is their principal residence.

If the solar or wind energy system qualifies for federal residential energy credit, the New York State energy credit will be reduced by the amount of federal credit allowed until the combined energy credits do not exceed 55 percent of the qualified investment or $6,750, whichever is less.

8) The Real Property Tax Credit is unchanged from 1983. The maximum credit allowed qualified taxpayers under age 65 is $45. Taxpayers 65 and older can receive a maximum credit of $250. The credit is based on residential real estate taxes paid, or 25 percent of adjusted rent paid, less a deduction ranging from four to 6.5 percent of household gross income. Following are the deduction rates and maximum credit limitations for 1984 for qualifying taxpayers. Excluded are individuals whose residences are wholly exempt from taxation, owners of real property valued in excess of $65,000, persons claimed as a dependent by another taxpayer and tenants paying more than $300 per month.

Real Property Tax Credit For Qualified Taxpayers, 1982-1984

Household Gross Income	Deduction Rate 1984	Maximum Credit Under 65	Maximum Credit 65 & Over
$ 0 - $ 3,600	.040	$45	$250
3,601 - 5,400	.045	45	250
5,401 - 7,200	.055	45	250
7,201 - 10,000	.055	45	100
10,001 - 16,000	.065	45	100

New York State residents not required to file an income tax return may claim the credit and receive a refund.

9) Other credits allowed against the New York personal income include investment credit, credit for sales tax paid on catalytic agents, mortgage recording tax credit, research and development credit, and resident credit for other state income taxes paid.

10) A spousal IRA deduction claimed on a joint federal return is allowed on the nonworking spouse's separate New York return. Each spouse's deduction must equal the amount contributed to his or her own account.

11) The maximum tax rate on New York personal service income continues at 10 percent for 1984 and the capital gains deduction will not be subtracted in

determining personal service income. Personal service income includes wages, salaries, professional fees, compensation for services, ordinary gains from the sale of property, plus most pension and annuity income.

12) Modification of AGI Related to New Business Investments

If a New York taxpayer realizes long-term capital gains from the sale of investments in new businesses in New York State, the taxpayer may be eligible for a reduction of federal AGI. To qualify, the new business investment must have been made after June 30, 1981 and held for at least four years. Only corporations and partnerships can issue qualified business investments. A qualified investment held four years will earn a 25 percent reduction, five years 50 percent, and six years or more 100 percent.

Beginning with 1982, a taxpayer may elect to subtract from federal AGI reinvested long-term capital gain realized from a capital asset which is not a business investment. The capital gain must be reinvested in a New York new business within one year from date of sale to qualify.

Review of Important New York State Income Tax Problems and Opportunities Affecting Farm Businesses

1) New York Remains Uncoupled From ACRS Through 1984

In the place of the ACRS deduction, New York State allows a deduction for depreciation equal to the deduction which would have been allowed under IRC Section 167 depreciation rules. Section 167 includes the old depreciation rules excluding AFYD. The required adjustment to federal taxable income are as follows:

Step 1: add the amount allowable as a deduction under IRC Sec. 168 (ACRS)

Step 2: subtract the depreciation allowable under IRC Section 167 as if it were still in effect.

The cost basis of an asset may not be adjusted when New York depreciation is less than federal. The federal basis must be used to compute New York depreciation and to determine gain or loss on disposition. However, the law allows a modification to federal AGI in the year of disposition on an asset where New York depreciation has been different than federal cost recovery. The modification enables a taxpayer claiming less New York State depreciation than allowed under ACRS to decrease federal AGI for state purposes in the year of disposition. If New York State depreciation were greater than federal, the modification would be an increase in AGI.

There are other major problems associated with the uncoupling amendment. The required two step adjustment implies that separate non-ACRS calculations are required. There is a second problem associated with the federal option to reduce basis by 50 percent of investment credit claimed. The basis for federal depreciation is the basis used for NYS depreciation. Taxpayers electing to reduce basis to gain the full amount of federal investment credit will give up an equal amount of NYS depreciation.

Farmers and their tax advisors are encouraged to use initiative and wisdom in computing and documenting acceptable state depreciation deductions that will be the same as federal ACRS deductions.

2) New York State investment credit continues at six percent on qualified tangible personal property acquired, constructed, reconstructed or erected on or after July 1, 1982.

ACRS property placed in service after December 31, 1980 qualifies for New York State investment credit. This means light trucks and breeding hogs in the ACRS three year class and used primarily for farm production will qualify for NYIC. There is no reduction in the amount of credit allowed for three year property. Farmers are continually disallowed NYIC on light trucks used for transportation. Three year ACRS property that qualifies for NYIC and is kept in use for three years will earn the full six percent NYIC. Five year ACRS property that qualifies for NYIC earns full credit after five years, even if a straight line 12 or 25 year recovery period is elected. Building and structural components on all non-ACRS properties that qualify for NYIC must still be held 12 years.

The remainder of the formula used to determine the amount of NYIC earned or allowable when investment credit property is disposed of remains the same. Multiply the original credit claimed by the ratio of months of qualified use divided by months of useful life to determine earned or allowable credit. Credit claimed less credit earned is subject to recapture.

New York investment credit must be taken by the lessee/user of qualified property involved in a Safe Harbor lease for taxable years beginning after December 31, 1981. NYIC cannot be claimed by the lessor.

New York investment credit covers qualified building rehabilitation expenses incurred by certain retail enterprises in New York State, on or after June 1, 1981. Retail enterprises must be a business selling tangible property to consumers and the owner must be a registered vendor. The credit is computed on the cost or other basis of an investment that qualifies for the federal investment credit on qualified rehabilitated buildings. The regular New York State IC rates apply.

Unused New York State investment tax credit claimed by a new business is refundable for tax years beginning on or after January 1, 1982. But, the election to claim a refund of unused credit can be made only once in one of the first four years. A business is new during its first four years in New York State. Only proprietorships and partnerships qualify. This refundable credit is not an additional credit for new businesses. A business that is substantially similar in operation and ownership to another business that has operated in the state will not qualify.

3) Employment incentive tax credit is still available to regular corporations that qualify for NYIC and increase employees one percent during the year. The credit is an additional one-half of the regular investment credit for each of the three years following the taxable year in which NYIC was allowed. The additional credit is available to newly formed as well as continuing corporations. The credit may not be used to reduce the franchise tax below the flat-fee minimum ($250).

4) Research and Development Tax Credit is now in effect on qualified property purchased after June 30, 1982. Although this 10 percent tax credit will not apply directly to commercial farmers, they may receive some long run

indirect benefits if agribusiness firms are encouraged to invest in qualified property.

5) New York State Minimum Tax

Federal items of tax preference after New York modifications and deductions are subject to the New York State minimum tax rate of six percent. The primary deduction is $5,000 ($2,500 for a married taxpayer filing separately).

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

6) 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. The minimum franchise tax is $250. The maximum for successful farm corporations is usually 10 percent of taxable income. Small corporations (less than $1,000,000) are no longer required to use the total capital method of tax computation during their first two years. Investment credit is claimed on CT-46. Claims for refunds resulting from net operating loss and capital loss carry backs are made on CT-8.

A declaration of estimated tax must be made by every corporation if New York State tax liability can be expected to exceed $1,000. The first installment is due when the previous year's final return is filed, is based on 25 percent of the previous year's tax, and must be paid even if tax liability is expected to be less than $1,000. Form CT-400 must be filed with the second installment on or before the 15th day of the seventh month of the tax year if a declaration is required. The payment is one-third of the estimated tax balance. Another one-third installment is due on October 15.

7) Information Returns

The New York State law is essentially identical to the federal law regarding payments of $600 or more to New York taxpayers.

8) Payment of New York State Income Taxes Withheld

Although income tax withholding is not mandatory for agricultural employers, an April 1, 1983 change in the payment rules may make withholding more attractive. An employer who expects to withhold less than $600 semiannually is required to file and deposit the tax on July 31 and January 31. This amount increases to $800 January 1, 1986. Monthly returns and deposits are required by employers withholding from $600 to $7,500 semiannually.

9) Estimated Tax Rules Updated

New York State has amended the state tax law to conform the estimated tax requirements to similar amendments made to the IRC by TFRA.

FEDERAL INCOME TAX SUGGESTIONS FOR PART-TIME FARMERS

People who work in town and live in the country sometimes derive income from their rural holdings. The manner in which such income and associated expenses should be reported to Internal Revenue depends on the kind and amounts involved. The following may help to clarify the federal income tax responsibiliies and opportunities of rural dwellers who have some farm income.

1) Every individual, partnership, or corporation that owns and operates a farm for profit is designated as a farmer. Income from the farming operation is treated as income from any other business in that it must be reported. Farmers are generally advised to report on the cash basis because it is easier and offers more flexibility than does the accrual method of reporting. Only individuals receiving two-thirds or more of their gross income from farming are exempt from quarterly estimates and subject to farm filing dates.

2) Many part-time farmers are more concerned about deducting losses than they are about reporting income. A person who operates a farm for recreation or pleasure without the motive of making a profit has a hobby and not a business. A hobby farmer may deduct farm interest, taxes, and casualty losses, and other farm expenses only to the extent of farm income.

3) Establish a profit motive to deduct farming losses. The key to being allowed to use farm losses to offset nonfarm income is the establishment of a profit motive. Actual profits are not required but the taxpayer must be prepared to present his or her case to the IRS to prove the profit motive. Here are the factors IRS considers in deciding whether an activity is engaged in for profit:

   1. The businesslike manner in which the business is conducted.
   2. The expertise of the taxpayer's advisors.
   3. Hiring of a professional farm manager.
   4. The time and effort expended by the taxpayer.
   5. The taxpayer's pursuit of knowledge.
   6. Expectation that assets may appreciate in value.
   7. Residence on or near farm.
   8. The size of farm losses in relation to outside income.
   9. The financial status of the taxpayer.

4) Managing farm income and expenses to have profit years is another alternative. Farmers that feel uncertain about establishing an acceptable profit motive have another opportunity to be classified as "profit farmers". Under Sec. 183 of the Tax Code, IRS provides a presumption that can operate in favor of the taxpayer. Under the presumption, the farming activity will be presumed to be a profit activity if it showed a profit two or more years out of five consecutive years (two out of seven for horse farmers). Electing this presumption does not guarantee safety from the IRS. It merely shifts the burden of proof from the taxpayer to the IRS. Use of the presumption rule can be postponed to give the taxpayer a chance to establish two profit years by filing Form 5213.