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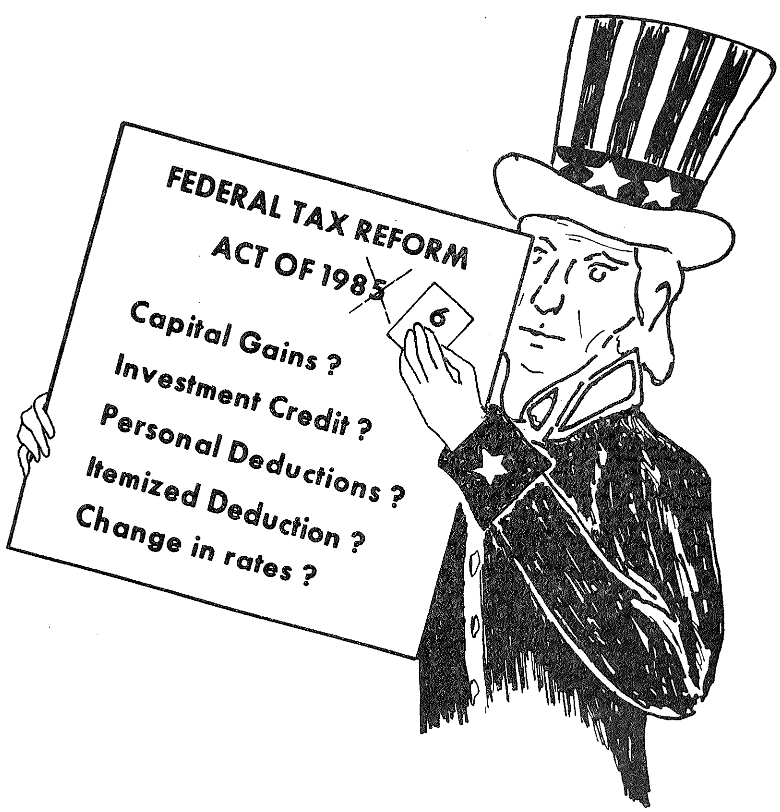
FARM INCOME TAX MANAGEMENT AND REPORTING

Reference Manual



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1985 TAX FORMS NEEDED BY NEW YORK FARMERS

Here is a list of the more important 1985 income tax forms needed by farmers and some indication of those that have changed.

Federal Forms

1040 - U.S. Individual Income Tax Return
- Schedule A & B - Itemized Deductions and Dividend and Interest Income
- Schedule D - Capital Gains and Losses - revised to include 1099-B DATA
- Schedule E - Supplemental Income Schedule
- Schedule F - Farm Income and Expenses - substantially revised
- Schedule G - Income Averaging
- Schedule R - Credit for Elderly and Permanently and Total Disabled
- 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
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 (undated)
4562 - Depreciation: use to report depreciation, cost recovery, and Section 179 expense election - revised for 1985 to include data on listed property
4684 - Casualties and Thefts
4797 - Supplemental Schedule of Gains and Losses
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)

CONTENTS

1985 FARM TAX AND INCOME SITUATION

New Legislation

After several years of major federal tax legislation, 1985 was a lull. The contemporaneous recordkeeping requirements included in the Tax Reform Act of 1984 were repealed and new recordkeeping rules instituted. The below-market interest rate issue was settled, along with a change from 18-year to 19-year property.

Tax Reform

Congress has been rather slow in reacting to President Reagan's tax reform proposals. The House of Representatives has considered several of the issues but, at this writing, had not yet acted on the major issues such as elimination of investment credit, elimination of many itemized deductions, and lowering of rates. The Senate is not likely to take action in 1985.

Some of the provisions in the President's proposal could have major impact on taxes paid by farmers. Elimination of investment credit and elimination of capital gains treatment on livestock sales, while partly offset by increased personal exemptions and the zero bracket amount, could have major impacts on the tax bills of some farmers. The proposed longer depreciation periods would have some impact initially but would be at least partly offset in the long run by inflation-adjusted depreciation changes. The proposal to require preproductive expenses (on orchards, vineyards, and replacement livestock) to be capitalized could initially reduce deductions and increase taxes but this would be offset by depreciation charges during the productive years. It is not clear that the provision would be applied to the raising of replacement dairy or beef animals.

The 1985 Income Situation

Dairy farm incomes in 1985 are likely to average somewhat higher than in 1984 because decreased feed costs more than offset lower milk prices. Data for January through September on 43 CAMIS dairy farms show a $7,800 per farm ($48 per cow) increase in cash operating income over 1984. However, milk prices in the last quarter of 1985 will be substantially below 1984 levels and will not be completely offset by lower feed prices. Therefore, the increase in cash flow over 1984 levels will moderate by year-end.

Producers of corn, wheat, oats, and potatoes are likely to have net incomes well below 1984 levels. Many grape farmers and some apple producers will have incomes in 1985 substantially below 1984 levels due to marketing problems.

Egg and hog prices in 1985 will average below 1984 levels but the lower receipts will be partly offset by lower feed prices.

A Tax Management Challenge

A relatively small number of farmers need and use good income tax management advice every year. All farmers need to think tax management in planning a farm sale or transfer. Some economists predict that as many as 25 percent of New York's commercial farmers will exit from farming in the next three to five years. If 5,000 farmers sell assets for more than $1 billion, good planning and tax management will save these families several hundred million dollars. Are you ready and prepared for this million dollar challenge?

REVIEW OF IMPORTANT CHANGES FROM ERTA THROUGH THE TRA OF 1984

Many of the changes have been included in later topical sections. Others that are potentially important to farmers are reviewed here.

Changes Affecting Individual Taxpayers

Indexing Provisions

Indexing provisions that will adjust individual tax rates, the zero bracket amount, and personal exemptions for inflation took effect in 1985. The adjustments are intended to prevent taxpayers from being pushed into high tax brackets by inflation.

The adjustment for 1985 is 4.1 percent based on the increase in the CPI for the 12 month period ending September 30, 1984. The resulting 1985 changes (rounded to the nearest $10) are:

- The personal exemption is $1,040 for 1985.
- The standard deduction is $3,540 for married couples filing a joint return, $2,390 for single taxpayers.
- Individual tax brackets are widened by 4.1 percent.

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 1985 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.

Charitable Contribution Deduction for Non-Itemizers

The maximum deduction in 1985 for non-itemized charitable deductions is 50 percent of qualified contributions. The deduction is scheduled to increase 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 later, the separate deduction for drug expenditures in excess of one percent of adjusted gross income was 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.

Earned Income Credit

For tax years beginning <u>after</u> 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.

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.

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 Sections 21-24) will be totaled and claimed as a group on 1040.

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

A "general business credit" (Code Section 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 carry over or carry back 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 Sections 31-34.

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.

Corporations

Corporate Tax Rates and Provisions

Corporate tax rates are the same in 1985 as in 1984. The progressive rates vary from 15 percent of taxable income not exceeding $25,000, to 46 percent of taxable income exceeding $100,000.

A regular corporation is subject to a 15 percent add-on minimum tax on tax preference items. Tax preference income is reduced by $10,000, or the regular income tax if greater than $10,000. A corporation's tax preference items are similar but not identical to those of an individual taxpayer.

Changes have been made in the rule that reduces certain corporate tax preferences. The item most likely to affect farmers is the treatment of gain from dispositions of Section 1250 property after 1984. Twenty percent of the additional amount that would have been recaptured as ordinary income if it had been Section 1245 property becomes ordinary income. Therefore, tax preference income from the sale of Section 1250 property must be reduced by 20 percent. The applicable percentage for 1983 and 1984 was 15 percent.

Graduated Tax Rates

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

S Corporations

The changes affecting S corporations due to the TRA of 1984 are too numerous to cover here. Most appear not to affect most farm S corporations substantially.

Other Changes Affecting Farmers

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.

LUXURY AUTOS, LISTED PROPERTY, AND SUBSTANTIATION OF BUSINESS EXPENSES

Depreciation and Investment Credit for Luxury Automobiles

For autos and other 4-wheeled vehicles manufactured primarily for use on public streets, roads, and highways weighing 6,000 pounds or less placed in service after June 18, 1984 and before April 3, 1985 used over 50 percent for business, the ACRS deductions and IC are limited. IC is limited to $1,000 unless the taxpayer elects the reduced IC, in which case IC is limited to two-thirds of what it would otherwise be. The ACRS deduction is limited to $4,000 the first year (Section 179 election would also be limited to $4,000) and $6,000 for succeeding years. The limits apply before the percentage allocation to business versus personal is made.

The 1985 Act placed lower limits on both depreciation and IC for vehicles placed in service after April 2, 1985. IC is limited to $675. If the reduced IC is elected rather than the reduced basis, the IC limit is $450. Depreciation or the Section 179 deduction is limited to $3,200 in the first year and $4,800 in later years. The inflation adjustment on IC and depreciation that the 1984 Act would have applied to vehicles acquired after 1984 was delayed by the 1985 Act until after 1988.

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 5-year life for 3-year property, 12-year life for 5-year property, 25-year life for 10-year property, and 40-year life for 18 or 19-year property. There are also several other new rules.

If the more than 50 percent test is met, IC 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 IC 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 IC and of depreciation and Section 179 expense election in excess of that which would be allowable under the applicable straight line method.

Substantiation of Business Expenses

The requirement for contemporaneous records (Code Section 274(d) as revised by the TRA of 1984), that was to have become effective in 1985 was repealed. Therefore, in 1985 the rules for substantiation of business expenses are the same as they were before the "contemporaneous record" rules were enacted. Tax deductions and credits may be substantiated either by adequate records or by sufficient evidence, oral or written, corroborating the taxpayer's own statement. Local travel was not subject to the 274(d) requirements before the 1984 Act.

The provision that would have imposed a penalty on return preparers if they failed to obtain a written confirmation that contemporaneous records were being kept was also repealed.

In 1985, local travel expenses are not subject to the Section 274(d) rules (time and place of travel or entertainment, business relationship to the taxpayer, etc.). They are subject to the substantiation requirements applicable to all other business expenses which presumably means proof that the expenditure was made.

For tax years beginning after 1985, the Section 274(d) rules as revised by the 1985 law, will apply to local travel and to listed property as defined in Section 280F(d)(4) as well as to the expenses covered by the substantiation rules in 1985 and earlier. In general, listed property includes automobiles, other property used as a means of transportation, property of a type generally used for purposes of entertainment, recreation or amusement, and computer or peripheral equipment.

Beginning in 1985, any taxpayer who claims deductions or credits for business use of an automobile will need to answer a series of questions on his/her tax return such as:

1. The total number of miles driven during the year.

2. The percentage of personal use claimed.

3. Whether the vehicle was used for commuting and, if so, the distance normally commuted.

4. Whether the vehicle was available for personal use in off duty hours.

5. Whether another vehicle was available for personal use.

6. Whether adequate records or sufficient evidence exist to justify the deduction, and whether or not the evidence is written.

Similar questions are to be answered about computers and other listed property.

Certain vehicles which are not likely to be subject to personal use, such as delivery trucks seating only one person, are exempt from the 274(d) requirements. Pickup trucks are <u>not</u> exempt.

<u>Personal Use by Employee of Employer Owned Vehicles</u>

If an employer has a written policy that prohibits personal use of company owned vehicles but requires (for bonafide noncompensatory business reasons) that the vehicle be used for commuting, then the substantiation rules of 274(d) do not have to be met with respect to such vehicles. But, the value of the use of the vehicle for commuting must be included in the employee's income.

ESTIMATED TAXES

Estimated Taxes

The rules governing payment of estimated taxes for years beginning in 1985 have been restructured. Exceptions 4 and 2 on Form 2210 described in old Section 6654(d) (3) and (4) were repealed. Form 2210 has been revised.

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 and later, IRS has more discretion in waiving penalties.

Estimated Tax Threshold and Farmers Exemption

If the 1985 estimated tax was $500 or more, estimated tax payments were required. In 1986, the estimated tax threshold remains at $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 (Revenue Ruling 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.

Although rental income is excluded from farm income, it must be included in gross income. If the taxpayer does not meet the two-thirds of gross income from farming test the estimated tax threshold rule applies and total gross income is subject to estimated tax.

INFORMATIONAL RETURNS

There are no major changes affecting the 1985 filing requirements and penalties associates with informational returns.

Provisions

The provisions affecting farm taxpayers are reviewed here.

1. Form 1099-MISC must be filed by any person engaged in a trade or business, on each nonemployee paid $600 or more for services performed during the year. Rental payments, royalties, prizes, awards, and fishing boat proceeds must also be reported when one individual receives $600 or more.

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

3. Farmers should include payments made to independent contractors, veterinarians, crop sprayers, repair shops, and building contractors. Payments made for grain, feed, supplies, and other merchandise are excluded.

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

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 with a maximum of $50,000 per calendar year. Failure due to intentional disregard of the law subjects the taxpayer to a minimum penalty of 10 percent of the amount not reported, except for brokers, and there is no $50,000 maximum. The $50,000 ceiling does not apply to failure to file 1099-DIV and 1099-INT returns.

The TRA of 1984 provided that the penalties are to be self-assessed by the payor without notices or demand from IRS. Interest accrues on these penalties from the due date.

Returns Required for Certain Payments Received

1. A person who receives $10,000 or more in cash (not including checks) in one transaction in the course of a trade or business must file a 1099. Applies to amounts received after December 31, 1984 (Code Section 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 on Form 1098.

3. The transferor of a partnership interest in appreciated inventory and unrealized receivables must notify the partnership and the partnership must file an informational return.

Magnetic Media

People who 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 Publication 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. Returns on magnetic media are to be sent to the National Computer Center (address below).

Taxpayers can get relief from the above requirement if they establish that filing on magnetic media would cause undue hardship. Requests for relief or more information should be directed to the National Computer Center:

Magnetic Media Reporting
Internal Revenue Service
National Computer Center
P.O. Box 1359
Martinsburg, West Virginia 25401-1359 Phone: (304)263-8700

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.

THE SOCIAL SECURITY TAX SITUATION AND MANAGEMENT OPPORTUNITIES

Increases in social security (FICA) taxes and self-employment taxes imposed by the Social Security Tax Act of 1982 and amendments of 1983, have placed a higher priority on exploring opportunities to reduce the burden of these taxes through wise tax management.

The Current Tax Burden

Currently (1985) self-employed individuals pay an effective rate of 11.8 percent (14.1 less 2.3 credit) that will generate a maximum of $4,673 self-employment tax. This is an increase of $402 or nine percent over the 1984 maximum of $4,271. The maximum self-employment tax increased 28 percent from 1983 to 1984. The 1986 effective rate increases to 12.3 percent.

Social Security (FICA) rates have increased to 7.05 percent for both employers and employees in 1985. The 1984 credit equal to 0.3 percent of employee income is not in effect for 1985. The combined employer and employee FICA tax rate for 1985 is 14.1 percent. The maximum earnings base was increased 4.8 percent to $39,600 for 1985 making the maximum combined FICA tax $5,584.

Social Security Tax Table

Year	Earnings Base	FICA Tax Rate		Self-Employment Tax		
		Employer	Employee	Specified Rate	Credit	Effective Rate
1984	$37,800	7.0%	6.7%	14.0%	2.7%	11.3%
1985	39,600	7.05	7.05	14.1	2.3	11.8
1986 & 87	*	7.15	7.15	14.3	2.0	12.3
1988 & 89	*	7.51	7.51	15.02	2.0	13.02
1990 & later	*	7.65	7.65	15.3	0.0	15.3

*To be recalculated each year to reflect the change in the CPI.

After 1989, the credit against the self-employment tax will be discontinued. Starting in 1990, self-employment taxpayers will be allowed a deduction from taxable income of one-half of the self-employment taxes paid that can be attributable to a trade or business. Or, they may deduct from self-employment income 7.65 percent of net earnings from self-employment when computing the self-employment tax.

Income Subject to The Self-Employment Tax

The self-employment tax is generally computed on the net earnings of a trade or business. For farmers this is the net profit shown on the bottom line of Schedule F. The tax for 1985 is computed on the first $39,600 of net earnings from the trade or business.

Wage Payment to Spouse or Children

If the person is a sole proprietor (not a corporation and not a partnership unless the partnership is solely owned by mother and father), wages paid to a spouse, or to a son or daughter under age 21 at the end of the calendar year, are not subject to Social Security taxes.

The wages paid have to be reasonable for the services performed and the services must be actually performed and detailed work and payment records kept.

Many farm wives provide labor for the business but are not paid a wage. The following example shows the effect on the husband's self-employment tax of an $8,000 wage paid to the wife for services to the business.

Example: Net farming income before payment	$25,000
Self-employment tax before payment	2,950
Salary to wife $8,000	
Net farm income after payment of salary to wife	17,000
Self-employment tax after payment	2,006
Self-employment tax savings =	$ 944

The $8,000 payment to the wife does not directly save federal income taxes because it would be included as income on a joint tax return. However, it does qualify for an IRA retirement contribution by the spouse.

Noncash Payments to Employees

Social Security tax does not have to be paid on payments that are other than cash for agricultural labor. So, wage payments to agricultural labor in crops or livestock are not subject to Social Security tax. This technique could be used for children who are working on the farm but are over age 21 or for other agricultural labor. When payments are made in kind and not in cash, the following conditions should be met.

1. Physical possession of the crop or livestock should be given to the employee.
2. Pre-arranged sales should be avoided.
3. The employees should be instructed to decide the time, place, and terms of the sale rather than simply adding them to the employer's marketing activity [Revenue Ruling 79-207].

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

Taxation of Social Security Benefits

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

A. one half of the benefits received, or
B. half of the excess of the sum of the taxpayer's adjusted gross income, interest on tax-exempt obligations, and half of the Social Security benefits over the base amount. ($32,000 for persons filing jointly, $0 for married persons filing separately, and $25,000 for all other individuals.)

Example: Joe and Mary Retiree provide you with the following information. How much of their benefits are taxable in 1985?

S.S. benefits received (joint return)	$14,000
AGI	38,000
Tax exempt interest	2,000

Lessor of: A. One-half of benefits ($7,000) or
B. 38,000 + 7,000 + 2,000 = 47,000. Half of the excess over $32,000 equals $7,500

Answer: $7,000 (lower of A or B) of the benefits of this couple will be included in gross income in 1985.

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 included 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.

If an S corporation elects the ITC basis reduction, each 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.

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 Section 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 a tax year to be effective for that tax year. 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.

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.

Reporting Exchanges of Interest in Section 751 Property

A transfer of partnership interest for unrealized receivables, substantially appreciated inventory items, or money will require an information return for exchanges beginning with the 1985 tax year. Unrealized receivables include depreciation recapture of Section 1245, 1250, 1251, and 1252 property plus any partnership right to payment for noncapital goods or for services rendered (to the extent not previously included in income). Inventory items include property held primarily for sale to customers, and trade accounts receivable. Unrealized receivables and substantially appreciated inventory are Section 751 property which is always treated as ordinary income in situations involving sale or exchange of a partnership interest, nonproportionate distribution, or liquidation.

IRS cannot get complete or adequate information on Section 751 exchanges from Form 1065, therefore, an information return is required. The information return shall state the name and address of the transferor and transferee in the exchange and whatever other information that the Secretary may prescribe in regulations. Every partnership making a return shall furnish each partner a copy of the return on or before January 31 following the calendar year for which the return was made.

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 (Section 754) to allocate the above items to take account of the difference between basis and fair market value. The new rule prevents the shifting of built-in deductions, gain or loss from the contributing partner to other partners which can cause economic inequity between partners.

Example: M.E. Plow in equal partnership with U. Plant contributed a tractor with an adjusted basis of $15,000, original cost $30,000 and a fair market value of $25,000. If the tractor were sold by the partnership for its fair market value, all the gain would be Section 1245 ordinary income. Under present regulations, if special allocation is not elected, the ordinary income from the sale would be shared equally by Mr. Plow and Mr. Plant. However, Plow has received all the benefit from the depreciation claimed and economically should report the full $10,000 in his income. Under the new rule, gain on the tractor to the extent of depreciation claimed by Plow (difference between FMV and basis) will be attributed to Plow.

Partnerships may continue to rely on the regulations in Section 704(c)(2) until IRS publishes the new regulations.

Some Important Guidelines for Transferring Partnership Interests

1. A Cost Basis balance sheet and FMV allocation to assets is the starting point for any transfers of partnership interest.

2. Before the sale, liquidation or disporportionate distribution of partnership assets, check for substantially appreciated inventory and unrealized receivables.

3. A proportionate distribution of assets, a sale or liquidation of a partnership interest requires an allocation of the partner's partnership basis to his or her share of the partnership assets.

4. A selling partner determines his or her gain as the difference between his or her allocated basis and the amount realized.

5. A purchasing partner (if a Section 754 election has been made by the partnership) allocates the difference between purchase price and his or her share of the common partnership basis of assets according to the difference between the total partnership basis and FMV of assets.

6. In the liquidation of a partner's interest, the assets are classified into 736(b) payments for property and inventory, and 736(a) payments. If a 754 election has been made, the liquidated partner's gain on the 736(b) payments is allocated to the partnership according to the difference between the partnership basis and FMV of assets.

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. (See further discussion under A Review of Business Property Sales.)

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.

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, goats or sheep held for dairy or breeding purposes because the ADR class life of these animals is greater than four years.

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

3. Race horses more than two years old when placed in service and 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:

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 ERTA 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 includes 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 are also 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 and before May 9, 1985. This class includes the same items that would have been in the 15-year class if placed in service prior to March 16, 1984. If placed in service after June 22, 1984, a mid-month convention applies.

Nineteen-year property. Property that would have been in the 18-year class if placed in service before May 9, 1985 is 19-year property if acquired on or after May 9, 1985.

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 on 3, 5, and 10-year property, the percentage recovered each year will be the amount shown in the table below. These rates approximate 150 percent declining balance with switchover to straight line and a half-year convention applied in the year of acquisition. The rates for 15, 18, and 19-year property are based on 175 percent declining balance with switchover to straight line and do not use the half-year convention. The 15 and 18-year property rates are shown in the following tables. See Publication 534 for rates on 19-year property.

FAST (REGULAR) RECOVERY PERCENTAGES FOR ACRS 3, 5, & 10-YEAR PROPERTY

Recovery Year	Type of Property: 3-Year	5-Year	10-Year
	----	percentage	----
1	25	15	8
2	38	22	14
3	37	21	12
4	--	21	10
5	--	21	10
6	--	--	10
7	--	--	9
8	--	--	9
9	--	--	9
10	--	--	9

FAST (REGULAR) RECOVERY FOR ACRS 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

FAST (REGULAR) RECOVERY FOR ACRS 18-YEAR PROPERTY PLACED IN SERVICE DURING TWO DIFFERENT TIME PERIODS

Property Placed In Service	Recovery Year	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:						
3/15/84	1	10	9	8	7	6	6	5	4	3	2	2	1
through	2	9	9	9	9	9	9	9	9	9	10	10	10
6/22/84	3	8	8	8	8	8	8	8	8	9	9	9	9
6/23/84	1	9	9	8	7	6	5	4	4	3	2	1	0.4
through	2	9	9	9	9	9	9	9	9	9	10	10	10
5/8/85	3	8	8	8	8	8	8	8	8	9	9	9	9

STRAIGHT LINE DEPRECIATION OPTIONS FOR ACRS 3, 5, 10, 15, 18, & 19-YEAR PROPERTY

Straight Line Option	1st Year	Intermediate Years	Last Year
3-year class options			
3 years	1/6	1/3 in each of next 2 years	1/6
5 years	1/10	1/5 in each of next 4 years	1/10
12 years	1/24	1/12 in each of next 11 years	1/24
5-year class options			
5 years	1/10	1/5 in each of next 4 years	1/10
12 years	1/24	1/12 in each of next 11 years	1/24
25 years	1/50	1/25 in each of next 24 years	1/50
10-year class options			
10 years	1/20	1/10 in each of next 9 years	1/20
25 years	1/50	1/25 in each of next 24 years	1/50
35 years	1/70	1/35 in each of next 34 years	1/70
15-year class options			
15 years	1/180 per mo.	1/15 in each of next 14 years	balance
35 years	1/420 per mo.	1/35 in each of next 34 years	balance
45 years	1/540 per mo.	1/45 in each of next 44 years	balance
18-year class options			
18 years	1/216 per mo.*	1/18 in each of next 17 years	balance
35 years	1/420 per mo.*	1/35 in each of next 34 years	balance
45 years	1/540 per mo.*	1/45 in each of next 44 years	balance
19-year class options			
19 years	1/228 per mo.*	1/19 in each of next 18 years	balance
35 years	1/420 per mo.*	1/35 in each of next 34 years	balance
45 years	1/540 per mo.*	1/45 in each of next 44 years	balance

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

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 3, 5, 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. First year depreciation on 15-year, 18-year, and 19-year real property is based on the month of acquisition.

ACRS Property Class Rules

For 3, 5, 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 1985, 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 1984 (3-year property) but choose straight line for three or five years for a pickup truck purchased in 1985. Keep in mind that fast recovery would be used on any other 3-year property purchased in 1984 and the same straight line option used on the pickup would be required on all 3-year property purchased in 1985.

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, 18-year, and 19-year property, the recovery options may be chosen on a property-by-property basis; that is, different options may be chosen on items in these classes purchased in the same year. If a substantial improvement is made to 15, 18 or 19-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 5.

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 15, 18, and 19-year 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 3 and 5-year ACRS property is ordinary income. ERTA left 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, 18 or 19-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 3, 5, 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, 18, and 19-year nonresidential property for two reasons: (1) The excess of rapid recovery over straight line is subject to the alternative minimum tax. (2) <u>All</u> gain due to fast ACRS recovery is subject to recapture as ordinary income when the real estate is sold at a gain while <u>none</u> 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 straight line 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 is used to report the Section 179 expense election (Part IA), depreciation of recovery property (Part IB), depreciation of nonrecovery property (Part IC), amortization (Part II), and specific information concerning automobiles and other listed property (Part III). 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 16 of Schedule F. However, partnerships will transfer the 179 expense election to Form 1065 rather than combining it with other items on 4562.

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.

Depreciable Property Must Be Used in a Business

Court Case: The Simonson's purchased a truck and trailer in 1979 and planned to use it for hauling grain. The taxpayers had not before the purchase hauled grain for profit. Because of the grain embargo imposed in 1980, the taxpayers decided not to enter the grain hauling business. They never used the truck or trailer for profit making activity and subsequently sold them in 1982. The taxpayers claimed deductions for depreciation and business operating expenses relating to the truck and trailer and amended earlier returns to carry back excess investment tax credit.

The sole issue was whether the taxpayers were entitled to deductions on a truck and trailer purchased with an intent to start a business where the truck and trailer were never used for that business or for any other profit making purpose.

Section 167 allows a deduction for depreciation for property used in a trade or business. The court found that to qualify under Section 167, the property at issue must be actually used in a trade or business. The truck and trailer purchased by the taxpayers, regardless of their intent, were not used in a trade or business and could not be depreciated.

Section 162 allows a deduction for ordinary and necessary business expenses. The court found that until a business is functioning as an ongoing concern, a taxpayer cannot be engaged in carrying on a trade or business within the meaning of Section 162 and, therefore, expenses were not deductible. [Lyle S. Simonson and Donna Simonson v. U.S.A., 85-1, USTC Par. 9134, U.S. Court of Appeals, 8th Circuit, No. 84-5127, 1-15-85 affirming an unreported District Court decision.]

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 credits are all part of Section 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 (Section 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 structures such as silos, grain bins, and 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).

-- Certified pollution control facilities that are rapidly amortized (60 months) and have actual useful lives of at least five years are 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 <u>$125,000 (joint return) in any one year</u> 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, 18, and 19-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. If acquired after April 2, 1985 the limit is $675 of IC. 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 3-year and 80 percent for other property. This option does not apply to the credit for rehabilitated buildings nor to 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 IC.

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 1981 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 Regulation 1.48-10 follow:

> A single purpose agricultural structure may be used only for: "Housing, raising and feeding a particular type of livestock and, at the taxpayer's option, its produce. .... The structure may also be used for storing feed or machinery, but more than strictly incidental 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 Regulation 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 and 19 years for expenditures after May 8, 1985). 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 Section 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.

<u>Special Rules on Livestock Investments and Replacements</u>

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 investment credit 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 investment credit 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 be 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 ACRS property:

A tractor was purchased September 1981 for $30,000 and is ACRS 5-year property. $3,000 of investment credit was claimed on the 1981 return, $900 was used in 1981, and $2,100 was used in 1982. The 1981 tractor was traded for a new tractor September 1985. The cost basis of the new tractor is $40,000, it is 5-year property, and investment credit is $4,000. The old tractor was held four years and earned 80 percent of $3,000 or $2,400 of investment credit. The earned credit is first applied to 1981 and the balance, $1,500, is applied to 1982. That used in 1982 but not earned, $600, does not need to be paid back because that amount of the 1985 credit can be carried back to the 1982 return in the taxpayer's recomputation (assuming there is excess credit in 1985).

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

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 on Property Leased to Others

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). In some cases, the noncorporate lessor could pass the investment through to the lessee even though he could not claim it himself.

Purchase of Property Formerly Leased

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.

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.

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, 7 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

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, Form 3800 will be required.

This is a change from the pre-1984 procedure. 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.

RESIDENTIAL ENERGY CREDITS: 1985 is the last year

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 the back 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 Section 1.47-3(f)(1)(ii)(c) of the regulations.

Subsequent to this decision, IRS revoked Rev. Rul. 76-514 which dealt with 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 Rul. 8220004, 1/29/82).

   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 Section 38 property (Section 46(e)(3)(A)].

2. In L.M. Carlson versus Commissioner, August 8, 1983, Carlson was denied IC 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. IRS claimed (1) assembling was not manufacturing, and (2) Carlson did not carry out the manufacturing function. The tax court 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 rules 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 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 3 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.

Investment Credit on Onion Shed Denied

Onions are stored in the shed during a six month period between harvest and sale. The shed has standard and garage sized doors, urethane coated walls and ceilings, and a ventilation system. When it is not used for storing onions, the shed is used to store empty onion crates and farm equipment.

The Ninth Circuit held that the structure is a building because: (1) it functions more like a barn, warehouse, or garage than it does a storage tank or silo, and (2) it could easily be converted to other uses. [Tamura vs. United States of America, 84-2 USTC. Par. 9545, 734 F. 2d 470 (9th Cir. 1984), reversing and remanding District Court.]

Capital Gains - Sale of Grain Pledged to The Commodity Credit Corporation

The taxpayers, grain farmers in South Dakota, in 1972, pledged 96,653 bushels of rye from their 1971 crop to the Commodity Credit Corporation (CCC) as security for a price support loan. They elected under Section 77 to treat the loan proceeds as ordinary income on their 1972 return. In 1973 the CCC required redemption of the price support loans. The taxpayers redeemed and left the rye in storage until they sold it in 1976. The taxpayers recognized $135,554.54 as long-term capital gain from this sale. In 1980 IRS denied the taxpayers capital gain treatment and assessed a deficiency of $43,368.63. The taxpayers paid the assessment and filed their claim for refund. The issue was whether the gain on the sale of grain in 1976 was long-term capital gain or ordinary income.

The court determined that for the taxpayers to be given capital gain treatment the redemption must be viewed as a "repurchase" of the rye following a sale of that rye to the CCC rather than a loan transaction. Section 77(a) states that "[a]mounts received as loans from the CCC shall, at the election of the taxpayer, be considered as income and shall be included in gross income for the taxable year in which received." The court, in following case law it considered closely related, determined that where an election was made to treat the transaction as a sale, as the taxpayers did, the transaction where redemption occurs could be treated as a repurchase. The court noted that classification as a repurchase did not circumvent the annual accounting concept of income tax law. The court further reasoned that since the redemption could be considered a repurchase, the focus shifted to the intent of the taxpayer in the repurchase. Noting that a producer of a commodity sold in the ordinary course of business is not automatically barred from holding such commodity as capital asset, the court found that the taxpayers sufficiently segregated the investment property from their ordinary course of business. The bins storing the repurchased rye were distinct and readily identifiable from those used in the ordinary course of trade or business. The rye was held with the intent of taking advantage of expected higher market prices in the future and was eventually sold in a single isolated transaction. Therefore, the court concluded that since the redemption was effectively a repurchase affording the taxpayers an opportunity to take advantage of an investment in their rye. The good faith intention of the taxpayers controlled and the gain was given capital treatment. [W.J. Asmussen and Alice Asmussen vs. United States of America, 85-1 USTC Par. 9304. U.S. District Court, Dist. S.D., Cent. Div., 11/2/84.]

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 six months (12 months for property acquired before June 23, 1984), cattle and horses held 24 months, other livestock held 12 months, casualty and theft losses and other involuntary conversions, qualified sales of timber, and unharvested crops sold with farmland which was held six months (12 months for property acquired before June 23, 1984). 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: The old favorable "capital gain - ordinary loss" rule of Section 1231 which allowed net gains to be taxed as long-term capital gains and net losses to offset ordinary income has been modified. For tax years beginning on or after January 1, 1985, net Section 1231 gains are treated as ordinary income to the extent of unrecaptured net Section 1231 losses for the five most recent prior years beginning with 1982. In other words, a taxpayer that claimed a net Section 1231 loss on the 1982, 1983 or 1984 return and has a net Section 1231 gain for 1985, must recapture the losses on the 1985 return. Losses are to be recaptured in the order in which they occurred.

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, purchased breeding, dairy, draft and sporting livestock held for the required period and sold at a gain are reported under this section.

   Tangible real property (except some Section 1250 buildings and their structural components) used as an integral part of farming is 1245 property. Single purpose livestock and horticultural structures are 1245 property if placed in service after 1980. Nonresidential 15, 18, and 19-year ACRS property becomes 1245 property if fast recovery has been used. Other tangible real property includes silos, storage structures, fences, paved barnyards, orchards and vineyards.

   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 livestock. 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 six months (12 months if acquired before June 23, 1984) and sold at a gain are reported in this section unless the assets are 1245 property. If other than straight line depreciation was used on non-ACRS property, the gain to the extent of depreciation claimed after 1969 that exceeds what would have been allowed under straight line depreciation is recaptured as ordinary income. No recapture takes place when only straight line depreciation has been used. A taxpayer may shift non-ACRS real property to straight line depreciation without special consent.

If regular (fast) recovery has been used on ACRS 15, 18, and 19-year real property other than residential property, all gain due to depreciation or cost recovery will be ordinary income. In effect, this property becomes 1245 property. Again, no recapture of depreciation occurs when an ACRS straight line option is used.

The law allows a different ACRS option to be used on a substantial improvement than on the original building. If fast recovery has been used on either the building or a substantial improvement to it, gain will be ordinary on the entire building to the extent of fast recovery and any remaining gain will be capital gain. For residential real estate, gain will be ordinary only to the extent that fast recovery deductions exceed straight line on 15, 18, and 19-year property.

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

4. Section 1252 - Gain on the sale of land held less than 10 years will be part ordinary and part capital gain when soil and water or land clearing expenditures after December 31, 1969 have been expensed. If the land was held five years or less, all soil and water or land clearing expenses taken will be "recaptured" as ordinary gain. If the land was held more than five and less than 10 years, part of the soil and water and land clearing expenses will be recaptured. The percentages of soil and water conservation or land clearing expenses subject to recapture during this time period are: 6th year after acquisition of the land 80 percent, 7th year 60 percent, 8th year 40 percent, and 9th year 20 percent.

   Here is an illustration:

Farmland acquired, 1981 cost	$30,000
Soil and water expenses deducted on 1982 tax return	$2,000
Land was sold, 1985 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.

5. Section 1255 - If government cost sharing payments for conservation have been excluded from gross income under the provisions of Section 126, the land improved with the payments will come under Section 1255 when sold. 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.

Livestock Sales

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

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, line 4. Sales of livestock purchased for resale are entered on line 1 of Schedule F, and for a cash basis farmer the purchase price is recovered in the year of sale on line 2.

Breeding, Dairy, Draft or Sporting Livestock

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

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

2. Cattle and horses held less than two years, and other breeding livestock held less than one year. These sales do not meet holding period requirements.

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

Reporting Sales of 1231 Livestock

Sales of 1231 livestock 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.

3. Records of livestock purchases and sales must be adequate to substantiate depreciation deductions, holding periods, and gains and losses.

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, Section 179 expense deduction and basis reduction. Casualty and theft gains and losses are reported on 4684 and transferred to 4797. If the 1231 gains and losses reported on 4797 result in a net gain, net 1231 losses reported in the prior five years must be recaptured first. Remaining gain is transferred to Schedule D and combined with capital gain or loss, if any, from disposition of capital assets. If the 1231 items result in a net loss, the loss is combined with ordinary gains and losses on 4797 and then transferred to Form 1040.

SUMMARY OF REPORTING MOST COMMON FARM BUSINESS PROPERTY

Type of Farm Property	Tax Form and Section
1. Cattle and horses held for breeding, dairy, draft or sporting purposes 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 six months 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 six months or more*	
a) Sale results in gain	4797, Part III
b) Sale results in loss	4797, Part I
6. Farmland, held for six months or more, sold at a gain*	
a) Soil and water expenses were deducted or cost sharing payments excluded	4797, Part III
b) If 6a does not apply	4797, Part I
7. Machinery, buildings, and farmland held for less than six months*	4797, Part II

*For real estate and machinery acquired before June 23, 1984 substitute one year for six months.

Other Provisions Related to Capital Gains and Losses

Section 1239 - When depreciable property is transferred between a taxpayer and (1) a partnership or corporation in which the taxpayer has at least 80 percent ownership, or (2) a trust in which the taxpayer or the taxpayer's spouse is a beneficiary, or (3) the taxpayer's spouse, capital gains treatment is denied. Section 1239 does not apply to sales of land.

Note: Property transfers between spouses after July 18, 1984 are treated as gifts for income tax purposes. No gain or loss is recognized and the basis of the property remains unchanged. This rule also applies to former spouses if the transfer is incident to a divorce.

Accumulated Earnings Tax - For taxable years beginning after July 18, 1984 the computation of net capital gains and losses for a corporation's accumulated earnings tax is changed.

Repeal of Pre-1970 Capital Loss Rule - For taxable years beginning after 1986, carry overs of pre-1970 long-term capital losses will no longer offset an equal amount of ordinary income. Instead it will take $2 of losses to offset $1 of ordinary income up to a maximum of $3,000.

Disposition of Property Contributed to a Partnership

When a partnership disposes of property which was "inventory property" in the hands of a partner immediately prior to its contribution, the gain or loss recognized by the partnership is ordinary income or loss. This rule is in effect for five years after the initial contribution. Gain or loss on a disposition of unrealized receivables contributed by a partner will be treated as ordinary income or loss regardless of the date of disposition.

Business property which would qualify as a capital asset under Section 1231 if held for one year or more by the partner or partnership prior to contribution or distribution will not be treated as ordinary income property.

INSTALLMENT SALES

The installment sale method of transferring ownership of farm and other business property continues to be an important 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.

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.

Ordinary Income Recapture

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 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 and special rules apply.

For installment sales made after June 6, 1984, that portion of the gain attributed to recaptured depreciation of Section 1245 and 1250 property must be excluded. The full amount of recaptured depreciation is reported as ordinary income in the year of sale regardless of the size of payments received.

The amount of recaptured depreciation reported as ordinary income in the year of sale is added to the property's basis for the purpose of computing the gross profit ratio. This adjustment is critical in order to avoid double taxation of installment payments.

Here is an example: Carl Cropper sells his corn drying facility (Section 1245 property) to M.W. Grainer for $90,000 on January 1, 1985. The adjusted basis was $50,000, total gain $40,000, depreciation claimed $30,000. Grainer will make five annual payments of $18,000 plus interest. Under the installment method, $30,000 of the $40,000 gain is recaptured depreciation and ordinary income for 1985. The $10,000 balance is capital gain, (Section 1231). Cropper's gross profit ratio is determined as follows: $50,000 adjusted basis plus $30,000 recaptured depreciation equals $80,000 installment basis. The $90,000 contract price less $80,000 installment basis equals $10,000 gain divided by $90,000 gives a gross profit ratio of 11.1 percent. The gain to report each year of the installment sale is $2,000 ($18,000 x 0.111). If the basis had not been increased by the amount of recaptured depreciation, the gross profit ratio could have been calculated incorrectly at 33.3 percent showing an annual reportable gain of $6,000.

For installment sales made before June 7, 1984, recaptured depreciation from Section 1245 and 1250 property is reported first as income is received. It is not excluded from the installment sale and reported in the year of sale. But, if a Section 179 deduction had been claimed on property included in one of these sales, the amount expensed is subject to recapture in the year of sale and the property's basis is increased accordingly.

Interest Rules

Interest received on the installment sale contract is ordinary income. Regulation 1.483-1 required that for installment sales exceeding $3,000 entered into after June 30, 1981 that qualified for capital gain, nine percent simple interest must be charged or the IRS would 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. Therefore, the implied minimum stated interest rate on these transactions is six percent simple interest. Up to $500,000 a year in land installment sales to a spouse, sibling, ancestor, or lineal descendant is eligible. The law specifically states land, not real estate.

Congress attempted to increase imputed interest rates with a new OID rule included in the TRA of 1984. The 1984 rule would have allowed IRS to impute interest rates of 120 percent of the Applicable Federal Rate (AFR) on installment sales of business property where total payments would not exceed $250,000. The implementation of this new rule was delayed in late 1984 and the rule was modified in October of 1985.

The modified imputed interest rule increases the total payment threshold (contract price plus interest) to $2.8 million and lowers the imputed rate to the lesser of nine percent (compounded semi-annually) or 100 percent of the AFR. It now appears as though acceptable stated or test rates will be the same as imputed rates. The new rule applies to sales and exchanges occurring after June 30, 1985. When seller financing exceeds $2.8 million, the entire amount is subject to the imputed interest rate equivalent to 100 percent of AFR. Seller financing of new property eligible for investment credit is subject to the 100 percent of AFR rate and that provided in connection with a sale leaseback transaction is subject to a rate of 110 percent of AFR. Seller financed sales occurring between 1/1/85 and 6/30/85 are subject to a transitional rule which sets the imputed rate at 10 percent and test rate at 9 percent on loans not exceeding $2 million.

The modified rule permits cash accounting of interest payments on seller financed sales of less than $2 million. The 1984 law would have required accrual accounting of all interest payments, forcing the seller to report annual interest payments as they accrued rather than as they were received.

BELOW MARKET INTEREST LOANS (CODE SECTION 7872)

Effective for term loans made after June 6, 1984 and outstanding amounts on demand loans after that date, loans made at a rate below the applicable federal rate (AFR) are subject to a set of rules too complicated to cover completely here.

The new rules apply to gift loans, compensation-related loans, corporation-shareholder loans, tax avoidance loans, and other loans where interest is charged below the federal rate. In such cases, interest at the federal rate is treated for tax purposes as if it had been paid by the borrower and received by the lender. There are also gift tax implications.

The AFR is based on semi-annual compounding and is determined semi-annually for three categories of term loans: 1) short-term (three years or less), 2) mid-term (more than three but not more than nine years), and 3) long-term (nine years or more). The short-term rate is used for demand loans. For 1984, all the rates were set at 10 percent. For the last half of 1985, the rates are: short-term - 10.15, mid-term - 11.45, and long-term - 11.73. By January 1985, the AFR was so far out of line that IRS began to publish monthly rates in addition to the six month rates. The procedures for applying these rates in order to compute the imputed interest are very complex.

"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 Section 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. On demand loans, foregone interest is treated as additional compensation to the borrower. The same amount is reported as interest income by the lender who is then given an offsetting wage deduction. In the case of corporation-shareholder below-market loans, the difference between the rate and the AFR is treated as a dividend to the shareholder and as interest income to the corporation. The $10,000 exception also applies in these cases, assuming that tax avoidance is not one of the principal purposes of the loan.

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 on below-market loans are much more complicated than the material here would imply.

ALTERNATIVE MINIMUM TAX

The alternative minimum tax (AMT) is the tax most commonly misknown, misunderstood, misliked, and misreported by farm taxpayers. 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. Unfortunately the AMT can cause big tax problems when moderate size farm businesses are sold, even when there are unused business tax credits.

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 now requires that Form 6251 be filed showing the AMT computations under the following conditions, even if there is no AMT liability: 1) The taxpayer has tax preference items other than capital gain exclusion and dividend exclusion or 2) if non-interest and/or dividend net investment income is a factor in computing AMTI.

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 business tax preference items include: excess amortization of certified pollution control facilities, excess mining development costs, excess depletion deduction, and excess intangible 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 (plus interest expense incurred for a limited interest in a partnership or S corporation, and less alcohol fuel credit included in income), less AMT deductions plus tax preference items. Allowable AMT deductions are:

1. AMTI Net Operating Loss Deduction - Starting with tax years beginning in 1984 the AMT net operating loss deduction is calculated by modifying the regular NOL as follows:

    a. Use AMT itemized deductions 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.

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 the 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. (See Form 6251 for instructions.)

AMTI Determination Example

A.B. Farmer's 1985 AGI is $40,000. He files a joint return, has no AMT NOL deduction, itemized deductions are $3,580 but only $1,800 qualifies as AMT itemized deductions ($1,780 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

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 1985 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
Less regular income tax net of $3,000 investment credit (estimated)	- 3,120
Net AMT	$ 1,320

A.B. Farmer pays $3,120 of regular income tax plus $1,320 of alternative minimum tax in 1985. 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 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 1985 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 $1,320 below his gross AMT causing the $1,320 net AMT. A.B. has lost $1,320 of IC tax benefit that should be added to the balance of unused IC for carry back or carry forward.

When more than one tax credit is canceled 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 1985 for $95,000. No other business assets were sold. Regular farm and other income was ($2,000). Adjusted gross income, including $38,000 from the cow sales, was $36,000. Assume regular income tax liability equals $5,400 and AMT itemized deductions equal $700.

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

Adjusted gross income	$36,000	AMTI	$92,300
less deductions	- 700	base deduction	40,000
plus tax preference income from		Taxable AMTI	$52,300
sale of cows, $95,000 x .60 =	57,000	Gross AMT	
Total AMTI	$92,300	(AMTI x .20)	$10,460

   C.G.'s 1985 federal income tax liability is $10,460. He must pay $5,400 of regular income tax plus $5,060 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 farm 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. If C.G. Farmer in the above example has an unused IC balance of $5,400 carried into 1985, his regular income tax liability is $0 but his AMT becomes $10,460.

NET OPERATING LOSSES

Many New York farmers will sustain a net operating loss in 1985 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 (NOL)

A farmer who has a net business loss, that is a negative Net Farm Profit on Schedule F (1040), should enter the loss on line 19 of page 1, 1040, as a negative 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. Losses on the sale of farm assets may also be included in a NOL. The NOL is not to be considered when calculating net earnings from self-employment for the year to which the NOL is carried.

The opportunities and consequences of carrying a NOL back should always be considered first. If the NOL is carried back it must be carried back three years, then to each succeeding year, if necessary, to use it up. A 1985 NOL would be first carried back to 1982, then to 1983, 1984, and then forward to 1986 and in order to 2000 if necessary. The carry forward provision is 15 years. A taxpayer may 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 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 (or Form 1139 for a corporation) must be filed within one year after the close of the NOL year. Form 1040X may be filed within three years of due date for the NOL year return. Schedule A (Form 1045) serves as a convenient NOL computation form.

A partnership (or small business corporation) is not allowed to claim a NOL, but each partner may use his or her share of the business NOL to determine his/her individual loss. A regular corporation's NOL is handled 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 step must be completed in order to determine how much loss can be applied to another year's return.

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.

Example: 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 ($20,400).

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	$3,580	
Personal exemptions (3)	3,120	
Total Deductions		- 6,700
Taxable Income		$(20,400)

No net operating loss was carried over to 1985 from a prior year.

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

Taxable Income		($20,400)
Personal exemptions	$3,120	
Capital gain exclusion	3,600	
Excess of nonbusiness deductions over nonbusiness income ($3,580 - 900 = $2,680)	2,680	
Total adjustments		$ 9,400
Net Operating Loss, 1985		$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 an $11,000 NOL.

Step Two - How to Carry Back 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 Three. 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 (unincorporated tax person):

1. The long-term capital gains exclusion must be included in income.

2. The capital loss deduction is limited to the amount of capital gains included in gross 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 an AGI modified by rules 2, 3, and 4 and by removing NOL carry backs.

Example: If D.T. Farmer carries his 1985 NOL of $11,000 back to 1982 where he had a taxable income of $12,380, the full NOL will be used. If 1982 taxable income had been less than $11,000, the adjustments listed above would have been applied to determine the modified taxable income. If 1982 modified taxable income was $8,000, D.T. would deduct only $8,000 of his 1985 NOL on the 1982 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.

Example: D.T. Farmer determines his 1982 refund as follows:

Adjusted gross income on 1982 return	$18,780
Less 1985 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 1982 return	1,324
Tax paid on 1982 return (net of IC)	$ 324
Less tax liability after carry back	0
Refund on 1982 Return	$ 324

D.T. Farmer paid no minimum tax or AMT in 1982 but $1,000 of investment credit was used to reduce the 1982 tax liability. If there had been no investment credit used in 1982, the tax paid would have been $1,324 and D.T. would be eligible for a $1,324 refund. Since only $324 of income tax was actually paid in 1982, that is the extent of the 1982 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 1979.

Step Four - Carry Over Unused NOL to Subsequent Year

Under the alternative assumption, D.T. Farmer's 1982 modified taxable income was $8,000 which limited 1985 NOL used in 1982 to $8,000. The amount of unused NOL, $3,000, is carried over to the 1983 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 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 beginning in 1984, they are, for the most part, indistinguishable. The purpose was to eliminate the incentive to incorporate a business or practice solely because of the more lucrative corporate pension plan provisions.

For 1985, the maximum annual deduction for a contribution to a defined contribution 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. There are two kinds of defined contribution plans: 1) profit sharing, and 2) money purchase pensions. Contributions to a profit sharing plan must be out of profits.

The limit on the deductions for a contribution to a profit sharing plan is the lesser of $30,000 or 15 percent of compensation (which is earnings less the plan contribution). The limit, when based on earnings, is 13.0435 percent. The limit on money purchase plans is the lesser of $30,000 or 25 percent of compensation. As a percent of earnings, the limit is 20 percent.

The maximum annual retirement benefit under a defined benefit plan will be $90,000 until 1988. In some circumstances, a self-employed person can shelter a much larger annual amount in a defined benefit plan than in a defined contribution plan. However, it is usually more difficult and expensive to establish a defined benefit plan.

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 be 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.

Anyone interested in establishing a Keogh should seek competent advice.

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 59½ and must begin by age 70½. At age 70½, 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 59½ 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 15 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 transfer 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 implications. However, if they receive the money themselves, various restrictions apply to the 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 repealed by TRA for deaths after 1984. However, there is a transitional rule that will apply in some cases.

NEW YORK STATE INCOME TAX

Changes Affecting Individual Taxpayers

On April 18, 1985 Governor Cuomo signed new tax legislation (Chapter 29) that will have major impact on the New York State personal income tax beginning with 1985.

Standard Deduction

The New York standard deduction has been increased and will no longer be calculated as a percentage of income with a minimum and maximum. It is now a uniform amount and the increase will be phased in over a three year period starting with 1985. The new standard deduction is:

	1985	1986	1987
Single Taxpayer	$2,500	$2,600	$2,800
Married, Head of Household, or Surviving Spouse	$2,750	$3,000	$3,800

Personal Exemption

The New York personal exemption is $850 for 1985 and 1986, up from $800 in 1984. It will increase to $900 for 1987.

Reduction in Tax Rates

1. The rate on taxable income over $23,000 was reduced from 14 percent to 13.5 percent effective July 1, 1985 for the calendar year taxpayer (first of seventh month for fiscal year taxpayer). The effective rate for the entire 1985 year is 13.75 percent.

2. For 1986, tax brackets starting at $11,000 will be widened by $500 to $2,500.

3. The same tax brackets will be widened to $3,000 for 1987. This is an additional $500 increase. A taxpayer reporting $15,000 of taxable income each year would have a tax liability of $860 for 1984, $855 for 1985, and $850 for 1986.

Low-Income Allowance to Increase in 1986

The 1985 low-income allowance remains at $2,500 for single taxpayers and $5,000 for married taxpayers, heads of households, and surviving spouses. The respective allowances will increase to $4,000 and $8,000 for taxable years beginning on or after January 1, 1986. An individual who has zero tax liability as a result of the low-income allowance will be exempt from filing a tax return starting with 1986.

Reduction in Maximum Tax on Personal Service Income

1. The maximum tax rate on personal service income is reduced from 10 percent to 9½ percent for taxable years beginning on or after January 1, 1985.

2. The rate is reduced to nine percent for taxable years beginning on or after January 1, 1987.

3. The amended law provides that personal service net income is to be computed prior to any allowable family adjustment. (Definition and information on family adjustment has not been released.)

Household Credit

The household credit will increase for tax years beginning in 1986. Single taxpayers with household gross income up to $28,000 and all other taxpayers with income up to $32,000 will qualify. A new separate schedule allows more credit for married taxpayers, heads of household, and surviving spouses, plus additional credit ($5 to $15) for additional exemptions.

Household credit is unchanged for 1985. It is available to 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 taxable income for other members of the household.

New York Household Tax Credit, 1982 through 1985

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

Real Property Tax Credit Increases for 1985

Numerous changes have been made in the Real Property Tax Credit but few farm or nonfarm real estate owners will qualify. Although most qualifications have been liberalized, owners of real property valued in excess of $85,000 (up from $65,000) are excluded. Here are other changes:

1. The household gross income limit has increased from $16,000 to $18,000.

2. The maximum adjusted rent is now an average of $450 a month but the taxpayer must occupy the same residence for six months or more to claim rent paid for credit.

3. Credit for renters is computed the same as for owners.

4. Real property tax credit is the lesser of the maximum credit or 50 percent of excess real property taxes. Taxpayers age 65 and older exempt from real property taxes will receive no more than 25 percent of excess real property taxes. Excess real property taxes are computed by multiplying household gross income times the applicable percentage and deducting the answer from real property taxes.

Partial Table for Computing Real Property Tax Credit, 1985

		Maximum Credit	
Household Gross Income	Applicable Rate	Under 65	65 & Over
$0 - $ 1,000	0.035	$75	$375
5,001 - 6,000	0.045	65	290
10,001 - 11,000	0.055	55	205
15,001 - 16,000	0.065	45	120
17,001 - 18,000	0.065	41	86

Deductions and Credits That Have Not Changed

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.

Spousal IRA's Allowed

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.

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.

Solar and Wind Energy Credit

New York State Solar and Wind Energy Credit amounting to 55 percent or 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.

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.

Review of New York State Farm Business Tax Problems and Opportunities

ACRS and New York State Depreciation

The provision that uncoupled New York State from federal ACRS expired at the end of 1984 but the resulting tax reporting implications are not at all favorable. Here is our current understanding of 1985 New York State depreciation.

1. New York State will recognize (accept) ACRS depreciation on assets placed in service on or after January 1, 1985.

2. ACRS depreciation taken on assets that were placed in service from 1982 through 1984 (while the uncoupling provision was in effect) will not be recognized by New York State and an adjustment to Section 167 depreciation is still required. The required adjustment to federal taxable income which implies that a separate New York schedule is required, follows:

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

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

   The basis of an asset may not be adjusted when NYS depreciation is less than federal. The federal basis must be used to compute NYS 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 NYS depreciation has been different than federal. This enables a taxpayer claiming less NYS depreciation than allowed under ACRS to decrease federal AGI for state purposes in the year of disposition. If NYS depreciation were greater than federal, the modification would be an increase in AGI.

   Another problem is associated with the federal option to reduce basis by 50 percent of IC 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 IC 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.

New York State Investment Credit (NYIC)

The 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 12/31/80 qualifies for NYIC. This means light trucks in the ACRS 3-year class and used primarily for farm production should qualify. There is no reduction in the amount of credit allowed for 3-year property and if kept in use for three years will earn six percent NYIC. Farmers are continually disallowed NYIC on light trucks used for transportation. The following tax commission decision sheds a new light on this problem.

> The New York State Department of Taxation and Finance Audit Division disallowed $172.91 of investment tax credit a Western New York farm business had claimed on two pickup trucks licensed for over-the-road use. After receiving notice of the tax deficiency, plus interest, the owners of the farm corporation filed a petition for redetermination or refund with the State Tax Commission. Five and one-half years after the deficiency notice was issued, the Commission reached the following conclusions:

> "..... a corporation subject to taxation ... is entitled to an investment credit with respect to tangible personal property which is depreciable, (has the required life, etc.), and is principally used by the taxpayer in the production of goods ..... Because the parties have stipulated that the trucks were used more than 50 percent of their operating time for transportation of goods during the manufacturing process, (20 NYCRR 5-2.4(c) defines the term "principally used" as meaning more than 50 percent), it follows that the petitioner meets the standards provided in (the) Tax Law.... The petition is granted and the Notice of Deficiency canceled."
>
> The TSB memo notes: This decision represents a change in the existing audit policy of the Department. TSB-H-85(19)c, Corporation Tax, July 2, 1985.

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. Non-ACRS properties that qualify for NYIC must still be held 12 years.

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

Employment incentive tax credit is 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 NYIC for each of the three years following the taxable year in which NYIC was allowed. The additional credit is available to newly formed as well as continuing corporations. The credit may not be used to reduce the franchise tax below the flat-fee minimum ($250).

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 carry over of net operating losses are used to reduce minimum taxable income. NYIC cannot be used to reduce the minimum income tax.

Payment of New York State Income Taxes Withheld and Informational Returns

Although income tax withholding is not mandatory for agricultural employers, it may be wise management policy. An employer who expects to withhold less than $800 (beginning 1/1/86) semiannually is required to file and deposit the tax on July 31 and January 31. Monthly returns and deposits are required by employers withholding from $800 to $7,500 semiannually.

New York State law is essentially identical to the federal law requiring informational returns on payments of $600 or more to New York taxpayers.