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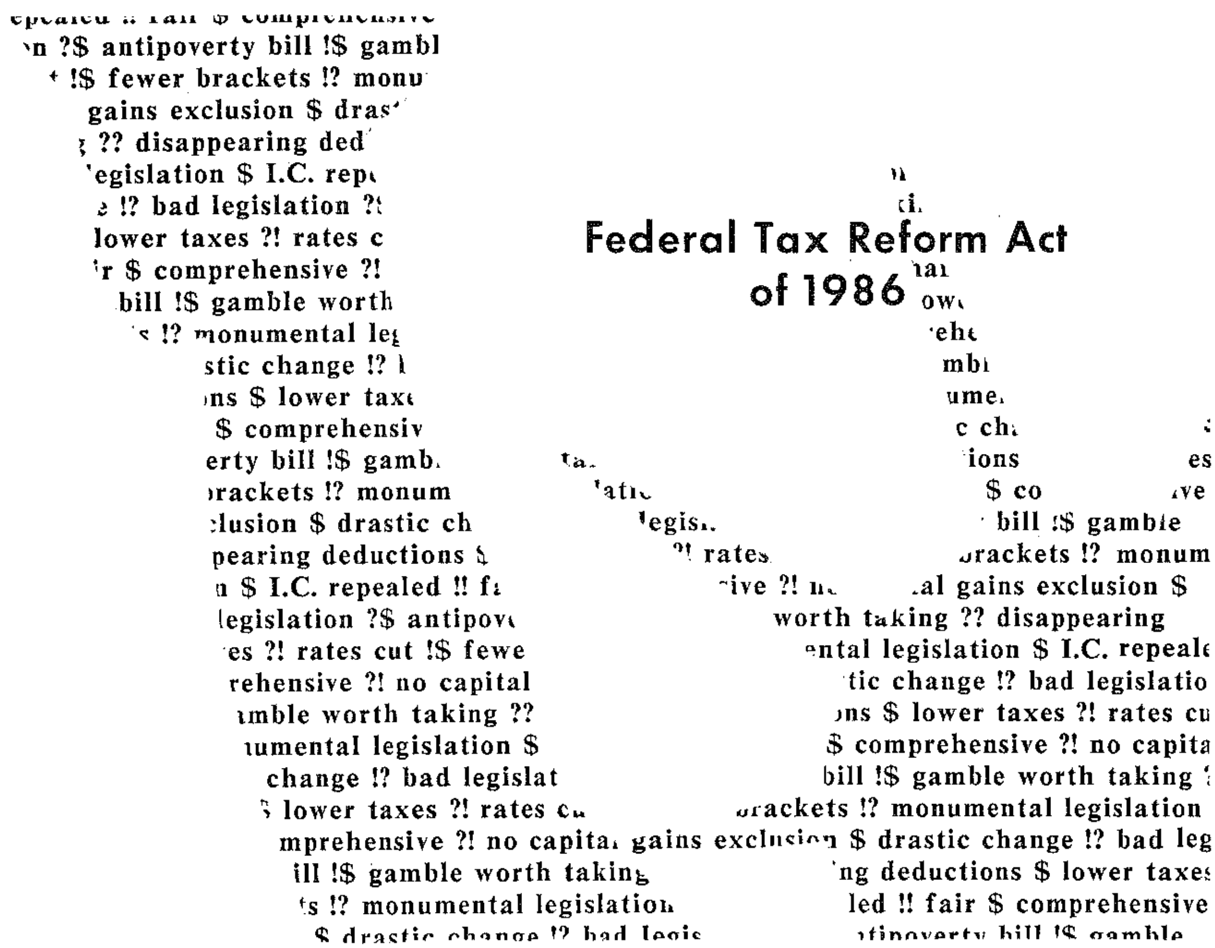
# FARM INCOME TAX MANAGEMENT AND REPORTING MANUAL



## Federal Tax Reform Act of 1986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1986 TAX FORMS NEEDED BY NEW YORK FARMERS

Here is a list of the more important 1986 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 - returned to former Part I, II, & III
- Schedule E - Supplemental Income Schedule
- Schedule F - Farm Income and Expenses - minor improvements
- 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 - For non-itemizers, less than $50,000 taxable income, other limitations
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, Section 179 expense election, and listed property
4684 - Casualties and Thefts
4797 - Supplemental Schedule of Gains and Losses
4835 - Farm Rental Income and Expense
6251 - Alternative Minimum Tax Computation

New York State Forms

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

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# 1986 FARM TAX AND INCOME SITUATION

## Tax Reform

On October 22, 1986 President Reagan signed into law the most extensive and drastic overhaul of the U.S. tax code in the last 40 years. The TRA of 1986 was passed by Congress on September 27, 1986 and then delayed by H.Con.Res. 395 as Congress attempted to make corrections and amendments. But the enrolling resolution was never passed and the 1986 Act was cleared for the President's signature without technical corrections.

Taxpayers are well familiar with the popular claims made by proponents of the bill. The New York Times claims 60 percent of Americans will pay lower taxes. The Washington Post calls it the biggest antipoverty bill in 60 years. The President said, "The American people...have a tax code they can be proud of."

The TRA of 1986 contains more than 400 sections under eighteen titles or major divisions. It features lower tax rates, higher standard deductions, fewer credits and special deductions, elimination of some income exclusions and a broader tax base. Tax simplification, an original and worthy objective, was overpowered by hundreds of exceptions and transition rules. The phase-ins, phase-outs and other transition rules may cause more complicated accounting and record keeping requirements for taxpayers. The loss of investment tax credit and the capital gains exclusion will have a major impact on many New York farmers and business owners.

## The 1986 Farm Income Situation

Average dairy farm incomes in 1986 are likely to equal or exceed average dairy farm incomes from 1985. Dairy farmers who have increased milk output efficiently will show higher incomes in 1986. Many dairy farmers will continue to have farm losses. The exodus from dairy farming intensified in 1986 resulting in more sales, taxable gains and special tax problems. Around 500 New York dairymen joined the buyout and may have unique tax problems.

Producers of cash grain crops will show low net incomes again this year. Those who participated in the wheat and feed grain programs will obtain much of their income from government payments and there will be reporting questions on some of this income. Fruit grower incomes should strengthen following a year of very low returns. Grape prices are a bit higher than last year but many grape growers will have net operating losses. Egg producers had a strong first quarter and are doing rather well late in the year due to low feed prices. Hog producers are having a fantastic second half in 1986.

## Use of farm Tax Manual

The following explanation of the 1986 Tax Law changes and provisions affecting individuals and farmers is not all inclusive. It is intended to provide basic information to enable the farm taxpayer and practitioner to recognize the most important tax changes and tax management opportunities. Major tax planning decisions should be based on a more complete study and understanding of the law than this material provides.

## THE TAX REFORM ACT OF 1986: PROVISIONS AFFECTING INDIVIDUALS

TRA of 1986 contains more than 30 changes that will affect individual taxpayers. Although most of the changes do not become effective until 1987, 1988 or 1989, early recognition of future changes is an important part of tax education and tax management. Following are the most important changes for individual farm taxpayers as well as others.

### Tax Rates are Reduced

Tax rates will be lowered substantially in 1987 and again in 1988. The top marginal rate for individuals in 1987 will be 38.5 percent versus 50 percent in 1986. In 1988, the top rate will be 28 percent but married individuals filing jointly will have a five percent surcharge on taxable income between $71,900 and $149,250 which makes the marginal rate on taxable income in this range 33 percent rather than 28 percent. (For an unmarried taxpayer, the income range is $43,150 to $89,560. Married couples with separate returns will pay the surtax on taxable income in the range of $35,950 to $74,625.) In addition, the benefit of each personal exemption is phased out by another five percent surtax on taxable income above $149,250 for a married couple filing jointly and above the appropriate point for other filers.

Here are the individual tax schedules for 1987 and 1988:

Married Couple Filing Joint Return

| 1987 | | 1988 | |
|---|---|---|---|
| Taxable Income | Tax | Taxable Income | Tax |
| $ 0 - $ 3,000 | 11% | $ 0 - $ 29,750 | 15% |
| 3,001 - 28,000 | $330 + 15% of amt. over $3,000 | 29,751 - 71,900 | $4,462.50 + 28% over $29,750 |
| 28,001 - 45,000 | $4,080 + 28% over $28,000 | 71,901 - 149,250 | $16,264.50 + 33% over $71,900 |
| 45,001 - 90,000 | $8,840 + 35% over $45,000 | $149,251 & over | 28% + * |
| 90,001 & over | $24,590 + 38.5% over $90,000 | *Must add second 5% surcharge | |

The second five percent surcharge is the phase-out of personal exemptions for high income taxpayers. This surcharge will be the lesser of 28 percent of all personal exemptions claimed or five percent of taxable income in the top bracket. In 1988, the surcharge will amount to five percent of $10,920 for each personal exemption claimed.

The rates for surviving spouses are the same as for married filing jointly. The brackets for head of household fall in between those for joint returns and single taxpayers.

Single Taxpayers

| 1987 | | 1988 | |
|---|---|---|---|
| Taxable Income | Tax | Taxable Income | Tax |
| $ 0 - $ 1,800 | 11% | $ 0 - $17,850 | 15% |
| 1,801 - 16,800 | $198 + 15% of amt. over $1,800 | 17,851 - 43,150 | $2,677.50 + 28% over $17,850 |
| 16,801 - 27,000 | $2,448 + 28% over $16,800 | 43,151 - 89,560 | $9,761.50 + 33% over $43,150 |
| 27,001 - 54,000 | $5,304 + 35% over $27,000 | 89,561 & over | 28% + * |
| 54,001 & over | $14,754 + 38.5% over $54,000 | *Must add second 5% surcharge | |

Married Taxpayers Filing Separate Returns

| 1987 | | 1988 | |
|---|---|---|---|
| Taxable Income | Tax | Taxable Income | Tax |
| $ 0 - $ 1,500 | 11% | $ 0 - $ 14,875 | 15% |
| 1,501 - 14,000 | $165 + 15% of amt. over $1,500 | 14,876 - 35,950 | $2,231.25 + 28% over $14,875 |
| 14,000 - 22,500 | $2,040 + 28% over $14,000 | 35,951 - 113,300 | $8,312.25 + 33% over $35,950 |
| 22,501 - 45,000 | $4,420 + 35% over $22,500 | 113,301 & over | 28% + * |
| 45,001 & over | $12,295 + 38.5% over $45,000 | *Must add second 5% surcharge | |

**Personal Exemptions and Standard Deduction will Increase**

The personal exemption and standard deduction will be increased by the TRA of 1986. The personal exemption will be $1,900 in 1987, $1,950 in 1988, and $2,000 in 1989 and then be indexed to inflation after 1989. In 1986, each exemption is $1,080.

The standard deduction for a married couple filing a joint return increases to $5,000 in 1988.

Beginning in 1987, the standard deduction will be deducted in the taxable income calculation rather than being built into the tax tables and schedules as the zero bracket amount. In other words, the ZBA has gone and the standard deduction has returned. This fact must be recognized in making comparisons of tax liability between 1986 and 1987 or later years.

Federal Standard Deductions, 1986-1988

| | Married, joint return | Single | Married, separate return |
|---|---|---|---|
| 1986 | $3,670 | $2,480 | $1,835 |
| 1987 | 3,760 | 2,540 | 1,880 |
| 1988 | 5,000 | 3,000 | 2,500 |
| 1989 & later: indexed to inflation | | | |

Starting in 1987 extra personal exemptions for taxpayers age 65 and older, and blindness are lost. A partial offset for this loss is provided through an increase in the standard deduction. Beginning with 1987, each taxpayer over 65 or blind will receive an additional $600 deduction on the joint return and $750 on a single return. A taxpayer who is both elderly and blind will receive an additional $1,200 deduction on the joint return and $1,500 on the single return. Also, taxpayers age 65 or over or blind taxpayers will use the 1988 standard deductions available to all taxpayers to establish their deduction base for 1987.

For example, Abe and Abigale Absolute are ages 66 and 65. They are married and plan to file a joint return in 1987. Their standard deduction will be $5,000 (base) plus $1,200 ($600 x 2) or $6,200.

The double exemption for children with income is gone after 1986. A personal exemption will not be allowed a taxpayer who can be claimed as a dependent by another taxpayer. A dependent child who qualifies as an exemption on the parents return may not claim his or her own exemption even if the parents do not use the child's exemption.

There are also changes in the standard deductions allowed dependent taxpayers. Starting in 1987, a dependent taxpayer who may be claimed on the parent's return may claim a standard deduction not exceeding $500 or earned income up to the basic standard deduction amount ($3,000 for a single individual in 1988), whichever is greater. A dependent taxpayer with $500 of earned income and $1,500 of interest and dividend income will have $1,500 of taxable income and a $165 tax liability (11 percent) in 1987. The tax liability will increase to $225 (15 percent of $1,500) in 1988.

Another new rule eliminates the tax advantage of funneling investment income to children under age 14. Net unearned income received by a child under 14 years of age will be taxed at the parents' marginal rate beginning in 1987 even if the income is from gifts made prior to 1987. This rule remains in effect until the child reaches age 14.

## Schedule W Deduction Repealed

The special deduction currently allowed working spouses when both have earned incomes will be lost beginning in 1987.

## Income Averaging Eliminated

This is the final year that taxpayers can use Schedule G. The advantages of income averaging will be lost for tax years beginning on or after 1/1/87.

## Dividend Exclusion Repealed

The $200 dividend exclusion for joint filers ($100 for singles) is gone after 1986.

Earned Income Credit Increased

The TRA of 1986 increases the maximum earned income credit from the current $550 to $800. In 1987, the credit will be 14 percent of the first $5,714 of earned income and must be reduced by 10 percent of AGI (or earned income, if greater) that exceeds $6,500. The $800 credit is reduced to zero when income reaches $14,500 ($6,500 + $8,000). The maximum $800 credit will be the same for 1988 but the 10 percent phaseout will not take effect until AGI or earned income hits $9,000. The new earned income credit will be indexed for inflation.

Unemployment Compensation Taxable

All unemployment compensation received after December 31, 1986 will be taxable income. The partial exclusion expires at the end of 1986.

Charitable Deduction for Non-Itemizers Ends

The old rule that allows 100 percent charitable deduction in 1986 to taxpayers that do not itemize deductions was scheduled to run out at the end of 1986 and was not extended by the new law. Qualified charitable deductions will continue to be deductible on Schedule A-1040.

Itemized Deductions Restricted

State and local sales taxes are eliminated from itemized deductions beginning in 1987.

Interest paid on most personal liabilities other than qualified residences will be phased out over a five year period. Sixty-five percent of personal interest will be deductible in 1987.

Medical expenses incurred after December 31, 1986 will be subject to a larger floor limitation. Only medical expenses exceeding 7.5 percent of AGI will be deductible.

Moving expenses and many unreimbursed travel and entertainment expenses have been moved to Schedule A. Beginning in 1987, a taxpayer must itemize to claim these deductions. Additional restrictions have been placed on business meal expenses, and certain travel and entertainment expenses.

Many miscellaneous deductions will be subject to a new floor equal to two percent of AGI. These "second tier" miscellaneous itemized deductions include: employment-related educational expenses, work clothes and fees, professional dues and fees, job hunting expenses, 80 percent unreimbursed business-entertainment expenses, legal and accounting fees, hobby expenses not exceeding hobby income, tax counsel and assistance.

The adoption expense deduction is repealed.

IRA Contributions

Contributions to an IRA continue to be deductible when the taxpayer and his or her spouse are not covered by an employer-provided retirement plan. The maximum deduction is $2,000 for an individual, $2,250 when the spouse is included.

Starting in 1987 if either the taxpayer or spouse are covered by their employer's plan, the deduction is phased-out when AGI before the deduction exceeds $40,000 on the joint return and $25,000 on the single return. The phaseout reduces the allowable IRA deduction at a rate of 20 cents per $1.00 of excess AGI thereby reducing the deduction to zero at $50,000 AGI on the joint return and $35,000 on the single return. A minimum $200 deduction is allowed if AGI does not exceed the top of the phaseout range.

Earnings from IRA's will continue to be tax-deferred, including earnings from nondeductible IRA's.

Deductibility of Non-Business Interest

Under the TRA of 1986, the deduction for investment interest is limited to the amount of net investment income. Any interest disallowed would be carried forward and used as investment interest in future years (subject to the investment income limit). Investment interest excludes interest on a real estate activity in which the taxpayer actively participates and it excludes "qualified residence interest". It is intended to include interest on property held for investment purposes and interest not taken into account in computing income or loss from passive activities. There is a new definition of investment income.

The disallowance of interest will be phased in over the 1987-90 period with a disallowance of 35, 60, 80, and 90 percent, respectively. However, the rules are more complicated than the previous sentence would appear to indicate.

Other

Scholarship and fellowships cannot be totally excluded from taxable income beginning in 1987. The new exclusion will be limited to amounts used by degree candidate students to pay tuition and course related expenses.

Awards made to employees for length of service and/or safety achievement will be excluded from the employee's gross income but included as a deduction for the employer within the following limitations. The limitations are $400 maximum annual exclusion per employee if the award is not a qualified plan award, and $1,600 maximum per employee in one year if it is a qualified plan award (established written plan that does not favor high salaried employees).

The political contribution credit has been repealed.

Home office expense deductions will continue to be subject to present law limitations except they cannot exceed net income from the business and the limitations are extended to cover office space leased to the taxpayer's employer.

Health insurance premiums paid by self-employed taxpayers may be deducted from AGI within specific limitations. Only 25 percent of the payments made to cover the taxpayer, his or her spouse and dependents are deductible. The deduction may not exceed earned income and the insurance plan must meet new nondiscrimination rules.

Dependents claimed will require tax identification numbers (social security numbers). Tax returns due on or after 1/1/88 will require an identification number for all dependents five years of age or older claimed by the taxpayer.

Estimated tax payments will increase for tax years beginning in 1987. Taxpayers required to make estimated tax payments must pay 90 percent (up from 80 percent) of the current year's tax liability in order to avoid the estimated tax penalty. Taxpayers still have the option of paying 100 percent of the preceding year's tax liability. This provision does not affect the final 1986 tax payment.

## PROVISIONS APPLYING PRIMARILY TO BUSINESS ACTIVITY

There are many changes in the TRA of 1986 that will affect the taxation of businesses. Only those affecting most business taxpayers are included here.

### Investment Credit

The regular investment credit was repealed for property placed in service after December 31, 1985 unless there was a binding contract in effect on that date (transition property). Investment credit carryovers from 1985 and earlier years may still be used but only 82.5 percent of that left over from 1986 may be carried to 1987 and 65 percent of that left after 1987 may be carried to 1988 and later years. This applies to taxpayers with a calendar year. For noncalendar year taxpayers, the limitation on carryovers will be calculated by a formula that reflects the portion of their tax year that falls after July 1, 1987.

For transition property, investment credit will be allowed according to the following schedule:

| ADR Class Life | Property must be placed in service by: |
|---|---|
| Less than 5 years | June 30, 1986 |
| 5 or 6 years | December 31, 1986 |
| 7 to 19 years | December 31, 1988 |
| 20 years or more | December 31, 1990 |

If investment credit is claimed on transition property, the basis for depreciation must be reduced by 100 percent of the investment credit.

A special provision allows qualified farmers to elect to carry back a portion of existing IC carry forwards for as much as 15 years. The carry back is limited to the smallest of (a) 50 percent of existing carry forwards, (b) the taxpayer's net tax liability for the carry back period, or (c) $750. The election must be made on the return for the first taxable beginning after 1986.

For tax years beginning after 1985, IC cannot offset more than $25,000 of tax liability plus 75 percent (rather than 85 percent) of the tax liability exceeding $25,000.

### Investment Credit for Rehabilitated Buildings

The credit for rehabilitated buildings was modified. The rehabilitation credit will be 10 percent for a qualified rehabilitated building and 20 percent for a certified historic structure. The building (other than a certified historic structure) must have been first placed in service before 1936. The new rules will apply to rehabilitated property placed in service after 1986. As usual, there are some transitional rules.

For buildings other than certified historic structures, 50 percent or more of the external walls must be retained as external walls, 75 percent or more of the external walls must be retained as internal or external walls, and 75 percent or more of the internal structural framework must be retained in place.

### Business Energy Investment Credit

The BEIC rules were modified by the TRA of 1986. See later section.

Depreciation

Depreciation is somewhat slower under the new law. The ACR system was modified so that many items will be in a longer recovery class if acquired after 1986. For example, cars and light trucks will be in the 5-year rather than 3-year class. Most farm machinery and single purpose agricultural structures will be in the 7-year rather than the 5-year class. Computers remain in the 5-year class. In the 3, 5, and 7-year classes, depreciation will be based on double declining balance with switchover to straight line and a half-year convention applied to the first year.

Buildings that would be in the 19-year class if acquired in 1986 will be in the 31.5 year class except for residential rental property which will be in the 27.5 year class. In both these classes, only straight line depreciation may be used.

Items with an ADR midpoint life of at least 25 but less than 27.5 years will be in the 20-year class. This class appears to include general purpose farm buildings because the ADR midpoint life is 25 years. Depreciation will be calculated with 150 percent declining balance with switchover to straight line.

The expensing election which is $5,000 under current law will be $10,000 for property placed in service after 1986. The $10,000 will be phased out for any taxpayer who places more than $200,000 worth of property in service in a taxable year.

The taxpayer has the choice of whether to use the new depreciation rules (but not the new expensing rules) for property placed in service after July 31, 1986.

If more than 40 percent of the year's depreciable assets are placed in service during the last quarter of the year, all non-real estate assets must be depreciated using a mid-quarter convention rather than the mid-year convention.

Listed Property Placed in Service after 1986

The limit on depreciation for passenger vehicles placed in service after 1986 will be $2,560 for the first year, $4,100 for the second year, $2,450 for the third year, and $1,475 for each succeeding year. If business use is less than 100 percent, the depreciation deductions will be reduced proportionately. If business use drops to less than 50 percent, the difference between the depreciation taken and depreciation with straight line over 5 years must be recaptured. Automobiles will be in the 5-year ACRS class.

Capital Gains

The 60 percent capital gain exclusion will end on December 31, 1986. This applies to capital gains of all kinds. For farmers, it means that all gains on livestock, real estate, and other farm property will be taxed as ordinary income for sales made after 1986 (see page 13 for exception for dairy buyout cattle). In 1987, the top marginal rate on capital gain income will be 28 percent, even though the top marginal rate on ordinary income is 38.5 percent. In 1988 and later, capital gain income will not be exempt from the five percent surcharge to offset the benefits of the 15 percent bracket and personal exemptions for higher income taxpayers.

There is no exception in the new law that would allow favorable capital gains treatment for timber sales. The gain from the sale of timber after

December 31, 1986 is subject to the same rates as other capital gain. However, the taxpayer who elected to treat the cutting of timber as a disposition under Sec. 631(a) before January 1, 1987 may now revoke that election on a one time basis without special permission.

## Capitalization and Inclusion in Inventory Costs of Certain Expenses

Section 263A has been added to the IRC and deals with the nondeductibility of certain direct and indirect costs. This section is complicated and covers property produced by the taxpayer as well as property acquired for resale.

For the applicability of this section to farm businesses, see page 13.

## Discharge of Indebtedness When the Taxpayer is Solvent

The provision that allowed solvent taxpayers to elect to exclude income from the discharge of "qualified business indebtedness" from gross income by electing to reduce the basis of depreciable property was repealed for discharges after December 31, 1986. (See page 13 for treatment of solvent farmers).

## Tax Year of Partnerships, S-Corporations, and Personal Service Corporations

For taxable years beginning after 1986, S-Corporations and Personal Service Corporations are required to adopt the calendar year unless the corporation can establish, to the satisfaction of the Secretary of the Treasury, a business purpose for using a different taxable year.

Partnerships are required to adopt the same taxable year as that of the partners owning a majority interest in partnership profits and capital unless a business purpose for a different year can be established. In some cases, a partnership may have to adopt a calendar year. The rules are complicated.

In all cases, deferral of income for three months or less will no longer satisfy the business purpose rule.

## Limitations and Deductibility of Passive Activity Losses and Credits

The intent of these provisions in TRA 1986 is to curb the use of tax shelters. The new rules are comprehensive and complicated.

If the activity is "passive", losses and credits from that activity are not allowed against income of the taxpayer other than income from the passive activities. Disallowed losses may be carried forward and applied against future passive income. In general, passive activities are those in which the taxpayer does not materially participate and any rental activity even if the taxpayer does materially participate. As usual, there are some exceptions.

The passive rules apply to individuals, personal service, and S-Corporations, estates, trusts, and a few others but not to C-Corporations.

In the case of rental real estate held by individual taxpayers (natural persons) who actively participate, the passive rules do not apply to losses up to $25,000. The $25,000 is phased out at a rate of 50¢ for each dollar of the taxpayer's AGI exceeding $100,000. AGI for this purpose is determined without the passive losses.

The use of passive losses by taxpayers will be phased out during 1987-90. The percentages disallowed are: 1987, 35 percent; 1988, 60 percent; 1989, 80 percent; and 1990, 90 percent. This phaseout applies only to activities in which the taxpayer was engaged before the enactment of TRA 1986.

Any tax practitioner who has clients with passive losses will need to learn more than is contained in this short summary.

<u>Hobby Loss Rule Change</u>

The Sec. 183(d) presumption that states the number of years a taxpayer must show a profit for the profit presumption to be in his or her favor has been changed from two to "three or more of the five previous taxable years". This change is effective January 1, 1987 and does not apply to horse farming activities which continue to be two profit years out of seven.

## ITEMS APPLYING TO INDIVIDUALS AND CORPORATIONS

<u>Alternative Minimum Tax</u>

Effective for tax years beginning after 1986, the corporate add-on minimum tax has been repealed and replaced with an alternative minimum tax. Sections 55-58 in the old law have been replaced with Sections 55-59. Individual and corporate AMT are now dealt with together rather than separately as under the old law. However, the items to be included in the computation of AMTI differ somewhat for individuals and corporations.

The alternative minimum tax for individuals has been expanded. The AMT rate for individuals will be 21 percent beginning in 1987. The exemptions remain the same as for prior law but there will be a phaseout of the exemptions at higher income levels.

Section 56 is applicable to all taxpayers and deals with "adjustments in computing alternative minimum taxable income". Section 56(a)(1) requires that for AMT purposes, depreciation on property placed in service after 1986 "be determined under the alternative system of Section 168(g)". (This appears to be less unfavorable to the taxpayer than the depreciation required if a farmer elects not to capitalize preproductive expenses. See page 13.) In addition, all taxpayers must make "adjustments" for mining exploration and development costs, treatment of certain long-term contracts, alternative tax net operating loss deduction, pollution control facilities, and installment sales of certain property.

Other adjustments applicable to individuals are: limitation on itemized deductions, and circulation and research and experimental expenditures.

Corporations must make adjustments for: book income or adjusted earnings and profits, Merchant Marine capital construction funds, special deduction for certain organizations, and several other items.

Items of tax preference for both individuals and corporations (Section 57) are depletion, intangible drilling costs, incentive stock options, reserves for losses on bad debts of financial institutions, tax exempt interest, appreciated property charitable deduction, and accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

» For individuals, the 60 percent capital gain exclusion and the $100 or $200 dividend exclusion will no longer be included in AMTI (because they won't exist after 1986). Note: It will be interesting to see how the preservation of capital gain treatment of buyout cattle in 1987 will be handled.

In addition, Section 58, Denial of Certain Losses, covers (a) Denial of Farm Loss (for noncorporate taxpayers), (b) Disallowance of Passive Activity Losses, and (c) Special Rules.

Section 59 covers Other Definitions and Special Rules.

There are many other interesting items dealing with AMT. Watch this space next year for more details.

The new AMT applies to all taxable years beginning after 1986.

## PROVISIONS APPLYING TO CORPORATIONS

There are many provisions in TRA 1986 that apply to corporations. Only a few are covered in this manual.

### Tax Rates

Effective for taxable years beginning on or after July 1, 1987, corporate tax rates will be:

| Taxable Income | Tax Rate |
|---|---|
| Not over $50,000 | 15% |
| Over $50,000 but not over $75,000 | 25% |
| Over $75,000 but not over $100,000 | 34% |
| Over $100,000 but not over $335,000 | 39%* |
| Over $335,000 | 34%* |

*Result of phaseout of benefits of lower rate by applying a five percent surcharge to income over $100,000, the surcharge not to exceed $11,750.

Corporations with a tax year that begins before and ends after July 1, 1987 will need to make two sets of tax calculations: (1) Tax on the entire income will be computed using 1986 rates, and (2) be computed again using 1987 rates (see table above). Then a blended tax will be calculated by weighting each tax by the portion of the year before and after the rate change.

## PROVISIONS SPECIFIC TO AGRICULTURE

### Expensing of Soil and Water Conservation Costs

After 1986, in order to be expensed rather than capitalized, soil and water conservation costs must be consistent with a conservation plan approved by the USDA Soil Conservation Service or by a comparable state agency. Costs for draining or filling of wetlands or land preparation for center pivot irrigation systems may not be expensed. Carry overs from previous years will not be affected by the rules of TRA 1986.

Expensing of Land Clearing Repealed

Any amounts paid or incurred after 1985 for land clearing are not eligible for expensing. Such costs must be added to the land's basis. Routine brush clearing for land already farmed will not be affected.

Dispositions of Converted Wetlands or Highly Erodible Croplands

Any gain on the disposition of converted wetlands or highly erodible cropland will be treated as ordinary income rather than capital gain. Any loss on such dispositions will be treated as long-term capital loss. The definitions of "converted wetlands" and "highly erodible cropland" are contained in the Food Security Act of 1985. The provision applies to land converted to farming after March 1, 1986.

Limitation on Certain Prepaid Farming Expenses

The limitation applies to prepaid expenses of cash basis taxpayers to the extent they exceed 50 percent of the deductible farming expenses of the taxable year (other than the prepaid expenses).

There are two exceptions to the 50 percent test for a "qualified farm related taxpayer":

1. Extraordinary circumstances such as a government crop diversion program.

2. If the 50 percent test is satisfied on the basis of aggregating the prepaid expenses and the farming expenses for the previous three years.

A "farm related taxpayer" is one (i) whose principal residence is on a farm, (ii) who has a principal occupation of farmer or (iii) who is a member of the family of a taxpayer described in (i) or (ii).

This provision is effective for amounts paid or incurred after March 1, 1986 in taxable years beginning after that date. For calendar year taxpayers the provision will become effective in 1987.

Alternative Minimum Tax Relief for Insolvent Farmers

Some relief from the alternative minimum tax for insolvent farmers was provided by Congress and the President in April 1986. An insolvent farmer who sold farmland after 1981 does not need to include the 60 percent capital gain exclusion on land in the computation of alternative minimum tax (AMT) to the extent of the insolvency. The exclusion from AMT applies only to land, not to the capital gain excluded on buildings or other depreciable property. To qualify, the land must have been transferred to the creditor in cancellation of indebtedness or sold or exchanged under threat of foreclosure. To qualify as a farmer, a taxpayer must have received at least 50 percent of annual gross income in the three previous years from farming. To meet the insolvency requirement, the taxpayer must, immediately before the transaction, have had an excess of liabilities over the fair market value of his assets.

At the time the legislation was enacted, there were only a few days left in which a taxpayer could have filed an amended return for 1982. Under the legislation, unless that was done before April 15, 1986, the taxpayer had lost the opportunity to make the AMT exclusion for 1982. The Tax Reform Act of 1986 extends the time for filing an amended return for this purpose to one year after the date of enactment of TRA 1986 (October 22, 1986).

Tax Treatment of Discharge of Certain Indebtedness of Solvent Farmers (IRC Section 108(g))

Discharge of "qualified farm indebtedness" of solvent taxpayers will be treated the same as debt discharge for insolvent taxpayers if the discharge occurred after April 9, 1986. Formerly, debt discharged for a solvent taxpayer had to be included in income unless the taxpayer chose to reduce the basis of depreciable assets. If the debt discharged was greater than the basis of depreciable assets, the remainder had to be included in income. The change would apply the insolvent taxpayer rules (which are more favorable to the taxpayer) to solvent farmers.

In addition, taxpayers would be allowed to reduce their basis in land (after reducing other tax attributes, as described in IRC Section 108 and Section 1017) in return for not including discharge of qualified farm indebtedness in income.

Treatment of Gain on Sale of Dairy Buyout Cattle

Capital gain treatment will be preserved for otherwise eligible cattle sold as part of the dairy production termination program during the period January 1, 1987 - August 31, 1987.

Capitalization of Preproductive Expenses

In situations where the preproductive period is more than two years (such as raising dairy or beef replacements or developing an orchard or vineyard), TRA 1986 requires that the preproductive expenses incurred after 1986 be capitalized (rather than expensed) and then be depreciated after the item is placed in service (that is, begins to produce).

Preproductive period expenses will presumably include direct growing or raising costs plus an appropriate share of indirect costs such as taxes, interest, and insurance. It is expected that IRS will permit taxpayers to use reasonable inventory methods to determine costs to be capitalized to avoid complicated accounting procedures.

There is a specific election available to farmers that would allow expensing, rather than capitalization, of preproductive expenses. In return, the farmer would be required to use "alternative depreciation" (IRC Section 168(g)(2)) on all assets placed in service during any year the election is in force. The taxpayer gets one chance to make this election: the "first taxable year which begins after December 31, 1986, and during which the taxpayer engages in a farming business".

The "alternative depreciation system" (IRC Section 168(g)(2)) in general specifies that depreciation must be taken via straight line (rather than accelerated) over the ADR class life of the property. For single purpose agricultural structures, the "alternate" straight line period will be 15 years and for buildings it will be 40 years (rather than 27.5 or 31.5).

It appears that there is no way for those who raise dairy or beef cattle for replacement purposes to avoid the capitalization rules. Producers of nursery stock, sod farmers, fruit and nut growers are also included. They must either capitalize the preproductive costs or elect the "alternative depreciation system". Timber and evergreen trees which are more than six years old when harvested (e.g. Christmas trees) are exempt from the capitalization rules.

# LUXURY AUTOS, LISTED PROPERTY, AND SUBSTANTIATION OF BUSINESS EXPENSES

## Depreciation and Investment Credit for Luxury Automobiles

ACRS deductions and IC are limited 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; and used over 50 percent for business. 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 (and before December 31, 1986). 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.

See page 8 for the rules on vehicles acquired after 1986.

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

Automobiles, computers, and other "listed property" placed in service after June 18, 1984 and before 1987 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 were 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.

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 were not subject to the Section 274(d) rules (time and place of travel or entertainment, business relationship to the taxpayer, etc.). They were 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, 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.

Temporary regulations (1.274-5T and 6T) were issued in November 1985 relating to substantiation of expenses for listed property. For tax years beginning in 1986 and later, the taxpayer must be able to substantiate each item of expenditure by "adequate records" or "sufficient evidence corroborating his own statement". A contemporaneous log is not required but a record of expenses and the business purpose made at or near the time of expenditure, supported by documentary evidence has a degree of credibility not present with a statement prepared later.

It is not possible to state exactly what records and substantiation are required to establish that the expenditure was made and the business purpose for it, but a combination of a log and receipts normally would be required. A cancelled check alone will not be sufficient in many cases.

In the absence of "adequate records", what constitutes "sufficient evidence ...." seems to be rather vague. In some cases, records from a sample of the week, month or year may be sufficient.

At this point, it is not clear what questions will be asked on the 1986 Form 4562 relative to business use of automobiles and other listed property.

There is a rather long list of vehicles that are specifically exempted from the automobile rules: Combines, flatbed trucks, cement mixers, refrigerated trucks, etc. Pickups are not exempt.

The substantiation requirements do not apply to certain vehicles used in connection with the business of farming if no more than 75 percent of the total costs of the vehicle are deducted as a farm expense. If the vehicle is also available for personal use by employees, the value of the personal use must be included in the employee's gross income.

Personal Use by Employee of Employer Owned Vehicles

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.

## GOVERNMENT PAYMENTS

### Milk Production Termination Program (MPTP) Payments

Approximately 540 New York dairy farmers contracted with USDA to terminate milk production and sell their dairy cattle in 1986 and/or 1987. Dairy cattle meeting the two year holding period will receive favorable capital gains treatment when sold before September 1, 1987.

As of this date (October 31, 1986) IRS has not issued a special ruling or regulation on the treatment of MPTP payments. In the absence of a special ruling, one can assume MPTP payments are to be reported similar to other agricultural program payments received by farmers. Here are our current recommendations and suggestions:

- Farmers report MPTP payments as cash agricultural program payments on Schedule F. The payments will be included in net farm profit and in net earnings from self-employment.

- Taxpayers no longer filing Schedule F should enter MPTP payments as other income on Form 1040 and identify the source. USDA will probably issue a 1099-G.

- Some MPTP farmers took 80 percent of their payments in 1986. They will need all the farm expenses, deductions, credits and NOL's available to reduce taxable income. Don't overlook income averaging.

- Recapture of investment credit could be another sticky problem on MPTP farms. It can not be avoided on Sec. 38 property sold or disposed of. Watch out for single purpose dairy structures that are converted to another use and equipment that is permanently removed from qualified use.

### PIK Certificates

The 1986 wheat and feed grain programs provide for issuance of generic PIK certificates denominated in dollars to farmers who participate in these programs. Our current understanding is that the face value of the certificate must be reported as income in the year the certificate is received regardless of how the farmer disposes of the certificate.

The producer has several options for disposing of the certificate (1) Cash in the PIK certificate for face value (less a Gramm-Rudman adjustment) at the ASCS office within 10 working days of the first transfer deadline. (2) Sell the PIK certificate to someone else. The proceeds may be more or less than the certificate's face value, but in general the certificates are selling at premium. (3) Use the PIK certificate to redeem grain from previous years stored under CCC loan. (4) Put current year grain under loan, receive the current loan rate and redeem it immediately using PIK certificates.

Under (1), if the certificate is cashed in the year received, the face value of the certificate less the 4.3 percent reduction will be reported as income. Under (2), the face value of the certificate would be reported as income in the year received and the premium would be reported as income in the year that the certificate is sold. Under (3) and (4), the value of the certificate will be reported as income in the year received. In addition there will be tax consequences related to the loan paid off when the grain is redeemed and to the sale of the grain. The tax consequences will differ depending on whether the taxpayer had included the loan in income the year the loan was received.

## CASES AND RULINGS

Embryo Transplants

"Farmer" A purchased 10 Cows with implanted purebred embryos for 250x dollars each. After the 10 calves were born, the cows were sold for 80x each. A had allocated all the 250x original cost to the cows and intends to claim an ordinary loss of 170x dollars per cow. The purebred calves would be held for later sale.

The portion of the 250x dollars paid to X for the pregnant non-purebred cows, the fair market value of the cows of 80x dollars, is treated as the purchase price of the cows. A will not recognize any gain or loss on the sale of cows because A's 80x dollar basis in the cows equals the 80x dollars received on the sale. (Note: The FMV of the cows at the time of purchase is not necessarily equal to the sale price but is in this case.) The balance of the 250x dollar purchase price, 170x dollars, is attributable to the cost of purchasing the purebred calves. Since the calves are not capital assets under section 1221 of the Code and are not property used in the taxpayer's trade or business within the meaning of section 1231(b), any gain or loss on the sale of the calves will be ordinary income or ordinary loss. [Rev. Rul. 86-24]

In TAM 8625007, the Service held that expenditures for cattle embryo transplants are non-deductible expenses which must be capitalized. Taxpayer purchased from a reproduction center embryos from selected breeding of donor cows for the express purpose of developing a breeding herd. Separate charges were incurred for breeding, embryo transplant and maintenance services and the fair market value of the recipient cows. Taxpayer used the cash method of accounting and paid the reproduction center $97,625.00 for breeding and maintenance fees and $52,250.00 for the 55 recipient cows. The only condition on Taxpayer's payment was that the recipient cows had to produce a positive pregnancy test 60 days after the transplant. Taxpayer received 30 cows in 1979 and the remainder in 1980. Taxpayer deducted $97,625.00 for breeding and maintenance expense on his 1979 tax return. Taxpayer capitalized the $52,250.00 and allocated this sum as the basis for the recipient cows.

Citing Gamble v. Commissioner, 68 TC 800 (1977), and Rev. Rul. 78-176, the National Office concluded that Taxpayer did not incur any obligation until the recipient cows produced positive pregnancy tests 60 days after the embryo transplants. The Service concluded that the transaction at issue here is the purchase of purebred cattle embryos, which will result in breeding calves. According to the TAM, such expenditure constitutes non-deductible capital expenditures under Sec. 263.

In Massengill v. Commissioner, No. 84-2075 (4/21/86), (CCH Dec. 43,006), the Taxpayer was not entitled to a depreciation deduction or an investment tax credit in connection with his embryo transfer, cattle breeding venture. Investment in the cattle did not qualify as an activity engaged in for profit. The Taxpayer, who was responsible for providing technical knowledge concerning the embryo transfers and then marketing the cattle, had no expertise in the area of embryo transfer. Further, he had been advised that embryo transfer was not economically feasible. Time spent by the Taxpayer with the embryo transfer project after purchasing his cattle was insignificant. The Taxpayer had not only a prior history of business losses, but a history of involvement in living trust tax avoidance schemes. Investment tax credits were denied because the cattle were not used in a trade or business or for the production of income. Despite the Taxpayer's claim that his accountant failed to timely file his returns, additions to tax were imposed. An accountant's failure to prepare returns is not a defense to a Taxpayer's failure to file returns or pay tax.

## INFORMATIONAL RETURNS

There are no major changes affecting the 1986 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 for nonbusiness services and to corporations are excluded.

3. Farmers should include payments made to independent contractors, veterinarians, crop sprayers, repair shops, and building contractors. Payments made for feed, seed, fuel, 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.

### Other Situations Requiring 1099-MISC

1. A. Attorney makes an agreement with P. Practitioner to help A's client, F. Farmer, develop a financial reorganization plan. A pays P a $900 fee and A must report the $900 on 1099-MISC.

2. The B & W Cattle Club holds a raffle and gives away a dairy heifer worth $800. The club must file Form 1099-MISC reporting the $800 and the recipient's name, address, and social security number.

1099-MISC is also used to report the occurance of direct sales of $5,000 or more of consumer goods for resale.

### Other Information Returns

1098 - Used by recipient to report $600 or more of mortgage interest from an individual on any mortgage during the year. Applies to real estate developers as well as those in the trade or business of lending money.

1099-G - Used to report agricultural program payments by USDA, discharge of indebtedness by federal government, state tax refunds, and unemployment compensation.

1099-INT - Payer reports interest payments not including interest on an IRA, SFP or DEC.

8300 - Recipient reports cash payments over $10,000 received in related transactions, in the course of operating a trade or business.

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

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 to include all the required information is a $5 penalty. Additional penalties are imposed for intentional disregard of the law. Penalties are to be self-assessed by the payor without notices or demand from IRS. Interest accrues on these penalties from the due date.

Magnetic Media

Filers of information Forms 1099-DIV, 1099-PATR, 1099-OID or 1099-INT for more than 50 payees must file on magnetic media. 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).

Payors filing over 500 informational returns of any kind in 1987 (for 1986) will be subject to the magnetic media requirement.

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

Twenty percent backup withholding is still required in connection with payments requiring a 1099-INT or 1099-MISC 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. 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 have placed a higher priority on exploring opportunities to reduce the burden of these taxes through wise tax management.

## The Current Tax Burden

The maximum earnings base for employees as well as self-employed taxpayers increased 6.1 percent to $42,000 for 1986 following a 4.8 percent increase in 1985. Social Security (FICA) rates increased to 7.15 percent for both employers and employees in 1986 but are not scheduled to increase again until 1988. The combined employer and employee FICA tax rate for 1986 is 14.3 percent. The maximum combined 1986 FICA tax increased 7.6 percent to $6,006.

Currently (1986) self-employed individuals pay an effective rate of 12.3 percent (14.3 less 2.0 credit) that will generate a maximum of $5,166 self-employment tax. This is an increase of $493 or 10.5 percent following a nine percent increase in 1985. The maximum self-employment tax increased 28 percent from 1983 to 1984. The 1987 effective rate is supposed to remain at 12.3 percent.

Social Security Tax Table

| | | FICA Tax Rate | | Self-Employment Tax | | |
|---|---|---|---|---|---|---|
| Year | Earnings Base | Employer | Employee | Specified Rate | Credit | Effective Rate |
| 1985 | 39,600 | 7.05 | 7.05 | 14.1 | 2.3 | 11.8 |
| 1986 | 42,000 | 7.15 | 7.15 | 14.3 | 2.0 | 12.3 |
| 1987 | * | 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-employed 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 1986 is computed on the first $42,000 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 favorable 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 (1986) | | 3,075 |
| Salary to wife | -8,000 | |
| Net farm income after payment of salary to wife | $17,000 | |
| Self-employment tax after payment | | -2,091 |
| Self-employment tax savings = | | $ 984 |

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 1986?

| | |
|---|---|
| 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 1986.

# DEPRECIATION AND COST RECOVERY RULES APPLICABLE TO 1986 AND PRIOR TAX YEARS

The Accelerated Cost Recovery System (ACRS) instituted by ERTA and modified by TRA of 1984 continues in effect 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. 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.

## 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 and before January 1, 1987 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), 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. Single purpose livestock and horticultural structures, silos, grain storage bins, fences, paved barnyards, water wells, and drain tiles.
4. Orchards, groves, and vineyards when they reach the production stage.

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

Nineteen-year property. The 19-year class includes Section 1250 property with an ADR class life of more than 12.5 years placed in service after May 8, 1985. This class includes all depreciable farm real estate 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 19-year class. If fast recovery is used on 19-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 type of property that is now in the 19-year class. This type of Section 1250 property placed in service between January 1, 1981 and March 16, 1984 was in the 15-year property class.

## 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 following table. These rates approximate 150 percent declining balance with switchover to straight line. The rates for 19, 18, and 15-year property are based on 175 percent declining balance with switchover to straight-line.

## Half-Year and Mid-Month Conventions

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. First year depreciation on 19-year, 18-year, and 15-year real property starts with the month of acquisition and assumes assets in the 18 and 19-year classes are placed in service at mid-month.

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 |

*Nine percent for recovery years 7 through 10.

FAST (REGULAR) RECOVERY FOR ACRS 19, 18, AND 15-YEAR PROPERTY EXCEPT LOW-INCOME HOUSING

| Recovery Class | 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: | | | | | | | | | | | |
| 19 yrs. | 1 | 8.8 | 8.1 | 7.3 | 6.5 | 5.8 | 5.0 | 4.2 | 3.5 | 2.9 | 1.9 | 1.1 | 0.4 |
| | 2 | 8.4 | 8.5 | 8.5 | 8.6 | 8.7 | 8.8 | 8.8 | 8.9 | 9.0 | 9.0 | 9.1 | 9.2 |
| | 3 | 7.6 | 7.7 | 7.7 | 7.8 | 7.9 | 7.9 | 8.0 | 8.1 | 8.1 | 8.2 | 8.3 | 8.3 |
| | 4 | 6.9 | 7.0 | 7.0 | 7.1 | 7.1 | 7.2 | 7.3 | 7.3 | 7.4 | 7.4 | 7.5 | 7.6 |
| | 5 | 6.3 | 6.3 | 6.4 | 6.4 | 6.5 | 6.5 | 6.6 | 6.6 | 6.7 | 6.8 | 6.8 | 6.9 |
| | 6 | 5.7 | 5.7 | 5.8 | 5.9 | 5.9 | 5.9 | 6.0 | 6.0 | 6.1 | 6.1 | 6.2 | 6.2 |
| | 7 | 5.2 | 5.2 | 5.3 | 5.3 | 5.3 | 5.4 | 5.4 | 5.5 | 5.5 | 5.6 | 5.6 | 5.6 |
| | 8 | 4.7 | 4.7 | 4.8 | 4.8 | 4.8 | 4.9 | 4.9 | 5.0 | 5.0 | 5.1 | 5.1 | 5.1 |
| 18 yrs. | 2 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 9 | 10 | 10 | 10 |
| | 3 | 8 | 8 | 8 | 8 | 8 | 8 | 8 | 8 | 9 | 9 | 9 | 9 |
| | 4 | 7 | 7 | 7 | 7 | 7 | 8 | 8 | 8 | 8 | 8 | 8 | 7 |
| | 5 | 7 | 7 | 7 | 7 | 7 | 7 | 7 | 7 | 7 | 7 | 7 | 7 |
| | 6 | 6 | 6 | 6 | 6 | 6 | 6 | 6 | 6 | 6 | 6 | 6 | 6 |
| | 7 | 5 | 5 | 5 | 5 | 6 | 6 | 6 | 6 | 6 | 6 | 6 | 6 |
| | 8 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 |
| | 9 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 |
| | 10 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 |
| 15 yrs. | 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 |
| | 11-15 | 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 |

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.

## 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 1986, 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 1985 (3-year property) but choose straight line for three or five years for a pickup truck purchased in 1986. Keep in mind that fast recovery would be used on any other 3-year property purchased in 1985 and the same straight line option used on the pickup would be required on all 3-year property purchased in 1986.

A taxpayer may select different recovery options for different ACRS classes established for the same year. For example, a taxpayer 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 and before 1986, the basis for cost recovery must be reduced by 50 percent of the regular investment tax credit. The basis of transition property that qualifies for regular IC in 1986 must be reduced by the full amount. Prior to 1986, the taxpayer had the alternative of reducing the regular investment credit by two percentage points rather than reducing the basis. When the taxpayer elected to reduce the regular investment credit rather than reduce the basis, the IC became four percent for 3-year property and eight percent for other recovery property that was eligible. The election was made on a property-by-property basis. This option may not be applied to transition property placed in service in 1986.

The basis of certified historic structures must be reduced by 50 percent of the 25 percent credit claimed for rehabilitating these structures.

If investment credit is recaptured on an asset on which the basis reduction was taken, the basis will be adjusted upward by 50 percent (100 percent for 1986 IC transition property) 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 Section 179 election is $5,000 for 1982 through 1986 (and will increase to $10,000 in 1987 due to TRA of 1986). 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. Beginning in 1987, the $10,000 Section 179 deduction is limited by several new restrictions (see price discussion).

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 pre-1987 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.

Prior to 1986, the major disadvantage of using the Section 179 election was the loss of investment credit, New York as well as federal. With the repeal of federal IC effective for 1986, only the New York IC will be lost when Section 179 is used. This makes Section 179 a more attractive and important tax management option for 1986 and future tax years. Every farmer who has purchased ACRS property in 1986 should consider the $5,000 expense deduction. It should not be used to reduce taxable income below the 1986 ZBA unless an additional reduction in 1986 self-employment income is worth more than depreciation in a future tax year.

Anti-Churning Rules

A set of anti-churning rules are designed to prevent a taxpayer from taking advantage of ACRS on property first acquired and placed in service 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

There are special rules for depreciation on automobiles and other "listed property" acquired after June 18, 1984. TRA of 1986 changed the depreciation allowance for "luxury" autos (see prior discussion).

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 acquired prior to January 1, 1987) is disposed of. New ACRS rules allow a deduction in year of disposition of property acquired after December 31, 1986. 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, all 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.

With the loss of the 60 percent capital gain exclusion (January 1, 1987), a major reason for avoiding fast ACRS recovery on 19-year nonresidential property has been eliminated. The use of straight line depreciation will no longer shield gain from ordinary income. When depreciable property is sold after December 31, 1986, the entire gain will be ordinary income regardless of the depreciation method used. However, the excess of rapid recovery over straight line depreciation is still subject to the alternative minimum tax. The choice of the best recovery option for 19-year ACRS property placed in service in 1986 should be based on the value of concentrating depreciation in early years versus spreading it out. The scheduled reduction in tax rates, increase in exemptions, and time value of money make 1986 and 1987 depreciation more valuable than that used in later years. However, depreciation claimed to reduce taxable income below the ZBA or standard deduction is depreciation wasted.

## 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.

## GENERAL BUSINESS CREDIT

Effective for tax years beginning after December 31, 1983, "regular" investment credit (repealed January 1, 1986 except for a few items), business energy investment credit, targeted jobs credit, alcohol fuels credit, and ESOP credits are all part of Section 38, General Business Credit. In 1986 and later, the credit allowable is limited to tax liability up to $25,000 plus 75 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

Items placed in service after December 31, 1985 are generally not eligible for the regular investment credit unless there was a binding contract to acquire the items in effect on December 31, 1985 (see page 7).

The material included here on the regular investment credit is largely for background on understanding investment credit for purposes of handling carryovers and recapture.

Until 1986, federal investment tax credit was one of the most important features of farm tax reporting and tax management. The regular credit (Sec. 45(a)(1)) was 10 percent of the amount of qualified investment. There are more liberal allowances for rehabilitated buildings and they remain in effect for 1986 and later years. 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 was 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 included:

-- Farm machinery and equipment, livestock (other than horses), fences, paved barnyards, roadways, water wells, drain tiles, irrigation systems, depreciable reservoirs and dams, orchards and vineyards in the year production starts, storage structures such as silos, grain bins, and manure storages, 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. Maximum qualifying investment in used property is <u>$125,000 (joint return) in any one year</u>. When used property is acquired to replace used property, only the boot qualifies unless investment credit is recomputed on the disposed property.

Qualified Investment

For Accelerated Cost Recovery (ACRS) Property acquired after 1980 and before 1986, 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 after 1980 and before 1986, 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 and placed in service before 1986, 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. Refer to the TRA of 1986 for basis adjustment rules applicable to IC transition property.

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 and Single Purpose Livestock and Horticultural Structures

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. Regulation 1.48-10, adopted July 18, 1983, contains the rules for single purpose agricultural (livestock) structures and single purpose horticultural structures.

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.

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 credit for rehabilitating buildings was not repealed by the Tax Reform Act of 1986 but was modified (see page 7).

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.

Carryovers from 1985 and earlier years may be used in 1986 without limitation except as described in the first paragraph on page 29. Carryovers to 1987 will be reduced by 17.5 percent and carryovers to 1988 will be reduced by 35 percent (see page 7 for details).

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 |

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

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

Investment Credit 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. The Tax Reform Act of 1986 does not put an end to investment credit for reforestation expenses.

# 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. The credit for qualified intercity buses, wind equipment, and hydroelectric equipment expired at the end of 1985.

## Qualifying Energy Property

The Tax Reform Act of 1986 modified the percentages for qualifying energy property as follows, depending on the date placed in service:

-- Biomass property will receive a 15 percent credit during 1986 and a 10 percent credit during 1987.

-- Solar equipment will receive a 15 percent credit during 1986, 12 percent in 1987, and 10 percent 1988. Ocean thermal equipment will receive a 15 percent credit 1986 through 1988. Geothermal equipment will receive 15 percent during 1986 and 10 percent in 1987 and 1988.

There are also some transitional rules.

Few farmers will be able to collect BEIC on property acquired after 1985. Active solar devices for either space heating or water heating would qualify under the solar 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.

<u>Amount of Credit</u>

The energy credit from 3468B is combined with the regular credit on 3468 and the total is subject to the limitations described on page 29 of this manual. If a taxpayer has one of the other credits in the general business credit group, Form 3800 will be required.

## RESIDENTIAL ENERGY CREDITS

The Tax Reform Act of 1986 did not extend residential energy credits that expired in 1985. Unused credit can be carried forward through taxable years ending before January 1, 1988. To claim the carryover credit, 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.

## A REVIEW OF FARM BUSINESS PROPERTY SALES

Note: This review applies to property sold before January 1, 1987. There will be some changes in reporting 1987 sales because of the TRA of 1986.

The reporting of gains and losses on the disposition of property held for use in the farm business is a complicated but important phase of farm tax reporting. Form 4797 must be used to report gains and losses on farm business property. Schedule D is used to accumulate capital gains and losses and calculate the capital gains exclusion. The 1987 Schedule D will be revised to reflect the elimination of the capital gains exclusion. 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 6/23/84), 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 6/23/84). There are instances, however, when gain on livestock, equipment, land, buildings, and other improvements is treated specifically under Section 1245, 1250, 1251, 1252, and 1255.

   Note: For tax years beginning in 1986, 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, 1984 or 1985 return and has a net Section 1231 gain for 1986, must recapture the losses on the 1986 return. Losses are to be recaptured in the order in which they occurred.

2. Section 1245 - This is the depreciation recapture section. Farm machinery, purchased breeding, dairy, draft and sporting livestock held for the required period and sold at a gain are reported under this section. Gain will be ordinary income to the extent of depreciation or cost recovery taken after 12/31/61 for equipment and 12/31/69 for livestock. Gain will also be ordinary income to the extent of Section 179 expense deductions and the basis reduction required after 1982.

   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.

3. Section 1250 - Farm buildings and other depreciable real property held over six months (12 months if acquired before 6/23/84) 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, 1982 cost | $30,000 |
| Soil and water expenses deducted on 1983 tax return | $2,000 |
| Land was sold, 1986 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. All the excluded income will be recaptured as ordinary income if the land has been held less than 10 years after the last government payment 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. Receipts from the sale of "bob" veal calves, feeder livestock, slaughter livestock, and dairy heifers raised for sale are entered on Schedule F, line 4. Sales of livestock purchased for resale are entered on line 1 of Schedule F, and for a cash basis farmer the purchase price is recovered in the year of sale on line 2.

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 are entered in Part I or 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 resulting from the sale of dairy and breeding livestock in 1986. The gains from livestock sold after 12/31/86 will be taxed as ordinary income regardless of depreciation recapture and holding periods (except for dairy buyout cattle).

The repeal of the 60 percent capital gains exclusion (1/1/87) presents a major tax management opportunity that requires immediate attention. Farmers planning to sell raised dairy and breeding stock may want to concentrate sales in 1986. The advantages of having the capital gains exclusion must be compared to the disadvantages of AMT and higher individual rates in 1986.

## 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 & held for 2 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, & 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 6 months or more* | |
| a) Sale results in gain | 4797, Part III |
| b) Sale results in loss | 4797, Part I |
| 5. Buildings, structures & other depreciable real property held for 6 months or more* | |
| a) Sale results in gain | 4797, Part III |
| b) Sale results in loss | 4797, Part I |
| 6. Farmland, held for 6 months or more, sold at a gain* | |
| a) Soil & water expenses were deducted or cost sharing payments excluded | 4797, Part III |
| b) If 6a does not apply | 4797, Part I |
| 7. Machinery, buildings, & farmland held for less than 6 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.

## 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 use and application of installment sale reporting were broadened in 1980.

The TRA of 1986 treats some installment sale payments as preference income subject to the individual minimum tax. Farm business and personal use property are excluded from this new rule. However, the loss of the 60 percent capital gains exclusion will affect all installment sale payments received after 1986.

### 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. This rule is relevant and applicable through 1986.

For installment sales made after 6/6/84, 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.

<u>Here is an example</u>: Carl Cropper sells his corn drying facility (Section 1245 property) to M.W. Grainer for $90,000 on January 1, 1986. 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 1986. 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 capital 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.

<u>Imputed Interest Rules</u>

Imputed interest rules applicable to certain debt instruments including installment sales are covered under IRC Section 1274 and Section 483. There are several special rules and numerous exceptions that complicate the understanding and application of imputed interest rules. Following is our understanding of the rules most applicable to farm business property installment sales made after 6/30/85.

1. All sales and exchanges after 6/30/85, where seller financing does not exceed $2.8 million, must have an imputed interest rate of the lesser of 100 percent of the AFR or nine percent (compounded semi-annually). The acceptable test or stated interest is the same.

2. Sales exceeding $2.8 million are subject to an imputed interest rate equal to 100 percent of the AFR.

3. The sales or exchanges of land between related persons, (brothers, sisters, spouse, ancestors or lineal descendants), must have a test or stated rate of six percent or interest will be imputed at seven percent. This rule applies to the first $500,000 of land between related people in one calendar year.

4. The imputed interest rules do not apply to the sale of personal use property, annuities, patents, and any other sale that does not exceed $3,000.

5. Imputed as well as stated interest can be accounted for on the cash accounting basis on sales of farms not exceeding $1 million and any other installment sale not exceeding $250,000.

The AFR (applicable federal rates) is the lower of the computed six-month rate or the monthly rate. The monthly rate can be the current month's rate or the lower of the two preceding months' rate. The October 1986 monthly AFR was 5.93 percent (short-term, not over three years), 6.75 percent (mid-term, three to nine years), 7.18 percent (long-term, over nine years).

## ALTERNATIVE MINIMUM TAX

The alternative minimum tax (AMT) will continue to have a major impact on farmers that sell business assets in 1986. 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 is currently (1986) the most important tax preference income item for farmers. There are 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. In 1987 and later, the dividend exclusion and capital gain exclusion will no longer be important in the AMT calculation because they won't exist.

### Determining Alternative Minimum Taxable Income (AMTI)

The first step in computing AMT is to determine AMTI. AMTI is adjusted gross income (less interest expense incurred for a limited interest in a partnership or S corporation, and alcohol fuel credit included in income), less AMT deductions plus tax preference items. The 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 1986 AGI is $50,000. He files a joint return, has no AMT NOL deduction, itemized deductions are $3,720 but only $1,800 qualifies as AMT itemized deductions ($1,920 was state income and sales taxes). His only tax preference income is $34,000 of capital gains deduction. AMTI is computed as follows:

| | |
|---|---|
| Adjusted gross income | $50,000 |
| AMT itemized deductions | - 1,800 |
| Tax preference income | +34,000 |
| Alternative Minimum Taxable Income | $82,200 |

### 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 1986 net AMT is computed as follows:

| | |
|---|---|
| Alternative Minimum Taxable Income | $82,200 |
| Less base deduction (joint return) | -40,000 |
| AMTI exceeding base | $42,200 |
| Gross AMT @ 20 percent | $ 8,440 |
| Less regular income tax net of $4,000 investment credit carryforward | -6,017 |
| Net AMT | $2,423 |

A.B. Farmer pays $6,017 of regular income tax plus $2,423 of alternative minimum tax in 1986. 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 no longer can 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 1986 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 $2,423 below his gross AMT causing the $2,423 net AMT. A.B. has lost $2,423 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 1986 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 1986 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 1986 if 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 1986, 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 1986 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 (IRS Section 172). 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 1986 NOL would be first carried back to 1983, then to 1984, 1985, and then forward to 1987 and in order to 2001 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 an 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 an 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 ($20,700).

| | | |
|---|---|---|
| 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 | $3,760 | |
| Personal exemptions (3) | 3,240 | |
| Total Deductions | | - 7,000 |
| Taxable Income | | $(20,700) |

No net operating loss was carried over to 1986 from a prior year.

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

| | | |
|---|---|---|
| Taxable Income | | ($20,700) |
| Personal exemptions | $3,240 | |
| Capital gain exclusion | 3,600 | |
| Excess of nonbusiness deductions over nonbusiness income ($3,760 - 900 = $2,860) | 2,860 | |
| Total adjustments | | $ 9,700 |
| Net Operating Loss, 1986 | | $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 1986 NOL of $11,000 back to 1983 where he had a taxable income of $12,380, the full NOL will be used. If 1983 taxable income had been less than $11,000, the adjustments listed above would have been applied to determine the modified taxable income. If 1983 modified taxable income was $8,000, D.T. would deduct only $8,000 of his 1986 NOL on the 1983 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 1983 refund as follows:

| | |
|---|---|
| Adjusted gross income on 1983 return | $18,780 |
| Less 1986 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 1983 return | 1,230 |
| Tax paid on 1983 return (net of IC) | $ 230 |
| Less tax liability after carry back | 0 |
| Refund on 1983 Return | $ 230 |

D.T. Farmer paid no minimum tax or AMT in 1983 but $1,000 of investment credit was used to reduce the 1983 tax liability. If there had been no investment credit used in 1983, the tax paid would have been $1,230 and D.T. would be eligible for a $1,230 refund. Since only $230 of income tax was actually paid in 1983, that is the extent of the 1983 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 1980.

Step Four - Carry Over Unused NOL to Subsequent Year

Under the alternative assumption, D.T. Farmer's 1983 modified taxable income was $8,000 which limited 1986 NOL used in 1983 to $8,000. The amount of unused NOL, $3,000, is carried over to the 1984 return.

## TAX DEFERRED RETIREMENT PLANS

Noncorporate farmers have two tax-deferred retirement plans available to them: the Keogh or HR-10 plan and the individual retirement account plan (IRA). An individual may take an income tax deduction for an IRA even if that taxpayer is an active participant in another qualified retirement plan, including a Keogh. Thus, a farmer may have an IRA in addition to a Keogh plan. To encourage the establishment of a retirement plan, tax is deferred on the contributions and fund earnings until retirement. When the retirement fund is liquidated the entire amount of the fund would normally be subject to taxation--both the original principal and any accumulated earnings from the principal.

### Keogh Plans

TEFRA combined the provisions of Keogh and Corporate plans so that 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 1986, the maximum annual 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 contributions 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

For tax years beginning after 1986, deductions for contributions to an IRA will be limited or eliminated for higher income taxpayers who actively participate in other tax favored retirement plans. (See page 5.)

For 1986, 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 or, in 1986 and later, a spouse who earns less than $250, 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. Life expectancy may 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 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.

# NEW YORK STATE INCOME TAX

New York State has not yet passed or formulated new tax legislation that will conform to changes made in federal law. Major changes are needed to prevent a $2 to 3 billion State tax windfall at taxpayers' expense. New York Taxable Income is based on Federal AGI so in 1987 capital gains become 100 percent taxable and itemized deductions are reduced unless the State takes action before the end of 1987.

## Review of Changes from 1985 Law

The changes included in 1985 legislation (Chapter 29) increased deductions and reduced tax rates over a three year phase-in period.

### Standard Deduction and Personal Exemption

The New York standard deduction is no longer calculated as a percentage of income with a minimum and maximum. It is a uniform amount that will increase in 1986 and 1987. The personal exemption remains at $850 for 1986.

| Standard Deduction: | 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: | $ 850 | $ 850 | $ 900 |

### 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).

2. For 1986, tax brackets starting at $11,000 were widened by $500 to $2,500. The 1986 rates range from 2 percent of taxable income not over $1,000 to 13.5 percent of TI over $26,000.

3. The same tax brackets will be widened to $3,000 for 1987. This is an additional $500 increase.

### Low-Income Allowance Increased in 1986

The 1986 low-income allowance increased to $4,000 for single taxpayers and $8,000 for married taxpayers, heads of households, and surviving spouses. An individual who has zero tax liability as a result of the low-income allowance is now exempt from filing a tax return.

### Reduction in Maximum Tax on Personal Service Income

The maximum tax rate on personal service income was reduced from 10 percent to 9½ percent for taxable years beginning on or after January 1, 1985. The rate is reduced to nine percent for taxable years beginning on or after January 1, 1987. The amended law provides that personal service net income is to be computed prior to any allowable family adjustment.

## Household Credit

The household credit increased 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 qualify 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.

In 1986 the amount of household credit for single taxpayers ranges from $75 (less than $5,000 of HGI) to $20 for taxpayers with $25,000 to $28,000 of HGI. 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. The maximum credit for a married couple with less than $5,000 of HGI is $90 plus $15 for each personal exemption less one.

## Real Property Tax Credit

Numerous changes were made in the Real Property Tax Circuit Breaker Credit but few farm or nonfarm real estate owners will qualify. Owners of real property valued in excess of $85,000 are excluded. Here are other rules and limitations:

1. The household gross income limit is $18,000.

2. The maximum adjusted rent is 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. Credit for renters is computed the same as for owners.

3. 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, 1986

| | | 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 claimed by filing Form IT-218.

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.

<u>Other Credits</u> 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 from federal ACRS expired at the end of 1984 but the resulting tax reporting implications are not at all favorable.

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) Remains in Affect for 1986

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.

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. Ten years ACRS property, 15, 18 and 19 ACRS real property also earn full NYIC after five years of qualified use. Non-ACRS properties that qualify for NYIC must still be held 12 years.

Excess or unused credit may be carried over to future tax years. There is no provision for carryback of NYIC. 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.

If property on which the NYIC was taken is disposed of or removed from qualified use before its useful life or specified holding period ends, the difference between the credit taken and the credit allowed for actual use must be added to the taxpayers tax liability in the year of disposition. However, there is no recapture once the property has been in qualified use for 12 consecutive years.

Use IT-212 to claim New York investment credit, retail enterprise credit and to report early disposition of qualified property.

Employment incentive tax credit 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.