November 1989

A.E. Ext. 89-34

FARM INCOME TAX MANAGEMENT AND REPORTING

Reference Manual

FARM INCOME TAX MEETINGS
1989
SCHEDULE

Date	Location	Host
November 14	Canton - Best Western University Inn	Russell Coombe
November 16	Canandaigua - Sheraton Inn	June Grabemeyer
November 20-21	Syracuse - Sheraton Inn Two-Day Tax Course	Jim Hilson
November 28	Ellicottville - Extension Center	Joan Petzen
November 29	Batavia - Town Fire Hall	George Allhusen
December 1	Kingston - Holiday Inn	Harold Hogan
December 4-5	Albany - Holiday (Turf) Inn Two-Day Tax Course	Tom Gallagher
December 8	Owego - Treadway Inn	Carl Crispell
December 15	Oneonta - Holiday Inn	William Gengenbach

Cooperative Extension - New York State
Department of Agricultural Economics
Cornell University

George L. Casler

Stuart F. Smith

Department of Agricultural Economics
New York State College of Agriculture and Life Sciences
A Statutory College of the State University
Cornell University, Ithaca, New York 14853

TABLE OF CONTENTS

1989 TAX FORMS NEEDED BY NEW YORK FARMERS

Here is a list of the more important 1989 income tax forms needed by farmers. Several of the forms have been revised for 1989.

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 (and Reconciliations of Forms 1099-B)
- Schedule E - Supplemental Income Schedule
- Schedule F - Farm Income and Expenses. Revised
- Schedule R - Credit for Elderly or the Disabled
- Schedule SE - Computation of Social Security Self-Employment Tax

1040EZ - Income Tax Return for single filers with no dependents, income under $50,000, interest under $400, other limitations
1040A - For non-itemizers, less than $50,000 taxable income, other limitations
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
1096 - Annual Summary and Transmittal of U.S. Information Returns
W-2 - Wage and Tax Statement; W-3 - Transmittal of Income and Tax Statement
W-5 - Earned Income Credit Advance Payment Certificate
W-9 - Request for Taxpayer Identification Number: used to provide TIN to individual filing 1099, use SS-4 to obtain employer ID
1065 - U.S. Partnership Return
3800 - General Business Credit
4136 - Computation of Credit for Federal Tax on Gasoline, and Special Fuels
4255 - Recapture of Investment Credit (including Energy Investment Credit)
4562 - Depreciation and Amortization: used to report depreciation, cost recovery, Section 179 expense election, and listed property
4684 - Casualties and Thefts
4797 - Gains and Losses From Sales or Exchanges of Assets Used in a Trade or Business and Involuntary Conversions
4835 - Farm Rental Income and Expense [Crop and Livestock Shares (not cash) Received by Landowner]
6251 - Alternative Minimum Tax Computation - Individuals
6252 - Computation of Installment Sale Income
8606 - Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions
8582 - Passive Activity Loss Limitations
8615 - Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000
8645 - Soil and Water Conservation Plan Certificate
8801 - Credit for Prior Year Minimum Tax

New York State Forms

IT-201 - Resident Income Tax Return (long form, comparable to Federal Form 1040
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 (recapture or early disposition schedule included)
IT-220 - Minimum Income Tax
IT-399 - New York State Depreciation (with instructions)
IT-2102 & IT-2103 - Wage and Tax Statement, and Reconciliation Form
IT-2102.1 & IT-2102.4 - Informational Return and Transmittal Form

1989 FARM TAX AND INCOME SITUATION

Proposed Tax Legislation and Important Issues

The first edition of this manual printed in early November contained more questions than answers concerning 1989 legislation. This update is based on the Revenue Reconciliation Act of 1989, passed by Congress on November 22, 1989 but still waiting for the President's signature.

-- Capital gains - Proposed capital gains tax reductions and indexing provisions were all excluded from RRA'89. The Capital Gains debate is almost certain to be continued in 1990.

-- Section 89 - Legislation enacted as part of TRA'96 requiring employers providing accident or health plans and group-term life insurance to follow tough new qualification and nondiscrimination rules was repealed. The old section 89 rules are now in affect.

-- Medicare Surtax - RRA'89 repeals the entire supplemental Medicare premium or surtax and is retroactive to 1989. There will be no surtax paid on 1989 tax returns.

-- Farm Employers Subject to Income Tax Withholding - Beginning January 1, 1990 farm employers must withhold federal and NY State income taxes from cash wages paid to all farm employees subject to FICA (social security) taxes. See page 51 for explanation of farm employees subject to social security.

-- Health Insurance - The 25 percent health insurance deduction for the self-employed taken on form 1040 has been extended through September 1990.

-- Tax Credits - The targeted jobs tax credit, business energy credit, low-income housing credit and research and experimentation credit (with modifications) have been extended through September 30, 1990. The childcare credit was not extended by RRA'89.

The 1989 Farm Income Situation

The price of milk received by New York dairy farmers is up seven percent through the first nine months of 1989. The potential for substantially higher 1989 taxable incomes exists on many dairy farms. Some could benefit from well planned tax management strategies. Investment in capital and depreciable assets has increased in 1989.

Prices received by poultry, beef, corn, fruit and potato producers have increased in 1989 but production has been variable. Some producers will show 1989 net operating losses.

FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

Standard Deduction

The "big switch" from itemizing deductions to using the standard deduction should be over. More than 5 million taxpayers stopped itemizing in 1987 and many more switched in 1988.

The standard deduction is now indexed to inflation and is adjusted annually. The 1989 standard deduction is approximately four percent higher than the 1988 standard deduction. The 1990 estimates in the following table are based on a five percent projected increase in CPI from 1988 to 1989.

Basic Federal Standard Deduction for 1989 and Estimates for 1990

Filing Status	1989	1990 Estimate*
Married filing jointly; surviving spouse	$5,200	$5,450
Head of household	4,550	4,750
Single individuals	3,100	3,250
Married filing separately	2,600	2,700

*RIA estimates based on September 1988 through August 1989 increase in CPI.

Each taxpayer over age 65 or blind receives the regular standard deduction plus an additional $600 deduction if married and filing a joint or separate return. The additional deduction is $750 if single or head of household. A taxpayer who is both elderly and blind receives double the additional deduction. The additional deductions for age and blindness cannot be claimed for dependents. The following table provides common examples.

Federal Standard Deductions for Elderly and Blind Taxpayers, 1989

Status	Basic Deduction	Additional Deduction	Total Standard Deduction
a. Married taxpayers filing jointly, both 65 or older	$5,200	$1,200	$6,400
b. Status *a* plus one spouse is blind	5,200	1,800	7,000
c. Married filing separately, age 65	2,600	600	3,200
d. Head of household, age 65	4,550	750	5,300
e. Single, age 65 or over	3,100	750	3,850
f. Single, age 65 and blind	3,100	1,500	4,600

The additional deduction is also subject to the inflationary adjustment. No adjustment was required in 1989 under the "rounding" convention used by IRS.

Personal Exemption Increases

The 1989 personal exemption is $2,000, up from $1,950 in 1988. It will be indexed to inflation starting in 1990. The 1990 personal exemption will be $2,050.

The benefit of the personal exemption is phased out for taxpayers with specific high levels of taxable income (see 1989 Tax Rate Schedule). The additional personal exemption for the elderly and blind was eliminated beginning in 1987.

Dependents

Taxpayers must report the social security numbers of all dependents two years old or older claimed on returns due after 1989.

Taxpayers may not claim a 1989 exemption for a dependent who has earned income of $2,000 or more unless it is for their child under age 19 or full time student child under age 24. The student age limit is new this year.

Individuals that can be claimed as dependents on another taxpayer's return may not claim a personal exemption. The so-called double exemption was eliminated in 1987 and there is no option to allow the qualified dependent to use his or her own exemption if the parent or guardian doesn't need it.

A qualified child or student dependent's basic standard deduction is limited to the greater of $500, or the individual's earned income up to his or her standard deduction. A single child or student dependent who has $3,100 or more of earned income in 1989 gets the $3,100 standard deduction regardless of the amount of unearned income. The single student dependent with more than $500 but less than $3,100 of 1989 earned income will receive a standard deduction equal to earned income while unearned income becomes fully taxed.

The single student dependent with less than $500 of earned income will get the $500 minimum standard deduction. The amount of adjusted gross income exceeding $500 becomes taxable income. In this case the standard deduction shields some unearned income (if there is any).

The $500 rule for qualified dependents limits only the basic standard deduction but not additional deductions for blind and elderly taxpayers. Therefore, a blind dependent child, age 14 or older with no earned income and more than $500 of unearned income, will receive a standard deduction of $1,250.

Investment or unearned income in excess of $1,000 received by a dependent child under age 14 is taxed at the parent's marginal rate if greater than the income tax using the child rates. A three-step procedure is required to compute the tax on Form 8615 unless an election (new for 1989) is made to claim the child's unearned income on the parents return where the excess of $1,000 will be taxed at the parents marginal rate and unearned income greater than $500 but less than $1,000 will be taxed at 15 percent. This election can not be made if the child has income other than interest and dividends or if estimated tax payments were made in the child's name.

1989 Tax Rates

Individual 1989 income tax brackets are wider than the 1988 brackets. The top of each bracket is approximately 4 percent higher due to 1988 inflation.

There are still two basic taxable income brackets at 15 and 28 percent. Two deviations in the 28 percent bracket push the maximum rate to 33 percent. The first is the required phase-out of the 15 percent rate for moderate and high income taxpayers. The second is the phase-out of personal exemptions for higher income taxpayers (see 1989 Tax Rate Schedules on next page).

Taxpayers with taxable incomes spanning the first two brackets will save $91 to $156 with the inflationary adjustment compared to last year. Savings are somewhat less when taxable incomes reach the 33 percent rate.

1989 Tax Rate Schedules

Single Taxpayers		Married Filing Joint Return & Surviving Spouses	
Taxable Income	Tax	Taxable Income	Tax
$0-$18,550	15%	$0-$30,950	15%
18,550-44,900	$2,782.50 + 28% over $18,550	30,950-74,850	$4,642.50 + 28% over $30,950
44,990-93,130	$10,160.50 + 33% over $44,900	74,850-155,320	$16,934.50 + 33% over $74,850
93,130 & over	28% + surcharge*	155,320 & over	28% + surcharge*

*Five percent surcharge for the phase-out of personal exemptions for taxpayers in this top income bracket.

The five percent surcharge applied to the top income bracket takes away the tax benefit attributed to personal exemptions. The surcharge is the lesser of 28 percent of all personal exemptions claimed ($560 per exemption for 1989), or five percent of taxable income in the top bracket.

Joint vs. Separate Returns

Married couples with two incomes who itemize deductions should consider filing separate returns. They may be able to save tax dollars because the 7 1/2 percent floor on medical deductions, the 2 percent floor on miscellaneous deductions and the 10 percent floor on casualty losses will be less on two individual incomes than it will be on joint income. Tax savings are most likely to occur when income is evenly split and one spouse can claim the majority of a deduction that is limited by percentage of AGI.

Remember that some benefits available to joint filers are not available on separate returns. The child & dependent care credit can only be claimed by filers of joint returns.

Here are some other factors to consider in deciding which way to file. Social Security benefits are protected with a higher threshold on the joint return. Pre-divorce alimony may not be deducted on the joint return. More unreimbursed employee expenses and investment expenses may be deducted on the separate return (misc. deductions subject to 2% floor). Married couples may not be claimed as dependents by another taxpayer if they file a joint return unless they are below the gross income filing requirements. Alternative minimum tax liability could be affected by the filing status and filing status may affect the new medicare tax limits. A married individual filing a separate return must include an exemption for his or her spouse when calculating additional tax liability resulting from the phase out of personal exemptions.

Itemized Deductions

A taxpayer should itemize if total itemized deductions are greater than his or her standard deduction. Here are some of the recent changes taxpayers must remember when itemizing deductions.

Personal interest is being phased out. Twenty percent is deductible in 1989, 10 percent in 1990. Personal interest will not be deductible after 1990. Personal interest excludes business interest, investment interest, interest on passive activities, interest on deferred estate tax, and qualified residence interest. Personal interest includes interest on car loans, educational loans, and credit card debt.

Home mortgage interest (qualified residence interest) on the taxpayer's principal and second home is an itemized deduction providing the mortgage does not exceed the following limitations:

1. $1 million ($500,000 if married filing separate return) to buy, build or remodel a home reduced by home mortgage outstanding before October 14, 1987. This is called "acquisition indebtedness". Interest on home mortgages acquired prior to this date is deductible.

2. The lesser of $100,000 ($50,000 if married filing a separate return), or the fair market value minus the acquisition indebtedness qualifies for home equity indebtedness. Home equity indebtedness may be used for personal expenditures.

Mortgage interest that exceeds these limits must be included with personal interest and will be reduced by the phase-out rules.

Investment interest is deductible on the 1989 return to the extent of net investment income plus the lesser of $10,000 or the excess of investment interest over net investment income times 20 percent. The percentage excess falls to 10 for 1990. Investment interest is interest paid on debt incurred to buy investment property which does not include investments in passive activities, nor activities in which the taxpayer actively participates, including the rental of real estate. Net investment income is gross investment income (including interest, dividends, taxable portion of annuities, certain royalties and gain but not losses from sales) less investment expenses (excluding interest). Investment interest disallowed because of last years limitation may be carried forward to the 1990 return.

Medical expenses that exceed 7.5 percent of AGI are itemized deductions not subject to the additional two percent AGI limit. "Medical expenses" are broadly defined to include payments made for nearly all medical and dental services, therapeutic devices and treatments, home modifications and additions made primarily for medical reasons, travel and lodging expenses associated with qualified medical care trips, legal fees required to obtain medical services, medicine and prescribed drugs, special schooling and institutional care, and qualified health insurance premiums. TAMRA88 made costs to acquire, train and maintain animals that assist individuals with physical disabilities deductible.

Handicapped taxpayers' business expenses for impairment related services at their place of employment are itemized deductions not subject to the 7.5 percent or two percent AGI limits. Handicapped taxpayers are individuals who have a physical or mental disability that is a functional limitation to employment.

Moving expenses are itemized deductions. Use Form 3903 to report moving expenses and Form 4782 to report employer reimbursements.

Other itemized deductions not subject to the two percent AGI limit are charitable deductions, state income and property taxes, and personal casualty losses and expenses of mutual funds allocated to shareholders (subject to 2% floor beginning in 1990). This list is not complete.

Miscellaneous Deductions Subject To Two Percent AGI Limit Include:

1. Unreimbursed employee business expenses including employment-related educational expenses, work clothes, dues, fees, and work-related small tools and supplies.

2. Reimbursed employee business expenses not substantiated to employer. The reimbursement is gross income and the expenses are subject to the two percent floor for the first time in 1989.

3. Professional dues, fees, books, magazines, journals and safe deposit box rental.

4. Job searching expenses.

5. Legal, accounting, and tax counsel fees.

6. Hobby expenses not exceeding hobby income.

7. Office-in-the-home expenses.

8. Fees paid to IRA custodian, and certain expenses of a partnership, grantor trust, or S corporation that are incurred for the production of income.

Business Meal and Entertainment Expenses

An 80 percent rule limits the amount of qualified business meal and entertainment expenses that may be deducted. Qualified expenses must be reduced by 20 percent.

Meal expenses must be directly related to the active conduct of the taxpayer's trade or business (i.e. an organized business meeting or a meal at which business is discussed). A meal taken immediately preceding or following a business meeting will qualify if it is associated with the active conduct of the taxpayer's trade or business.

Entertainment expenses must also be directly related to the active conduct of a trade or business to be 80 percent deductible. Deductions for tickets are limited to their face value, before application of the 80 percent rule.

Business Use of Automobiles by Rural Mail Carriers

For taxable years beginning after 1987, rural mail carriers are allowed a special mileage rate equal to 150 percent of the basic standard mileage rate. The special mileage rate applies to all business use of an automobile (including vans, pickups, and panel trucks) while performing "qualified services," including use that exceeds the 15,000 mile annual limitation or the 60,000 mile cumulative limitation.

If an auto also is used in another business, the standard mileage rates may be used for that business. While mileage at the special mileage rate is not subject to the 15,000 and 60,000 mile limitations, it is counted against those limitations in determining the extent to which business-use mileage in the other business qualifies for the basic standard mileage rate. For example, suppose that A, a Postal Service employee, has deductions prior to 1988 for 8,000 miles of business use of an auto. During 1988 A drove the auto 9,000 miles for postal work and 7,000 miles in another business for a total of 16,000 miles. In 1988, A may use the 36 cent rate for 9,000 miles, the 24 cent rate for 6,000 miles and the 11 cent rate for 1,000 miles. At the end of 1988, 8,000 + 15,000 = 23,000 miles are counted against the 60,000 mile cumulative limitation. If in 1989, A drives 10,000 miles for postal work and 8,000 miles in another business, the special postal rate apples to 10,000 miles, the basic standard rate applies to 5,000 miles and the lower standard rate applies to 3,000 miles. At the end of 1989, 23,000 + 15,000 = 38,000 are counted against the 60,000 mile cumulative limit.

If A in 1988 had driven the auto 18,000 miles for postal work and 2,000 miles in another business, A would be able to use the 36 cent rate for 18,000 miles and the 11 cent rate for 2,000 miles. At the end of 1988, 8,000 + 18,000 = 26,000 miles would be counted against the 60,000 mile limitation.

Earned Income Credit

Earned Income Credit has been increased, and the AGI range eligible for maximum credit has been extended due to the adjustment for inflation. The dollar amount of EIC is rounded to the nearest multiple of 10 after being increased by inflation.

Changes in Earned Income Credit, 1988-1989

Year	Maximum Earned Income	Credit Percent	Maximum Credit	Phase-Out AGI Range	Phase-Out Percent
1988	$6,243 - 9,850	14	874	$9,850 - 18,566	10
1989	$6,500 - 10,240	14	910	$10,240 - 19,340	10

Eligibility rules have not changed. The taxpayer must maintain a home, have a dependent child, file a joint return if married, and have a 12 month tax year.

Form W-5, Earned Income Credit Advance Payment Certificate must be used by any employee eligible for EIC to elect advanced payments from his or her employer. EIC payments made by an employer to his or her employee offset the employer's liability for federal payroll taxes. Use IRS tables to determine advanced payments of EIC. An employer's failure to make required advanced EIC payments is subject to the same penalties as failure to pay FICA taxes. Employers of farm workers do not have to make advance payments to farm workers paid on a daily basis (IRS Pub. 225).

A notice must be furnished to employees about refundable earned income credit. For services performed after December 31, 1986 every employer shall furnish to each employee who did not have income taxes withheld Notice 797 or a statement that contains the exact wording of Notice 797, *"You may be eligible for a refund on your federal income tax return because of the Earned Income Credit (EIC)."* The notice may be attached to the employee's 1989 W-2 or given to the employee within one week before or after February 1, 1990. Now, according to IRS Notice 89-95 the employer may merely furnish a substitute W-2 with the appropriate language on the front or back of the form. Employees who have claimed exemption from withholding on Form W-4 or W-4A do not have to be notified.

Other Reminders for Individual Taxpayers

All unemployment compensation benefits are includable in gross income. The limited base amount exclusion is gone.

Nonbusiness casualty losses are subject to a claim filing requirement. A taxpayer covered by insurance must now file an insurance claim for reimbursement of damaged or stolen property before the casualty loss will be allowed. Any reimbursement will reduce the casualty loss. Each personal casualty loss must be reduced by $100 and total annual casualty losses by 10 percent of AGI. Casualty losses are not subject to the two percent of AGI limit.

Scholarships and fellowships can not be totally excluded from taxable income. Degree candidates may exclude the cost of required tuition, fees, books, supplies, and equipment. No amount of a grant earmarked for room, board or other nonqualified expenditures is excludable. The rule applies to all types of scholarships and grants regardless of their source or origin.

Non-degree candidates have no exclusions. The new rule applies to fellowships and scholarships received on or after January 1, 1987 except those granted before August 17, 1986.

Estimated tax payments are required for taxpayers that will owe $500 or more in estimated tax for the year, and expect total income tax withheld will be less than the smaller of:

1. 90 percent of the tax shown of the current year's tax return, or

2. 100 percent of the tax on last year's return.

Child Care Credit rules have changed. For tax years beginning in 1989 the dependent child being cared for must be age 12 or less. Eligible work-related expenses claimed must be reduced by reimbursement received from the taxpayers employer. The child care providers TIN must go on the individual taxpayers return unless the provider is a tax-exempt organization. An individual claimer must require the care provider to complete and provide form W-10 which contains all the information needed to fill out Form 2441 (Credit for Child and Dependent Care Expenses) or Schedule 1 of 1040A. Form W-10 (Dependent Care Provider's Identification and Certification) is kept by the claimer. The provider does not file Form W-10 with IRS.

Jury pay surrendered to ones employer is now an "above-the-line" deduction on Form 1040, line 30. This TAMRA88 provision is effective for tax years after 1986.

Gain on the Sale of Principal Residence may be rolled over into the purchase price of a new home when one spouse dies before the new home is purchased as long as the surviving spouse completes the purchase within the specified period of time. TAMRA88 also provides the $125,000 lifetime exclusion on the sale of a principal residence to a physically or mentally disabled taxpayer age 55 or over who fails to meet the prior use rule (three out of five years) providing he or she lived in the residence for at least one year and was moved to a licensed care facility anytime during the five year period prior to the sale.

Employee Awards - Employee achievement awards of tangible personal property for length of service or safety achievement are excluded from the employee's gross income, but are deductible expenses for the employer providing the aggregate cost of qualified plan awards made to the same employee does not exceed $1,600. The maximum is $400 for nonqualified plan awards. Tangible personal property does not include cash, negotiable certificates, vacations, meals, lodging, tickets to theater and sporting events, stocks, bonds and other securities. Low value "de minimus fringe" awards are not subject to these limitations.

Interest Allocation Rules

According to TRA86, interest expense is divided into six categories: (1) trade or business, (2) investment, (3) passive activity, (4) qualified residence interest, (5) interest on federal estate tax and (6) personal interest. Interest paid in categories (1) and (5) is fully deductible while interest in the other categories may be partially or completely disallowed. Therefore, the taxpayer must allocate interest according to use of the debt on which the interest is paid. The taxpayer who deposits loans in an account from which funds are expended for various purposes such as paying for items for which the money was borrowed, paying farm expenses, and paying living expenses may be faced with great difficulty in complying with the interest allocation rules.

The allocation rules can be avoided by (1) not mixing the proceeds of a loan with the proceeds of other loans or with money from other sources (2) always using the proceeds of a loan for only one purpose or for purposes that are in the same category and (3) always using the proceeds from the sale of an asset to which debt is allocated to pay off the debt or to make only one new expenditure.

Complexities arise and allocation is required when loan proceeds are used in more than one expenditure category and when there is a change in use of an asset purchased with debt proceeds. The following guidelines are from IRS publication 545.

Interest paid on a loan is allocated according to the use made of the loan proceeds. The allocation is not affected by the use of secured property.

A deposit of loan proceeds in a taxpayers account is treated as property held for investment until it is used for something else. Any interest paid on the loan before it is used is investment interest expense. When the proceeds of the loan are withdrawn from the account and used interest is allocated based on the use of the funds.

Generally, loan proceeds that are deposited in an account are treated as used before any unborrowed amounts in the same account. Two or more loans deposited in the same account are allocated using the first in - first out convention. Interest paid on loans deposited in an account may be allocated to any expense paid within 30 days of the loan deposit without regard to other allocation rules.

If loan proceeds are placed in an interest bearing account, the first expenses paid may be allocated to the interest earned. If loan proceeds are received in cash, expenses paid with the loan must be allocated within 30 days of receiving the cash. Otherwise loans received as cash are treated as personal loans.

A line of credit or similar account that allows periodic borrowing under a single loan agreement is treated as a single loan if interest accrues at the same fixed or variable rate for all borrowings charged to the account. Borrowings subject to different interest rates are treated as different or separate loans.

When payments are made on loans that have been allocated to more than one use, the loan is treated as being repaid in the following order; (1) amounts allocated to personal use, (2) amounts allocated to investments and most passive activities, (3) amounts allocated to passive activities in connection with rental real estate in which the taxpayer actively participates, (4) amounts allocated to former passive activities, and (5) amounts allocated to a trade or business and certain low-income housing projects.

PROVISIONS APPLYING PRIMARILY TO BUSINESS ACTIVITY

Only those changes from TRA 1986 affecting most business taxpayers and not covered in detail elsewhere in the manual are included here.

Capital Gains

The 60 percent capital gain exclusion ended 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 (except for dairy buyout cattle). In 1988 and later, capital gain income is not 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 TRA 1986 that allows 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.

Capital Losses

For tax years beginning after 1986, net short-term capital losses and net long-term capital losses will be combined for the purpose of offsetting ordinary income. The previous rule that required $2.00 of net long-term capital loss to offset $1.00 of ordinary income has been eliminated. Therefore, net short-term capital losses and net long-term capital losses may be used to offset up to $3,000 of ordinary income ($1,500 for married filing a separate return). Any excess capital losses may be carried forward and retain their character as short or long-term losses. TAMRA88 changed the rules (effective as if part of TRA86) so that a taxpayer will not lose the benefit of the capital loss deduction because of a negative taxable income.

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 later section 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 partner or partners owning a majority interest in partnership profits and capital. If no partners own a majority interest, or if the majority of partners do not have the same tax year, the partnership must adopt the tax year of its principal partners. If neither of these applies, the partnership must adopt a calendar year.

A partnership, S Corporation or personal service corporation may adopt a "natural business year". Rev. Proc. 87-32 provides a test to determine a natural business year. It's not simple.

OBRA 1987 provides a "Section 444 election" which allowed a partnership, S corporation, or personal service corporation to elect, for its first tax year beginning after 1986, to retain the last tax year it had beginning in 1986 or to elect to change its tax year if the result is a deferral period of not more than three months. The election is allowed only if the deferral period is the shorter of three months or the deferral period of the tax year being changed. The election is made by filing Form 8716 "Election to have a Tax Year Other Than a Required Tax Year". In return for retaining deferral, partnerships and S corporations must make a "required payment". Personal service corporations are required to distribute certain amounts to owner-employees.

The requirements do not apply if a business purpose for a different year can be established. Deferral of income for three months or less will no longer satisfy the business purpose rule.

Hobby Loss Rule Change

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 was effective January 1, 1987 and does not apply to horse farming activities which continue to be two profit years out of seven.

Business Use of Home

Home office expense deductions are limited to a modified net income from the business use of the home. The modified net income is the gross business income minus the business share of mortgage interest, real estate taxes, casualty losses; and the business expenses other than those related to the business use of the home.

Deductions for home office use will be disallowed if a portion of the taxpayer's home is leased or rented to his or her employer. An independent contractor is subject to this provision. Furthermore, all home office expenses that increase the net loss of the related business activity are not deductible.

Health Insurance Premiums

Twenty-five percent of health insurance premiums paid by self-employed taxpayers are deductible as an adjustment to income on 1040. The payments must be limited to health insurance coverage of the taxpayer and/or the spouse and dependents. The deduction may not exceed earned income and the insurance plan must meet applicable nondiscrimination requirements like those affecting employer provided health insurance. The amount deducted is included in income subject to self-employment tax and may not be included in medical expenses claimed as itemized deductions. A taxpayer eligible for coverage in an employer's subsidized health insurance plan may not deduct insurance premiums he or she pays even if it is the taxpayer's spouse that is the employee. This provision expires at the end of 1989.

Corporate Tax Rates

Corporate tax rates are the same for 1989 as for 1988. There is no indexing of brackets.

PROVISIONS SPECIFIC TO AGRICULTURE

Expensing of Soil and Water Conservation Costs

Beginning in 1987, 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. Carryovers from previous years are not 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 is treated as ordinary income rather than capital gain. Any loss on such dispositions is 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 became effective in 1987.

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

After the TRA86 and TAMRA88 some of the insolvent debtor rules are applied to solvent farmers for debt discharged after April 9, 1986. The discharged debt must be "qualified farm indebtedness". To meet the qualified farm indebtedness definition, (1) the debt must have been incurred directly in connection with the operation of the farm business, (2) 50 percent or more of the aggregate gross receipts of the farmer for the three previous years must have been attributable to farming and (3) the discharging creditor must be (a) in the business of lending money and (b) not related to the farmer, did not sell the property to the farmer and did not receive a fee for the farmer's investment in the property.

These rules are quite restrictive and may prevent some solvent farmers from using tax attributes to offset discharge of indebtedness income (DII). For example, a farmer with DII who had purchased the real estate or other property from the lender who later cancelled part or all of the debt would not meet the QFI rules, at least for the DII related to this property.

Solvent farmers must reduce tax attributes in exchange for not reporting DII as income. Also, for solvent farmers, the basis reduction for property owned by the taxpayer must take place in the following order: (1) depreciable assets, (2) land held for use in the trade or business of farming and (3) other property. The limit on reducing the basis below the remaining debt does not apply to solvent taxpayers.

Unlike the rules for insolvent debtors, any DII remaining after the tax attributes have been reduced must be included in taxable income. In other words, if the DII exceeds the total of the tax attributes, all the tax attributes will be given up and the excess of DII over the tax attributes will be included in income and therefore may cause a tax liability.

<u>Diesel Fuel Excise Tax</u>

TAMRA88 made farmers, operators of school and city buses, operators of vessels and certain aircraft, and other off-highway business users exempt from the 15.1¢ federal excise tax on all diesel fuel purchased effective January 1, 1989. Farmers and other business owners may use the exemption on fuel used off the highway. They must pay the tax on diesel fuel used in highway vehicles.

To avoid paying the tax wholesale distributors or dealers must have an exemption certificate signed by the exempt purchaser on file. IRS does not print and distribute copies of the exemption certificate but provides the content and acceptable form for an exemption certificate in Notice 88-132.

Dealers may not deliver tax exempt fuel to a storage tank with less than 250 gallons of capacity or to any vehicles fuel supply tank. Users who store exempt and non-exempt fuel in the same tank should indicate on their exemption certificate what quantity of the fuel delivered is for exempt use and pay the tax on the non-exempt fuel. Overstating projected tax-free needs or failing to pay tax on the additional gallons used for a non-exempt purpose will be considered to be an abuse of tax-free purchases. The tax on fuel purchased for exempt purposes and then used on the highway must be paid to IRS quarterly using forms 720 and 8743.

Starting in 1990 the exempt purchaser and the dealer (seller) must file an information return covering the tax exempt transaction. Farmers and other exempt purchasers must keep records showing the amount of exempt diesel fuel used, dates of purchase, name, address and registration number of the fuel supplier. The record keeping requirement is effective in 1989.

DEPRECIATION AND COST RECOVERY

The Tax Reform Act of 1986 replaced the accelerated cost recovery system (ACRS) with the modified accelerated cost recovery system (MACRS). MACRS provides for eight classes of recovery property, two of which may be depreciated only with straight line and applies to property placed in service after 1986. MACRS provides for less accelerated depreciation on most property than did ACRS, but there are exceptions.

Pre-MACRS property will continue to be depreciated under the ACRS or pre-ACRS rules. Therefore most taxpayers will be dealing with MACRS, ACRS, and the depreciation rules that apply to property acquired before 1981. This bulletin concentrates on the MACRS rules but some ACRS information is included. Additional information on ACRS and pre-ACRS rules can be found in prior issues of this manual or the Farmers Tax Guide.

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.

Farmers are required to capitalize pre-productive expenses of trees and plants if the pre-productive period is more than two years, unless they elect not to capitalize, which triggers a requirement to use straight line depreciation. Such capitalized expenses will be depreciated when the productive period starts. Taxpayers other than farmers are also subject to uniform capitalization rules.

MACRS Classes

The MACRS class life depends on the ADR midpoint life of the property. For some items, the ADR midpoint life was specifically changed by TRA 1986. For example, autos and light duty trucks were given an ADR life of five years which moves them from the 3-year ACRS to the 5-year MACRS class.

MACRS Class	ADR Midpoint Life
3-year	4 years or less
5-year	More than 4 but less than 10
7-year	10 or more but less than 16
10-year	16 or more but less than 20
15-year	20 or more but less than 25
20-year	25 or more other than 1250 property with an ADR life of 27.5 or more
27.5-year	Residential rental property
31.5-year	Non-residential real property

MACRS is similar to ACRS in that assets are placed in one of the eight classes regardless of the useful life of the property in the taxpayer's business. Examples of the types of farm assets included in each MACRS class are shown below.

Three-year property. The 3-year MACRS class includes:

1. Section 1245 property with an ADR class life of four years or less. This includes 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 all other horses more than 12 years old when placed in service.

Five-year property.

1. All purchased dairy and breeding livestock (except hogs and horses included in the 3 or 7-year classes).

2. Automobiles, light trucks (under 13,000 lbs. unladen), and heavy duty trucks.

3. Computers and peripheral equipment.

Seven-year property.

1. All farm machinery and equipment.

2. Single purpose livestock and horticultural structures (if placed in service before 1989), silos, grain storage bins, fences, paved barnyards, water wells, and drain tiles.

3. Breeding or work horses.

Ten-year property.

Prior to 1989, there was no farm property included in the 10-year class. Single purpose agricultural structures and orchards and vineyards placed in service after 1988 are in the 10-year class.

Fifteen-year property.

1. Depreciable land improvements such as sidewalks, roads, drainage facilities and fences other than farm fences (which are in the 7-year class). Does not include land improvements that are explicitly included in any other class.

2. Orchards, groves, and vineyards when they reach the production stage if they were placed in service before 1989.

Twenty-year property includes farm buildings such as general purpose barns and machine sheds.

27.5-year property includes residential rental property.

31.5-year property includes non-residential real property.

ACRS, MACRS and Alternative MACRS
Recovery Periods for Common Farm Assets

Asset	ACRS	MACRS	Alternative MACRS
	Recovery Period		
Airplane	5	5	6
Auto (farm share)	3	5	5
Calculators	5	5	6
Cattle (dairy or breeding)	5	5	7
Citrus groves	5	15	20
Communication Equipment	5	7	10
Computer and peripheral equipment	5	5	5
Computer software	5	7	12*
Copiers	5	5	6
Cotton ginning assets	5	7	12
Farm buildings (general purpose)	19	20	25
Farm equipment and machinery	5	7	10
Fences (agricultural)	5	7	10
Goats (breeding or milk)	3	5	5
Grain bin	5	7	10
Greenhouse (single purpose structure)	5	10**	15
Helicopter (agricultural use)	5	5	6
Hogs (breeding)	3	3	3
Horses (non-race, less than 12 years of age)	5	7	10
Horses (non-race, 12 years of age or older)	3	3	10
Logging equipment	5	5	6
Machinery (farm)	5	7	10
Mobile homes on permanent foundations (farm tenants)	10	15	20
Office equipment (other than calculators, copiers or typewriters)	5	7	10
Office fixtures	5	7	10
Office furniture	5	7	10
Orchards	5	10***	20
Paved lots	5	15	20
Property with no class life	5	7	12
Rental property (non-residential)	19	31.5	40
Rental property (residential)	19	27.5	40
Research property	5	5	12*
Sheep (breeding)	3	5	5
Single purpose agricultural structure	5	10**	15
Single purpose horticultural structure	5	10**	15
Solar property	5	5	12*
Tile (drainage)	5	15	20
Tractor units for use over-the-road	3	3	4
Trailer for use over-the-road	5	5	6
Truck (heavy duty, general purpose)	5	5	6
Truck (light, less the 13,000 lbs.)	3	5	5
Typewriter	5	5	6
Vineyard	5	10***	20
Wind energy property	5	5	12*

*No class life specified. Therefore, 12-year life assigned.
**7 if placed in service before 1989.
***15 if placed in service before 1989.

Cost Recovery Methods and Options

Accelerated cost recovery methods for MACRS property are shown below. For farm property placed in service after 1988, depreciation is limited to 150 percent declining balance rather than the 200 percent available for non-farm property. There is an exception from the 150 percent declining balance rule for property placed in service before July 1, 1989 that was under construction or under a binding written contract before July 14, 1988. In addition, there are two straight line options for the classes eligible for rapid recovery. Straight line may be taken over the MACRS class life or, using alternative MACRS depreciation system, over the ADR midpoint life. TAMRA of 1988 provided for a fourth option which is 150 percent declining balance over the ADR midpoint life. This is the same depreciation required for alternative minimum tax purposes, which is discussed under Alternative Minimum Tax.

Orchards and vineyards placed in service after 1988 are not eligible for rapid depreciation. They are in the 10 year class and depreciation is limited to straight line.

Class	Most Rapid MACRS Method Available
3, 5, 7 and 10-year	Non-farm assets: 200% declining balance with switch-over to SL. Farm assets: If placed in service after 1988 are limited to 150% DB. If placed in service 1987 through 1988, 200% applies.
15 and 20-year	150% declining balance with switch-over to SL
27.5 and 31.5-year	Straight line only

Unlike ACRS, MACRS does not provide for standard percentage recovery figures for each year. However, several of the tax services have computed, to the nearest hundredth of a percent, their versions of annual percentages. One set of these is shown below.

Annual Recovery (Percent of Original Depreciable Basis)
(The 150% DB percentages are for 3, 5, 7 and 10 year class farm property placed in service after 1988.)

Recovery Year	3 Year Class 200% d.b.	3 Year Class 150% d.b.	5 Year Class 200% d.b.	5 Year Class 150% d.b.	7 Year Class 200% d.b.	7 Year Class 150% d.b.	10 Year Class 200% d.b.	10 Year Class 150% d.b.	15 Yr. Class 150% d.b.	20 Yr. Class 150% d.b.
1	33.33	25.00	20.00	15.00	14.29	10.71	10.00	7.50	5.00	3.75
2	44.44	37.50	32.00	25.50	24.49	19.13	18.00	13.88	9.50	7.22
3	14.82	25.00	19.20	17.85	17.49	15.03	14.40	11.79	8.55	6.68
4	7.41	12.50	11.52	16.66	12.49	12.25	11.52	10.02	7.69	6.18
5			11.52	16.66	8.93	12.25	9.22	8.74	6.93	5.71
6			5.76	8.33	8.93	12.25	7.37	8.74	6.23	5.28
7					8.93	12.25	6.55	8.74	5.90	4.89
8					4.45	6.13	6.55	8.74	5.90	4.52
9							6.55	8.74	5.90	4.46
10							6.55	8.74	5.90	4.46
11							3.29	4.37	5.90	4.46
12-15									5.90	4.46
16									3.00	4.46
17-20										4.46
21										2.25

Half-Year and Mid-Month Conventions

MACRS, like ACRS, provides for a half-year convention in the year placed in service regardless of the recovery option chosen. Unlike ACRS, a half-year of recovery may be taken in the year of disposal. No depreciation is allowed on property acquired and disposed of in the same year. Property in the 27.5 and 31.5-year classes is subject to a mid-month convention in the year placed in service.

Alternative MACRS Depreciation

Alternative MACRS depreciation is required for some types of property and is a straight line system based on the alternative MACRS recovery period. Farmers who are subject to capitalization of preproductive expenses, discussed more fully later, may elect to avoid capitalization but if they do so they must use alternative MACRS on all property. The recovery periods are, in general, the ADR midpoint lives.

Election to Expense Depreciable Property

The Section 179 expense deduction is available under MACRS in the amount of $10,000. The $10,000 will be phased out for any taxpayer who places over $200,000 of property in service in any year. At $210,000 the Sec. 179 election is completely phased out.

The amount of the Section 179 expense election is limited to the amount of taxable income of the taxpayer that is derived from the <u>active</u> conduct of all trades or businesses of the taxpayer during the year. Taxable income for the purpose of this rule is computed without regard to the Section 179 deduction. Any disallowed Section 179 deductions are carried forward to succeeding years. (TAMRA88 limits the deduction of current and carryover amounts to $10,000 in any year.)

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.

If post 1986 property is converted to personal use, the Section 179 expense recapture is invoked no matter how long the property was held for business use.

With the repeal of federal investment credit 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 than prior to 1987. Every farmer who has purchased MACRS property in 1989 should consider the $10,000 expense deduction. It should not be used to reduce adjusted gross income below the standard (or itemized) deductions plus exemptions unless an additional reduction in 1989 self-employment income is worth more than depreciation in a future tax year. Also, the taxpayer must be sure not to use more 179 deduction than the amount of taxable income from the conduct of an active trade or business.

Mid-quarter Convention

If more than 40 percent of the year's depreciable assets (other than 27.5 and 31.5-year property) are placed in service in the last quarter, all of the assets placed in service during that year must be depreciated using a mid-quarter convention. The assets placed in service during the last quarter will earn only 12.5 percent rather than 50 percent of a year's depreciation. The determination of whether the mid-quarter convention applies is made before the Section 179 deduction is made. Once the determination is made that the mid-quarter convention applies to the taxpayer, the Section 179 election could be applied to the property acquired in the last quarter to minimize the impact of the mid-quarter convention.

Example: Ed placed $100,000 worth of property in service during 1989. If this was all 7-year farm property, 1989 depreciation would be $10,710. But if $50,000 of the property was placed in service in the last quarter, Ed would be subject to the mid-quarter convention rules. Depreciation of the $50,000 would be $1,340. If the remaining $50,000 had been placed in service during the second quarter, it would be depreciated using a mid-quarter convention in that quarter and depreciation would be $6,695. Total depreciation would be $6,695 + $1,340 = $8,035 vs. the $10,710 that would have been available had not the mid-quarter convention been triggered.

MACRS Property Class Rules

For 3, 5, 7, and 10-year MACRS property, the same recovery option must be used for all the property acquired in a given year that belongs in the same MACRS class. Taxpayers do not have the option to establish subdivisions of a property class. For example, if a farmer purchased a new tractor, forage harvester and combine in 1989, all belong in the 7-year property class. The farmer may not recover the tractor over seven years with rapid recovery and the other items over seven or ten years with SL. However, the taxpayer may choose a different recovery option for property in the same MACRS class acquired in a subsequent year. For example, a farmer could have chosen fast recovery for a tractor purchased in 1988 (7-year property) but have chosen straight line for ten years for a combine purchased in 1989. Keep in mind that fast recovery would be used on any other 7-year property purchased in 1988 and the straight line option used on the combine would be required on all 7-year property purchased in 1989.

A taxpayer may select different recovery options for different MACRS classes established for the same year. For example, a taxpayer could select fast recovery on 5-year property, straight line over seven years on 7-year property, and straight line over 25 years on 20-year property.

Anti-Churning Rules

A set of anti-churning rules are designed to prevent a taxpayer from taking advantage of MACRS on property first acquired and placed in service under ACRS. Usually, MACRS will result in slower write-off so there is no incentive to churn, but there are exceptions. For example, property that was 5-year ACRS and is now 5-year MACRS property will get a faster write-off under MACRS.

Some Special Rules on Auto and Listed Property

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.

Additional Rules

Accelerated depreciation in excess of 150 percent becomes an income adjustment subject to inclusion in alternative minimum taxable income.

Salvage value is disregarded when computing MACRS recovery. MACRS rules allow half a year's deduction in the 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 27.5 and 31.5-year property.

Gain to the extent of MACRS deductions whether rapid or SL on all Section 1245 3, 5, 7, 10 and 15-year MACRS property is ordinary income. Property in the 20-year class will be eligible for capital gains treatment if straight line recovery is used. However, this is of dubious value unless preferential treatment for capital gains returns.

The costs of leasehold improvements are recovered under the same rules that apply to an owner of property.

Choosing Recovery Options

Taxpayers will always be better off using rapid recovery on 3, 5, 7, 10, and 15-year MACRS property, assuming the recovery deductions can be used to reduce taxable income and do not create an AMT adjustment that results in AMT liability. 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 MACRS recovery on 20-year property no longer exists. The use of straight line depreciation will not give preferential treatment to gains from sales. When depreciable property is sold after December 31, 1986, the entire gain will be taxed as ordinary income regardless of the depreciation method used. The excess of rapid recovery over straight line depreciation on real property is still subject to the alternative minimum tax. The choice of the best recovery option for 20-year MACRS property should be based on the value of concentrating depreciation in early years versus spreading it out. The time value of money makes 1989 depreciation more valuable than that used in later years. However, depreciation claimed to reduce taxable income below zero is depreciation wasted.

ACRS Recovery Percentages

Recovery percentages for ACRS property commonly held by farmers are shown in the following tables.

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

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

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

Reporting Depreciation and Cost Recovery

Form 4562 is used to report the Section 179 expense election, depreciation of recovery property, depreciation of nonrecovery property, amortization, and specific information concerning automobiles and other listed property. Depreciation, cost recovery, and Section 179 expenses are combined on 4562 and entered on Schedule F. However, partnerships will transfer the 179 expense election to Form 1065 rather than combining it with other items on 4562.

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.

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.

UNIFORM CAPITALIZATION RULES AFFECTING FARMERS

The preproductive costs of raising livestock are now exempt from the uniform capitalization rules. Dairy and beef farmers will be able to deduct the costs of growing replacements on Schedule F without agreeing to depreciation restrictions. The exemption which is effective for costs incurred after 1988 does not apply to large farm corporations, partnerships or tax shelters that are required to use accrual accounting. The exemption does not apply to trees, vines and other applicable plants.

Review

Capitalization rules went into effect in 1987. Farmers were required to capitalize the costs of producing dairy and beef cattle replacements, fruit trees, vines, and other plants that had a preproductive life of more than two years. Farmers could elect out of capitalization by adopting alternative MACRS depreciation for all newly acquired depreciable assets. Although this was a non-revocable election most farmers took it because it was simple, required less time and record keeping, and saved tax dollars in the short run.

Safe harbor values were announced in 1988 allowing livestock producers to use $540 as the cost of raising a dairy cow replacement and $340 per beef cow replacement. Since these IRS values were less than the total costs or market values of cow replacements, and cost of production records were not required, it was advantageous for some farmers to adopt them. The election not to capitalize and use alternative MACRS depreciation could be revoked by adopting safe harbor values. Farmers had until October 16, 1989 to adopt safe harbor values on 1987 amended returns.

Old Livestock Rules Affect Current Cost Recovery

Livestock capitalization rules and elections adopted in 1987 and 1988 will affect 1989 records and depreciation claimed on Schedule F.

1. Assets placed under alternative MACRS depreciation in 1987 and 1988 must remain under this method of cost recovery until fully depreciated or disposed of.

2. Preproductive period costs capitalized in 1987 and 1988 will remain on the depreciation schedule until the capitalized costs are fully recovered. Capitalized preproductive period costs are not placed on the depreciation schedule until the animal begins production.

3. The sales of animals subject to capitalization rules are Section 1245 transactions. Unrecovered capitalized costs become the basis, and gain to the extent of depreciation claimed is ordinary income. If the cow is held for two years or more, additional gain is capital gain, and losses are treated as capital losses.

4. Farmers who elected out of capitalization are also subject to the Section 1245 recapture rules. When raised dairy and breeding livestock are sold, any gain to the extent of preproductive period costs that would have been capitalized if the election had not been made, must be recaptured as ordinary income. IRS says you can not use safe harbor values for this calculation. At this time there are no IRS guidelines or instructions on how to make this calculation and entry on Form 4797 Part III.

New Revocation and Accounting Guidelines

Farmers that are now exempt from the uniform capitalization rules and made the election to use alternative MACRS depreciation to avoid capitalization in 1987 and or 1988, must revoke that election on their 1989 return by checking the "does not apply" box and printing "PRIOR ELECTION FOR ANIMALS REVOKED" on line G of Schedule F.

Non-calendar year farm taxpayers now exempt from capitalization rules who used safe harbor values for the tax year ending in 1988 may continue to use safe harbor values for the full year ending in 1989. An alternative is to use safe harbor values for that portion of the tax year that includes the months before January 1989.

Fruit Growers and Nurserymen

"The preproductive period of a plant begins when the plant or seed is first planted or acquired by the taxpayer. It ends when the plant becomes productive in marketable quantities or when the plant is reasonably expected to be sold or otherwise disposed of." [Temp. Reg. 1.263A-1T(c)(4)(ii)(B)].

"The preproductive period of plants grown in commercial quantities in the U.S. shall be based on the weighted average preproductive period for such plant, determined on a nationwide basis." [Temp. Reg. 1.263A-1T(c)(4)(ii)(D)].

Plants subject to capitalization rules will include fruit trees, vines, ornamental trees and shrubs, and sod providing the preproductive period is 24 months or more. An evergreen tree which is more than six years old when harvested, (severed from the roots), is not an ornamental tree subject to capitalization rules. Timber is also exempt.

If trees and vines bearing edible crops for human consumption are lost or damaged by natural causes, the costs of replacement trees and vines do not have to be capitalized.

Suggestions for Growers

The costs of trees, vines, and plants that do not reach the productive stage for two or more years have always been subject to capitalization. Growers have had the option to capitalize all preproductive period expenses under the old law but few used it.

Fruit growers who choose to capitalize will need to establish reasonable estimates of the preproductive costs of trees and vines. The farm-price method would be difficult for growers to apply but could be used by nurserymen to establish their preproductive costs of growing trees, vines, and ornamentals.

Capitalization will delay the recovery of orchard, vineyard, and ornamental tree preproductive period expenses for 10 years. Small fruit plants and related expenses subject to capitalization may be depreciated in seven years.

If growers elect alternative MACRS the cost of trees and vines are still subject to depreciation (20 year straight line). Only the preproductive period growing costs may be expensed.

CAPITALIZATION RULES APPLIED TO NONFARMERS

In general, all costs that are incurred in the production of real or tangible personal property, or in acquiring property for resale, are to be capitalized by taxpayers with average annual gross receipts of $10 million or more. Intangible oil and gas well drilling costs are excluded and there are other exceptions.

TAMRA 1988 repealed uniform capitalization rules for free-lance writers, photographers and artists (excluding the production of films and videotapes) effective starting with 1987. An artist is defined as any individual whose personal efforts may be expected to create a picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print edition. The production of jewelry, silverware, pottery, furniture and household crafts is not considered the work of an artist for this purpose. Expenses paid or incurred by an employee do not qualify for this exemption.

STORM RELATED CASUALTIES

A casualty includes the damage or loss resulting from a sudden, identifiable, unexpected event such as the destructive wind storms that blew across upstate New York on October 14, 1989. Casualties also include damage from fire, flood, lightning, freezing, earthquake and accidents.

Business Casualty Losses and Gains

Storm losses of farm buildings, vehicles, equipment and purchased livestock will result in casualty losses or gains. The deductible loss is the lesser of the adjusted basis or loss in market value, minus any insurance received. When the insurance is greater than the loss in value or basis, there is a casualty gain that may be treated as an involuntary conversion. When calculating casualty losses and gains the remaining basis is decreased by any insurance received.

Example: Hy Tower lost a 20′ x 80′ concrete stave silo in the October storm. The silo was a total loss, undepreciated balance $3,000, loss in market value $14,000, insurance $10,000. The tax basis ($3,000) minus the insurance received ($10,000) equals a $7,000 casualty gain that Tower will calculate on Form 4684. If he wants to postpone the gain by reinvesting it in a new silo, the election is made on the 1989 return. If he spends $40,000 to build a new silo the adjusted basis will be $40,000 less $7,000 or $33,000. He has two years or through the end of the 1991 tax year to replace the property.

Losses of raised crops and livestock are not deductible to the cash basis farmer because the value of these production items has not been reported as income.

Personal Casualty Losses

Storm losses of shade trees, ornamentals, and damage to other nonbusiness real property may result in casualty losses or gains. A loss can not exceed the basis of the property, the first $100 of each loss is not deductible and nonbusiness casualty losses must exceed 10 percent of AGI before they become deductible. Expenses for cleaning up damaged property, repairs, replacement costs and other related costs are not deductible.

GOVERNMENT PROGRAMS: GENERIC COMMODITY CERTIFICATES AND RELATED CCC LOAN TRANSACTIONS

In recent years wheat and feed grain programs provide for issuance of generic commodity certificates denominated in dollars to farmers who participate in these programs. The certificates may represent either set aside payment or deficiency payments. The taxability of the value of the certificates is rather complicated due to an interaction with Commodity Credit Corporation (CCC) loan transactions. The situation was made even worse by USDA regulations issued in October 1986 and Revenue Ruling 87-17 issued in February 1987, but revoked in October 1987 by Ruling 87-103.

CCC Loans

A taxpayer may place grain under CCC loan, using the grain as security. The taxpayer has the option of treating the loan as income in the year the loan is received. Once he has elected this option, in the future he must continue to treat all CCC loans as income in the year received. Under this option, the amount of the CCC loan that is reported as income becomes the basis of the grain. When the grain is sold, he will have either gain or loss to report, depending on whether the grain is sold for more or less than the basis.

If the taxpayer does not elect to report the loan as income, there is no income to report until the grain is sold. The taxpayer has the option of forfeiting the grain to CCC in return for cancellation of the loan. Normally, a taxpayer would forfeit only if the market price of grain never exceeded the loan rate during the period of the loan which is usually nine months. There is also a three year reserve program. If the grain is forfeited, the amount of the loan becomes income to the taxpayer at the time of forfeiture.

The table below shows the income tax treatment of various dispositions of CCC loans and grain.

	Treatment of CCC Loan when Received	
Disposition of the Loan or Grain	Treated as Income (i.e. taxpayer made IRC Sec. 77 election)	Treated as Loan (i.e. taxpayer did not make IRC Sec. 77 election)
Loan paid by forfeiting grain	No further income to be reported	Amount of loan reported as income
Grain redeemed by paying off loan with cash	Farmer has basis in grain equal to loan	Farmer has a zero basis in the grain
Redeemed grain is sold	Farm has income (loss) equal to sale price less amount of loan, which is the basis in the grain	Farmer has income equal to sale price
Redeemed grain is fed	Farmer has a feed deduction equal to amount of the loan, which is his basis in the fed grain	Farmer has no deduction

Income From Certificates

The producer has several options for disposing of a generic certificate:

1. Cash in the certificate for face value at the ASCS office within 10 working days of the first transfer deadline.
2. Sell the certificate to someone else. The proceeds may be more or less than the certificate's face value, but in general the certificates sell at premium.
3. Use the 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 certificates. This is sometimes called "PIK and roll."

Under option (1), if the certificates is cashed in the year received, the face value of the certificate (less any Gramm-Rudman reduction) will be reported as income. Under option (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 options (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 has included the loan in income the year the loan was received. During 1988 and 1989 the posted county price has been above the loan rate so there was no incentive to use certificates to redeem CCC grain.

Tax Treatment Under USDA Regulations and IRS Ruling 87-103

In a situation where the certificate is used to redeem grain under CCC loan, the producer will be concerned about the tax treatment of the certificate, the tax treatment of the loans and the tax treatment of the commodity. We will first assume that the loan was not treated as income in the year that is was received.

Example: Corn Grower has 20,000 bushels of 1988 corn under loan at $2.10 per bushel = $42,000. A certificate worth $9,000 was received in 1989. C.G. redeems part of the corn (5,000 bu.) at the posted county price (PCP) of $1.80. This reduces the loan by 5,000 bu. x $2.10 = $10,500. Note that the loan is reduced by $1,500 more than the value of the certificate. C.G. then sold the corn in 1988 for $2.00 per bushel x 5,000 = $10,000.

C.G. will report the $9,000 certificate as income on his 1989 tax return. The difference between the amount of loan canceled and the value of the certificate ($10,500 - 9,000 = $1,500) is reported as 1989 income. When the corn was sold in 1988, there was $10,000 income from the sale of corn. The total income reported will be $9,000 + 1,500 + 10,000 = $20,500 (plus the sale of the remaining corn).

Now assume that the $42,000 loan had been reported as income. We are primarily interested in the loan on the 5,000 bushels that were redeemed. The basis of those bushels is 5,000 x $2.10 = $10,500. When this grain is sold for $2.00 per bushel = $10,000 there will be a loss of $10,500 - $10,000 = $500. Total income reported will be the $9,000 certificate +$10,500 loan included in income + $1,500 excess of the loan cancelled over the value of the certificate - $500 loss = $20,500 (plus the sale of the remaining corn).

Tax Treatment of Purchased Certificates

It is legal to sell generic certificates and many of them have been sold at a premium over the face value. The purchaser of a certificate has a basis equal to the purchase price, not the face value. If the purchased certificate is used to redeem CCC grain, the tax consequences are similar to those described above. However, if the certificate was purchased at a premium it will have a basis higher than the face value and this will affect the gain or loss when the certificate is used to pay off the CCC loan. In the example above, suppose that C.G. has purchased the $9,000 certificate for $10,000. When it was used to pay off the $10,500 loan, there was a gain of $500 rather than $1,500.

OTHER GOVERNMENT PROGRAMS

Disaster Payments and Crop Insurance

The Disaster Assistance Act of 1988 substantially revised the disaster payments that had been available to farmers. The 1988 Act, among other things, provides (1) Emergency livestock assistance and (2) Emergency crop loss assistance. Emergency livestock assistance includes the emergency feed program which in some cases provides for donation or sale at reduced prices of feed to farmers from CCC stocks and the emergency feed assistance program which provides for cash payments to farmers. The crop loss assistance program provides for cash payments to farmers whose crop loss in 1988 was at least 35 percent. There is also a 1989 Disaster Act.

Some New York farmers received benefits from the 1988 or 1989 Acts during 1989. Such benefits, including the value of donated feed, will produce taxable income. Some New York farmers also collected crop insurance benefits because of drought and other calamities.

Normally, cash basis farmers are required to report disaster payments and crop insurance benefits in the year the payments are received. Under the Agricultural Act of 1949, there is an exception that allows such benefits to be reported in a later year if the taxpayer can show that under normal business practice, the income from the crop for which the benefits were received would have been reported in a later year. (There is no provision to allow payments received in a year later than the loss occurred to be reported in an earlier year.) According to TAMRA 1988, payments received under the 1988 Act are eligible for the same delay in reporting.

The taxpayer makes the election to report in a later year by attaching a statement to his return indicating the election is being made under Sec. 451(d).

Conservation Reserve Program

Under this program, farmers bid to retire highly erodible land for 10 years. Land in the Conservation Reserve Program is not treated as rental property. CRP payments will be self employment income subject to SE tax unless the taxpayer can find a way not to materially participate in the operation of his CRP land.

The Social Security Administration states that CRP payments are not earned income for the annual earnings test if they are received in a year <u>after</u> the person became eligible for SS benefits. CRP payments <u>are</u> earned income if received in the year a person becomes eligible for SS benefits. The landowner might still be eligible for benefits under the monthly earnings test.

Dairy Termination Program Payments

TRA of 1986 and technical corrections made in 1988 preserved the 60 percent capital gain exclusion for otherwise eligible cattle sold before October 1, 1987 as part of the Dairy Production Termination Program.

IRS notice 87-26 released February 27, 1987 provided Dairy Production Termination Program participants an opportunity to report part of the government payments received for not producing milk on Form 4797 rather than 1040F. The amount of the DTP government (CCC) payment that one could shift from 1040F to 4797 was the value of the dairy herd lost from selling it for slaughter rather than for dairy purposes. DTP farmers who sold their dairy herds and filed their tax returns without making the CCC income adjustment must file amended returns to take advantage of this provision. The potential tax savings will come from switching ordinary income to capital gain and reducing self-employment income.

DTP CCC income received in 1988 and 1989 may still be allocated to the value of dairy cattle sold under the rules in notice 87-26 but the 60 percent capital gains exemption would not apply. The transition rules that extended the capital gains exclusion to DTP herds sold before October 1, 1987 did not extend the 60 percent exclusion to income received and reported after 1987. If a DTP participant had elected to report the entire current and future proceeds from the sale of the herd on a timely filed 1987 return, the capital gains exclusion would have applied.

The DTP taxpayer must report all 1988 and 1989 DTP CCC payments (net of compensation for reduced cattle values), as Schedule F and self-employment income even when no longer self-employed.

DROUGHT SALES OF LIVESTOCK

Sales of livestock in excess of normal sales due to drought may be eligible for postponement of reporting for tax purposes. There are two sets of rules.

Dairy, draft and breeding animals are eligible for a two year postponement of gain if the proceeds are used to purchase "like kind" animals within two years. The livestock do not have to be located in a Federally declared disaster area, but the sales must be solely on account of drought conditions. The taxpayer will have a basis in the replacement animals equal to the basis in the animals sold plus the amount that the cost of the replacement livestock exceeds the proceeds from the sale. The taxpayer makes the election under Sec. 1033(e) by attaching a statement to his return which explains the circumstances and the amount of gain deferred. Only livestock sold in excess of the number normally sold under usual business conditions in the absence of drought are considered involuntarily converted.

The income from sales of all livestock and poultry including those held for sale may be deferred for one year, if the following conditions are met: (1) The taxpayer's principal business is farming and cash basis reporting is used, (2) The sale was caused by drought conditions, (3) Drought conditions were severe enough so that counties in the region were designated as eligible for federal assistance even though the livestock do not have to be raised or sold in a federally declared drought area.

The election is made under Sec. 451(e). The amount eligible for delay in reporting is the excess of sales over the sales the taxpayer would normally make and must be documented. The deferred gain is reported in the subsequent year and there is no requirement that animals be replaced.

GENERAL BUSINESS CREDIT

General business credit (GBC) is a combination of "regular" investment credit (generally repealed January 1, 1986), business energy credit, jobs credit, alcohol fuels credit, research credit, and low-income housing credit. Form 3800 is used to claim GBC for the current year, to apply carryforward GBC from prior years, and to claim carryback GBC from future years. 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 limits apply to married persons filing separate returns, controlled corporate groups, estates and trusts, and certain investment companies and institutions [Sec. 46(e)(i)].

FEDERAL INVESTMENT CREDIT

Review

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 investment credit was repealed for property placed in service after December 31, 1985 unless it is credit earned on transition property or qualified reforestation expenses. The regular credit (Sec. 45(a)(1)) is 10 percent of the amount of qualified investment. There are more liberal allowances for some rehabilitated buildings. The credit is a direct reduction against income tax liability. If the credit cannot be used in the year it is earned, it can be carried back and carried forward to offset tax liability in other years. If property is disposed of before credit claimed is fully earned, the credit must be recomputed to determine the amount to recapture.

Investment credit carryovers from 1986 and earlier years may still be used but only 65 percent of that left over from 1987 may be carried to 1988 and later years. A special 15 year carryback provision is still available to farmers if they amend their 1987 tax returns. See Unused Investment Credit for more information on the carryover and carryback rules and provisions.

Form 3468 was used for computing the credit, but records showing credit claimed on individual property should be a part of the depreciation record. Copies of prior years' forms can be used to keep track of the running balance of credit available. Form 3800 is used for calculating the availability of carryforwards, carrybacks and unused credit.

Transition Property

Transition property is qualified IC property acquired or constructed pursuant to a written contract that was binding as of December 31, 1985. Property with an ADR midpoint life of less than seven years must have been placed in service prior to 1987, property with an ADR midpoint life of seven through 19 years must have been placed in service before 1989, and property with an ADR midpoint life of 20 years or more must be placed in service before 1991 to qualify as transition property eligible for IC. Therefore, only 20 to 40 year ADR midpoint life property including general purpose farm buildings, orchards, vineyards and rental property is still eligible for IC. If IC is claimed on transition property, the basis for depreciation must be reduced by 100 percent of the investment credit.

Reforestation Expenses

Qualified reforestation expenses consist of up to $10,000 of the direct expenses of planting or replanting a forest or woodlot held for timber or wood production. Direct expenses include site preparation, seedlings, labor, tools, and depreciation of equipment used. These are the same expenses that qualify for seven year amortization. Operating costs that are deductible on an annual return, all costs that have been reimbursed through government cost-sharing programs, and all costs associated with planting Christmas trees are excluded. The basis of any depreciable reforestation expense must be reduced by 50 percent of IC claimed.

Rehabilitated Buildings

The rehabilitation credit is 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. These new rules apply to rehabilitated property placed in service after 1986. As usual, there are some transitional rules.

The basis for depreciation must be reduced by 100 percent of the investment credit claimed.

The rehabilitation must be "substantial", that is, qualified rehabilitation expenditures during a 24-month period selected by the taxpayer must exceed the greater of the adjusted basis of the property or $5,000. Qualified ITC expenditures are not limited to those incurred during the 24 month "substantial test period". All qualified expenditures for the current tax year should be included.

Qualified rehab expenditures are incurred by the taxpayer on the date such expenses would become expenses under accrual accounting. A taxpayer acquiring an unused building under rehabilitation may be able to claim rehab credit on rehab expenses incurred by the transferor.

Expenditures for the interior or exterior renovation, restoration or reconstruction of the building qualify for the credit. Costs for acquiring or completing a building or for the replacement or enlargement of a building do not qualify. 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.

A building will qualify for purposes of meeting Section 48(g)(1)(A)(iii) (the 75 percent rule) if, 1) 50 percent or more of the existing exterior walls of the building are retained as exterior walls, 2) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls, and 3) 75 percent or more of the existing internal structural framework of such building is retained in place.

Unused Investment Credit

A special provision of TRA 1986 allowed qualified farmers and steel companies to elect to carry back up to $1,500 of IC carry forwards for as much as 15 years to get refunds up to $750. IRS Announcement 88-88 provides the details of this special provision. Unfortunately the taxpayer had to use $2 of IC for $1 of refund. The refund was limited to the regular income tax liability during the 15-year carryback period. Taxpayers can still use this special provision on an amended 1987 return.

Unused IC may be carried over to the 1989 return with Form 3800. Carryovers to 1987 were reduced by 17.5 percent and carryovers to 1988 were reduced by 35 percent after making an adjustment by adding back the unused portion of the 1987 reduction. The instructions on the 1988 Form 3800 told the taxpayer to carryforward to 1989 the unused portion of IC plus the corresponding portion of the 35% reduction made on the 1988 return. Therefore, the IC carried forward to 1989 from a correctly filed 1987 and 1988 return will again require a 35% reduction. Reforestation IC does not require the 35% reduction.

Here is an example of how to make the reductions and adjustments from 1987 to 1989:

I.C. Surplus, a calendar year taxpayer, carried over $25,000 of unused IC to 1987. Her 1987 federal income tax liability was $5,125. I.C. Surplus reduced her $25,000 of carryover by 17.5 percent or $4,375, leaving $20,625 available for 1987 tax reduction. I.C.'s 1987 tax liability was reduced to $0 leaving a $15,500 balance of unused IC after the 17.5 percent reduction. I.C.'s carryover to 1988 was $15,500 plus a corresponding proportion of the $4,375 reduction. The proportion was $15,500/$20,625 or 75 percent. I.C.'s carryover to 1988 was $15,500 + $3,281 (4,375 x 0.75) = $18,781.

In 1988 I.C. Surplus had an income tax liability of $9,400. Her carryover was reduced by 35 percent leaving 65 percent of $18,781 or $12,208 available in 1988. I.C.'s 1988 tax was reduced to $0 leaving an IC carryforward of $2,808 plus 23 percent ($2,808/$12,208) of $6,573, or $4,320 for 1989.

In 1989 IC Surplus has an income tax liability before credits of $10,700. The IC carryforward of $4,320 must be reduced by 35% to $2,808 which reduces her 1989 tax liability to $7,892.

Recapture of Credit

Section 38 assets acquired in late 1984 and 1985 and disposed of in 1989 are still subject to IC recapture rules. Only recapture provisions for ACRS property acquired after 1980 are discussed here.

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 ACRS class life. If the recomputed credit is less than the credit actually used to decrease tax, 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 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:

	The recapture percentage is:	
If the recovery property ceases to be Section 38 property within the period:	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 and Pub. 572.

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.

FEDERAL BUSINESS ENERGY INVESTMENT CREDIT

The computation of the business energy credit is made on Schedule B, Form 3468, Business Energy Investment Credit. 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.

The Tax Reform Act of 1986 modified the percentages for qualifying energy property and TAMRA '88 extended the rates on the following credits through 1989.

1. Solar equipment will receive a 10 percent credit in 1989.

2. Ocean thermal equipment will still receive a 15 percent credit through 1989.

3. Geothermal equipment will continue to receive 10 percent in 1989.

Property eligible for the business energy investment credit that is also ACRS property has 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.

The energy credit from 3468 is combined with other investment credits on 3468 and the total is subject to the limitations described under General Business Credits. If a taxpayer has one of the other credits in the general business credit group, Form 3800 will be required.

OTHER CREDITS

There is a $3 credit for producing 5.8 million BTU's of energy (equivalent to one barrel of oil) of methane from burning wood in facilities placed in service before 1989. This credit continues through 2000.

An alcohol fuel credit may be claimed by taxpayers who blend or use gasohol and other alcohol fuels in their trade or business. The credit is 60 cents per gallon when the blend is 190 proof or more. This credit continues through 1991.

A REVIEW OF FARM BUSINESS PROPERTY SALES

The 1986 Tax Reform Act did not eliminate the distinction between gains from sales of property used in the farm business eligible for capital gain treatment and gains subject to recapture of depreciation. Therefore, it still is important to understand the difference between these two types of gains. Form 4797 will continue to be used to report sales of property used in the farm business.

In 1987 and later the 60 percent capital gain exclusion that was in effect in 1986 and earlier no longer applies. Capital gain income is not exempt from the five percent surcharge.

The reporting of gains and losses on the disposition of property held for use in the farm business continues to be 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. 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, 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. 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 and later, 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 1984, 1985, 1986, 1987 or 1988 return and has a net Section 1231 gain for 1989, must recapture the losses on the 1989 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. It also applies to depreciation claimed on capitalized production costs and to amounts which would have been capitalized if the taxpayer had not elected out of capitalization. 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 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.

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, 1985 cost	$50,000
Soil and water expenses deducted on 1986 tax return	$4,000
Land was sold in 1989 for	$65,000

   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 $50,000. The gain of $15,000 would normally be all capital gain. But the land was not held for more than five years, so the gain is divided; $11,000 qualifies as capital gain, $4,000 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 had 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.

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 are 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, purchased 1231 livestock that produce a gain upon sale will be entered in Part III where they become 1245 property. Sales of raised animals on which costs were capitalized are also reported in Part III as are animals on which preproductive costs would have been capitalized if the taxpayer had not elected to do so during the years when livestock were required to be capitalized. 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.

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 as ordinary income by transferring 1231 gain equal to the nonrecaptured losses to Part II. Any 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, preproductive costs not subject to capitalization rules (1231 Property)	4797, Part I
b) Purchased and raised subject to capitalization rules, sale results in gain (1245 Property)	4797, Part III
c) Purchased and raised subject to capitalization rules, 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

INSTALLMENT SALES

The Revenue Act of 1987 repealed the proportionate disallowance rules for tax years beginning in 1988, and made the installment sales method unavailable to dealers of real and personal property on dispositions made after 1987. The installment method of reporting may still be used by non-dealers for the sale of real property or personal property (except depreciation recapture). The installment method is required when qualified property is sold and at least one payment is received in the following tax year unless the seller elects to report all the sale proceeds in the year of disposition.

Dealers of Real and Personal Property

Beginning in 1988 all payments received from a dealer disposition of property must be reported as received in the year of sale.

A dealer disposition is: 1) any disposition of real property held by the taxpayer for sale to customers in the ordinary course of a trade or business; and 2) any disposition of personal property by a taxpayer who regularly sells such property on the installment plan.

Exceptions: A dealer disposition does not exclude property used or produced in the trade or business of farming from the installment method. The sale of time shares and residential lots are allowed providing the "dealer" elects to pay interest on the tax attributed to payments received in future years.

New Rules for Nondealers of Real Property (except farms)

Installment sales of nonfarm real property used in the taxpayer's trade or business, or held for the production of rental income, and sold for more than $150,000 are called "nondealer real property installment obligations" (NRPIO's). When the balance of deferred payments on these sales made during the year exceeds $5 million at the end of the year, interest must be paid on the deferred income tax. When a nondealer sells real property used in a trade or business or for the production of rental income for more than $150,000 and then uses the installment sales contract as security for a loan, the loan proceeds received are treated as installment payments received for tax purposes.

Old Rules Still in Effect

Losses cannot be reported on the installment sale method. A partnership may use the installment sale method of reporting gain on the sale of partnership property even though an individual partner may realize a loss and recognize it in the year of sale.

The loss of the 60 percent capital gains exclusion affects all installment sale payments received after 1986. The law in effect when an installment payment is received and reported determines how the income is treated. However, a change or increase in the capital gain holding period requirement during an installment sale would not move a long-term gain to a short-term gain.

Property sold on a revolving credit plan may not be reported on the installment method. All payments must be reported in the year of sale. Publicly traded stocks and securities may not be reported using the installment method (TRA 1986).

Recaptured depreciation does not qualify for the installment sale. 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. Remember that Section 179 expenses and capitalized expenditures are treated as Section 1245 dispositions. The full amount of recaptured depreciation is reported as ordinary income in the year of sale regardless of the size of payments received.

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

Here is an example: Carl Cropper sells his corn drying facility (Section 1245 property) to M.W. Grainer for $90,000 on January 1, 1989. 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 1989. 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 11.11 percent. The capital gain to report each year of the installment sale is $2,000 ($18,000 x 0.1111). 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.

Installment Sale Resale Rules

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.

Imputed Interest Rules

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 rate) 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 December 1989 monthly AFR was 7.74 percent (short-term, not over three years), 7.77 percent (mid-term, three to nine years), 7.80 percent (long-term, over nine years). The monthly AFR is currently running below the semiannual rates. The monthly long term AFR hit a low of 7.91 percent in September compared to this year's high of 9.05 percent in May.

Cancelation of Installment Obligations

A cancelation of all or part of an installment obligation is treated like a sale or other disposition of the obligation. Gain or loss is calculated as the difference between the amount realized and the "basis" of the obligation. "Basis" is the excess of the face amount of the obligation and the amount realized by the seller or holder of the obligation.

ALTERNATIVE MINIMUM TAX

TRA of 1986 replaced the add-on minimum tax for corporations with a new alternative minimum tax and expanded the AMT for individuals. TAMRA 1988 clarified some of the changes made in the 1986 Act. The changes described here pertain to individuals unless indicated otherwise.

The AMT resembles a separate but parallel tax system. Separate calculations of many types of income and deductions including depreciation are required for many taxpayers. Some taxpayers will receive postponement of tax benefits rather than permanent removal. Form 8801 is used to calculate credit for prior year minimum tax.

Higher Rates and Exemption Phaseout

The AMT flat rate has been increased from 20 percent to 21 percent. The basic exemptions remain unchanged. An exemption phaseout reduces the exemption at a rate of 25 percent of AMT income exceeding specific levels. If the taxpayer's AMTI exceeds the exemption he or she will have an AMT liability.

Alternative Minimum Tax Exemption and Phaseout

Filing Status	Maximum Exemption	AMTI Phaseout Range	Phaseout Percent
Joint & qualifying widow(er)	$40,000	$150,000-310,000	25
Single & heads of household	30,000	112,500-232,500	25
Married filing separately	20,000	75,000-155,000	25

Alternative Minimum Taxable Income

AMTI is calculated by starting with taxable income which is negative on 6251 when line 35 less line 36 of 1040 is negative, even though it is zero on line 37 of 1040. Any NOL carryforward used in calculating the regular tax is added. Income and deduction adjustments are then added and tax preference items are included.

Here are the adjustments that must be added to TI. The first two categories are adjustments treated as "exclusions". AMT due to exclusions is not eligible for a credit against the following year's regular tax.

1. Standard deduction or certain itemized deductions from Schedule A including most medical deductions, miscellaneous deductions subject to the two percent rule, state and local income taxes, the difference between qualified housing interest and residence interest. (These are lines 4a and c through h on Form 6251.)

2. Personal exemptions (due to TAMRA 1988 and retroactive to 1987).

3. Depreciation on personal property placed in service after 1986 that exceeds 150 percent declining balance using alternative MACRS years of life (i.e. 150 percent declining balance alternative MACRS depreciation is the fastest method allowed for calculating AMTI). There are some exceptions including property depreciated under the unit-of-production method, and property subject to transition rules for MACRS. The depreciation adjustment is the net difference between accelerated MACRS depreciation and that allowed for AMT. If Straight Line is used for regular tax, it must be used for AMT. The Section 179 expensing election deduction is allowed in calculating AMTI.

4. The difference between the regular tax deduction for circulation and research and experimental expenditures and the allowable AMT deduction based on 10 year amortization.
5. The difference between the regular tax deduction for mining exploration and development costs and 10 year amortization allowed for AMTI.
6. Incomplete long-term contract costs calculated using the completed contract method less those using the percentage of completion method.
7. Cost recovery for pollution control facilities amortized over 60 months less alternative MACRS allowed for AMTI.
8. Entire gain from installment sales of property held primarily for sale in the ordinary course of the business. Dealer installment sales are not an adjustment because these cannot be reported on an installment basis for regular tax purposes. Exceptions include property used in farming and personal property not used in a trade or business.
9. The difference (due to different depreciation allowances) between the regular income tax gain or loss and the AMTI gain or loss when there is a taxable exchange. Any AMT adjustment from the exercise of stock options after 12/31/87 is also included here.
10. A difference in allowed losses including losses from all tax shelter farm activities. Losses cannot be offset by gains.
11. The difference between passive activity losses allowed for AMTI and those allowed for regular tax.

Preference Items - The first three are treated as "exclusions".

1. The appreciated portion of capital gain gifts claimed under charitable contributions. The appreciated portion is the difference between the property's fair market value and its basis.
2. Tax-exempt interest from private activity bonds.
3. The excess of the tax depletion allowance over the adjusted basis of the property.
4. Accelerated depreciation of real and leased personal property placed in service before 1987 remains a tax preference subject to AMT as does amortization of certified pollution control facilities.
5. Intangible drilling costs.

AMT Net Operating Loss Deduction

The AMT net operating loss is limited to 90 percent of AMTI and is calculated and deducted after all adjustments and deductions are completed. The regular tax NOL is added to TI on line 2 of Form 6251. The AMT NOL is calculated the same as the regular NOL except:

1. Taxable income is adjusted as it is adjusted in computing AMTI.
2. Taxable income is reduced by the preference items included in calculating the regular tax NOL.

The deduction of AMT NOL is the last step in calculating alternative minimum taxable income. Schedule A (Form 1045) can be used to calculate the AMT NOL providing the above exceptions are included.

The AMT NOL absorption rules for tax years beginning after 1986 are the same as for regular tax. The rules are different for tax years prior to 1987.

Tentative Minimum Tax

The minimum tax exemption reduced by the 25 percent phase out is subtracted from AMTI before the 21 percent rate is applied. Then the AMT foreign tax credit is subtracted to arrive at tentative minimum tax. A taxpayer who has regular foreign tax credit will compute AMT foreign tax credit in much the same manner although the amount that can be used to reduce AMT is limited.

Alternative Minimum Tax and Credits

Tentative minimum tax less the regular income tax equals AMT. Regular income tax excludes several miscellaneous taxes including tax on lump-sum distributions, accumulated earnings tax, and tax on certain built-in gains of S corporations. Regular income tax is reduced by the foreign tax credit (but not business tax credits) before it is entered on line 18 Form 6251.

Foreign tax credit is still the only credit allowed in the calculation of AMT. The other credits, including investment credit, can be carried forward to the extent they do not provide a tax benefit because of the AMT.

The AMT calculation on Form 6251 appears to be inconsistent with the rule that does not allow a taxpayer to use business credits to reduce regular tax below AMT. This general business credit limitation is still in effect and is calculated on Form 3800.

Who Must File Test

Many more taxpayers are required to file Form 6251 than have an AMT liability. Form 6251 must be filed when line 6 (TI plus all adjustments and preference items) is greater than the exemption on line 9. An AMT liability will be incurred when adjustments plus preference items nearly equal the exemption.

Corporate Alternative Minimum Tax

The Corporate AMT is very similar to the AMT for individuals. It replaces the old corporate add-on minimum tax. The exemption is $40,000 reduced by 25 percent of the amount of AMTI that exceeds $150,000. The tax rate is 20 percent.

Although some of the AMT adjustments are different on the corporate return, the major ones including depreciation are the same. An adjustment for business untaxed reported profits or "book income" is also required by corporations. In 1987 through 1989, AMTI must be increased by 50 percent of the amount by which adjusted net book income exceeds AMTI before the effect of any NOL's. After 1989 the adjustment will be plus 75 percent. In general, the book income used in computing the adjusted net book income is the net income or loss on the taxpayer's applicable financial statement.

A corporation can use investment credit to reduce regular income tax below AMT to the extent regular tax exceeds 75 percent of tentative AMT, or IC can instead be used in an amount equal to 25 percent of the taxpayer's tentative AMT, whichever is greater. In applying this rule, the corporation maintains a single IC account for both regular and AMT purposes. Another rule limits the use of credits and NOL's to a 90 percent reduction of applicable AMT liability.

NET OPERATING LOSSES

Farmers and nonfarm taxpayers who sustain a net operating loss in 1989 may carry it back to recover taxes paid in former years or carry it forward to reduce taxes to be paid in future years. The net operating loss is the taxpayer's business 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. The NOL calculation steps and rules of procedure have not been changed by recent tax legislation and are not included in this publication. The Illinois Farm Income Tax Workbook contains an excellent NOL chapter including illustrations and worksheets. IRS Pub. 334 contains a section on NOL's. Following are general rules and guidelines to consider before computing an NOL.

A net farm loss on Schedule F or net business loss on Schedule C is not equal to a <u>net operating loss</u>. The NOL is usually less than but it could be greater than the net business loss. Business losses must be combined with all other income, losses, and deductions on 1040 to determine if there is a <u>taxable loss</u>. The taxable loss, after adjustments, determines how much NOL is available to carryback and carryover to other tax years.

The opportunities and consequences of carrying an 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 1989 NOL would be first carried back to 1986, then to 1987, 1988, and then forward to 1990 and in order to 2004 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 year the NOL occurred by attaching a statement to the return. Once the election is made it is irrevocable for that tax year. If the election is not made by the applicable date, the NOL will be considered absorbed as if it had been carried back, even if it had not been claimed in a carryback year. 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.

Reasons to forego the carryback period include: low income during the carryback period, the presence of long-term capital gains in 1986 and investment tax credit used before the 35 percent reduction.

In making a claim for an NOL, a concise statement showing its computation 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.

The NOL is <u>not</u> to be considered when calculating net earnings from self-employment for the year to which the NOL is carried.

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.

PASSIVE ACTIVITY LOSSES

Section 469, added to the IRC by TRA of 1986, placed new and significant limits on the use of tax losses to shelter business and investment income as well as salary and wage income. The IRS has issued hundreds of pages of temporary and proposed regulations relative to passive losses (1.469-0T through 5T and 11T) and has plans to issue 1.149-6T through 10T.

The Rule

Passive activity losses (and credits) can only be used to offset passive activity income. Passive activity loss is defined as the excess of the aggregate losses from all passive activities over the aggregate income from all passive activities. Losses from passive activities cannot be deducted against any other income. Excess losses can be carried forward and used to reduce future passive activity income.

The use of passive losses is phased out over a four year period. In 1989, 80 percent and in 1990 100 percent will be disallowed. The phaseout applies only to activities in which the taxpayer was engaged before TRA 1986 was passed (October 22, 1986). Losses from activities in which the taxpayer became engaged after that data are 100% disallowed.

A passive activity includes:

1. Any trade or business in which the taxpayer does not materially participate. Working interests in oil and gas property are excluded.

2. Any rental activity regardless of whether the taxpayer materially participates (see $25,000 loss allowance).

3. Limited partnership interest.

Material participation occurs when the taxpayer (or the spouse) is involved in the operation of the activity on a regular, continuous, and substantial basis.

Regulations at Sec. 1.469-5T list seven tests for material participation. Meeting any one of these means that the taxpayer materially participates in the activity.

1. The individual participates for more than 500 hours in the taxable year.

2. The individual is the sole participant in the activity for the year.

3. The individual spends more than 100 hours on the activity during the year and no other individual spends more time on the activity than does this individual.

4. The individual spends less than 500 hours in each of several activities (excluding rental activities) but spends more than 500 hours total in all of them and more than 100 hours in each. (The IRS calls these "significant participation" activities, a term which has no legislative history.)

A problem with each of these four tests will be substantiation of the hours spent.

5. A person who has materially participated (by tests 1 through 4) in an activity for five of the past 10 years will be considered a material participant in the current year.

6. An individual who has materially participated in a personal service activity for at least three years will be treated as a material participant for the rest of his/her life.

7. An individual who participates in the activity for 100 hours or more may be treated as a material participant if based on all the facts and circumstances, the person participates on a regular, continuous and substantial basis.

Relative to the facts and circumstances in #7, the regulations set out the following rules:

1. The fact that an individual satisfies a material participation test under another section of the code, such as IRC Sec. 1402 (self-employment tax) or IRC Sec. 2032A (special use valuation) has no bearing on the material participation test for these passive activity rules. **Exception.** If an individual is treated as materially participating under IRC Sec. 2032A(b)(1)(C)(ii) because he or she meets the requirements of IRC Sec. 2032A(b)(4) or (5), the individual is treated as materially participating for purposes of the passive activity rules. Sec. 1.469-5T(h)(2).

   IRC Sec. 2032A(b)(4) treats a retired or disabled farmer as materially participating if he or she materially participated for 5 out of the 8 years preceding retirement or disability. IRC Sec. 2032A(b)(5) treats the surviving spouse of a farmer as materially participating if the farmer met requirements at the time of death and the surviving spouse actively participates in the farm business.

2. Management activities of the taxpayer are not counted if:

   a. Anybody other than the taxpayer is compensated for management services; or

   b. Somebody provides more hours of management services than the taxpayer.

3. If the taxpayer participates 100 hours or less, he or she cannot be treated as materially participating under the facts and circumstances test.

The General Explanation includes the following helpful comments.

> "**Since a limited partner generally is precluded from participating in the partnership's business** if he is to retain his limited liability status, the committee believes it should not be necessary to examine general facts and circumstances regarding material participation in this context. Therefore, under the Act, **a limited partnership interest is treated as intrinsically passive** (except as provided in regulations)."

> "**Material participation** of a taxpayer in an activity is **determined separately for each taxable year.** In most cases, the material participation (or lack thereof) of a taxpayer in an activity is not expected to change from year to year, although there will be circumstances in which it does change."

"An estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating."

The General Explanation also included statements about corporations relative to passive losses.

The types of farm management decisions that may be relevant to material participation if made on a regular, continuous, and substantial basis include: (1) Crop rotation, selection, and pricing, (2) the incursion of embryo transplant or breeding expenses, (3) the purchase, sale, and leasing of capital items such as cropland, animals, machinery and equipment, (4) breeding and mating decisions, (5) selection of herd and crop managers who act on behalf of the taxpayer.

A farmer who receives self-employment income will generally be treated as materially participating even if she/he contributes no physical labor.

Disposal of the entire interest in a passive activity in a taxable disposition, means that losses, including nondeducted losses from prior years from that activity can be deducted against any kind of income.

Aggregation and Separation of Activities

A May 1989 regulation requires separation of activities into four classes (1) Oil and Gas, (2) Rental, (3) Professional Service, and (4) Other trade or business. The intent seems to be to prevent the taxpayer from combining activities in order to circumvent the rules.

Then the regulation tends to combine a taxpayer's interests in similar activities into a single activity. From the taxpayer's standpoint, this will make it difficult to recognize suspended losses upon disposition of one of the sub-activities.

Election to Separate

A taxpayer may make a permanent election to separate undertakings which otherwise would be combined into a single activity (Sec. 1.419-4T(0)). For interests held in 1989, the election must be made with the 1989 return. For interests acquired in future years the election must be made with the return for the year in which the taxpayer acquires interest in the activity.

Real Estate Rental

A special real estate rental rule allows an individual taxpayer (natural person) to use real estate rental activity losses in which he/she actively participates to offset up to $25,000 of nonpassive income. The $25,000 exemption is reduced by 50 percent of the amount by which the taxpayers modified AGI exceeds $100,000. There are special rules for married taxpayers filing separate returns.

Active participation only requires participation in major management decision making and will be much less difficult to establish than material participation. Major management decisions include approving new tenants, selecting rental terms, and approving repairs and capital expenditures. An individual whose interest in the rental activity is less than 10 percent will not qualify as actively participating.

INFORMATIONAL RETURNS

There are no major changes affecting the 1989 filing requirements and penalties associated with informational returns.

Provisions

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. Also used to report direct sales of $5,000 or more of consumer goods for resale. Payments made for nonbusiness services and to corporations are excluded.

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.

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.

A recent IRS letter ruling required a California real estate closer who made payments in excess of $600 to a company providing computer services and termite control for home buyers and sellers, to report the payments on 1099-Misc. The reporting requirement is not imposed on the person who provides the ultimate funding, but on the payer on the check.

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-S - Required for all real estate transactions closings occurring after December 31, 1986. The person responsible for reporting is 1) the person responsible for closing, 2) the mortgagor, 3) the seller's broker, 4) the buyer's broker, or 5) any other person designated by regulation, in this order. Form 1099-B is used by brokers and for barter exchanges.

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

1099-INT - Payer reports interest payments (not interest on an IRA, SEP 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.

8809 - New form to request extension of time to file 1099's, 1098 and others (available January 1990).

Filing Dates and Penalties

The 1099's must be furnished to the person named on the return on or before January 31 and to the IRS on or before February 28. Penalties for failure to file with the IRS and to provide a copy to the payee are consolidated ($50 penalty for each failure). Failure to include all required information is a $5.00 penalty. Additional penalties are imposed for intentional disregard.

Backup Income Tax Withholding still required when payee fails to provide TIN.

THE SOCIAL SECURITY TAX SITUATION AND MANAGEMENT OPPORTUNITIES

Increases in social security (FICA) and self-employment tax rates, and increases in earnings subject to the tax 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 6.67 percent to $48,000 for 1989. Social Security (FICA) rates remained at 7.51 percent for both employers and employees in 1989 and will increase to 7.65 percent in 1990. The maximum combined FICA tax will be $7,209.60, up $451 from last year. Next year the maximum combined FICA tax will be $7,711.

Currently (1989) self-employed individuals pay an effective rate of 13.02 percent (15.02 less 2.0 credit) that will generate a maximum of $6,249.60 self-employment tax. This is an increase of $391 over 1988.

Social Security Tax Table

Year	Earnings Base	FICA Tax Rate		Self-Employment Tax		
		Employer	Employee	Specified Rate	Credit	Effective Rate
1988	45,000	7.51	7.51	15.02	2.0	13.02
1989	48,000	7.51	7.51	15.02	2.0	13.02
1990	50,400	7.65	7.65	15.3	0.0	15.3
1991	*	7.65	7.65	15.3	0.0	15.3

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

Beginning in 1990, the credit against the self-employment tax will be discontinued. 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. Taxpayers in the 15 percent marginal income tax bracket will receive the greater deduction from the second alterntive. Once taxable income reaches the 28 percent bracket the first alternative or taxable income deduction is greater. The taxable income deduction will be greater than the current two percent credit when taxpayers reach the 28 percent bracket.

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 1989 is computed on the first $48,000 of net earnings from the trade or business. Low income farmers may use the optional method and report up to $1,600 of self-employment income when net income is less than $1,600. Nonfarmers have a similar option.

Wage Payment to Spouse/Children Changed by RA 1987

Cash wages earned by a person employed by his or her spouse were subject to Social Security coverage and FICA taxes beginning January 1, 1988. Cash wages paid to individuals 18 years old and over working for their parent(s) are also subject to FICA taxes.

Farm employers must pay Social Security on their employees if they pay more than $2,500 to all agricultural labor during the year. This $2,500 rule replaces the old $150 test if the annual payroll exceeds $2,500. The $150 test is still in effect for payrolls of $2,500 or less (i.e., any employee receiving $150 or more of cash wages is subject to Social Security even if the total cash payroll is less than $2,500). All employees are covered if the annual cash payroll exceeds $2,500. Seasonal farm piece work labor is exempt from the $2,500 rule providing the employee is a hand harvester, commutes to the job daily from a permanent residence, and has been employed in agriculture less that 13 weeks in the prior year. The old 20 days test has been eliminated.

The new law eliminates most of the tax management incentives formerly associated with paying cash wages to family members. One remaining incentive is that an individual employed by their spouse can use his or her salary to buy an IRA that may reduce the current total marginal tax rate more than 15 percent. Remember however, deductible IRA contributions are taxed when distributed.

Social Security coverage has also been extended to a parent employed for domestic service by a son or daughter who has dependents under 18 or incapacitated dependents. Director's fees are now income when services are rendered not when paid or received. This will prevent postponement of payment until age 70 (Section 1402(a)).

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, livestock and other commodities are not subject to FICA tax and as they are payments received as employees, they are not subject to self-employment tax. This technique could be used for paying the spouse, for children who are working on the farm but are over age 18 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, and (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 a private letter ruling IRS said the payment of wages with milk was not subject to the FICA tax, even though the employee chose the same milk market and milk hauler as the employer. IRS has also allowed wages to be paid with grain, calves and the services provided for livestock care. Not all of these types of rulings have favored the taxpayer. If the IRS disallows a non-cash payment, the employer will have to pay the full FICA tax.

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. one-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 but living together, and $25,000 for all others.)

Example: Joe and Mary Retiree received $8,400 in social security benefits.

One half of S.S. benefits received (joint return)	$ 4,200	Tax exempt interest	3,000
AGI (without soc. sec.)	26,500	Base amount	32,000

Calculation: $26,500 + 3,000 + 4,200 = $33,700;
$33,700 - $32,000 = $1,700; ÷ 2 = $850.
Include $850 since it is less than $4,200.

Reduction of Benefits

Farmers and other self-employed taxpayers and wage earners will have their social security benefits reduced if they exceed the earnings limit. When a person's wage and self-employment earnings exceed the earnings limit, his or her social security benefits are reduced by 50 percent of the excess earnings.

Reduction of Benefits for Self-Employed & Wage Earners

Age (years)	1989 Earnings Limit	Reduction of Social Security Benefits
Less than 65	$6,480	.50 of excess earnings
65 to 70	8,800	.50 of excess earnings
70 and over	0	none

The earnings limit is calculated on an annual basis except in the year of retirement it is calculated on a monthly basis. In the year the individual reaches age 70 the earnings in the part of the year prior to the birthday are used in calculating an earnings limit for that part of the year only.

Total wages and self-employment income are included as earnings. Some farm receipts are excluded from self-employment income. A special provision [26 CFR Sec. 404-429] appears to exclude from the earnings limit; cattle (held for sale), grain, fruit and other crops held over and sold in the year or years following retirement. This income is not excluded from income subject to self-employment tax. Dairy Termination Program payments received from the CCC are included as earnings.

Eligibility for Benefits

Two different tests are used to determine 1) when an individual retires and becomes eligible for social security retirement benefits, and 2) whether a person has self-employment income after retirement that will reduce benefits.

The "substantial services" test is used to determine if and when an individual retires and is eligible for benefits. An individual will not be considered retired if he or she is providing substantial services. Time, nature of services, prior services, presence of paid management, type of business and capital invested are factors considered.

The material participation test is used to determine if the retiree is receiving self-employment income. In general, rental income from real estate and personal property leased with the real estate, including crop shares, do not constitute self-employment income. If there is an arrangement for the retired owner to provide labor and management services, there is material participation.

INDIVIDUAL RETIREMENT ARRANGEMENTS

Rules for 1987 and later years reduce or eliminate the deduction that some taxpayers may take for IRA contributions. The limits on contributions generally are the same as they were in 1986. In other words, each taxpayer may contribute the lesser of $2,000 or earned income to an IRA. However, in the situation where either the taxpayer or the spouse is an active participant in an employer retirement plan and adjusted gross income is above prescribed levels, the amount that may be deducted is partially or wholly eliminated. The 1986 law created an unintended incentive for married couples to file separate returns to increase their IRA deduction. TAMRA '88 closed this loophole effective for tax years beginning after 1987 for married taxpayers who lived together anytime during the year. If they did not live together, each is treated as an unmarried taxpayer.

If non-deductible contributions are made, the earnings on the non-deductible part of the IRA will accumulate on a tax-deferred basis. The complications introduced by having an IRA with two different types of tax treatment when withdrawals are made in later years may make taxpayers reluctant to make non-deductible contributions to an IRA. Also, the requirement to file Form 8606 in the year the nondeductible contributions are made discourage such contributions.

IRA deductions are phased out for taxpayers covered by an employer's retirement plan with AGI's (computed without the IRA deduction) in the following ranges:

Filing Status	Deduction is reduced if AGI is within the phaseout range of
Single or head of household	$25,000 - 35,000
Married, joint return or qualifying widow(er)	40,000 - 50,000
Married, separate return	0 - 10,000

If AGI is above the top end of the range, no deduction for an IRA contribution can be taken.

Any taxpayer with AGI above the minimum level for phaseout must determine whether he, she, or the spouse is covered by an employer retirement plan. W-2's issued at the end of 1989 will have a "Pension Plan" box to be checked by the employer. Coverage under either Social Security or Railroad Retirement is not considered to be an employer retirement plan. A Keogh or SEP is an employer plan. A person receiving benefits from a previous employer's plan is not an active participant in that employer's plan.

Within the phaseout range the "partial deduction" is calculated by subtracting AGI from the top of the range and multiplying the result by 20 percent.

Example: Married, filing jointly; AGI = $46,000.

$50,000 - 46,000 = $4,000 of AGI qualified for partial deduction
$4,000 x .20 = $800 = allowable deduction

The deduction is rounded upward to the nearest $10. If the computed deduction is greater than zero but less than $200, a $200 deduction is allowed. On a joint return each spouse is allowed a deduction of the computed amount (assuming earned income of each is at least that much). However, if one spouse contributed less than the allowed amount, the other spouse is not permitted to deduct the amount unused by the first spouse.

Announcement 88-38 provides a method by which certain taxpayers receiving social security benefits are to calculate the IRA deduction limits.

Spousal IRA's

Prior to 1987 a spouse with earned income of any amount was prevented from having a spousal IRA and was limited to an IRA deduction based on his/her own earned income. This prevented spouses with $1 or more but less than $250 of earned income from taking advantage of the $250 spousal IRA. In 1987 and later, a spousal IRA may be created for spouses with less than $250 of earned income.

Spousal IRA's are subject to the phaseout rules. The partial deduction is computed as in the previous example and the resulting amount is deductible by the working spouse. Then a second partial deduction is computed using a factor of 0.225. The difference between this result and the first result may be deducted for the spousal IRA.

Example: $4,000 of AGI qualified for partial deduction x .225 = $900.

The deduction for the working spouse would be $800 and the remaining $100 would be deductible for the non-working spouse. Not more than $800 could be contributed to either IRA.

Distributions from Deductible and Non-Deductible IRA's

A taxpayer who has both deductible and non-deductible contributions in an IRA will have distributions that are taxable (from the deductible portion and earnings on both the deductible and non-deductible portions) and non-taxable (from the non-deductible portion). Non-deductible contributions to IRA's must be reported on Form 8606 "Non-deductible IRA Contributions, IRA basis, and Non-Taxable IRA Distributions". If non-deductible contributions are not reported, at the time of distribution all withdrawals will be treated as taxable.

Simplified Employee Pensions

The maximum amount that may be contributed to a SEP is the lesser of $30,000 or 15 percent of the employee's compensation.

Some employees can elect to make contributions to the SEP through a salary reduction program. If the employee elects to make the contribution to the SEP, it is not included in the employee's taxable income but it is included in wages for self-employment tax purposes. In 1989 the maximum amount that may be contributed to the SEP in this manner (on a tax deferred basis) is the lesser of (1) 15% compensation or (2) approximately $7,600. Such plans have a number of limitations. One is that the employer maintaining the plan must have had no more than 25 employees in the previous taxable year. Another is that at least 50 percent of the employees must choose to contribute to SEP-IRAs.

Employer contributions and the elective deferrals under a SEP are excludable from the employee's gross income, rather than being treated as a deduction by the employee.

NEW YORK STATE INCOME TAX

New York passed two tax laws in 1987 to reduce the tax windfall that the State would have received as a result of the Federal Tax Reform Act of 1986. The Tax Reform and Reduction Act of 1987 (NYTRRA 1987) was signed by the Governor in April and the Business Tax Reform and Rate Reduction Act of 1987 (BTRA 1987) was signed in August. NYTRRA included many changes that affect the tax bills of individuals, including most farmers. BTRA 1987 primarily affects the corporate tax but includes an important provision relative to investment credit for individuals.

NYTRRA 1987 largely accepted the changes in TRA 1986 relative to the elimination of the capital gain exclusion, limitations on itemized deduction, etc. It reduces the tax windfall primarily by gradually lowering rates and increasing the standard deduction and personal exemption between 1987 and 1991. There are many other changes, some of which are phased in and others that were fully effective in 1987.

Exemptions and Standard Deductions

The standard deductions are increased gradually between 1987 and 1990 while the exemption increased to $1,000 in 1988 and will remain at that level.

Year	1986	1987	1988	1989	1990
	Standard Deduction ($)				
Tax Status:					
Joint	3,000	5,300	8,500	9,500	13,000
Single	2,600	3,600	5,000	6,000	7,500
Head of household	3,000	4,600	6,000	7,000	10,500
Married filing separately	1,000	2,650	4,250	4,750	6,500
	Exemption ($)				
	850	900	1,000	1,000	1,000

Married persons filing separately each will receive one-half of the joint standard deduction. The standard deduction of a dependent individual whose federal exemption is zero is $2,800 in 1987-89 and $3,000 in 1990 and later.

Beginning in 1988, an exemption is not counted for either the filer or the spouse. This makes the increase in the standard deduction from 1987 to 1988 somewhat misleading. Most of the increase is offset by the loss of one exemption for a single filer and two exemptions for joint filers.

Itemized Deductions

For taxpayers who filed joint federal returns but are required to file separate New York returns, itemized deductions will be divided between them as if their federal taxable incomes had been determined separately. <u>Taxpayers who do not itemize deduction on their federal returns may not itemize on their N.Y.S. returns</u>.

In 1988 and later years itemized deductions of higher-income taxpayers are subject to limitations. Itemized deductions are reduced by the sum of two percentages:

1. In 1989 and later, the first percentage is 25 percent of a ratio which depends on the taxpayer's filing status:

Filing Status	Numerator = Lessor of $50,000 or the excess of NYAGI over:	Denominator
Married filing jointly	$200,000	$50,000
Single and married filing separately	$100,000	$50,000
Head of household	$150,000	$50,000

Example of first percentage (married, joint return): NYAGI = $225,000

$25,000 ($50,000 = .5; .5 x 25% = 12.5%

2. In 1989 and later years the second percentage is 25 percent of a ratio, the numerator of which is the lesser of $50,000 or the excess of NYAGI over $475,000 and the denominator of which is $50,000.

Example of second percentage: NYAGI = $550,000

$550,000 - $475,000 = $75,000; $50,000 is lesser.

$50,000 ($50,000 = 1.0; 1.0 x 25% = 25%

This taxpayer whould also be subject to the full 25% from the first calculation so the total reduction in itemized deductions would be 50%.

Rates

There are now three separate rate tables for (1) married filing jointly and qualifying widow(er)s, (2) single, married filing separately, and estates and trusts and (3) heads of households. Filing status will conform to federal status except that when the New York resident status of spouses differs, separate returns must be filed.

The law is written in terms of the rates to be in effect at the end of the phase-in period which will be 1991. Rates for that year are:

New York State Tax Rates, 1991

Filing Status	New York Taxable Income	Rate
Married filing jointly & surviving spouse	Not over $27,000	5.5%
	Over $27,000	7.0
Single, married filing separately estates & trusts	Not over $12,500	5.5
	Over $12,500	7.0
Head of household	Not over $19,500	5.5
	Over $19,500	7.0

However, there is a gradual phase-in. The rates for 1989 are on the next page.

Married Filing Jointly and Qualifying Widow(er)

If the New York taxable income is:

Over	Not Over	Tax
$ 0	$11,000	4% of the excess over $ 0
11,000	16,000	$ 440 plus 5% " " " " 11,000
16,000	22,000	690 plus 6% " " " " 16,000
22,000	26,000	1,050 plus 7% " " " " 22,000
26,000		1,330 plus 7.875% " " " 26,000

Single, Married Filing Separately and Estates and Trusts

If the New York taxable income is:

Over	Not Over	Tax
$ 0	$ 5,500	4% of the excess over $ 0
5,500	8,000	$220 plus 5% " " " " 5,500
8,000	11,000	345 plus 6% " " " " 8,000
11,000	13,000	525 plus 7% " " " " 11,000
13,000		665 plus 7.875% " " " 13,000

Head of Household

If the New York taxable income is:

Over	Not Over	Tax
$ 0	$ 7,500	4% of the excess over $ 0
7,500	11,000	$ 300 plus 5% " " " " 7,500
11,000	15,000	475 plus 6% " " " " 11,000
15,000	17,000	715 plus 7% " " " " 15,000
17,000		855 plus 7.875% " " " 17,000

In 1987 and 1988 there was a tax on part or all of the unearned income of individuals with a New York AGI exceeding $100,000 ($50,000 for married taxpayers filing separately and estates and trusts). In 1989, this tax is gone.

Household Credit

Single taxpayers with household gross income up to $28,000 and all other taxpayers with income up to $32,000 qualify for a household credit providing they cannot be claimed as a dependent on another taxpayer's return. Household gross income is <u>federal adjusted gross income</u> (total for both spouses if separate returns are filed).

In 1989 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 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

The tax credit computations and limits are the same for 1989 as for 1988. 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 who elect to include the exempt amount of 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, 1989

		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

Pass and Tuition Deduction

The tuition deduction for higher education was eliminated for tax years beginning after 1988. Contributions to PASS were eliminated after 1987.

Spousal IRA's Allowed

A spousal IRA deduction claimed on a joint federal return is allowed on the New York return. If separate returns are filed, 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.

Solar and Wind Energy Credit Carryover

New York State Solar and Wind Energy Credit amounting to 55 percent or qualified costs up to $2,750 of credit, was available to homeowners through 1986. The carryover credit is claimed by filing Form IT-218.1.

Other Credits

Other New York personal income tax credits include resident credit for income taxes paid to other states, accumulation distribution credit, investment credit, mortgage recording tax credit, and economic development zone credit.

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 or MACRS 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.

   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 is Four Percent Beginning in 1987

The credit for individuals is four percent (five percent for corporations) on qualified tangible personal property acquired, constructed, reconstructed or erected on or after January 1, 1987. For corporations, the rate in 1989 is five percent on the first $500,000,000 of investment credit base and four percent on any excess. MACRS property placed in service after December 31, 1986 qualifies for NYIC. This means that farm property in the ACRS or MACRS 3-year class should qualify. There is no reduction in the amount of credit allowed for 3-year property and if kept in use for three years it will earn four percent NYIC. The fact that pickups are now 5-year MACRS property will not change the disallowance of NYIC for farmers.

Five-year ACRS or MACRS property that qualifies for NYIC earns full credit after five years, even if a longer straight line option is elected. Ten year ACRS property and 15, 18, and 19-year ACRS real property also earn full NYIC after five years of qualified use. The same is true of 7, 10, 15, and 20-year MACRS property. Non-ACRS/MACRS properties that qualify for NYIC must still be held 12 years.

Excess or unused credit may be carried over to future tax years but the carryforward period is limited to seven 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 minimums ($325, $425, $800 and $1,500 depending on the size of the corporation).

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.

The primary item that triggered New York minimum tax for farmers was the 60 percent capital gain exclusion. With the elimination of the exclusion, few New York farmers will pay minimum tax.

Payment of New York State Income Taxes Withheld and Informational Returns

Income tax withholding is not mandatory for agricultural employees in 1989. Withholding for agricultural employees subject to social security is required for cash wages paid after December 31, 1989. An employer who expects to withhold $200 or more but less than $800 semiannually is required to file and deposit the tax on July 31 and January 31. Annual returns are required if the employer expects to withhold less than $200 semiannually or if withholding is not required. 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.

Other Agricultural Economics Extension Publications

No. 89-23	Milk Production Records for Management Control	S. Telega G. Hutt
No. 89-24	Farm Management Planner	G. Hutt S. Telega
No. 89-25	Management Control Clinic	G. Hutt J. Kauffman III R. Milligan
No. 89-26	Cornell Cooperative Extension Farm Business Management Program Guidelines, Suggestions and Resources	S. Smith W. Knoblauch G. White
No. 89-27	Budgeting Data for Limited Resource Dairy Farms, New York	R. Murray-Prior B. F. Stanton
No. 89-28	Milk Quality, A Pro-Dairy Management Focus Workshop for Farm Managers -- A Facilitator's Manual	R. A. Milligan
No. 89-29	Milk Quality, A Pro-Dairy Management Focus Workshop for Farm Managers -- A Participant's Guide	R. A. Milligan
No. 89-30	The Economics of Yard Waste Composting in Westchester County, New York	S. Sherman
No. 89-31	Feeding Management: A Pro-Dairy Management Focus Workshop for Dairy Farm Managers, Teacher's Manual	L. Chase G. Bigger J. Conway
No. 89-32	Feeding Management: A Pro-Dairy Management Focus Workshop for Dairy Farm Managers, Participant's Manual	L. Chase G. Bigger J. Conway
No. 89-33	1988 Northeast Beef Farm Business Summary	C. Rasmussen S. Smith D. G. Fox