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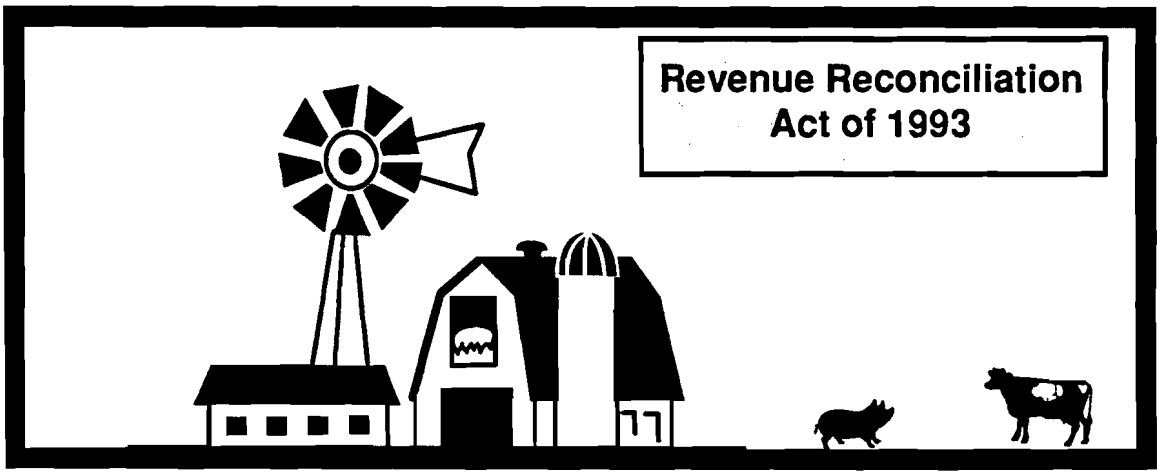
FARM INCOME TAX MANAGEMENT AND REPORTING

Reference Manual



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PERSONAL INCOME TAX PROVISIONS OF THE REVENUE RECONCILIATION ACT OF 1993

Here are some of the most important provisions. Not every item in the 1993 Act is covered here.

Rates

A 36 percent bracket is added beginning January 1, 1993. This rate applies to taxable income in excess of:

$140,000 for married individuals filing jointly and surviving spouses
127,500 for heads of households
115,000 for single individuals
70,000 for married individuals filing separately
5,500 for estates and trusts.

The brackets will be indexed for inflation for tax years beginning after 1994.

The taxpayer may elect to pay the added 1993 tax due to the new rate in three equal installments. The first installment must be paid by the due date of the 1993 return; the second payment, one year later; and the third, two years later. The election does not apply to estates and trusts. You will need to study the "fine print".

High-Income Surtax

A 10 percent surtax applies to taxable income above $250,000 which creates a rate of 39.6 percent. For married individuals filing separately, the threshold is $125,000. For estates and trusts, the threshold is $7,500. The surtax is effective for tax years beginning after 1992. The surtax does not apply to capital gain income tax at 28 percent. The brackets will be indexed for inflation for tax years beginning after 1994.

Alternative Minimum Tax Rates Increased for Individuals

Effective for tax years beginning after 1992, a 26 percent rate will apply to the first $175,000 of AMTI in excess of the exemption amount and a 28 percent rate to AMTI above $175,000. For married individuals filing separately, the 28 percent rate will apply to AMTI above $87,500. The exemption amounts were increased to $45,000 for joint returns, $33,750 for unmarried individuals, and $22,500 for married individuals filing separately and estates and trusts.

Taxation of 85 Percent of Social Security and Tier 1 Railroad Retirement Benefits

Beginning in 1994, this provision applies to single taxpayers with provisional incomes above $34,000 and married taxpayers filing jointly with provisional incomes above $44,000. The rules are incredibly complicated. Provisional income is modified AGI plus 50 percent of SS or TlRR benefits. (Hereafter, read SS to include TlRR benefits.) Modified AGI is AGI plus tax-exempt interest plus certain foreign source income.

For taxpayers with provisional incomes above the new thresholds, gross income includes the lesser of:

1. 85 percent of the taxpayer's SS benefit or
2. the sum of 85 percent of the excess of the taxpayer's provisional income above the applicable threshold amount plus the smaller of:

a. the amount of SS benefit included under previous law or
b. $4,500 ($6,000 for married taxpayers filing jointly).

For married taxpayers filing separately, gross income will include the lesser of 85 percent of SS benefits or 85 percent of provisional income. (In other words, the threshold is $0.)

Additional revenue from this provision will be transferred to the Medicare Hospital Insurance Trust Fund.

Example 1: A and B Taxpayers have the following 1994 income:

Taxable interest and dividends	$9,000
Tax-exempt interest	6,000
Social security benefits	16,000
Taxable pensions	30,000

Provisional income = $9,000 + 6,000 + 30,000 + (1/2 x 16,000) = $53,000. Taxable portion of SS benefits is the lesser of:

1. 85 percent of $16,000 SS benefits = $13,600; or
2. the sum of 85 percent of the excess of $53,000 over $44,000, which is $9,000 x .85 = $7,650 plus the smaller of:

   a. 1/2 of $16,000 = $8,000 or
   b. $6,000.

   So 2.a. = $7,650 + 8,000 = $15,650;
      2.b. = $7,650 + 6,000 = $13,650.

Therefore, the SS benefit included in gross income = $13,600, which is the smallest of 1, 2.a. or 2.b.

Example 2: Same as Example 1 except that the taxable pensions, taxable interest and dividends, and tax-exempt interest each are $2,000 less.

Provisional income = $7,000 + 4,000 + 28,000 + 8,000 = $47,000. Taxable portion of SS benefits is the lesser of:

1. 85 percent of $16,000 SS benefits = $13,600 or
2. the sum of 85 percent of the excess of $47,000 over 44,000, which is $3,000 x .85 = $2,550 plus the smaller of:

   a. 1/2 of $16,000 = $8,000; or
   b. $6,000.

   So 2.a. = $2,550 + 8,000 = $10,550;
      2.b. = $2,550 + 6,000 = $8,550.

Therefore, the SS benefit included in gross income = $8,550, which is the smallest of 1, 2.a. or 2.b.

Medicare Cap Repealed

Beginning in 1994, all wages and self-employment income are subject to the 2.9 percent Medicare tax.

Estimated Tax

For tax years **beginning after 1993**, persons whose AGI for the preceding tax year exceeds $150,000 ($75,000 if married filing separately) will be able to use the "safe harbor" by paying 110 rather than 100 percent of the preceding year's tax.

Health Insurance Deduction for Self-Employed

The 25 percent deduction was extended retroactively from July 1, 1992 and is effective through 1993. Amended returns will be required to obtain the deduction for the last half of 1992. The determination of whether self-employed individuals or their spouses are eligible for employer-paid health benefits will be made on a monthly basis for 1993.

Earned Income Credit Simplified and Expanded

For 1993, the earned income credit is based on prior law. The calculations, credit rate, and phaseout provisions are different from 1992, but the differences were provided for in prior law. See page 16 for 1993 EIC information.

Beginning in 1994, the supplemental young child credit and the health insurance credit will be eliminated and the other provisions substantially modified. For taxpayers with one qualifying child, the EIC is 26.3 percent of the first $7,750 of earned income. The maximum credit is $2,038 and is reduced by 15.98 percent of earned income (or AGI, if greater) exceeding $11,000. For taxpayers with two or more qualifying children, the EIC is 30 percent of the first $8,425 of earned income. The maximum credit is $2,527 and is reduced by 17.68 percent of earned income (or AGI, if greater) exceeding $11,000.

In 1995, the credit percents are increased to 34 percent for one child and 36 percent (40 percent in 1996 and later) for more than one child. The earnings levels for maximum credit will be reduced in 1995 but indexed for inflation. The phaseout rates also will be modified.

It will be possible for some low-income taxpayers to be eligible for EIC even though that taxpayer doesn't have a qualifying child. To be eligible, such a taxpayer would have to be 25 or more, but under 65, years of age and cannot be claimed as a dependent for any taxable year beginning in the same calendar year as the taxable year for which the credit is being claimed. The credit percentage will be much lower (7.65 percent). Watch for more information about EIC.

Estate and Gift Tax Rates

The two top estate and gift tax rates (53 and 55 percent) that expired December 31, 1992 have been reinstated as if they had never expired.

Limitation on Itemized Deductions

This provision, that was to have expired at the end of 1996, has been made permanent.

Alternative Minimum Tax Treatment of Contributions of Appreciated Property

The difference between fair market value and the adjusted basis of appreciated capital gain and 1231 property contributed to charitable organizations will not be a tax preference item for AMT purposes after June 30, 1992 for tangible personal

property and after December 31, 1992 for real property and intangible property. The tangible personal property provision really is an extension of the provision that previously had been terminated as of June 30, 1992. The real and intangible property provisions are new and do not apply to carryovers for contributions made before the effective date. Contributions of inventory or other ordinary income property, short-term capital gain property, and certain gifts to private foundations are not affected by these provisions.

The Treasury must report to Congress not later than one year after enactment on the development of an advance valuation procedure.

Substantiation and Disclosure Requirements in Regard to Charitable Contributions

Effective for contributions made after December 31, 1993 a new set of rules will apply to separate contributions of $250 or more. The rules are rather complicated and not fully covered here. For noncash contributions, the taxpayer must obtain from the charity a receipt that describes the donated property and indicates whether anything was given to the taxpayer in exchange. For cash contributions, a taxpayer cannot rely solely on a canceled check but needs substantiation from the charity.

For contributions exceeding $75 where the taxpayer receives something in exchange (such as a dinner), the charity must provide a statement to the taxpayer that informs the donor that the value of the contribution that is deductible is the difference between the contribution and the value of the goods or services received by the taxpayer. Also, the charity must provide the donor with a good-faith estimate of the value of whatever the charity gave to the donor.

Moving Expenses Deduction Limited

For expenses incurred after December 31, 1993, moving expenses are defined as the reasonable costs of (1) moving household goods and personal effects from the former residence to the new residence, and (2) travel, including lodging during the period of travel, from the former residence to the new place of residence. Meal expenses are no longer included. The new place of work must be at least 50 (rather than the old 35) miles farther from the taxpayer's former residence than was the old place of work. The deduction will be subtracted from gross income in arriving at AGI.

Some expenses currently allowed as moving expenses won't be in 1994 and later: selling and buying expenses on the old and new residences, meals while traveling or living in temporary quarters near the new place of work, cost of pre-move house hunting, and cost of temporary living expenses for up to 30 days at the new job location.

Qualified moving expenses reimbursed by an employer are excludable from gross income to the extent they meet the requirements of qualified moving expense reimbursement (which appears to be the new definition of deductible moving expenses as described above).

Disaster Loss Relief on Residences

Property involuntarily converted as a result of disasters for which a Presidential declaration is made on or after September 1, 1991 qualifies for special tax treatment of insurance proceeds. No gain is recognized on insurance proceeds for personal property in a residence if the property was not scheduled under the insurance policy.

Other insurance received for the residence or contents may be treated as a common pool. If the funds are used to purchase property similar to the converted residence or contents, the taxpayer may elect to recognize gain only to the extent that the pool of funds exceeds the cost of the replacement property.

The replacement period is extended to four years after the close of the first taxable year in which any part of the conversion gain is realized. The property must have been located in an area that warranted federal assistance under the Disaster Relief and Emergency Assistance Act. Renters qualify to the extent that the residence would qualify as their principal residence if they owned it.

Treatment of Net Capital Gains as Investment Income

For taxable years beginning after December 31, 1992, net capital gain from disposition of property held for investment is not included in investment income for purposes of computing the investment income limitation. The taxpayer may elect to include net capital gain in investment income if he also reduces the amount of capital gain eligible for 28 percent maximum rate by the same amount.

Limitation on Compensation for Retirement Plan Calculations

For years beginning after 1993, the maximum amount of compensation that can be taken into account under qualified retirement plans, SEPs, etc., is lowered to $150,000, down from $200,000 (actually $235,840 in 1993 when adjusted for inflation). The $150,000 will be adjusted for inflation after 1994 but only in increments of $10,000. That is, if the adjustment for the year calculates to less than $10,000, no adjustment will be made. Transition rules apply to governmental plans and plans maintained under a collective bargaining agreement.

Employer-Provided Education Assistance

The exclusion from gross income of up to $5,250 of employer-provided education assistance that qualifies under Code Sec. 127 was extended retroactively from June 30, 1992 through December 31, 1994. Assistance that does not meet Sec. 127 requirements may still qualify for exclusion if it qualifies as a working condition fringe benefit under Sec. 132. This provision applies to taxable years beginning after 1988.

Tax Credits for Contributions to Community Development Corporations

Taxpayers can receive a credit for qualified cash contributions to community development corporations (CDCs) selected by the secretary of HUD. The credit of 5 percent of the contribution (which could be a loan as well as a gift) may be claimed each year for ten years for a total credit of 50 percent. The provision is effective on the date of enactment, which is August 10, 1993.

Other

There are new provisions dealing with recharacterization of capital gain as ordinary income for "conversion transactions," treatment of market discounts on bonds as ordinary income, and treatment of stripped stock. These provisions are effective after April 30, 1993.

BUSINESS PROVISIONS IN THE REVENUE RECONCILIATION ACT OF 1993

Section 179 Election

For property placed in service in taxable years beginning after December 31, 1992, the Section 179 expensing election has been increased from $10,000 to $17,500.

Depreciation of Nonresidential Real Estate

For nonresidential real estate placed in service on or after May 13, 1993, the recovery period is increased from 31.5 to 39 years. The AMT recovery period remains at 40 years. The 39-year recovery period does not apply to property placed in service before 1994 if there was a binding contract before May 13, 1993 or construction had started before that date.

Tax Credits

The targeted jobs tax credit is extended for individuals who began work after June 30, 1992 and before January 1, 1995. The research tax credit was extended for three years, that is, from July 1, 1992 through June 30, 1995. The fixed-base percentage used to compute a start-up company's base amount has been modified for the company's sixth through tenth years. This provision applies to tax years beginning after 1993.

Low-Income Housing Credit

The low-income housing credit which expired on June 30, 1992 has been permanently extended. Many modifications were made in the provisions related to this credit.

Amortization of Goodwill and Purchased Intangibles

New Code Sec. 197 allows 15-year amortization of goodwill and other purchased intangibles acquired after August 10, 1993. In some situations, the taxpayer may elect to amortize intangibles acquired after July 25, 1991. You will need to study Sec. 197, which is too long and complicated to cover here.

Denial of Deduction for Travel Expenses of Spouse and Dependents

Effective for amounts paid after December 31, 1993, business trip expenses for a spouse, dependent or other individual are not deductible unless the person is an employee of the person paying or reimbursing the expenses, the travel is for a *bona fide* business purpose, and the expenses for the spouse, dependent or other individual would otherwise be deductible.

Business Meals and Entertainment

For taxable years beginning after 1993, the deductible portion of meal and entertainment expenses paid in connection with a trade or business is reduced from 80 to 50 percent.

Club Dues Deduction

For taxable years beginning after 1993, no deduction is allowed for club dues for any kind of club, including airline and hotel clubs. Specific business

expenses such as meals incurred at a club are deductible only to the extent they satisfy standards for deductibility as business expenses.

Executive Pay Over $1 Million (Code Sec. 162).

In general, the deduction for compensation of an employee of a publicly-held corporation is limited to $1 million per year beginning in 1994. There are several exceptions and lots of rules.

Discharge of Indebtedness

Additional tax attributes are added to the list of those that are reduced in the case of discharge of indebtedness in taxable years beginning after 1993 that is excludable income under Sec. 108(a)(1). The attributes are (1) the minimum tax credits as of the beginning of the tax year immediately after the taxable year of the discharge, and (2) passive activity losses and credit carryovers from the taxable year of the discharge.

Business Tax Credit for Social Security Tax on Tips

Effective for taxes paid after 1993, employers in food or beverage establishments may receive a tax credit (as part of the general business credit) for the employer's 7.65 percent FICA obligation attributable to reported tips in excess of those treated as wages for the purpose of satisfying minimum wage provisions. To prevent a double benefit, no deduction is allowed for any amount used in determining the credit. Read the fine print.

Election to Exclude Cancelled Debt on Real Estate from Income

Taxpayers other than C corporations may elect to exclude from income certain income from the discharge of qualified real property business indebtedness (not including qualified farm indebtedness). The amount excluded may not exceed the adjusted basis of the taxpayer's depreciable real estate and is applied to reduce the basis of the taxpayer's depreciable property. Also, the amount excluded may not exceed the excess of the debt on the property over the fair market value of the property. The provision applies to discharges after 1992. Indebtedness incurred or assumed after 1992 is not qualified unless (1) it is debt incurred to refinance debt incurred or assumed before that date, or (2) it is qualified acquisition indebtedness. The code states that the provision does not apply to a discharge to the extent the taxpayer is insolvent (i.e., it is a solvent debtor provision). If you have a case like this, you will need to study the code and regulations.

Rental Real Estate Passive Losses

Taxpayers in the real property business will not be subject to the passive activity loss (PAL) rules for losses from rental real estate for tax years beginning after December 31, 1993. An individual taxpayer will not be subject to the PAL rules for a taxable year when (1) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. In the case of a joint return, the requirements of the preceding sentence are satisfied if and only if either spouse separately satisfies such requirements.

In the case of a closely-held C corporation, the requirements for not being subject to the PAL rules shall be treated as met for any taxable year if more than 50 percent of the gross receipts of such corporation for such taxable year are derived from real property trades or businesses in which the corporation materially participates.

Lobbying Expenses

For amounts paid or incurred after 1993, lobbying expenses (to influence federal or state legislators or federal executive branch employees) are not deductible as ordinary and necessary business expenses. Provisions are long and complicated.

Withholding on Supplemental Wage Payments

For payments made after 1993, the withholding rate on bonuses, commissions, and overtime pay that are not paid concurrently with wages (or are stated separately if paid concurrently with wages) will be 28 percent.

Other

Substantial changes were made in the treatment of certain partnership liquidation payments (effective January 5, 1993). The definition of substantially appreciated inventory was changed for transactions after April 30, 1993. The market-to-market rules for dealers in securities was changed effective for taxable years ending on or after December 31, 1993. Nine empowerment zones and 95 enterprise zones with special tax incentives will be created in 1994-95 in distressed urban and rural areas.

INVESTMENT INCENTIVES IN THE REVENUE RECONCILIATION ACT OF 1993

Capital Gains Exclusion for Small Business Stock (Sec. 1202)

This provision permits a noncorporate taxpayer who holds qualified small business stock for more than five years to exclude from income 50 percent of any gain on the sale or exchange of the stock. Gain eligible for exclusion is limited to the greater of (1) 10 times the taxpayer's basis in the stock, or (2) $10 million gain from stock in that corporation. Many pages of rules govern this provision and there will be lots of regulations. The provision applies to stock issued after August 10, 1993. Tax returns will not be affected until 1998.

Rollover of Gain into Specialized Small Business Investment Companies (SSBIC)

Any C corporation or individual is permitted to rollover without payment of tax any capital gain on the sale of publicly traded securities where the proceeds are used to purchase common stock or a partnership interest in a SSBIC within 60 days. An SSBIC is any partnership or corporation that is licensed by the Small Business Administration under Sec. 301(d) of the Small Business Investment Act of 1958 as in effect on May 13, 1993. The provision is effective for sales after August 10, 1993. There is a limit on how much gain can be rolled over each year.

Extension of Qualified Small-Issue Bonds and Qualified Mortgage Bonds

The authority of state and local governments to issue private activity bonds (Code Sec. 144) and qualified mortgage bonds for housing (Code Sec. 143), which expired on June 30, 1992, has been extended permanently. There is some fine print.

CORPORATION PROVISIONS IN THE REVENUE RECONCILIATION ACT OF 1993

Corporate Tax Rates

For taxable years beginning on or after January 1, 1993, there is a 35 percent rate on taxable income exceeding $10 million. A corporation with taxable income exceeding $15 million is required to increase its tax liability by the lesser of 3 percent of the excess or $100,000 to recapture the benefit of the 34 percent rate.

Estimated Tax Payments

For taxable years beginning after 1993, a corporation that bases its estimated tax on the current year's tax is required to make estimated tax payments equal to 100 percent of the tax shown on its return for the current year. Corporations may continue to pay estimated tax based on 100 percent of last year's tax. There is a modification of the income annualization rules for estimated tax purposes.

Other

For property placed in service after 1993, there is a provision simplifying AMT depreciation for corporations. The AMT foreign tax credit rules were modified for tax years beginning after 1993.

COMPLIANCE AND ADMINISTRATION PROVISIONS IN THE REVENUE RECONCILIATION ACT OF 1993

Information Returns for Payments for Services to Corporations

A proposal to require information returns for payments exceeding $600 for services to corporations was included in the House bill. The Conference Agreement did not include this provision but directed OMB to recommend ways of improving information reporting by federal agencies.

Accuracy-Related Penalties

Adequate disclosure under the accuracy-related penalty will not be sufficient to avoid penalty unless there is also a **reasonable basis** for the taxpayer's treatment of the item. The reasonable basis is now in the Code (Sec. 6662(d)(2)(B)(ii.)) and replaces the "not frivolous" standard which was in the Regs. This provision is effective for returns due (without regard to extensions) after December 31, 1993. This does not change the preparer penalty regulations in Sec. 6694.

Information Returns Relative to Discharge of Indebtedness

"Applicable financial entities", which include federal agencies such as FDIC and RTC as well as essentially all financial institutions, are required to file information returns with the IRS and provide a copy to the person whose debt was discharged in any situation where debt is satisfied for less than its outstanding balance. This provision applies to all federal agencies for debt discharged after August 10, 1993 and all other financial institutions for debt discharged after 1993. There are substantial penalties for failure to furnish such statements.

TAX PROVISIONS FROM THE ENERGY POLICY ACT OF 1992

Here are the provisions that seem to be the most important to your taxpayers.

Reporting of Taxpayer Identification Numbers in Seller-Financed Mortgage Transactions

For taxable years beginning after 1991, a taxpayer (buyer) who claims a deduction for qualified residence interest on any seller-provided financing shall include on his or her tax return the name, address, and taxpayer identification number of the seller to whom the interest is paid. This information must be furnished on Schedule A of the buyer's tax return for every year in which the buyer deducts this interest. Any person who receives interest from seller-provided financing shall include on his or her tax return the name, address, and taxpayer identification number of the person from whom the interest is received or accrued. This information must be furnished on Schedule B of the seller's tax return for every year in which the seller is required to include this interest in income.

Increase in Backup Withholding Rate

For amounts paid after December 31, 1992, the backup withholding rate is 31 percent, rather than 20 percent.

Travel Expenses for Employment Lasting One Year or More

For costs paid or incurred after December 31, 1992, a taxpayer's employment away from home in a single location will be indefinite rather than temporary if it lasts for one year or more.

Reporting of Property Tax Reimbursements to Sellers

For transactions after December 31, 1992 in a real estate transaction involving a residence, the real estate reporting person is required to include on an information return and on the customer statements the portion of any real property tax that is treated as a tax imposed on the purchaser.

Business Energy Tax Credits for Solar and Geothermal Property

The tax credits for qualified investments in solar and geothermal property, which expired July 1, 1992, were permanently extended.

Treatment of Pre-contribution Gains on Certain Partnership Redemptions

For partnership distributions on or after June 25, 1992, a partner who contributes appreciated property to a partnership is required to include pre-contribution gain in income to the extent that the value of other property distributed by the partnership to that partner exceeds his adjusted basis in his partnership interest. In accordance with the five-year limitation of prior law, the provision applies only if the distribution is made within five years after the contribution of the appreciated property.

Employer-Provided Transportation Benefits

For benefits provided by the employer on or after January 1, 1993, limits have been placed on the amount of parking and other transportation benefits that are excludable from an employee's gross income.

FEDERAL TAX PROVISIONS AFFECTING INDIVIDUALS

Standard Deduction

The standard deduction is indexed to inflation and is adjusted annually. The 1993 standard deduction is 2.8 to 3.3 percent higher than the 1992 standard deduction. The inflationary adjustment was 3 percent in 1993 and will be 3 percent for 1994. Look for a joint standard deduction of $6,350 for 1994.

Basic Federal Standard Deduction for 1992 and 1993

Filing Status	1992	1993
Married filing jointly; or qualifying widow(er)	$6,000	$6,200
Head of household	5,250	5,400
Single individuals	3,600	3,700
Married filing separately	3,000	3,100

A married taxpayer filing a separate return is not allowed to use the standard deduction if his or her spouse claims itemized deductions.

Each taxpayer over age 65 or blind receives the regular standard deduction plus an additional $700 deduction if married and filing a joint or separate return. The additional deduction is $900 if single or head of household. The additional deductions are subject to the inflationary adjustment. 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.

Personal Exemption

The 1993 personal exemption is $2,350, up 2 percent from $2,300 in 1992.

Taxpayers are entitled to claim one exemption each for themselves, their spouses, and their dependents on their federal return. Taxpayers may not claim an exemption for themselves or any other person who can be claimed as a dependent on someone else's tax return.

The phaseout of the personal exemption for certain high-income individuals was made permanent by the RRA of 1993. For 1993, the benefit of the personal exemption is phased out for taxpayers with the following specific high levels of adjusted gross income:

$162,700 if married filing jointly or qualifying widow(er) with dependent child;
$135,600 if head of household;
$108,450 if single
$ 81,350 if married filing separately.

These threshold amounts are up 3 percent from 1992 and are adjusted for inflation annually.

The reduction is 2 percent of the exemption amount for each $2,500 increment (or any fraction thereof) by which AGI exceeds the appropriate high or threshold amount. A married taxpayer filing separately will lose 2 percent of his or her exemption for each $1,250 increment above $81,350.

The personal exemption phaseout or reduction is calculated on an eight-line worksheet included in 1040 instructions before claiming the personal exemption deduction on line 36 of Form 1040.

Example: Mr. and Mrs. V. Grower file jointly, have two children, and their 1993 AGI is $198,000. They claim four personal exemptions. Their reduction and net exemption are calculated as follows:

> AGI $198,000 - $162,700 threshold = $35,300 excess. $35,300 excess ÷ $2,500 = 14.1 or 15 excess increments. Their reduction is 15 x .02 (2 percent) = .30 x $9,400 (4 @ $2,350) = $2,820. Their net personal exemption is $9,400 - 2,820 = $6,580.

Another way to evaluate the cost of the personal exemption phaseout to the taxpayer is to calculate the additional tax liability. In the example, Mr. and Mrs. Grower are in the 36 percent taxable income bracket, where the $2,820 of phased-out personal exemption will cost $1,015 in additional taxes. In other words, their $35,300 of excess AGI caused an additional tax liability of $1,015 or added 2.9 percent to their marginal tax rate.

Dependents

Taxpayers must report the social security numbers of all dependents one year old or older by the end of the tax year. The penalty for failure to report this information is $50. Apply for a social security number by filing Form SS-5 with the Social Security Administration.

Taxpayers may not claim an exemption for a dependent who has gross income of $2,350 or more unless it is for their child under age 19 or a full-time student child under age 24 at the end of the tax year. Nontaxable social security benefits and earnings from sheltered workshops are excluded. A full-time student must be enrolled in and attend a qualified school during some part of each of five calendar months. Individuals who can be claimed as dependents on another taxpayer's return may not claim a personal exemption on their own return.

A qualified child, student or other qualified dependent's basic standard deduction is limited to the greater of $600 or the individual's earned income up to his or her standard deduction. The $600 rule limits the basic standard deduction but not additional deductions for blind and elderly taxpayers.

Investment or unearned income in excess of $1,200 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 where the excess over $1,200 will be taxed at the parent's marginal rate and unearned income greater than $600 but less than $1,200 will be taxed at 15 percent. The election to claim the child's unearned income on the parent's return with Form 8814 is still available, but the $1,000 base amount and $500 tax exemption are not indexed for inflation on Form 8814. This election cannot be made if the child has income other than interest and dividends or if estimated tax payments were made in the child's name.

1993 Tax Rates

The RRA of 1993 adds a new 36 percent taxable income bracket and a 10 percent surtax which is equivalent to a top rate of 39.6 percent. The old 15, 28 and 31 percent brackets have been adjusted for inflation again this year. Each bracket has been moved up approximately 3.0 percent from 1992, which results in taxpayers

with constant taxable incomes paying less income taxes in 1993. The new 36 and 39.6 percent brackets will be indexed for inflation for tax years beginning after 1994.

1993 Tax Rate Schedules

Single Taxpayers		Married Filing Joint Return & Surviving Spouses	
Taxable Income	Tax	Taxable Income	Tax
$0-$22,100	15%	$0-$36,900	15%
$22,100-53,500	$3,315 + 28% on excess	$36,900-89,150	$5,535 + 28% on excess
$53,500-115,000	$12,107 + 31% "	$89,150-140,000	$20,165 + 31% "
$115,000-250,000	$31,172 + 36% "	$140,000-250,000	$35,929 + 36% "
> $250,000	$79,772 + 39.6% "	> $250,000	$75,529 + 39.6% "
Head of Household		**Married Filing Separate Returns**	
Taxable Income	Tax	Taxable Income	Tax
$0-$29,600	15%	$0-$18,450	15%
$29,600-76,400	$4,440 + 28% on excess	$18,450-44,575	$2,768 + 28% on excess
$76,400-127,500	$17,544 + 31% "	$44,575-70,000	$10,082 + 31% "
$127,500-250,000	$33,385 + 36% "	$70,000-125,000	$17,964 + 36% "
> $250,000	$77,485 + 39.6% "	> $250,000	$37,764 + 39.6% "

The rates for heads of household are most favorable. Single taxpayers who are maintaining a home for themselves and a dependent should qualify. Married taxpayers not living in the same household for the last six months of the year are treated as unmarried and may qualify as heads of household.

The tax rates for married taxpayers continue to be higher than for single taxpayers. Two married taxpayers each with $50,000 of taxable income will pay $1,276 more federal income taxes in 1993 than two singles with the same taxable income. As taxable income increases, the "marriage penalty tax" increases. A single taxpayer is not subject to the 36 percent rate until taxable income exceeds $115,000, but a married taxpayer reaches the 36 percent tax rate when taxable income exceeds $70,000 per person.

Some taxpayers will be subjected to "bracket creep" in 1994 because the thresholds for the 36 and 39.6 percent tax rate brackets will not be adjusted for inflation until 1995.

Installment Payment of Additional 1993 Tax

Individual taxpayers may pay the additional 1993 income tax attributable to the 36 percent and 39.6 percent tax rates in three equal, interest-free installments. The first installment must be paid on the due date of the taxpayer's 1993 return without extensions. The second and third equal installments are due one and two years, respectively, after the due date, without extension, of the 1993 return.

The installment option applies only to a taxpayer's additional tax caused by the increase in marginal rates from 31 percent to 36 and 39.6 percent in 1993. In

other words, married taxpayers filing a joint 1993 return could use the installment election to pay 5 percent of their ordinary taxable income ranging from $140,000 to $250,000 and 8.6 percent of that exceeding $250,000. All credits except those for wage withholding and use of special fuels must be deducted from the installment tax.

Example: Mr. and Mrs. V. Grower file jointly and report $183,000 of 1993 taxable income. $43,000 will be taxed at the new 36 percent marginal rate. Five percent of $43,000, or $2,150, is their 1993 tax caused by the increase in tax rates. Their total 1993 federal income tax liability is $51,400. Only $2,150 is eligible for the installment election.

The election to use the installment option must be made on the individual taxpayer's return for the tax year that begins in 1993. Form 8841 must be attached. The installment election does not apply to estates and trusts.

Itemized Deductions

A taxpayer should itemize if total itemized deductions are greater than his or her standard deduction. The limitation for high-income taxpayers must be considered when comparing itemized deductions with the standard deduction.

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 is nondeductible.

Investment interest is deductible on the 1993 return and is limited to the amount of net investment income. Investment interest is interest paid on debt incurred to buy investment property. It does not include investments in passive activities or activities in which the taxpayer actively participates, including the rental of real estate. Net investment income is gross investment income (including investment interest, interest received from the IRS, dividends, taxable portion of annuities, and certain royalties) less investment expenses (excluding interest). Gross investment income has been redefined by the 1993 Act to exclude net capital gain on the disposition of investment property. A taxpayer may elect to include net capital gain as investment income only if it is excluded from income qualifying for the 28 percent capital gain tax rate.

Form 4952, Investment Interest Expense Deduction, is designed to calculate the amount of carryover interest that may be deducted in the current tax year. The carryover interest deduction is limited to the excess of current year's net investment income over investment interest expense, and no deduction is allowed in any year in which there is a net operating loss.

Personal interest is no longer deductible.

Medical expenses that exceed 7.5 percent of AGI are itemized deductions not subject to the additional 2 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, prescribed medicine and drugs, special schooling and institutional care, qualified health insurance premiums and the costs to acquire, train and maintain animals that assist individuals with physical disabilities. Most cosmetic surgery, general health maintenance, such as gym fees and weight loss programs, and well-baby care programs will not qualify. Remember that itemized medical expenses must be reduced by any reimbursement, including health insurance payments received.

Handicapped taxpayers' business expenses for impairment-related services at their place of employment are itemized deductions not subject to the 7.5 percent or 2 percent AGI limits. Handicapped taxpayers are individuals who have a physical or mental disability that is a functional limitation to employment.

Charitable contributions made after 12/31/93 are subject to new substantiation and disclosure rules (see page 4).

Moving expenses are itemized deductions. Report moving expenses and employer reimbursements on Form 4782. See new limitations for 1994, page 4.

Other itemized deductions not subject to the 2 percent AGI limit include state income and property taxes, and personal casualty losses (list not complete).

Miscellaneous Deductions Subject To 2 Percent AGI Limit Include:

1. Unreimbursed employee business expenses including employment-related educational expenses, travel, meals and entertainment expenses (subject to 80 percent rule), lodging, work clothes, dues, fees, and small tools and supplies. Employee business expenses reimbursed under a nonaccountable plan are also subject to the 2 percent AGI limit.

2. Investment expenses, including legal, accounting, and tax counsel fees, clerical help and office rental, and custodial fees.

3. Other deductions: professional dues, books, journals and safe deposit box rental, job searching expenses, hobby expenses not exceeding hobby income, office-in-the-home expenses, and indirect miscellaneous deductions passed through grants or trusts, partnerships and S corporations.

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.

Limitation for High-Income Taxpayers

Taxpayers with a 1993 AGI in excess of $108,450 ($54,225 if married and filing separately) must reduce all itemized deductions except medical expenses, investment interest, casualty losses, and wagering losses to the extent of wagering gains. The reduction equals the lesser of 3 percent of excess AGI or 80 percent of the applicable itemized deductions. Three percent of excess AGI will be the most common reduction and will not be a major additional tax burden unless AGI is very

high and/or the applicable itemized deductions are relatively low. The 7.5 percent of AGI medical expense adjustment and 2 percent floor on miscellaneous itemized deductions must be applied before the high-income deduction.

Example: Max and Molly Moneymaker's 1993 AGI is $135,000. Their itemized deductions total $17,000 including $12,000 of deductible medical expenses (after the 7.5 percent AGI deduction) and investment interest. They claim no casualty or wagering losses. They must reduce their itemized deductions as follows:

> $135,000 AGI - $108,450 maximum = $26,550 excess x .03 = $796.50. $796.50 is less than (.80 x $5,000) = $4,000 of applicable itemized deductions. They reduce itemized deductions by $796.50; $17,000 - $796.50 = $16,203.50 adjusted itemized deductions.

Earned Income Credit for 1993

The earned income credit rules from 1992 are still in effect for 1993, but earned income brackets and credit amounts have increased from 1992. There are three parts: (1) the basic earned income credit, (2) a health insurance credit, and (3) a supplemental young child credit. If the credits exceed the tax liability, the taxpayer will receive a refund. Filers use Schedule EIC and tables A, B, and C to determine the credit amount. The following table shows the 1993 earned income credit (EIC) rates for the three parts of the program. Do not use these rates; use the IRS tables for claiming EIC.

1993 Earned Income Credit Rates

Earned Income[1]	Basic Credit %		Health Insurance Credit %	Young Child Credit %
	One Child	Two or More Children		
$1 -$7,750	18.5[2]	19.3[2]	6.1 to 6.0[2]	5.1 to 5.0[2]
$7,750-$12,200[3]	18.5 to 11.8 $1,434	19.3 to 12.4 $1,511	6 to 3.8 $465	5 to 3.2 $388
$12,200-$23,050	11.8 to 0	12.4 to 0	3.8 to 0	3.2 to 0

[1] Use AGI when it is $12,200 or more and greater than EI.
[2] Rates are somewhat higher when EI is less than $1,000.
[3] Maximum range, $ amount of credit is constant throughout.

The maximum basic credit is $1,434 if the family has one child and $1,511 if there is more than one child. The credit peaks at earned income (EI) levels between $7,750 and $12,200 and gradually goes to zero as EI and AGI levels reach $23,050. It also gradually increases from zero at EI levels of zero to the maximum stated earlier. Note that if AGI is greater than EI and AGI is greater than $23,050, AGI rather than EI is used to compute the credit.

The health insurance credit of up to $465 applies to taxpayers who paid health insurance premiums that covered one or more qualifying children. The credit claimed may not exceed the health insurance premiums paid. If this credit is claimed, the credit must be deducted from itemized medical and dental expenses. Self-employed persons must deduct the credit from any amount used to calculate the self-employed health insurance deduction on 1040. The health insurance credit peaks at the same EI and AGI levels as the basic credit and has the ""umbrella"-shaped phaseouts.

A taxpayer with two children and eligible for health insurance credit can earn a maximum 1993 EIC of $1,976 without the new child credit and $2,364 with it.

The supplemental young child credit maximum is $388 for 1993 and applies if a child was born during the year. This credit will not increase if more than one child is born. Claiming this credit disallows claiming the child and dependent care credit or the exclusion of employer-provided dependent care benefits for the same child. However, the credit and exclusion may be claimed if the family has other children. The supplemental young child credit peaks at the same EI and AGI levels as does the basic credit and has a similar phaseout.

Beginning in 1994, EIC will be extended to low-income workers (AGI < $9,000) with no qualifying children, basic credit rates are increased, and the health insurance and young child components are eliminated. The maximum credit with two or more children will be $2,527 for 1994. See page 4 for 1994 and 1995 changes.

To be eligible for the Earned Income Credit, the taxpayer must have (1) a qualifying child; (2) earned income; (3) earned income and adjusted gross income, each below $23,050; (4) a return that covers 12 months (unless a short-year return is filed because of death); (5) a joint return if married (usually); (6) included income earned in foreign countries and not deduct or exclude a foreign housing amount; (7) not be used as a qualifying child making another person eligible for the earned income credit.

There are three tests for a qualifying child: relationship, residency, and age.

To meet the relationship test, the child must be (1) the taxpayer's son or daughter or a descendant of the taxpayer's son or daughter, (2) the taxpayer's step-son or step-daughter, or (3) the taxpayer's eligible foster or adopted child.

To meet the residency test, the child must live with the taxpayer in his or her main home for more than half the year (all year if a foster child), and the home must be in the U.S. However, a child that was born, or died, anytime in 1993 and lived in the taxpayer's home will meet the residency test.

To meet the age test, the child must be (1) under 19 at the end of the year, (2) a full-time student under 24 at the end of the year, or (3) permanently or totally disabled at any time during the tax year, regardless of age.

Earned Income Credit Reminders for Farmers

If earned income is negative, there is no credit. Therefore, a farmer with a negative Schedule F net farm profit would not get a credit unless there were wage and Schedule C income more than enough to offset the loss on F, or the optional method of reporting self-employment income is used. A farmer with a negative 1993 net farm profit may use the optional method of reporting up to $1,600 of self-employment income, to collect an EIC which would partially or wholly cover the self-employment tax and thus provide two quarters of social security coverage, providing nonearned income (such as gains from cattle sales) plus earned income are less than $23,050.

If AGI is greater than $23,050, there will be no credit even if earned income is between zero and $23,050. Many dairy farmers could have a Schedule F profit in the EIC range, but not get a credit (or at least have it limited) because of gains from cattle sales on 4797 (or any other source of income that is not classified as "earned") which would be included in AGI.

Before attempting to manage the net farm profit or self-employment income to result in an EIC with which to pay the SE tax and provide a year's social security credit, a farmer needs to understand the EIC rules and the interactions between EIC, SE tax and income tax.

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. Advanced payments are limited to the basic credit amount for one qualifying child, regardless of the total number of children a taxpayer may have. 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).

Estimated Tax Rules for 1993 and 1994

Prior to 1992, individuals could avoid estimated tax penalties if less than $500 of tax (net of taxes withheld) was owed, or by paying the lesser of 90 percent of the current year's income tax liability or 100 percent of last year's income tax as a timely-deposited estimated tax. For 1992 and 1993, the 100 percent of last year's tax safe harbor provision no longer applies when (1) current year's AGI exceeds $75,000 ($37,500 if married and filing separate return), and (2) current year's modified AGI (AGI minus gains from sale of principal residence, involuntary conversions and qualified pass-thru items) exceeds last year's AGI by more than $40,000 ($20,000 if married and filing separate return in the current year).

Taxpayers subject to the AGI limits could be penalized to the extent that any of their 2nd, 3rd, and 4th quarter estimates were less than the required amount which was often based on estimates of current year's income. However, no penalty will be imposed for any period prior to 4/16/94 for underpayments caused by any '93 Act provision.

The '93 Tax Act reinstates the 100 percent of last year's tax safe harbor rule for tax years beginning after 12/31/93. To avoid underpayment of estimated tax, individuals with prior year AGI not exceeding $150,000 ($75,000 if married, filing separately), must make timely estimated payments at least equal to (1) 100 percent of last year's tax, or (2) 90 percent of the current year's tax liability. Individuals who exceed the $150,000 prior year's AGI limit must increase the 100 percent safe harbor to 110 percent. Similar rules apply to trusts and estates.

The estimated tax provisions apply to NYS as well as federal income taxes. Farmers and fishermen who receive at least two-thirds of their total gross income from farming are exempt from estimated tax payments, providing they file and pay taxes by March 1. New York State will officially follow the federal definition of gross income from farming for tax years beginning after 1992.

Topics Excluded this Year:

- Child Care Credit (no changes for 1993, see IRS Publications 17 and 503);
- Credit for the Elderly and the Disabled (no changes, see Pub. 524);
- Interest Allocation Rules (see IRS Publication 545);
- Excluding Interest from Series EE U.S. Savings Bonds Purchased to Pay Qualified Education Expenses (Pub. 550);
- Taxation of Mutual Fund Sales or Transfers (Pub. 564).

CONSERVATION EASEMENTS AND DEVELOPMENT RIGHTS

Qualified Conservation Contribution

A donation of a perpetual conservation easement on a piece of real estate to a governmental unit or a land trust may result in a deduction as a "qualified conservation contribution" under Sec. 170(h). The donation of such an easement normally would reduce the value of the property. The decline in the value of the property due to the donation of the easement, as determined by a qualified appraiser (if it exceeds $5,000), is the amount that may qualify as a charitable contribution using Form 8283.

The taxpayer may not be able to deduct the full value of the qualified conservation contribution in the year that the easement is donated. The deduction will be limited to a percentage of adjusted gross income (probably 20 percent of AGI) under the rules that apply to all charitable contributions. Donations that exceed the limit based on adjusted gross income may be carried forward up to five years subject to the AGI limits in the carryforward years.

Sale of Development Rights

A taxpayer who sells development rights gives up the right to develop the property. How should the income from sale of the rights be reported? Rev. Ruling 77-414 states that the taxpayer may reduce basis before reporting gain as income. Usually, when an interest in such a piece of property is sold, the basis must be allocated between the part that is sold and the part retained. The gain would be the difference between the sale price of the part sold and its basis.

If it is impossible to allocate the basis, the taxpayer is allowed to reduce the basis on the entire property before reporting any gain. Rev. Ruling 77-414 states that the sale of development rights does not require the allocation of basis and allows the taxpayer to reduce the basis in land before recognizing gain on the sale of development rights. Note: If the sale of development rights does not cover the entire parcel (e.g., the house and some surrounding land is excluded), an allocation of part of the basis to the land not included likely would still be required.

USDA Wetland Reserve Program

The 1990 Farm Bill authorized the USDA to enter into permanent easement agreements with farmland owners to restore to wetland some land that now is cropped. New York is one of the pilot states, and some bids were accepted during 1993. Landowners will be paid for the easement either in a lump sum or in installments over a ten-year period. Landowners are also eligible to receive cost-sharing payments from the USDA on expenses involved with the restoration to wetland status. The cost-sharing payments will almost certainly be income to the landowners.

The easements are very similar to the sale of development rights. It seems logical that the easement payments would have tax treatment similar to the sale of development rights as discussed above.

PROVISIONS APPLYING PRIMARILY TO BUSINESS ACTIVITY

Business vs. Hobby

To be fully deductible, business expenses must be incurred in carrying on a trade or business that has an economic activity and a profit motive. Expenses incurred in a hobby may be deducted only to the extent of hobby income, and they are claimed as itemized deductions on Schedule A.

Taxpayers have two opportunities to assure that their enterprise will be treated as a trade or business:

1. The business is organized and conducted in good faith for the purpose of making a profit and is characterized by activities that are accepted business practices. In short, the taxpayer is trying to make a real profit and has enough evidence in his/her favor to convince IRS or the court.

2. The enterprise shows a profit in any three years out of five consecutive tax years (two out of seven years for raising, breeding, racing or caring for horses). If a taxpayer meets this criteria, it is presumed that he/she is operating a business and no other proof is needed. New businesses may delay the use of the presumption by filing Form 5213.

Refer to Chapter 5, Publication 225, or Chapter 21, Publication 334, for more detailed information on not-for-profit farming.

Business Use of Home

Expenses associated with the business use of the home are deductible only if they can be attributed to a portion of the home or separate structure used exclusively and regularly as the taxpayer's place of business for any trade or business, or a place where the taxpayer meets or "deals with" customers or clients in the ordinary course of business.

Recent developments revolve around the Soliman Case which involved a self-employed anesthesiologist who worked in three hospitals and claimed a home office deduction for a room in his home where he compiled billing records, contacted patients and physicians by phone, and performed other activities related to his profession. After the deduction was denied, he went to Tax Court, where the deduction was allowed (Jan. 18, 1990). IRS appealed in court but did not win. In effect, the old "focal" point test was replaced by a "facts and circumstances" test. IRS appealed again, and the case went to the Supreme Court where IRS won and Soliman lost (Jan. 12, 1993). As a result of that decision, IRS revised Pub. 587. Examples from the revision indicate that a home office deduction will not be allowed in many situations where they formerly were. In one example, an anesthesiologist spends 10 to 15 hours per week in the home office and 30 to 35 hours per week in hospitals and is not allowed the deduction. In another, a salesman who spends 12 hours a week in his office and 30 hours per week visiting customers is denied a deduction.

Recordkeeping rules for licensed or certified day-care providers using their homes for business have been relaxed. They are no longer required to keep detailed records of the exact time each room is used for day-care. A room that is available for business use throughout the day, and is regularly used, will be considered used for the entire day (Rev. Rul. 92-3). The portion of general home expenses that may be claimed as a day-care business expense is determined by the percentage of total house floor area and the portion of total annual hours used for day-care.

Schedule C filers who claim expenses for business use of the home must file form 8829. This form requires a large amount of detail and has 52 possible entries. Separate entries are required for direct expenses, such as painting the room used as an office, and indirect expenses, such as electricity, which are used in running the entire home. Form 4562 will be required if it is the first year the taxpayer claims such expenses. Limitations on use of home expenses as business deductions are calculated on 8829.

Health Insurance Premiums

The provision that expired July 1, 1992 has been extended through 1993. 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 (one-half of annual EI for 1992 calendar year). The deduction does not reduce 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. Employers are not required to provide health insurance to their employees to be eligible for the 25 percent deduction.

Reporting Rental of Personal (Non-Real) Property

The IRS argues that rental of property other than real estate (when not rented along with real estate) is a business, and the income must be reported on Schedule C or C-EZ where net income will be subject to self-employment tax.

Business Use of Automobiles

Automobile expenses are deductible if incurred in a trade or business or in the production of income. Actual costs or the standard mileage rate method may be used. Employers with 10 or more employees using their own cars for company business may use the Fixed and Variable Rate (FAVR) allowance or may devise their own consistent mileage allowance. The 1993 standard mileage rate remains at 28 cents per mile for all business miles driven. There is no longer a reduction in rate for over 15,000 miles and fully depreciated autos.

Rural mail carriers are allowed a special mileage rate equal to 150 percent of the basic standard mileage rate (42 cents for 1993). The special mileage rate applies to all business use of an automobile (including vans, pickups, and panel trucks) while performing "qualified services." But this special rate may not be used if the mail carrier claimed depreciation on the vehicle for any tax year beginning after 1987.

Tax Preparation Fees

Rev. Rul. 92-29 states that sole proprietors who report business income on Schedules C and/or F may deduct "expenses incurred in preparing that portion of the return that relates to the taxpayer's business as a sole proprietor." In other words, a portion of the tax preparation fees incurred by a small business are deducted on Schedules C/F. The "personal share" may be claimed as an itemized deduction subject to the 2 percent AGI floor. This ruling is more favorable than LTR 9126014, 6/28/91, which classified all tax preparation fees as a miscellaneous deduction.

Independent Contractor vs. Employee

The IRS has established and is using regulatory guidelines to find misuse of the safe haven for independent contractors. The safe haven provision allows employers to continue to treat workers as independent contractors and avoid income tax and FICA withholding as long as (1) the employer did not treat the worker as an employee, (2) there is a "reasonable basis" for not classifying the worker as an employee, and (3) all required tax returns are filed. IRS auditors are using the following common law rules/factors that provide criteria for determining the status of a worker or individual providing services:

1. The worker is an employee if the employer has the right to direct and control his/her work. Only the right to exercise control is required. The worker's designated title and grade have no consequence; it is the existing employer/employee relationship that is critical.

2. Following are criteria used by the IRS to determine the extent of employer control. We have divided them into two groups: "high control" implies the worker is an employee, "low/no control" favors independent contractor status. These criteria are based on the 20 factors set out in IRS Audit Manual Exhibit 4640-1 and in Rev. Rul. 87-41. Any single fact or small group of facts is not conclusive evidence of the presence or absence of control. An agent will evaluate the reason for the existence or absence of each factor.

High Control	Low/no Control
Work instructions/training required	No instructions/training required
Worker (contractor) is integrated into the business operations	Service provided is common, easily subcontracted
Services must be rendered personally, they cannot be subcontracted	Contractor hires and supervises employees, sets own hours
Assistant workers are hired, supervised or paid by the "employer"	Work performed off employer's premises
Continuing relationship exists	Contractor sets sequence of work, pays own expenses, provides own tools and & materials
Set number of hours are required	Significant trade investment required
Work sequence is set by "employer"	Contractor controls profit or loss
Reports are required	Providing service for more than one firm; service made available to general public
Regular, periodic payments for services are provided	
Service can be terminated without breach of contract/current liability	

In addition to these factors that favor independent contractor status, an employer may rely on one of the following types of authority:

1. Court rulings and decisions, published rulings, or a private-letter ruling issued to the taxpayer-employer;

2. Past audit of taxpayer that approved this or similar practice;

3. A long-standing, recognized practice of the applicable industry.

As a final resort, a taxpayer/employer may fill out and submit Form SS-8 which will be used by the IRS to make the employee vs. independent contractor status decision for the taxpayer. Filing SS-8 will trigger an IRS investigation.

COMPLETING FORM 1065, SCHEDULES L, M-1 AND M-2

Schedules L, M-1 and M-2 on Form 1065 are to be completed on all partnership returns unless the partnership's total receipts are less than $250,000, total partnership assets are less than $250,000, and Schedules K-1 are filed and furnished to the partners on or before the due date of the partnership return, including extensions. There is no longer an exemption for family farm partnerships with 10 or fewer partners.

Schedule L contains the tax basis partnership balance sheet at the beginning and end of the tax year. The tax basis of the partnership assets will not equal their fair market value, but the tax basis is important information to have in case of a sale or dissolution. The total tax basis of assets less total liabilities equals the total basis of partners' capital accounts. The basis of the capital account may be negative from the beginning of the partnership if debts assumed exceeded the tax basis of assets contributed, or if the partnership sustained losses.

Schedule M-1 (shown below) is the reconciliation of book income with Schedule K income. Net income per books (line 1) would be net income from the partnership's annual income statement. (This is not a statement based on market values.) Any income or expense adjustments made on Schedule K are recorded on Schedule M-1 (lines 2 and 3). For example, guaranteed payments made to partners and deducted in calculating book net income are an addition to income on Schedules K and M-1. Excess deductions shown on the partnership books that cannot be claimed for tax purposes are reported on line 7, Schedule M-1.

Schedule M-1, Reconciliation of Income Per Books with Income Per Return

1. Net income (loss) per books	$_____	6. Income recorded on books this year not included on Sch. K, lines 1-7 (itemize):	$_____
2. Income on Sch. K, lines 1-4, 6, & 7, not recorded on books this year	_____	a. Tax-exempt interest	_____
3. Guaranteed pymts. (not health insurance)	_____	7. Deductions included on Sch. K, lines 1-12a, 17e, and 18a, not charged against book income this year (itemize):	_____
4. Exp. recorded on books this year not included on Sch. K, lines 1-12a, 17e, and 18a (itemize):		a. Depreciation	_____
a. Depreciation	_____	_____	_____
b. Travel & entertainment	_____	8. Total, lines 5 and 6	$_____
_____	_____	9. Income (loss) (Schedule K, line 23a). Line 8 - line 5	$_____
5. Total, lines 1-4	$_____		

Schedule M-2, Analysis of Partners' Capital Accounts, is the old reconciliation schedule with a few more lines and modifications. Line 3 is the net income per books which will include 4797 income on many farms. Formerly 4797 income was excluded in step 3 and added in step 4. Use entries on lines 4 and 7 to balance.

Schedule M-2, Analysis of Partners' Capital Accounts

1. Balance at beg. of year	$_____	6. Distributions: a. Cash	$_____
2. Capital contributed	_____	b. Property	_____
3. Net income (loss) per books	_____	7. Other decreases: _____	
4. Other increases: _____		_____	_____
_____	_____	8. Total lines 6 and 7	$_____
5. Total lines 1-4	$_____	9. Balance, end of yr. (ln. 8-5)	$_____

PROVISIONS SPECIFIC TO AGRICULTURE

Expensing of Soil and Water Conservation Costs

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. Form 8645, Soil and Water Conservation Plan Certification, is required. Costs for draining or filling of wetlands or land preparation for center pivot irrigation systems may not be expensed.

Expensing of Land Clearing Repealed

Amounts paid after 1985 for land clearing are not eligible for expensing and must be added to the land's basis (except routine brush clearing for land already farmed).

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).

Disaster Payments and Crop Insurance

Normally, cash basis farmers are required to report disaster payments and crop insurance benefits in the year the payments are received. On February 23, 1990 the Treasury issued a Temporary Regulation (1.451-6T) that allows the taxpayer to elect to report such benefits 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. This applies to federal payments received as a result of (1) the destruction of, or damage to, crops caused by drought, flood or any other natural disaster, or (2) the inability to plant crops because of such a natural disaster. This regulation is effective for payments received after December 31, 1973. See Publication 225 for details on making the election. Revenue Ruling 91-55 reaffirms that disaster payments are treated the same as crop insurance and overrules Rev. Rul. 75-36 which stated the opposite.

Many New York counties were declared disaster areas in 1993. Some farmers in these counties will receive disaster payments from the federal government in either 1993 or 1994.

Income from Cancellation of Debt

Some New York farmers are likely to have debt cancelled by their lenders during 1993 or other years. The tax code specifies that cancellation of debt, called discharge of indebtedness income (DII), is ordinary income to the borrower. In many situations, the DII does not result in income that is reported and taxed. In return for not reporting the income, the taxpayer must reduce "tax attributes," such as investment credit, net operating losses and basis in assets. Reducing these attributes may result in tax liability for the taxpayer in future years.

There are two sets of rules that control reporting of cancelled debt. One applies to bankrupt and insolvent debtors, including farmers. The other set applies to **solvent farmers**. The bankrupt and insolvent rules provide that if the cancelled debt is greater than the total tax attributes, the excess cancelled debt is not reported and, therefore, does not result in tax liability. Some insolvent farmers who have debt cancelled by lenders will find that enough debt is cancelled so that they become solvent. Therefore, they are subject to both sets of rules because once they become solvent they are treated under the solvent farmer rules.

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 will prevent some solvent farmers from using tax attributes to offset 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. The basis reduction for property owned by the solvent 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. Also, any DII remaining after the tax attributes have been reduced must be included in a solvent farmer's 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.

Certain Conservation Payments Excluded (IRC Sec. 126)

Payments farmers receive for certain conservation and environmental protection programs may be excluded from income when approved as qualified under IRC Sec. 126. Federal and NYS approval has been granted to payments for the purchase and installation of capital improvements and the implementation of best management practices made to farmers by the NYCDEP under the NYC Watershed Agricultural Program. The exclusion will not apply to incentive payments made to encourage the preparation of whole farm plans and participation in demonstration field days or tours. Payments for operating items that would be expensed on Schedule F are not excluded. If IRS determines payments have substantially increased the annual income derived from the farm, only part of the payment may be excluded (see Pub. 225). This determination is made on a case-by-case basis.

DEPRECIATION AND COST RECOVERY

The modified accelerated cost recovery system (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 taxpayer is allowed cost recovery or depreciation on purchased machinery, equipment, buildings, and on purchased livestock acquired for dairy, breeding, draft, and sporting purposes unless reporting on the accrual basis and such livestock are included in inventories. Depreciation must be claimed by the taxpayer who owns the asset. A taxpayer cannot depreciate property that he or she is renting or leasing from others. The costs of most capital improvements made to leased property may be depreciated by the owner of the leasehold improvements under the same rules that apply to owners of regular depreciable 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 are 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 (39 if acquired after 5/13/93)	Nonresidential real property

Assets are placed in one of the eight MACRS 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:

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, typewriters, copiers and adding machines.

4. Logging machinery and 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, and paved barnyards.

3. Breeding or work horses.

Ten-year property includes single purpose agricultural structures and orchards and vineyards placed in service after 1988.

Fifteen-year property:

1. Depreciable land improvements such as sidewalks, roads, bridges, water wells, 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, or buildings or structural components.

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 (39 if acquired after 5/13/93) property includes nonresidential real property.

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

Asset	Recovery Period ACRS	MACRS	Alternative MACRS
Airplane	5	5	6
Auto (farm share)	3	5	5
Calculators and copiers	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 (nonrace, less than 12 years of age)	5	7	10
Horses (nonrace, 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 furniture & fixtures	5	7	10
Orchards	5	10***	20
Paved lots	5	15	20
Property with no class life	5	7	12
Rental property (nonresidential real estate)	19	31.5 (39)	40
Rental property (residential)	19	27.5	40
Research property	5	5	12*
Sheep (breeding)	3	5	5
Silos	5	7	12*
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. Depreciation on farm property placed in service after 1988 is limited to 150 percent declining balance (DB) rather than the 200 percent available for nonfarm property. There is an exception from the 150 percent DB 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 (SL) options for the classes eligible for rapid recovery. SL may be taken over the MACRS class life or, using alternative MACRS depreciation system, over the ADR midpoint life. A fourth option is 150 percent DB over the ADR midpoint life, the depreciation method required for alternative minimum tax purposes 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	Farm assets: 150 percent DB if placed in service after 1988. 200 percent if placed in service 1987 through 1988. (See exception for orchards and vineyards above.)
	Nonfarm assets: 200 percent DB with switch-over to SL.
15 and 20-year	150 percent declining balance with switch-over to SL
27.5 and 31.5(39)-year	Straight line only

The MACRS law does not provide for standard percentage recovery figures for each year. However, tables have been made available by IRS and several of the tax services.

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.)

	3-Year Class		5-Year Class		7-Year Class		10-Year Class		15-Yr. Class	20-Yr. Class
Recovery Year	200% d.b.	150% d.b.	200% d.b.	150% d.b.	200% d.b.	150% d.b.	200% d.b.	150% d.b.	150% d.b.	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	44.45	37.50	32.00	25.50	24.49	19.13	18.00	13.88	9.50	7.22
3	14.81	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	8.92	12.25	7.37	8.74	6.23	5.28
7					8.93	12.25	6.55	8.74	5.90	4.89
8					4.46	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 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 property and is an option for the rest. It is a straight line system based on the alternative MACRS recovery period (ADR midpoint lives). Farmers who are subject to capitalization of preproductive expenses, discussed later, may elect to avoid capitalization, but if they do so, they must use alternative MACRS on all property.

Election to Expense Depreciable Property

The Section 179 expense deduction which had been $10,000 is increased to $17,500 for property placed in service in tax years beginning after 1992. The $17,500 is phased out for any taxpayer who places over $200,000 of property in service in any year, with complete phaseout at $217,500. Property eligible for Sec. 179 is now defined as Sec. 1245 property to which Sec. 168 (accelerated cost recovery) applies. Several types of property that were included in Sec. 38 are not included in the Sec. 1245 definition and several types included in 1245 were not included in Sec. 38. The current definition is in 1245(a)(3).

In the case of partnerships, the $17,500 limit applies to the partnership and also to each partner as an individual taxpayer. A partner who has Sec. 179 allocation from several sources could be in a situation where not all of the 179 allocated to him/her could be used because of the $17,500 limitation. The same concept applies to S corporations and shareholders.

The amount of the Sec. 179 expense election is limited to the amount of taxable income of the taxpayer that is derived from the active 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 Sec. 179 deduction. Any disallowed Sec. 179 deductions are carried forward to succeeding years. The deduction of current plus carryover amounts is limited to $17,500 in 1993 and later.

Sec. 179 regulations provide that wage and salary income qualifies as income from a trade or business. Therefore, such income can be combined with income (or loss) from Schedules C or F in determining income from the "active conduct of a trade or business" when calculating the allowable 179 deduction. Sec. 1231 gains and losses from a business actively conducted by the taxpayer are also included. Regulations issued Dec. 23, 1992 deal with the taxable income limitation, carryover of disallowed 179 amounts, and active conduct of a trade or business.

Gains from the sale of Sec. 179 assets are treated like Sec. 1245 gains. The amounts expensed are recaptured as ordinary income in the year of sale. The Sec. 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 or if business use drops to 50 percent or less, the Sec. 179 expense recapture is invoked no matter how long the property was held for business use. The amount recaptured is the excess of the 179 deduction over the amount that would have been deducted as depreciation.

Every farmer or owner of another business who has purchased MACRS property in 1993 should consider the $17,500 expense deduction because only the New York IC will be lost when Section 179 is used. It should not be used to reduce adjusted gross income below the standard (or itemized) deductions plus exemptions unless an additional reduction in 1993 self-employment tax 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 "active conduct of a 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. Assets placed in service during the first, second, third and fourth quarters will earn 87.5, 62.5, 37.5 and 12.5 percent, respectively. Since 1991, the amount expensed under Sec. 179 is not considered in applying the 40 percent rule. In other words, the amount expensed under Sec. 179 can be taken on property acquired in the last quarter, which may help avoid the mid-quarter convention rule. The increase from $10,000 to $17,500 may help more taxpayers avoid the mid-quarter convention rule.

Example: Pete placed $100,000 worth of property in service during 1993, all 7-year MACRS property. He could expense $17,500 and claim $8,836 of depreciation in 1993 ($100,000 - 17,500 = $82,500 x .1071 = $8,836) under the half-year convention. If $50,000 of Pete's property were placed in service in the last quarter and Sec. 179 was limited to $10,000, he would have been subject to the mid-quarter convention rules ($50,000 - 10,000 = $40,000, which is greater than 40 percent of $90,000). His first-year depreciation, assuming the remaining $50,000 worth of property was purchased evenly throughout the first three quarters, would have been $7,667. The $17,500 Sec. 179 applied to the $50,000 purchased in the last quarter will avoid the 40 percent rule. Therefore, the higher Sec. 179 deduction provides Pete a two-fold benefit in 1993. His Sec. 179 deduction has increased $7,500 and his depreciation is up $1,169. Pete's total line 16 Sch. F deduction has increased $8,669.

Note that if the 40 percent rule is triggered, the depreciation on property acquired in the first and second quarters actually increases. Taxpayers are not allowed to use the mid-quarter rules voluntarily. However, choice of property to expense under 179 could work to the advantage of a taxpayer who wanted to become subject to the rules. If third quarter property could be expensed and thereby have the 40 percent rule triggered, the depreciation on first and second quarter property would be increased. Whether this increases total depreciation for the year would depend on the proportion placed in service in each quarter.

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. For example, if a farmer purchased a new tractor, forage harvester and combine in 1993, all belong in the 7-year property class. The farmer may not recover the tractor over seven years with rapid recovery (150 percent DB) 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 SL 10-year recovery for a tractor purchased in 1992 (7-year property) but could have chosen 150 percent DB for seven years for a combine purchased in 1993. Keep in mind that 150 percent DB would be used on any other 7-year property purchased in 1993.

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.

Some Special Rules on Autos and Listed Property

There are special rules for depreciation on automobiles and other "listed property." If the car is used less than 100 percent in the business, the maximum allowance is reduced, and if used 50 percent or less, the Sec. 179 deduction is not allowed and depreciation is limited to SL. The maximum first year allowance for depreciation and Sec. 179 expense is $2,860 on cars placed in service in 1993. Cellular telephones acquired in 1990 and later are listed property.

Additional Rules

For property placed in service after 1986, accelerated depreciation in excess of 150 percent, calculated with the alternative MACRS life, becomes an income adjustment subject to inclusion in alternative minimum taxable income. If SL alternative MACRS life depreciation is used for regular tax calculations, it must be used for AMT.

MACRS rules allow half a year's depreciation in the year of disposition using the half-year convention. 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 depreciation whether rapid or SL on all Section 1245 3, 5, 7, 10 and 15-year MACRS property is ordinary income. There is no recapture of depreciation on property in the 20-year class if straight line recovery is used (see A Review of Farm Business Property Sales for more on depreciation recapture).

Property placed in service during a short tax year is subject to special allocation rules that vary with the applicable convention used. Details are provided in Pub. 534.

Choosing Recovery Options

Taxpayers will maximize after-tax income by using Section 179 and rapid recovery on 3, 5, 7, 10, and 15-year MACRS property, assuming the deductions can be used to reduce taxable income and do not create an AMT adjustment that results in AMT liability. To simplify depreciation records and avoid AMT adjustments, taxpayers may prefer 150 percent declining balance over the ADR midpoint life. 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.

Using straight line rather than 150 percent declining balance on 20-year property will preserve capital gain treatment at the time of disposal. This is not of great value to most taxpayers because the capital gain break applies only to taxpayers in the 31 percent and higher brackets, and the tax savings will be realized many years from now. For most taxpayers, 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 1993 depreciation more valuable than that used in later years. However, depreciation claimed to reduce taxable income below zero is depreciation wasted.

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 Sch. K, Form 1065 rather than combining it with other items on 4562. Since it is excluded when calculating net earnings for self-employment on Sch. K and K-1, include it as an adjustment to net farm profit on Sch. SE.

ACRS Recovery Percentages

Tables for rapid recovery of ACRS property are available in the *Farmers Tax Guide* and Pub. 534. A table for straight line ACRS depreciation is shown below.

Straight Line Depreciation Options for ACRS 5, 10, 15, 18, & 19-Year Property

Straight Line Option	1st Year	Intermediate Years	Last Year
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

*Use one-half this amount for the month of acquisition (after 6/22/84).

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.

REVIEW OF UNIFORM CAPITALIZATION RULES FOR FARMERS

The preproductive costs of raising livestock are exempt from the uniform capitalization rules for tax years ending after December 31, 1988. The exemption does not apply to large farm corporations, partnerships or tax shelters that are required to use accrual accounting, or to the preproductive costs of establishing fruit trees, vines and other applicable plants.

Fruit Growers and Nurserymen

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. The preproductive period 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. 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.

Fruit growers who choose to capitalize will need to establish reasonable estimates of the preproductive costs of trees and vines. The farm-price method could be used by nurserymen to establish their preproductive costs of growing trees, vines, and ornamentals. Capitalization requires the recovery of orchard, vineyard, and ornamental tree preproductive period expenses over 10 years. If growers elect not to capitalize, they must use alternative MACRS to recover the costs of trees and vines (20-year straight line) and all other depreciable assets placed in service. Only the preproductive period growing costs may be expensed.

See Publication 225, *Farmers Tax Guide*, for other uniform capitalization rules.

ENVIRONMENTAL CLEANUP COSTS

In Ltr. Rul. 9315004, Dec. 17, 1992, IRS required capitalization of costs incurred by a firm for environmental cleanup activities from PCP contamination at some of its plant sites. IRS ruled that much of these cleanup activities were to rehabilitate the property to a general state of usefulness and were not incidental repairs. However, IRS did not require that the cleanup costs be added to the basis of the land. They were to be treated as nonland depreciable assets.

IRS agreed that legal fees could be deducted currently to the extent incurred to defend the taxpayer's business or secure contractual rights. Also, costs incurred in determining if contamination has occurred are currently deductible if the investigation concludes that property rehabilitation is not required.

In a similar ruling (Ltr. Rul. 9240004), IRS held that asbestos removal costs would have to be capitalized rather than currently expensed because the costs represented modifications and improvements rather than repairs.

CASUALTY LOSSES, GAINS, AND INVOLUNTARY CONVERSIONS

A casualty includes the damage or loss resulting from a sudden, identifiable, unexpected event such fire, flood, wind, lightning, freezing, storm and accident.

Business Casualty Losses and Gains

Fire and 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.

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. The costs of replacing raised crops is a business expense; crop insurance is ordinary income. Insurance proceeds from casualty losses of raised dairy and breeding livestock are casualty gains that qualify as involuntary conversions.

Involuntary Conversion

Casualty gains and gains from forced sales due to condemnation, threat of condemnation, are involuntary conversions. Gains from the sale or death of any diseased livestock (IRC Sec. 1033(d)), or dairy, draft and breeding livestock sales caused by drought (Sec. 1033(e)), are involuntary conversions. Reporting gains from involuntary conversions may be postponed if replaced with property similar or related in service or use. The replacement period ends two years after the close of the year in which any part of the gain is realized.

Postponement of gains is an election that must be made on the tax return for the year in which the gain first occurred. Attach a statement that explains what the gain is, how it was determined, and when it will be reported. Another statement is requested in the year the replacement property is acquired, explaining what it is and how its basis was determined. If the property is not replaced within the required period, the return for the election year must be amended to report the gain realized.

Livestock Sold Due to Drought Conditions

There are two tax provisions that allow special treatment of gains from livestock sold due to drought conditions. The first allows for involuntary conversion of gains from the sale of only dairy, draft and breeding livestock (see Involuntary Conversion above) disposed of solely because of drought. And only those sold in excess of the number that would have normally been sold qualify. This provision does not require disaster area designation by a federal agency.

The second provision is an election to postpone for one year reporting the gain from any livestock sold due to drought conditions. This provision applies to all livestock, including poultry. Only gains on those sold in excess of the number that would have normally been sold may be postponed, and the drought must have resulted in an area being designated as eligible for federal assistance. The election is made by attaching a statement to the tax return and should include a reference to IRC Sec. 451(e), evidence of the drought, the affect the drought had on livestock sales, the number sold, comparisons with normal sales years, and computation of income to be postponed. See publication 225 for more details.

GENERAL BUSINESS CREDIT

General business credit (GBC) is a combination of investment tax credit (generally repealed 1/1/86), targeted jobs credit, alcohol fuels credit, research credit, low-income housing credit, and the new disabled access credit. Form 3800 is used to claim GBC for the current year, to apply carryforward 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, AMT taxpayers, controlled corporate groups, estates and trusts, and certain investment companies and institutions [Sec. 46(e)(i)].

Review of Federal Investment Credit

Federal investment tax credit (IC) was one of the most important features of farm tax reporting and tax management before 1986. It was repealed for most property placed in service after 12/31/85. In 1993, IC may be earned on rehabilitated buildings, qualified reforestation expenses, and certain business energy investments. IC (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 it cannot be used in the year it is earned, it can be carried back and carried forward to offset tax liability in other years. If property is disposed of before credit claimed is fully earned, the credit must be recomputed to determine the amount to recapture. Form 3468 is used for computing IC.

Rehabilitated buildings (expenditures) 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. 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. 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. The basis for depreciation must be reduced by 100 percent of the investment credit claimed. These rules apply to rehabilitated property placed in service after 1986.

Qualified reforestation expenses consist of up to $10,000 ($5,000 if married filing separately) 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, and depreciation of equipment used. These are the same expenses that qualify for amortization. Deductible operating costs, all costs 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.

Business energy investment credit is equal to 10 percent of the basis of qualified solar and geothermal energy equipment placed in service during the tax year. Active solar devices for either space heating or water heating would qualify under the solar category if put to original use by the taxpayer.

Unused investment credit carried over from 1986 and earlier years may still be used but only 65 percent of that left over from 1987 may be carried to later

years. Use Form 3800 to claim carryovers. Reforestation IC does not require the 35 percent reduction. Unused credit may be carried over for 15 years, and if unused credit still exists, one-half can be deducted in the 16th year.

Recapture rules apply when there is early disposition of rehabilitated buildings, business energy property and/or reforested land for which investment credit has been claimed. The amount of recapture is 100 percent during the first year of service and declines to zero after five full years of service.

Other General Business Credits

Targeted jobs credit was reinstated retroactive to 7/1/92 and extended through 12/31/94. The credit is equal to 40 percent of the first $6,000 of qualified first-year wages paid to employees from targeted groups. Targeted groups include handicapped individuals undergoing vocational training, an individual receiving federal, state or local social services benefits, youth enrolled in qualified cooperative education programs, qualified (economically disadvantaged) summer youth employees, and economically disadvantaged Vietnam-era veterans. The credit is limited to 40 percent of the first $3,000 paid to qualified summer youth employees. It is not available on wages paid to an employee related to a taxpayer who owns more than 50 percent of the business.

Low-income housing credit was reinstated, permanently extended, and modified by the '93 Tax Act. It is a tax credit on capital invested in residential property that qualifies as low-income housing under certain statutory requirements. Changes include allowing the credit for units occupied by qualified full-time students and for projects receiving assistance under the HOME Investment Partnership Act.

Credit for qualified research expenditures made by a taxpayer carrying on a trade or business was reinstated retroactive to 7/1/92. The credit is 20 percent of the excess of qualified research expense for the tax year over an average for the preceding four years. Qualified research expenditures include costs of developing new products, processes, models, software, formulas and technologies. Market and consumer research is excluded.

Disabled access credit may be claimed by an eligible small business that incurs expenses for providing access to persons with disabilities. The maximum amount of the refundable credit is $5,000 per year (50 percent of eligible expenses that exceed $250 but do not exceed $10,250). An eligible business is one that for the preceding year did not have more than 30 full-time employees or did not have more than $1 million in gross receipts. An employee is considered full-time if employed at least 30 hours per week for 20 or more calendar weeks in the preceding year.

The $5,000 maximum credit limit applies to a partnership and to each partner. The partnership allocates the credit among the partners. A similar rule applies to an S corporation and its shareholders. To claim the credit, file Form 8826, Disabled Access Credit. For more information, see Publication 907, *Tax Information for Persons with Handicaps or Disabilities*.

Other general business credits: The alcohol fuels credit, the enhanced oil recovery credit, the renewable electricity production credit.

Other nonrefundable credits: Credit for interest on certain home mortgages, foreign tax credit, orphan drugs credit, alternative fuels credit, and credit for qualified electric vehicles.

LIKE-KIND EXCHANGES

Deferred Exchanges of Like-Kind Real Estate

Regulations issued in 1991 clarify the rules for delayed exchanges of real estate under IRC Sec. 1031. These regulations make it possible to dispose of one parcel of real estate (called the relinquished property) held for trade, business, or investment purposes, and acquire another parcel of real estate to be held for trade, business or investment purposes (replacement property) within a limited period of time without paying tax on the gain from the disposition. However, the proceeds from the disposition must not be paid to the seller. They must be held in an escrow account where they are not available to the seller and then used to acquire the replacement property. The person or firm who holds the money must not have been the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent during the two-year period prior to the transfer of the relinquished property. The taxpayer must not be in actual or constructive receipt of the proceeds from the relinquished property. However, it is legal for the seller to receive, at the end of the replacement period, interest on the money that is placed in the escrow account. The new regulations apply to transactions on or after June 10, 1991. These regulations make it possible to have the tax-deferral benefits of a "trade" without directly trading (exchanging) property with the owner of the property the taxpayer wishes to acquire. One way to handle the transactions is to deal with a "qualified intermediary."

The regulations are very specific about the hoops the taxpayer must jump through in order for the transaction to be considered an exchange rather than a sale. If the transaction does not comply with the rules, then the taxpayer will have tax liability on the gain from the relinquished property. It is important to keep in mind that the exchange process does not mean that the gain is tax free. The process is one of tax deferral, and the tax will eventually be paid when the taxpayer sells the replacement property. The only exception would be that, if the taxpayer dies, the person who inherits the property will have a stepped-up basis equal to the value of the property at the death of the taxpayer and when the property is sold will escape paying tax on gain rolled over into the replacement property.

The taxpayer has 45 days from the date of the sale (closing) of the relinquished property to "identify" the replacement property and 180 days after the sale to actually acquire the replacement property. However, if the due date of the taxpayer's return is less than 180 days from the date of the sale of the relinquished property, the taxpayer has only until the due date of the return to acquire the replacement property. For example, any sale after October 17, 1993 would actually have less than 180 days in which to acquire the replacement property because the 1993 return (if due April 15) will be due in less than 180 days. There is no fudging of the 45 and 180 days. Every day is counted, including the date of sale, weekends, and holidays.

The fact that the relinquished property is not debt-free will not disqualify a deferred exchange. However, debt on either the relinquished or replacement property may complicate the mechanics of the exchange and reduce the amount of gain that does not have to be recognized.

More than one piece of real estate can be used as replacement property. For example, a farm could be exchanged for three rental properties. The replacement property could have a higher fair market value than the relinquished property but there are limits as to how much higher. If the replacement property has a

lower value than the relinquished property, the transaction will not necessarily be disqualified as an exchange, but there will be taxable gain.

Application to Transfers of Farm Real Estate. Tax deferral through a deferred real estate exchange could be useful to owners of farm real estate in at least two situations: (1) a farmer who wants to sell one farm and acquire another without paying tax on the gain on the sale, and (2) a farmer who wishes to leave farming and is willing to acquire other "like-kind" real estate, such as an apartment house, motel, or commercial building, without paying tax on the sale of the farm real estate. Many farmers who wish to leave farming do not have the expertise to manage other types of real estate and, therefore, should be extremely careful about exchanging their real estate for such property. In some situations, the taxpayer could make the investment in such a way that it would be managed by someone with sufficient expertise. This could mean placing a substantial part of a farmer's retirement assets and income in the hands of someone else. It would not be wise to do a real estate exchange to save the tax on the gain unless the taxpayer is confident that the real estate received in the exchange is a good investment.

Anyone who is interested in a deferred exchange must be sure to get advice from a knowledgeable attorney, accountant, or qualified intermediary.

Like-Kind Exchanges Between Related Parties

Exchanges made between related parties after July 10, 1989 are subject to tax in some situations. The rules affect both direct and indirect exchanges. As with other like-kind exchanges, when related parties exchange like-kind property, no gain or loss is recognized (included in income). Under these rules, if either party disposes of the property within two years after the exchange, the exchange is disqualified from nonrecognition treatment. The gain or loss must then be recognized as of the date of disposition of the property. The two-year holding period begins on the date of the last transfer of property which was part of the like-kind exchange.

Related parties. Under these rules, a related party includes a member of your family (spouse, brother, sister, ancestor or lineal descendant) and a corporation in which you have more than 50 percent ownership (plus others described in Code Section 267(b). For exchanges after August 3, 1990, related parties also include (1) a person and a partnership in which the person owns more than 50 percent interest, and (2) two partnerships in which the same person(s) own more than 50 percent interest (Code Section 707(b)(1).

Exceptions to the Related Party Rules. The following kinds of property dispositions are excluded from the new limits on nontaxable like-kind exchanges between related parties: (1) dispositions due to the death of either related person, (2) involuntary conversions, or (3) exchanges or dispositions if it is established to the satisfaction of the IRS that the main purpose is not the avoidance of federal income tax.

Form 8824

If you exchange property in a like-kind transaction, you must file Form 8824, Like-Kind Exchanges, in addition to Schedule D (Form 1040) or Form 4797. The instructions for each form explain how to report the details of the exchange. Report the exchange even though no gain or loss is recognized. For more information on like-kind exchanges, see Like-Kind Exchanges in Publication 544, *Sales and Other Disposition of Assets*.

A REVIEW OF FARM BUSINESS PROPERTY SALES

The larger spread between the maximum tax rate on capital gains (28 percent) and the new individual tax rates of 36 and 39.6 percent means that tax planning and management of farm property sales has increased in importance. Making the distinction between gains from sales of property used in the farm business eligible for capital gain treatment, gains subject to recapture of depreciation, and Schedule F income is the first step in tax planning.

The 1993 Tax Act did not change the 28 percent maximum tax rate on capital gain. The new 50 percent exclusion of gain from the sale of certain small business stock does not apply to farm assets.

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 sales of 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 one year, 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 at least one year. 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 1988, 1989, 1990, 1991, or 1992 return and has a net Section 1231 gain for 1993, must recapture the losses on the 1993 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 (placed in service after 1980) are 1245 property. 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 one year 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

property placed in service before 1981, 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 such real property to straight line depreciation without special consent.

Property placed in service after 1980 and before 1987 is subject to a number of ACRS recapture rules. Here are the two most important.

All gain due to regular (fast) recovery of ACRS 15, 18, and 19-year real property, other than residential property, will be ordinary income when the property is sold. In effect, this property becomes 1245 property. No recapture of depreciation occurs when an ACRS straight line option is used.

Farm buildings placed in service after 1986 are MACRS 20-year property eligible for 150 percent DB depreciation. The amount claimed that exceeds straight line must be recaptured as ordinary income when the buildings are sold. The law allows a different ACRS or MACRS 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, April 1, 1986 cost	$100,000
Soil and water expenses deducted on 1987 tax return	$8,000
Land was sold May 15, 1993 for	$130,000

   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 $100,000. The gain of $30,000 would normally be all capital gain. The land was held for seven years, so the gain is divided; $8,000 x .60 = $4,800 is ordinary gain and $30,000 - $4,800 = $25,200 qualifies as capital 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 pre-productive costs would have been capitalized if the taxpayer had elected not to do so during the years when livestock were required to be capitalized. Sales of raised 1231 livestock not subject to the capitalization rules 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 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 Sales

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, pre-productive 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 one year 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 one year or more	
a) Sale results in gain	4797, Part III
b) Sale results in loss	4797, Part I
6. Farmland, held for one year or more, sold at a gain	
a) Soil & 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 one year	4797, Part II

INSTALLMENT SALES

The installment method of reporting may still be used by nondealers for the sale of real property or personal property (except depreciation recapture). It continues to be a practical and useful method used in transferring farms to the next generation. 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.

Taxable income from installment sales is computed by multiplying the amount received in any year by the gross profit ratio. The gross profit ratio is gross profit (selling price minus basis) divided by contract price (selling price less mortgage assumed by buyer). Form 6252 is used to report installment sales income. IRS publication 225 contains a chapter on installment sales.

Depreciation Recapture

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. Section 179 expenses and capitalized expenditures also are treated as Section 1245 dispositions. The full amount of recaptured depreciation is reported as ordinary income in the year of sale regardless of when the payments are received.

Example: Frank Farmer sells his raised dairy cows, machinery and equipment to son, Hank, for $180,000. The cows are valued at $80,000, the machinery at $100,000. Hank will pay $30,000 down and $30,000 plus interest for five years. Frank's machinery and equipment has an adjusted basis of $45,000; its original basis was $125,000. The raised cows have zero basis. Frank's gain on the sale of machinery and equipment is $55,000 ($100,000 - $45,000). The full $55,000 is recaptured depreciation since prior year's depreciation, $80,000, is greater. Frank must report $55,000 received from machinery in the year of sale. He will report the $80,000 cattle sale gain on the installment method.

When the sale of 1245 and 1250 property produces gain in addition to that which is recaptured, the amount of recaptured depreciation reported 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.

Related Party Rules (IRC Sec. 453)

The installment sale/resale rules should be reviewed and understood before farmers or other taxpayers agree 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 spouse, parent, children, and grandchildren, but not brothers and sisters.

An additional resale rule prevents the use of the installment method for sales of depreciable property between a taxpayer and his or her partnership or corporation (50 percent ownership), and a taxpayer and a trust of which he or she (or spouse) is a beneficiary. All payments from such a sale must be reported as received in the first year and all gains are ordinary income (IRS Sections 453(g) and 1239).

Rules for Dealers and Nondealers of Real Property (except farms)

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. 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 is allowed providing the "dealer" elects to pay interest on the tax attributed to payments received in future years.

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" (NRPIOs). 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.

General 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 capital gains rules 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).

A sale or exchange of an installment sale contract results in a gain or a loss. The gain or loss is the difference between the "amount realized" and the "basis" of the contract. The "amount realized" is the amount received by the seller, including fair market value of property received instead of cash. The "basis" of the contract is the same as the remaining basis of the underlying property.

A cancelation of all or part of an installment obligation is treated like a sale or other disposition of the obligation except gain or loss is calculated as the difference between the fair market value and the "basis" of the obligation if the parties are unrelated (IRC Sections 453B(f)(1) and 453B(a)(2)).

Grain and other farm inventory property, including livestock held for sale, may be included in a cash basis taxpayer's installment sale. However, amounts received from inventory property or property held for sale under installment sale obligations must be included in alternative minimum taxable income in the year of disposition.

Unstated and Imputed Interest Rules

If the installment sale contract does not provide an adequate interest rate, part of the principal payment must be treated as ordinary interest income by the seller and an interest deduction by the buyer. The amount of interest that must be recognized is called imputed interest. The imputed interest rule applies even if the seller elects out of the installment method or has a loss on the sale. When recharacterization of the loan is required, the seller's interest income increases and capital gain decreases.

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.

1. All sales and exchanges where seller financing does not exceed $3,234,900 must have an imputed interest rate of the lesser of 100 percent of the AFR or 9 percent (compounded semiannually). The acceptable test or stated interest is the same.

2. Sales exceeding $3,234,900 are subject to an imputed interest rate equal to 100 percent of the AFR. Sale-leaseback transactions of any amount are subject to interest rates equal to 110 percent of 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 6 percent or interest will be imputed at 7 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' rates.

The November 1993 monthly AFR was 3.62 percent (short term, not over three years), 4.81 percent (mid term, three to nine years), 5.69 percent (long term, over nine years). The monthly AFR is currently below the semiannual rate and the mid- and long-term rates are the lowest of the '90s.

ALTERNATIVE MINIMUM TAX

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. AMT may be created by either "adjustments" or "preferences". In either category, there are "exclusions" and "deferrals". Deferrals create a postponement of tax benefits rather than permanent removal and result in an AMT credit (Form 8801) in future years. Exclusions will never create an AMT credit.

AMT Rate and Exemption Phaseout

The AMT is no longer a flat rate. Beginning in 1993, there are two rates -- 26 and 28 percent. The 28 percent rate begins at $175,000 of AMTI ($87,500 for married filing separately). The exemptions have been increased but not indexed. An exemption phaseout reduces the exemption at a rate of 25 percent of AMT income exceeding specific levels, as shown in the table below. If the taxpayer's AMTI exceeds the exemption, he or she will have a calculated AMT but will pay AMT only if it exceeds the regular tax. See regular tax defined later.

Alternative Minimum Tax Exemption and Phaseout

Filing Status	Maximum Exemption	AMTI Phaseout Range	Phaseout Percent
Joint & qualifying widow(er)	$45,000	$150,000-310,000	25
Single & heads of household	33,750	112,500-232,500	25
Married filing separately	22,500	75,000-155,000	25

Alternative Minimum Taxable Income

Form 6251 has been revised for 1993. AMTI is calculated by starting with line 35 on 1040 which is before subtracting the personal exemptions. This would be negative on line 16 of Form 6251 when line 32 less line 34 of 1040 is negative, even though the entry on line 35 of 1040 is zero. Any NOL carryforward used in calculating the regular tax is added. Itemized deductions disallowed on Schedule A for higher income taxpayers are included on line 18 of 6251.

Here are the adjustments that must be added to taxable income. The first category contains adjustments treated as "exclusions". AMT due to exclusions is not eligible for a credit against the following year's regular tax. The remaining adjustments are deferral items (2 through 12 in the list below) and are used in computing AMT credit in future years.

1. Exclusion items: Standard deduction or certain itemized deductions from Schedule A, including most medical deductions, miscellaneous deductions subject to the 2 percent rule, state and local income taxes, and interest adjustments. Interest adjustments include the difference between qualified housing interest and qualified residence interest, interest income on private activity bonds that are exempt from regular tax, and a net investment income adjustment which could be either positive or negative. These are lines 1 through 7 on Form 6251.
2. Depreciation on personal property placed in service after 1986 that exceeds 150 percent declining balance using alternative MACRS years of life. Exceptions include 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 Sec. 179 deduction is allowed in calculating AMTI.

3. The difference between the regular tax deduction for circulation and research and experimental expenditures and the allowable AMT deduction based on 10-year amortization.

4. The difference between the regular tax deduction for mining exploration and development costs and 10-year amortization allowed for AMTI.

5. Incomplete long-term contract costs calculated using the completed contract method less those using the percentage of completion method.

6. Cost recovery for pollution control facilities amortized over 60 months less alternative MACRS allowed for AMTI.

7. 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.

8. 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.

9. Any AMT adjustment from the exercise of stock options after 12/31/87.

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.

12. AMTI from estates and trusts.

Preference Items - The first three are treated as "exclusions"; 4 and 5 are "deferral items".

1. The appreciated portion of capital gain gifts, that is, the difference between the property's fair market value and its basis, claimed under charitable contributions. Charitable contributions of appreciated real, personal, or intangible property (not inventory or other ordinary income property nor short-term capital gain property nor certain gifts to private foundations) do not create a tax preference.

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 and amortization of certified pollution control facilities placed in service before 1987.

5. Intangible drilling costs.

Energy Preference Adjustment - For some taxpayers, an adjustment is allowed based on energy preference deductions.

AMT Net Operating Loss Deduction

The deduction of AMT NOL is the last step in calculating alternative minimum taxable income. The AMT net operating loss is limited to 90 percent of AMTI and is calculated and deducted after all adjustments and preferences have been added in. The AMT NOL is calculated the same as the regular NOL except:

1. The regular tax NOL is adjusted to reflect the adjustments required by the AMT rules.

2. The AMT NOL is reduced by the preference items that increased the regular tax NOL.

Schedule A (Form 1045) can be used to calculate the AMT NOL providing the above exceptions are included.

Tentative Minimum Tax

The minimum tax exemption reduced by the 25 percent phaseout is subtracted from AMTI before the 26 and 28 percent rates are 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, using a separate Form 1116.

Alternative Minimum Tax and Credits

Tentative minimum tax less the regular income tax equals AMT. Regular income tax excludes several miscellaneous taxes, such as the tax on lump-sum distributions. Regular income tax is reduced by the foreign tax credit (but not business tax credits) before it is entered on line 27 of Form 6251. The general business credit limitation is calculated on Form 3800, not on 6251.

Foreign tax credit is 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.

Who Must File Test

More taxpayers are required to file Form 6251 than have an AMT liability. Form 6251 must be filed if the taxpayer is liable for AMT (AMTI on line 21 is greater than the exemption on line 22), or if credits are limited by the tentative AMT amount on lines 24 or 26. If the total of lines 7 through 14 is negative, Form 6251 should be filed to show the IRS that the taxpayer is not liable for AMT.

The AMT Credit

The AMT credit allows a taxpayer to reduce regular income tax to the extent that deferral adjustments and preferences created AMT liability in previous years. The AMT credit also includes any credit for producing fuel from a nonconventional source that was disallowed in an earlier year due to AMT. The credit means that the taxpayer, in the long run, will not pay AMT on the deferral items.

Part I of Form 8801 is used to compute the AMT that would have been paid in the previous year on the exclusion items if there had been no deferral items. This requires the computation of a "minimum tax credit net operating loss deduction" (MTCNOLD), which is calculated like the AMT NOL except that only the exclusion adjustments and preferences are included. It also requires computation of the minimum tax foreign tax credit on the exclusion items.

Part II of 8801 is used to compute the allowable minimum tax credit and the AMT credit carryforward. The computation includes unallowed credit for producing fuel from a nonconventional source.

NET OPERATING LOSSES

Farmers and nonfarm taxpayers who sustain a net operating loss in 1993 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 1992 edition of this manual has an NOL example. The 1993 *Illinois Farm Income Tax Workbook* contains an excellent NOL chapter including illustrations and worksheets. IRS Pub. 536 covers NOLs. 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 net operating loss. 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 net operating loss. The NOL is carried back or forward to other tax years, but sometimes not all of it will be used to reduce taxable income in those 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 1993 NOL would be first carried back to 1990, then to 1991, 1992, and then forward to 1994 and in order to 2008 if necessary. The carryforward provision is 15 years. A taxpayer may elect to forego the entire carryback 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. **It cannot be made on an amended 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 and the investment tax credit recomputation that would be required.

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 carryback 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. Schedules A and B (Form 1045) are used to compute the NOL and NOL carryovers.

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

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

PASSIVE ACTIVITY LOSSES

Section 469 limits 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). Reg. 1.469-4T has been superseded by Proposed Reg. 1.469-4.

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. Beginning in 1994, the passive loss rules will be eased somewhat for persons in the real property business. See next page.

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. Any 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. 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

Regulation 1.469-4T issued in May 1989 requires separation of activities into four classes: (1) Oil and Gas, (2) Rental, (3) Professional Service, and (4) Other trade or business. This regulation is long and complicated.

Proposed Reg. 1.469-4, which applies to tax years ending after May 10, 1992, is intended to provide simple rules for determining a taxpayer's activities for passive loss purposes. This will replace Reg. 1.469-4T and adopts a facts-and-circumstances approach to identifying a taxpayer's activities. The Commissioner has a right to redetermine a taxpayer's activities. For the tax year that included May 10, 1992, the taxpayer could apply the 1.469-4T rules rather than Proposed Reg. 1.469-4. The Proposed Reg. provides that the taxpayer may, under some circumstances, dispose of part of an activity and treat that part as a separate activity.

Election to Separate

Under 1.469-4T(0), a taxpayer may make a permanent election to separate undertakings which otherwise would be combined into a single activity. For interests acquired in years after 1989, 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 taxpayer's 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.

Crop Share Farm Leases

In the past, "knowledgeable tax experts" have stated that crop share leases of farms did not qualify under the real estate rental active participation rules. The landlords typically did not "materially participate" in the operation of the farm and, if their share of the farm income when combined with their expenses produced a loss, it was a passive loss. These experts have changed their position and now believe that crop share leases where the landlord actively participates qualify as rental activities so that up to $25,000 of losses could be used to offset nonpassive income. Practitioners who have not taken advantage of this interpretation for their clients in previous years may want to consider filing amended returns for open years.

Rental Real Estate Passive Losses

Taxpayers in the real property business will not be subject to the passive activity loss (PAL) rules for losses from rental real estate for tax years beginning after December 31, 1993. An individual taxpayer will not be subject to the PAL rules for a taxable year when (1) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer **materially participates**, and (2) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the **taxpayer materially participates**. In the case of a joint return, the requirements of the preceding sentence are satisfied if and only if either spouse separately satisfies such requirements. See page 8 for the rules on closely held C-Corporations.

Forestry Operations

A forestry or woodlot operation where the owner materially participates should be able to deduct losses, that is, the excess of expenses over income from sales of timber (assuming the operation is not determined to be a hobby). However, if there is no evidence of material participation (someone else manages the property or it is not really managed at all), losses could be determined to be passive and the losses disallowed.

INFORMATIONAL RETURNS

Some of the most important of the many informational returns to be issued or received by farmers are reviewed here.

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. Payments made for nonbusiness services and to corporations 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.

Farmers must include payments made to noncorporate independent contractors, attorneys, accountants, veterinarians, crop sprayers, and repair shops. Payments made for feed, seed, fuel, supplies, and other merchandise are excluded.

Health plan participants must report aggregated payments of $600 or more to physicians and health care providers.

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

1099-INT- Statement for Recipients of Interest Income. Filed by bankers and financial institutions when interest paid or credited to individual taxpayers is $10 or more, and by any taxpayer if in the course of a trade or business $600 or more of interest is paid to a noncorporate recipient.

1099-PATR - Taxable Distributions Received from Cooperatives. Must be filed for each patron receiving $10 or more.

1099-S - Report payments of timber royalties under "pay-as-cut" contracts and gross proceeds from the sale of most real estate transactions.

8300 - Recipient reports cash transactions of over $10,000 received in the course of a trade or business, within one year in one lump sum or in separate payments, from the same buyer or agent, in a single or related transaction. Cash includes all currency and specific monetary instruments with a value of less than $10,000 (cashier's checks, bank drafts, traveler's checks, and money orders). The report must be filed within 15 days after receiving $10,000.

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

8809 - Request extension of time to file informational returns with IRS.

Filing Dates and Penalties

The 1099s must be furnished to the person named on the return on or before January 31 and to the IRS with Form 1096 (Annual Summary and Transmittal) on or before March 1. There is a single $50 per return penalty for failure to file correct and timely information returns. There is no penalty if failure is due to reasonable cause. The penalty is reduced when the failure is corrected on or before August 1. The penalty applies to each failure, and there is a $25,000 penalty cap for small businesses. If failure to file/include correct information is due to intentional disregard of the regulations, the penalty is $100 or 10 percent of the amount reported on the information return, whichever is greater. The penalty for intentional disregard of reporting cash payments over $10,000 received is now the greater of $25,000 or the amount of the cash payment up to $100,000.

SOCIAL SECURITY TAX AND MANAGEMENT SITUATION, AND OTHER PAYROLL TAXES

Annual increases in the earnings subject to social security (FICA) and self-employment taxes continue to place a high priority on exploring opportunities to reduce the burden of these taxes through wise tax management. Additional payroll tax issues are included.

The Current Social Security Tax Burden

The social security earnings base increased to $57,600 for 1993, and the medicare tax base increased to $135,000. There will be no cap on the amount of earnings subject to medicare tax beginning in 1994. FICA and self-employment tax rates remain the same as in 1992. The total rate is divided into two components representing the social security and medicare tax. The maximum 1993 FICA tax is $5,528.70 (employer's share), up $200 from 1992. The maximum self-employment tax is $11,057.40 in 1993, up $400 from 1992.

Social Security Tax Table

	Earnings Base		FICA Rate %[1]		Self-Employment Rate %	
Year	Soc. Sec.	Medicare	Soc. Sec.	Medicare	Soc. Sec.	Medicare
1992	$55,500	$130,200	6.20	1.45	12.40	2.90
1993	$57,600	$135,000	6.20	1.45	12.40	2.90
1994	$60,600	Unlimited	6.20	1.45	12.40	2.90

[1] Paid by both employer and employee.

Separate social security and medicare tax withholding tables are used by employers. Forms 941, 942 and 943 require that social security and medicare taxes be reported separately. The self-employment tax on long Schedule SE is also computed separately.

Two Deductions for Self-Employed

1. Self-employed taxpayers deduct from taxable income on line 25, Form 1040, one-half of self-employment taxes that can be attributed to a trade or business. The rationale for this tax deduction is that employees do not pay income taxes on the one-half of FICA taxes paid by their employer.

2. Self-employed taxpayers deduct 7.65 percent from self-employment income when computing net earnings from self-employment. This is achieved by multiplying total profit (or loss) from Schedules C and/or F by 0.9235 on Schedule SE. This adjustment is made before applying the social security and medicare tax earnings base. Taxpayers reporting less than $57,600 of self-employment income will receive the greatest benefit from the deduction. This adjustment is allowed because employees do not pay social security tax on the value of their employer's share of FICA tax.

Farmer's Optional Method

Low-income farmers may still use the optional method and report up to $1,600 of self-employment income when net farm income is less than $1,733. Self-employed nonfarmers have a similar option. Self-employed workers should give serious consideration to using the optional method if they are not currently insured under the social security system. To be eligible for social security disability benefits, a worker must be fully insured and have 20 of the last 40 quarters of coverage. Unfortunately, the earnings required to receive one

quarter of credit increased to $590 in 1993. Thus, the optional method will yield only two quarters of coverage.

Wages Paid to Spouse, Children and Farm Workers

Farm employers must pay FICA taxes and withhold income taxes on their employees if they pay wages of more than $2,500 to all agricultural labor during the year. Any employee receiving $150 or more of wages is subject to FICA and tax withholding even if the employer's total annual payroll is less than $2,500. All employees are covered if the annual 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 was employed in agriculture for less than 13 weeks in the prior year. Seasonal farm piece work labor is subject to the $150 rule. The $150 test is applied separately by each employer.

Wages earned by a person employed in a trade or business by his or her spouse and wages paid to individuals 18 years old and over working for their parent(s) in a trade or business are subject to FICA taxes and income tax withholding. Children under age 18 working for a parent's partnership, corporation, or estate also are covered by social security. Wages paid by a parent to a child for domestic service in the home are not covered until the child reaches 21.

Noncash Payments to Employees

There has been no change in the IRS code and regulations that exempt in-kind or noncash agricultural wages from FICA, FUTA, and income tax withholding. Social security tax does not have to be paid on payments that are other than cash for agricultural labor. 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 commodity 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 noncash payment, the employer will have to pay the full FICA tax.

When farm commodities are used to pay employees for services, their employer must report the fair market value of the commodity on the date of payment as Schedule F income. The same amount is claimed by the employer as a labor expense on Schedule F, but it is not reported as a cash wage on Form 943 or the employee's W-2. It is included as other compensation in box 10 of Form W-2.

Employees who receive commodities in lieu of wages must report their initial market value as wage income. When the commodities are sold, the sale price is reported on Schedule D less the basis which is the initial market value plus storage and marketing expenses.

It is important to document all the details of the employment arrangement when noncash wages are paid and to be consistent with the treatment of the transaction on the employer's and employee's tax returns. A written employment contract that states the rate and form of payment for services is recommended. When the employee sells the commodity, the proceeds from the sale should be deposited in the employee's separate account.

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

The 1993 Tax Act increases the amount of social security and railroad retirement benefits that higher-income retirees must include in gross income beginning in 1994 (see pages 1 & 2). For 1993, the inclusion is still limited to the lessor of (1) one-half of the benefits received, or (2) 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.) Medicare payments are excluded from gross income.

Example: M. and P. Retiree received $15,200 in 1993 social security benefits, $3,000 of tax-exempt interest, and their AGI (joint return) was $26,400 (excluding social security).

Calculation:
a. $26,400 + $3,000 + $7,600 (one-half social security) = $37,000
b. $37,000 - $32,000 (base amount) = $5,000 ÷ 2 = $2,500.
c. M. and P. include $2,500 since it is less than $7,600.

Calculation a. is provisional income under the '93 Tax Act. M. and P. Retiree will not be taxed on 85 percent of their 1994 social security benefits if their provisional income does not exceed $44,000.

Reduction of Benefits

When a person's wage and self-employment earnings exceed the earnings limit, social security benefits of the working beneficiary and dependents are reduced by a percentage of the excess earnings. In 1993 the annual earnings limit for those less than age 65 is $7,680, and for those age 65 to 70 it is $10,560. The reduction of benefits is one-half of excess earnings when less than age 65 and one-third of excess earnings when age 65 to 70.

Rental Income and Deductions (IRC 1402(a)(1)

Generally, rental income from real estate and from personal property leased with the real estate (including crop share rents) is reported on Sch. E and not included in net earnings from self-employment. Crop and livestock share rents are reported on 4835 and flow through to Sch. E. There are two exceptions.

1. Rentals received in the course of the trade or business of a real estate dealer are included in net earnings from self-employment.

2. Production of agricultural or horticultural commodities. Income derived by the owner or tenant of land is included in net earnings from self-employment if:

a. there is an arrangement between the taxpayer and another person under which the other person produces agricultural or horticultural commodities on the land and the taxpayer is required to participate materially in the production or the management of the production of such commodities, and/or

b. there is material participation by the taxpayer with respect to the agricultural or horticultural commodity.

Income and expenses from the rental of personal property (not leased with real estate) is reported on Schedule C or C-EZ. Net profit from Schedule C is included in self-employment income. Material participation is not a factor in classifying income from the rental of personal property not leased with real estate.

Paying Rent to a Spouse

It is common for husbands and wives to own farm real estate as joint tenants, for the husband to operate the farm as the sole proprietor and to pay self-employment tax on the entire farm "net profit." Paying rent to a spouse for use of the property he or she owns reduces self-employment tax.

Although Rev. Rul. 74-209, 1974-1 allows a husband to deduct rent paid to his wife as a joint owner of business property equal to one-half its fair rental value, more recent IRS rulings and opinion have qualified that ruling. In Ltr. Rul. 9206008, the rental deduction on Schedule F was disallowed primarily for using inconsistent methods of deducting the ownership costs of the property. IRS is also utilizing Code Sections 482 and 162 to prevent tax avoidance via related-party transactions. They may argue that paying rent to a spouse is not an arms-length transaction, is not necessary and ordinary, and in some cases the lessee has an equity interest in the property.

If you deduct rental payments made to the spouse for use of his or her jointly owned property, follow these precautions: (1) have evidence that the spouse acquired the equity in the property; (2) make sure there is a written rental agreement and a fair market value rental rate, and (3) deduct the taxes, interest, and insurance on the rented property on the spouse's Schedule E.

Exemptions for Members of Religious Orders

Members of religious orders who have conscientious objections to social security because of their adherence to established teachings of a religious sect which has been in continuous existence since 12/31/50, may obtain an exemption from self-employment tax (IRC §1402(g)). The application for exemption is filed on Form 4029. Exemption is granted only when there is adequate evidence of membership in a qualified religious sect and adherence to the teachings that denounce insurance.

An employer and one or more of his or her employees who all have conscientious objections to insurance as members of a qualified religious sect may obtain exemption from FICA taxes (IRC §3127; SSA §202(v)(2)). Members of a qualified sect employed by a nonmember cannot obtain exemption from FICA taxes. The exemption provisions should apply to FUTA but do not cover income taxes.

New Rules for Depositing FICA and Federal Income Taxes

Farm employers who reported $50,000 or less of federal payroll taxes in 1991 must make timely monthly deposits beginning in 1994. FICA and federal income taxes accumulated from cash wages paid during a calendar month must be deposited by the 15th day of the following month. Farm employers who reported payroll taxes of more than $50,000 during 1991 must use the following semi-weekly deposit rules:

- -- Payroll taxes from wages paid on Wednesday, Thursday and/or Friday must be deposited the following Wednesday.
- -- Payroll taxes from wages paid on Saturday, Sunday, Monday, and/or Tuesday must be deposited on the following Friday.

New employers are subject to the monthly deposit rule during their first calendar year unless they accumulate payroll taxes of $100,000 or more on any day during a deposit period. All employers who accumulate $100,000 or more in payroll taxes must make the deposit by the next banking day.

An employer who accumulated less than $500 of payroll taxes for the entire year may make the payment with the annual tax return. However, a farm employer can no longer wait for payroll taxes to accumulate to $500 and then make timely quarterly deposits. Most farmers with annual cash payrolls of $2,000 to $150,000 will be subject to the new monthly deposit rule. Many farm employers with annual cash payrolls exceeding $150,000 will be subject to the new Wednesday/Friday deposit rules. The transition or grace period for converting to the new deposit rules was 1993. The IRS says the conversion to the new rules must be completed by 12/31/93. Each November the IRS will notify employers what their deposit status is for the coming calendar year.

Federal Unemployment Tax (FUTA)

As farm businesses grow in size and employ more workers, more farm employers become subject to FUTA and New York unemployment insurance. A farm employer must pay U.I. if (1) cash wages of $20,000 or more were paid to farm employees in any calendar quarter during the current or preceding calendar year, or (2) ten or more farm workers were employed for some portion of any day in each of 20 different calendar weeks during the current or preceding calendar year.

Unemployment taxes must be paid by the employer; they may not be deducted or withheld from employee wages. The FUTA rate is 6.2 percent on the first $7,000 of cash wages paid to each employee in 1993. The 1993 NYSUI rates range from 2.5 to 7.0 percent on the first $7,000 of each employee's total earnings. The "new employer" rate is 4.3 percent. Employers receive a credit of up to 5.4 percent of NYSUI taxes paid on their FUTA liability. Therefore, a farmer subject to the 4.3 percent NYSUI would pay a FUTA rate of 1.9 percent in 1993.

The FUTA tax deposit rule is different from those for other payroll taxes. When the amount subject to deposit reaches $100, it must be deposited within one month following the close of the current calendar quarter. Form 940 (or 940-EZ) is the annual FUTA return to be filed by January 31.

NEW YORK STATE INCOME TAX

New York passed a tax law in 1993 which further delayed the phase-in that was provided for in the Tax Reform and Reduction Act of 1987. The phase-in that was intended to be complete by 1991 will now be complete in 1996.

Exemptions and Standard Deductions

The 1993 law holds the 1993 standard deductions at 1989-92 levels and gradually increases them between 1994 and 1996 to the levels that NYTRRA 1987 intended for 1991. Tune in again next year for news of additional delays.

	Year				
	1992	1993	1994	1995	1996 and after
	Standard Deduction ($)				
Tax Status:					
Joint	$9,500	$9,500	$10,800	$12,350	$13,000
Head of household	7,000	7,000	8,150	10,000	10,500
Single	6,000	6,000	6,600	7,400	7,500
Married filing separately	4,750	4,750	5,400	6,175	6,500
Dependent filers	2,800	2,800	2,800	2,900	3,000
	Exemption ($)				
	1,000	1,000	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 1991-94, $2,900 in 1995, and $3,000 in 1996 and later. An exemption is not counted for either the filer or the spouse.

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. Taxpayers who do not itemize deductions on their federal returns may not itemize on their NYS returns.

Itemized deductions of higher-income taxpayers are subject to limitations. Itemized deductions are reduced by the sum of two percentages. The first percentage becomes effective at NYAGI levels which depend on the taxpayer's filing status, and the second becomes effective at NYAGI levels above $475,000.

1. 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%

This taxpayer would not be subject to the second percentage because AGI is less than $475,000.

2. 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 would also be subject to the full 25 percent from the first calculation so the total reduction in itemized deductions would be 50 percent.

Supplemental Tax for Taxpayers with NYAGI Exceeding $100,000

Beginning in 1991, taxpayers with New York adjusted gross incomes exceeding $100,000 pay a special tax computed with a worksheet. The purpose of this tax is to remove the benefits of the lower tax brackets (the "tax table benefit"). Over the NYAGI range of $100,000 to $150,000, the benefits of the rates below the top rate will be completely phased out.

Example: Hi and Higher Income have a NY taxable income of $105,000 and a NYAGI of $120,000. Tax on $105,000 from the tax table is $7,551, but at the top rate of 7.875 percent is $8,268.75. The $20,000 that exceeds the NYAGI level of $100,000 is 40 percent of $50,000. The difference between $8,268.75 and $7,551 is $717.75; 40 percent of this is $287, which is added to the tax computed from the table to make the total tax $7,838.

Rates

There are 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 1993 law delayed the implementation of the 1990 rates that were in the 1987 law until 1996. Rates for that year are:

New York State Tax Rates, 1996 and Later

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

There is a gradual phase-in. The rate schedules for 1993 follow. These are the same schedules that were in effect for 1990, 1991, and 1992. The 1994 and 1995 rates in the 1992 law were modified by the 1993 law but are not shown here.

Married Filing Jointly and Qualifying Widow(er)

If the 1993 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 1993 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 1993 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

Household Credit

The 1993 law provided that the full amount of credit will be allowed for taxable years beginning in 1993 and 1994, and 50 percent of the credit will be allowed for 1995. For taxable years beginning after 1995, the credit is eliminated.

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 federal adjusted gross income (total for both spouses if separate returns are filed).

In 1993, 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.

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.

Real Property Tax Credit

The tax credit computations and limits are the same for 1993 as for 1992. 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, 1993

Household Gross Income	Applicable Rate	Maximum Credit	
		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

Spousal IRAs 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.

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.

New York State Investment Credit is 4 Percent

There is a lot of controversy over which property does and does not qualify for New York investment credit. Some of the court decisions appear to be inconsistent with others.

The credit for individuals is 4 percent on qualified tangible personal property acquired, constructed, reconstructed or erected on or after January 1, 1987. For corporations, the rate for years beginning in 1990 was 5 percent on the first $425,000,000 of investment credit base and 4 percent on any excess. In 1991 and later, the 5 percent credit applies only to the first $350 million.

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 4 percent NYIC. The fact that pickups are 5-year MACRS property will not change the disallowance of NYIC for farmers.

All ACRS and MACRS property that qualifies for NYIC and is placed in a 5-year or longer life class earns full credit after 5 years even if a longer straight line option is elected.. 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. 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 taxpayer's 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 at least 1 percent during the year. The credit is 1.5 percent of the investment credit base if the employment increases less than 2 percent, 2 percent if the increase is between 2 and 3 percent, and 2.5 percent if the increase is 3 percent or more for each of the two 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 6 percent. The specific deduction is $5,000 ($2,500 for a married taxpayer filing separately). A farmer who has over $5,000 of preference items must complete Form IT-220 but may not be subject to minimum tax. New York personal income tax (less credits) and carryover of net operating losses are used to reduce minimum taxable income. NYIC cannot be used to reduce the minimum income tax.

Payment of New York State Income Taxes Withheld and Informational Returns

For 1992 and later, filers with less than $700 in quarterly withholding liability are required to deposit the withholdings for each quarter by the end of the month following the end of the quarter, except for the last quarter, which is due February 28. In general, filers with $700 or more in quarterly withholding liability are required to make the deposit within three business days following the payroll date on which the $700 total was attained. There are exceptions and additional rules. See WT-100, *New York State Withholding Tax Guide*, for the complete rules.

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

Estimated Tax Rules for 1992-97

New York residents with New York source income are required to make payments of estimated tax if they expect to owe, after withholding and credits, at least $100 of New York tax and withholding and credits are expected to be less than the smaller of (1) 90 percent of the tax for the year, or (2) 100 percent of the tax on the prior year's return (provided a return was filed and the taxable year consisted of 12 months).

For tax years beginning after 1991 and before 1997, a taxpayer may not use the preceding year's tax part of the rule if modified NYAGI exceeds NYAGI for the preceding year by more than $40,000 ($20,000 if married and filing separate return), NYAGI for the current year exceeds $75,000 ($37,500 if married with separate return), the taxpayer has made an estimated tax payment in any of the preceding three years, or was assessed a penalty for failure to pay estimated tax for such years and the amount computed based on 90 percent of the current year's tax is greater than the estimated payments based on 100 percent of the tax shown on the prior year's return.

Modified AGI for the current year is AGI less any gain from the sale or exchange of a principal residence or from an involuntary conversion and some other items. See publication 150 (5/92) for additional information and the complete definition of modified NYAGI.

Farmers and fisherpersons may use the preceding year's tax as a method of determining the required annual payment without regard to the above limitation.

Estimated Tax Rules for Farmers and Fishermen

For tax years beginning after 1992, the definitions of farmers and fishermen for estimated tax purposes has been changed so that Federal Gross Income rather than New York Adjusted Gross Income is used in determining whether at least two-thirds of the person's income is from farming. The law now reads, "An individual is a farmer or fisherman for any taxable year if the individual's (New York adjusted) FEDERAL gross income from farming or fishing (including oyster farming) for the taxable year is at least two-thirds of the total (New York adjusted) FEDERAL gross income from all sources for the taxable year or if such individual's (New York adjusted) FEDERAL gross income from farming or fishing (including oyster farming) shown on the return of the individual for the preceding taxable year is at least two-thirds of the total (New York adjusted) FEDERAL gross income from all sources shown on such return." The words in (brackets) have been replaced by the words in CAPITAL letters.

OTHER AGRICULTURAL ECONOMICS EXTENSION PUBLICATIONS

No. 93-08	Dairy Farm Business Summary Central New York and Central Plain Regions 1992	Wayne A. Knoblauch Linda D. Putnam George Allhusen June C. Grabemeyer James A. Hilson Jacqueline M. Mierek
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